Preventative Policy Measures to Tackle Undeclared Work in Croatia

Colin C Williams
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Activity 1.3: Defining preventive activities focused on identifying causes of undeclared work

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Executive summary

This report examines the drivers of the undeclared economy in Croatia, the current organisation of the fight against undeclared work, and reviews the current and potential policy approaches and measures for tackling undeclared work in Croatia.

Drivers of the undeclared economy in Croatia

Recently, significant advances have been made in explaining the determinants of undeclared work. To explain undeclared work, it has been understood that every society has institutions which prescribe, monitor and enforce the ‘rules of the game’ regarding what is socially acceptable. In all societies, these institutions are of two types: formal institutions that prescribe ‘state morality’ about what is socially acceptable (i.e., laws and regulations), and informal institutions which prescribe ‘citizen morality’ (i.e., socially shared rules, usually unwritten).

Viewed from this institutional perspective, undeclared work is explained as arising when the failings of formal institutions lead to state morality being different to citizen morality. In the last few years, multiple studies have identified these formal institutional failings. Undeclared work is more prevalent when there is: lower GDP per capita; higher public sector corruption and lower quality governance; lower expenditure on labour market interventions to help the most vulnerable groups; low social expenditure, and social transfer systems that are ineffective in reducing the level of inequality and severe material deprivation.

To tackle the undeclared economy in Croatia, therefore, there will be a need to continue to:

- improve the level of GDP per capita;
- improve governance and reducing public sector corruption;
- maintain and improve the levels of expenditure on labour market interventions to help the most vulnerable groups from its current low relatively base level;
- persist with increasing social expenditure; and couple this with
- developing more effective social transfer systems that reduce the levels of income inequality and levels of severe material deprivation in Croatian society.

Besides addressing these structural determinants, there are many additional organisational and policy initiatives that can be also pursued to tackle the undeclared economy.

Organisation of the fight against undeclared work: institutional framework

Croation has neither a single agency responsible for the fight against undeclared work, nor a central body responsible for ensuring coordinated action by the multifarious departments involved in tackling undeclared work. Instead, there is a more fragmented approach. Responsibility for tackling undeclared work is distributed across a range of institutions, with
each taking responsibility for different segments of the undeclared economy. Whilst labour law violations are the responsibility of the Labour Inspectorate, tax non-compliance responsibility lies with the Ministry of Finance and social security and insurance fraud violations with the social insurance bodies. There is currently little coordination in the fight against undeclared work across the multifarious institutions in strategic, operational or data-sharing terms, and no common cross-cutting targets. The quality of governance, therefore, needs to be improved. A more coordinated response is required, which in part will be dealt with by the decision to establish a State Inspectorate in late 2017.

The involvement of social partners in relation to tackling undeclared work remains relatively weak, with little involvement in decision making. Given that tackling undeclared work requires their participation, greater involvement of the social partners is recommended.

**Current policy approach and measures: an evaluation**

Croatia currently employs a relatively narrow deterrence approach and the policy measures heavily focus upon deterring participation in undeclared work by increasing the penalties and risks of detection. Little emphasis is put on improving the benefits of and incentives for declared work, or more indirect preventative tools, such as awareness raising campaigns and dealing with the imperfections and failings of formal institutions (e.g., by facilitating procedural and redistributive justice and fairness, and pursuing wider economic and social policies). There is therefore a need to shift away from such a heavy reliance on deterrence measures to the broader use of preventative incentives, as well as awareness raising and a focus upon targeting and tackling the major drivers of the undeclared economy.
1. Introduction

The aim of this report is to review the preventative policy approaches and measures that can be used to tackle undeclared work in Croatia. Conventionally, that is, governments in general, and enforcement authorities in particular, have pursued a deterrence policy approach which seeks to increase the perceived or actual probability of detection, and to improve the sanctions, for those caught. This policy approach, however, does not deal with the causes of undeclared work, and neither does it focus upon preventing such activities occurring in the first place. In this report, therefore, the intention is firstly, to review the causes of undeclared work and secondly, to discuss policy approaches that seek to prevent the emergence of undeclared in the first place.

To achieve this, section 2 first outlines an analytical framework for understanding the determinants of undeclared work and following this, reviews the trends in Croatia so far as each of the key determinants of undeclared work are concerned. Section 3 then outlines the organisation of the fight against undeclared work in Croatia by reviewing the various institutions who play a part in the fight against undeclared work and their responsibilities, as well as the role played by social partners. Section 4 then turns its attention towards how the existing policy approaches and measures in Croatia can be enhanced to improve the effectiveness and efficiency of the fight against undeclared work. To do this, this section commences by providing a typology for understanding the different policy approaches towards undeclared work, followed by a summary overview of the range of policy measures currently used. It then reviews in turn the existing policy measures and how they might be improved in relations to firstly, sanctions, secondly, the perceived and/or actual probability of detection, thirdly, supply-side incentives and fourthly demand-side incentives to make declared work easier and more beneficial, fifthly, measures to change values, beliefs and norms regarding the acceptability of undeclared work and sixth and finally, the measures that seek to reform formal institutions so as to tackle the wider macro-level causes of undeclared work.

The outcome will be a comprehensive overview of the determinants of undeclared work and the trends in these drivers in Croatia, how the fight against undeclared work is organised in Croatia, and a review of the current policy approach and measures used in Croatia along with an overview the full range of policy approaches and measures potentially at its disposal for tackling undeclared work. This will set the scene for a set of policy recommendations on how Croatia might more effectively and efficiently tackle undeclared work.
2. Drivers of the undeclared economy in Croatia

2.1 Analytical framework

To identify the drivers of the undeclared economy is important because these need to be tackled to reduce the undeclared economy. Recently, significant advances have been made in understanding the determinants of undeclared work by adopting an institutional approach which transcends the previous competing views about the varying causes of undeclared work (Godfrey, 2015; Webb et al., 2009, 2013; Williams and Franic, 2016; Williams and Horodnic, 2015a,b,c; Williams et al., 2015a). In this view, institutions (i.e., governance mechanisms) prescribe, monitor and enforce the ‘rules of the game’ regarding what is socially acceptable, and exist in every society (Baumol and Blinder, 2008; North, 1990). In all societies, these institutions are of two types: formal institutions that prescribe ‘state morality’ about what is socially acceptable (i.e., laws and regulations), and informal institutions which describe ‘citizen morality’ (i.e., socially shared rules, usually unwritten) (Helmke and Levitsky, 2004).

Undeclared work, from this institutional perspective, is explained as arising when the failings of formal institutions lead to state morality being different to citizen morality. Indeed, the greater is the non-alignment of state morality and citizen morality, the greater is the prevalence of the undeclared economy. Which specific formal institutional failings, therefore, result in the non-alignment of citizen morality with state morality, and thus the prevalence of undeclared work?

Until now, there have been three competing theories which each identify different formal institutional failings as the cause of more extensive undeclared economies. Firstly, modernisation theory has argued that undeclared work is rife in societies which are under-developed economically (i.e., with lower levels of GDP per capita) and where the formal institutions of governance are not modernised, displayed by the existence for example of higher levels of public sector corruption and lower qualities of governance. Secondly, ‘state over-interference’ theory has argued that undeclared work is a resistance practice voluntarily pursued and a rational economic response to high tax rates and too much state interference such as over-burdensome rules and regulations (e.g., Becker, 2004; De Soto, 1989, 2001; London and Hart, 2004; Nwabuzor, 2005; Sauvy, 1984; Small Business Council, 2004). Third and finally, ‘state under-intervention’ theory views undeclared work as a direct by-product of too little, rather than too much, state intervention in work and welfare arrangements. In this approach, undeclared work is viewed as an inherent and integral component of contemporary capitalism and a key facet of the sub-contracting, downsizing and outsourcing arrangements that are emerging in advanced capitalism and enable enterprises to achieve profit through flexible production and cost reduction (Meagher, 2010; Taiwo, 2013). Consequently, undeclared work is depicted as unregulated, insecure and low paid employment conducted out
of necessity by marginalised populations excluded from the declared economy and conducted as a last resort when no other options are available to them (Castells and Portes, 1989). As such, undeclared work is seen to result from a lack of social protection for workers and the remedy is greater state intervention in work and welfare provision to protect workers from poverty (Davis, 2006; Gallin, 2001; Slavnic, 2010).

Reviewing the studies that evaluate these theories by examining the cross-national variations in these economic and social conditions, and cross-national variations in the size of the undeclared economy, the same findings continuously emerge. Whether one measures the size of the undeclared economy using Schneider’s MIMIC estimates (Williams, 2014d) or using direct surveys (Williams, 2014a,b,c, 2015a,b, 2016; Williams and Martinez-Perez, 2014) and whether one compares the 28 member states of the European Union (Williams, 2014c; 2016; Williams and Horodnic, 2016, 2017), post-socialist transition economies (Williams, 2014a, 2015b) or countries across the developing world (Williams, 2014b, 2015a,c,d), the finding is that there is no evidence to support the state over-interference thesis. Instead, the prevalence of the undeclared economy is positively associated with the tenets of the modernisation and state under-intervention theses. To tackle the undeclared economy, therefore, these multiple studies reveal a need to focus upon:

- increasing GDP per capita;
- improving the quality of governance and reducing corruption;
- increasing expenditure on labour market interventions to help the most vulnerable groups;
- increasing social expenditure; and
- developing more effective social transfer systems so as to reduce the level of inequality and severe material deprivation, which includes improving the efficiency of collection.

Indeed, unless these formal institutional failings are tackled that produce an asymmetry between state morality and citizen morality, undeclared work will persist.

2.2 Trends in the drivers of undeclared work in Croatia

Above, we highlighted the formal institutional failings that cause this asymmetry between state morale and citizen morale, and thus the greater prevalence of undeclared work. Here, we evaluate the direction of change in each of these causal determinants of undeclared work in Croatia in order to evaluate where macro-level intervention is required in order to stem the growth of the Croatian undeclared economy.

Figure 1 examines the trends in GDP per capita (in current euros) in Croatia, which has been widely identified as strongly correlated with the size of the undeclared economy. The lower the GDP per capita, the larger the undeclared economy (ILO, 2013; Williams
2014a,b,c,d, 2015a,b, 2016; Williams and Horodnic, 2016). This reveals that the real GDP per capita in Purchasing Power Standards (PPS) in Croatia was €16,700 in 2015, which is 58% of the EU28 average, whereas the nominal difference was even higher (less than 40% of EU average).

It is also the case that cross-national studies reveal that the greater the level of public sector corruption and the lower the quality of governance, the more extensive is the undeclared economy. In Croatia, according to Transparency International’s Corruption Perceptions Index (CPII), there is a relatively higher level of perceived public sector corruption than in other EU member states. Indeed, and as Figure 2 displays, in 2015, Croatia was ranked 50th out of 167 nations globally. Improving the quality of governance and reducing corruption are key means of reducing the undeclared economy. One reason this is the case is because many exit the declared economy due to the level of public sector corruption, since it increases the cost of doing business and operating undeclared is a means of escaping from having to make such bribe payments. Despite Croatia remaining in a relatively low position at 50th out of 167 countries globally, there does nevertheless appear to have been progress made in recent years, albeit from a low starting point. As Figure 2 displays, on a scale where 0 equals highly corrupt to 100 equals very clean, the rating of Croatia in Transparency International’s
Corruption Perceptions Index (CPII) has steadily improved from 46 in 2012 to 51 in 2015. As such, although corruption is improving, further reductions in public sector corruption and the quality of governance are required if the prevalence of undeclared work is to be tackled. Nevertheless, it needs to be considered that businesses and citizens make decisions about (non-)compliance in accordance with their personal perception of the state of affairs, which often does not match the real situation.

**Figure 2: Corruption Perceptions Index for Croatia (higher value means lower corruption)**

It is often popularly assumed that tax rates are an important determinant of the undeclared economy. Higher tax rates are asserted to lead to a growth of the undeclared economy. Based on this assumption, it is asserted that the higher tax rates in Croatia have caused a larger undeclared economy. For example, this is argued by Grdović, Gnip and Tomić (2010) who found that Croatian workers face a much higher overall tax burden than their European counterparts. This is particularly pronounced in the case of workers with a lower income (67% of the average gross wage) whose personal average tax rate¹ in 2009 accounted for 27.5% of the gross wage, while it was 23.4% in the EU27. For Croatian workers with average earnings this rate was 30.5% (27.6% in the EU27), and for those with high income it was 35.2% (33.2% in the EU27). Together with a high tax burden, an additional rationale for non-compliance can be found in a broadly accepted belief among workers in Croatia that high

¹ The sum of income tax and social security contributions paid by the employee as the proportion of the gross wage
social security contributions “are not proportionate to their future pension and health care insurance costs and benefits” (Bejaković, 2012, p. 2).

However, a multitude of studies reveal little, if any, evidence that higher tax rates are significantly correlated with higher levels of undeclared work (Friedmann et al., 2000; Kuehn, 2007; Schneider, 2002; Williams, 2014a,b,c,d, 2015a,b, 2016; Williams and Martinez-Perez, 2014; Williams and Horodnic, 2016). For example, Vanderseypen et al. (2013) in the European Commission’s annual Economic and Social Developments in Europe 2013, examined the relationship between undeclared work and various tax rate variables, namely the implicit tax rate on labour, the share of labour wages in total taxes, and the tax wedge on labour. They find no statistically significant correlation between the prevalence of undeclared work and tax rates.

Tax reductions in Croatia, therefore, are not the way forward. Instead, the situation is more complex. In societies where citizen morality and state morality are aligned, tax rates can be high since citizens realise that taxes are the price they pay for a civilised society. Tax rates, therefore, are not the problem. It is the lack of trust in the state and belief that they receive appropriate public goods and services for the taxes they pay. There is no evidence, therefore, that reducing tax rates reduces the undeclared economy. Instead, the focus needs to be on improving the ability to sustain higher tax rates by aligning state morality and citizen morality, not least by improving perceptions of distributive fairness (i.e., that people receive a fair and equitable return in terms of public goods and services for the taxes they pay).

There is also no evidence that reducing state intervention in the labour market reduces the size of the undeclared economy. Instead, quite the opposite is the case. Undeclared work is lower in countries where a larger proportion of GDP is spent by governments on interventions in the labour market targeted at groups with difficulties, such as the unemployed, people in jobs but at risk of involuntary job loss, and inactive persons currently not part of the labour force but who would like a job and are disadvantaged in some manner (Eurofound, 2013; Vanderseypen et al., 2013; Williams, 2014a,b,c,d, 2015a,b, 2016; Williams and Horodnic, 2016).

As Figure 3 reveals, Croatia has indeed increased the proportion of GDP spent on such labour market interventions, which is a positive step to facilitate reductions in the level of undeclared work, although this level of expenditure has reduced in recent years. Indeed, as a proportion of GDP, it now has one of the lowest levels of expenditure on labour market policy interventions targeted at vulnerable groups with difficulties, such as the unemployed, people in jobs but at risk of involuntary job loss, and inactive persons currently not part of the labour force but who would like a job and are disadvantaged in some manner. Such expenditure, therefore, needs to be increased if the undeclared economy is to be tackled.
It has also been widely shown that the greater the level of expenditure on social protection as a proportion of GDP, the less prevalent is undeclared work (Eurofound, 2013; Vanderseypen et al., 2013; Williams, 2014a,b,c,d, 2015a,b, 2016). As Figure 4 reveals, there are again positive steps in this direction in Croatia. There has been a small overall increase in the expenditure on social protection in recent years which should mean that the necessity to enter the undeclared economy is reduced. With a weak ‘safety net’, that is, it is little surprise that citizens have to turn to undeclared work as a last resort and survival practice. Putting in place a stronger ‘safety net’, therefore, and targeting social expenditure at groups likely to enter the undeclared economy, is a necessary prerequisite for reducing the ready-supply of labour for the undeclared economy.
Similarly, the more the state is successful in using direct taxes to reduce the proportion of the population at risk of poverty, the less prevalent is undeclared work in economies. Examining the effectiveness of state redistribution via direct taxes, measured by the decrease in percentage points of poverty (defined as the proportion of the population with an income below 60% of the national median income) after social transfers, a statistically significant positive correlation is found (Eurofound, 2013; Vanderseypen et al., 2013; Williams, 2014a,b,c,d, 2015a,b, 2016).

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2 Social protection expenditure contain: social benefits, which consist of transfers, in cash or in kind, to households and individuals to relieve them of the burden of a defined set of risks or needs; administration costs, which represent the costs charged to the scheme for its management and administration; other expenditure, which consists of miscellaneous expenditure by social protection schemes (payment of property income and other). It is calculated in current prices as percentage of GDP.
As the European Commission (2015a) state, not only is social expenditure lower than in the EU28 as a whole, amounting to 21.6% of GDP in Croatia (compared with an EU average of 28.7%), but as Figure 5 reveals, the percentage of the population suffering from severe material deprivation remains above the EU28 average level. Therefore, although the absolute numbers in the population suffering from severe material deprivation is decreasing (see Figure 5), there remains a need to improve the effectiveness of social transfers in reducing poverty.

Figure 5: Severe material deprivation, % of population (left axis) and 1,000 persons (right axis) in Croatia

Source: Eurostat

Studies have also revealed a strong positive relationship between the level of equality in societies and the prevalence of undeclared work. The greater the income inequality, the more prevalent is the undeclared economy (Williams, 2014a,b,c,d, 2015a,b, 2016; Williams and Martinez-Perez, 2014; Williams and Horodnic, 2016). As Figure 6 reveals, the level of income inequality in Croatia has decreased in recent years, suggesting that this will have contributed to reducing the size of the undeclared economy. As the European Commission (2014c, 2015) and Tafenau et al. (2010) recognise, higher levels of income inequality and greater levels of undeclared work go hand-in-hand. Indeed, on this determinant of the undeclared economy, Croatia appears to be outperforming the EU28 in terms of the direction of change. Continuous moves in this direction will result in a reduction in the size of the

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3 The collection "material deprivation" covers indicators relating to economic strain, durables, housing and environment of the dwelling. Severely materially deprived persons have living conditions severely constrained by a lack of resources, they experience at least 4 out of 9 following deprivations items: cannot afford i) to pay rent or utility bills, ii) keep home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) a week holiday away from home, vi) a car, vii) a washing machine, viii) a colour TV, or ix) a telephone.
undisclosed economy. Indeed, by 2015, Croatia had achieved the same levels of income inequality as the EU28 in general and the direction of change was towards further reducing this ratio, whilst it was increasing in the EU28 taken as a whole.

**Figure 6: Income inequalities in Croatia**

![Graph showing income inequalities in Croatia](image)

Source: Eurostat

In sum, to tackle the undeclared economy in Croatia, it is not simply a case of pursuing enforced compliance/direct controls (using deterrents and incentives) and voluntary cooperation/indirect controls (using awareness raising campaigns about the unacceptability of undeclared work and reforms to the processes of formal institutions). Although these are necessary, they are insufficient. There is also a need to change the macro-level economic and social conditions which result in the prevalence of the undeclared economy. These include:

- improving GDP per capita;
- improving governance and reducing public sector corruption;
- maintaining and improving the levels of expenditure on labour market interventions to help the most vulnerable groups;
- persisting with increasing social expenditure; but coupling this with
- developing far more effective social transfer systems that reduce the levels of income inequality and levels of severe material deprivation in Croatian society.

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4 The ratio of total income received by the 20% of the population with the highest income (top quintile) to that received by the 20% of the population with the lowest income (lowest quintile). Income must be understood as equivalised disposable income.
Given this identification of the drivers of the undeclared economy, attention now turns to the organisation of the fight against undeclared work in Croatia and an evaluation of the policy approach and measures being pursued.
3. Organisation of the fight against undeclared work: Institutional framework

3.1 Responsibilities of government ministries

How, therefore, is the fight against undeclared work organised? And are there ways in which the institutional framework can be improved? Table 1 provides a conceptual framework for evaluating the current organisational approach of the Croatian government. At the top of this spectrum are fully joined-up forms of government where one agency/department is responsible for the whole undeclared economy. Moving down the spectrum, there are then a range of cross-government departmental co-operations ranging from initiatives where the co-operating government departments have common shared targets to achieve at the level of strategy, operations or data matching (and which relate to the whole undeclared economy or specific sectors, occupations and so forth). Following this, there are then cross-government departmental co-operations where the departments involved have separate targets to achieve and which again can be applied at the level of strategy, operations or data matching. Finally, and at the bottom of the spectrum, are completely fragmented forms of government in the form of a departmental ‘silos’ approach.⁵

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<th>Approach</th>
<th>Scope</th>
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<td>Single compliance unit</td>
<td>Whole undeclared</td>
<td>Common</td>
<td>Strategy, operations and data matching</td>
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<td>economy</td>
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<tr>
<td></td>
<td>Segment</td>
<td>Common</td>
<td>Strategy, operations &amp;/or data matching</td>
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<td>Cross-Departmental Co-</td>
<td>Whole/segment</td>
<td>Shared</td>
<td>Strategy</td>
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Source: derived from Dekker et al. (2010)

⁵ This table only considers joined-up government, not joined-up ‘governance’, which includes tripartite social dialogue.
There is no single agency responsible for tackling undeclared work or no single committee in charge of co-ordinating actions in this field in Croatia. Instead, responsibility is shared between different ministries and government departments, including the Ministry of Labour and Pension System, Ministry of Finance, Ministry of Interior, Ministry of Tourism, Ministry of Agriculture, Tax Administration, Employment Service and Customs Administration. Despite some examples of co-operation in data sharing and joint actions, generally there is a lack of co-ordination among these ministries and departments (Baric and Williams, 2013). They rather define their own separate targets and this often results in overlapping or awkward divisions of responsibility. One such example is surveillance in tourism. The Ministry of Tourism is authorised only for the inspection of activities carried out by registered entities and individuals engaged in providing services in tourism, but not for detection and prosecution of undeclared businesses in this field, which is a responsibility of the Customs Administration. In addition, the Customs Administration is in charge of surveillance of compliance regarding sojourn tax.

There is therefore a fragmented approach. Responsibility for tackling undeclared work is distributed across a range of institutions, with each taking responsibility for different segments of the undeclared economy. There is currently little coordination in the fight against undeclared work across the multifarious institutions in strategic, operational or data-sharing terms, and no common cross-cutting targets. The quality of governance, therefore, needs to be improved. A more coordinated response is required, which in part will be dealt with by the decision to establish a State Inspectorate in late 2017. Below, a short description is provided of each institution and their responsibilities prior to this reorganisation which is taking place at the time of writing and is due to be completed by December 2017.

**Ministry of Labour and Pension System (MoLPS)**

The Ministry of Labour and Pension System (MoLPS) is responsible for employment policy, regulation of labour relations, the labour market, active employment policies and social partnerships. The Ministry of Labour and Pension System is responsible for the labour market and employment policy while within the Ministry, the Labour and Safety at Work Directorate is responsible for legislative regulation of labour relations, while in the Directorate for Co-ordination of EU Programmes and Projects in the Field of Labour and Social Security, Project Implementation Unit is situated.

The new Labour Act came into force on 7 August 2014 as part of the reform efforts in the labour market. The main objectives to be achieved by the Labour Act (OG 93/2014) are: safeguarding jobs, boosting employment and internal mobility, flexibility in business operations and reduction in costs of labour, enabling employers to restructure their businesses.
in a more effective and prompt manner, preventing unreported employment. Among the steps already taken to prevent undeclared work, the Labour Act allows full-time workers to take up an additional contingent work with a different employer, provided it does not exceed 8 hours a week and 180 hours a year, and that they have written consent from their primary employer. Allowing and legalising additional work is in the interests of both the employers and the workers and will reduce undeclared work. A special model of monitoring the implementation of the Labour Act was established in order to monitor the achievements and impact of the reform of labour legislation, based on the continued co-operation of the government, social partners and stakeholders. Since these changes are new it would be helpful to make comparative analysis with other EU countries in order to apply the best practices in prevention and application of labour legislation. The Ministry of Labour and Pension System of the Republic of Croatia is responsible for the labour market and employment policy and hence for the design of the strategy and the necessary amendments of the existing Labour Act.

**Labour Inspectorate**

The Labour Inspectorate (LI), as an integral part of the Ministry of Labour and Pension System, operates on the basis of the Labour Inspectorate Act (OG 19/2014), which regulates the organisation and management of the Labour Inspectorate, conditions for performing inspection supervision of the regulations within the competence of the Labour Inspectorate and duties of the labour inspectors. The LI has some 235 employees in total, including 120 labour inspectors for labour relations. The Central Office is located in Zagreb, with five regional offices located in Split, Osijek, Varaždin, Rijeka and also Zagreb. Each regional office has between 2 and 4 branch offices (in total 15).

Based on the Labour Inspectorate Act, the LI is in charge of inspection of compliance with the laws and other regulations that prescribe the relationship between employers and employees (workers). These inspections have inter alia the aim to check whether the employees (workers):

- are registered in the data system of the Croatian Pension Insurance Institute (CPII),
- work with a contract of employment in a written form,
- receive their salary,
- get at least the minimum wage,
- get payment of salary or part of salary cash in hand (envelope wages),
- from foreign countries work with a mandatory work permit.

The LI uses the so-called E-Register (E-Očevidnik) as its database. Every piece of data which was provided or gathered via performed inspections and audits of the LI is stored in this database. The E-Register is an extensive database where all kinds of queries regarding a respective inspection can be made.
The LI shares none of its data in digital form. Only information which has been gathered through performed inspections and which are obviously crucial for other institutions are submitted to the respective institutions in paper form. The LI itself has extensive access to many different databases. Some of these databases are publically available, some of them provide a restricted access especially for the LI.

**Ministry of Finance – Tax Administration**

The Tax Administration (TA) is responsible for collecting all taxes and all the social contributions Croatian employers have to pay due to the employment relationship (e.g., pension insurance, health insurance and unemployment insurance). If corrections are necessary, these corrections are also made by the TA.

Every Croatian worker or self-employed person, and every Croatian, has a personal identity number. Also all Croatian legal persons have a single ID number. This single number called “OIB” is valid for the TA and furthermore, for all authorities in Croatia. Every month the employer has to declare the gross wage and all information relevant for taxation for all his/her employees with the form called ‘JOPPD’. In the ‘JOPPD’, the employer calculates the taxes and the social contributions owed by the employee. The calculated amount is paid by the employer. Traders and craftsmen have to declare the taxable income at the end of the year. The TA also screens bank accounts to check whether the correct tax base was declared.

The Ministry of Finance uses the ISPU (Information System of Tax Administration) which includes many different databases or applications. Institutions that are electronically connected to the TA-database are the Pension Insurance Institute and the Health Insurance Institute. The Customs Administration (CA) has a reading access to the database of the TA. The CA and the TA are part of the same Ministry, so they are natural partners in case of co-operation. The Labour Inspectorate does not have automatic access to TA-database, but when the employer does not pay the workers wage, the Labour Inspectorate can block the account of an employer. In other cases, the Labour Inspectorate must ask for data from the TA in writing. Conversely, the TA also informs the Labour Inspectorate in cases of recognised violations. The same procedure refers to co-operation with the CA regarding unregistered activities. There is also some co-operation with the Croatian Police.

**Customs Administration**

The Customs Administration (CA) is part of the Ministry of Finance with head office in Zagreb. There are four regional offices (Rijeka, Split, Osijek and Zagreb) and so-called customs field offices (e.g., airports, harbours, frontiers) located all over the country of Croatia represent the CA and perform duties laid down by the relevant laws. CA also plays an important role in combating unregistered economic activities of legal and natural persons. It is
responsible for inspection surveillance under the Act on Prohibition and Prevention of Unregistered Activities.

Two important departments in the fight against undeclared work should be mentioned here: These are the Supervision Department for Unregistered Activities, and the Supervision Department in the Field of Trade of Goods and Services. The first is dedicated to detection and prosecution of unregistered activities, while the latter supervises approvals for starting a business and monitors usage of product labelling stamps. There were 2,163 controls in the field of unregistered activities, almost two times more in comparison to 2011 (State Inspectorate, 2013b). A total of 589 violations were identified (388 in 2011).

The Supervision department for unregistered activities deals with inspections of unregistered activities according to the Act on Prevention of Undertaking of Unregistered Activities. These unregistered activities are defined in Article 5 as:

- if a legal person carries out an activity not registered in the Register of Companies (court register in Croatia) or some other relevant register;
- if a legal person has no statutory prescribed acts on fulfilling the pre-conditions for carrying out the registered activity;
- if a natural person carries out an activity not registered with the competent body or tax authorities;
- if a natural person has no statutory prescribed acts on fulfilling the pre-requisites for carrying out of registered activity; and
- if a legal or natural person carries out an activity in spite of being prohibited to carry out an activity.

In the case of detecting undeclared activities, a standard procedure comes into operation and the CA submits minutes to the Tax Administration, Ministry of Demography and Employment Service. One draft remains at the Customs Service. Because there is no automatically electronic data exchange established, all documents are sent in paper form or by mail.

In cases of detecting undeclared work, the findings of the CA are additionally forwarded in paper form to the relevant state body which is the Labour Inspectorate. The same procedure applies, when discovered unregistered activities fall under a competence of another entity which is not included in standard procedure. The Act on Prevention of Undertaking of Unregistered Activities obliges Customs Administration to respect requirements governed by this law. Also trade law and other laws as *lex specialis* to the before mentioned act cover unregistered activities.
Ministry of Interior – Border Police

The Ministry of Interior is responsible for enforcement of the Act on Foreigners (OG 130/2011 and 74/2013), that regulates the stay and work of foreigners in the Republic of Croatia. The Act is aligned with all the regulations and directives of the EU in this field. The involvement of the Ministry of Interior should be focused on assistance in removal of the existing obstacles and finding the adequate legal framework in the area of suppression of undeclared work of foreign citizens. Working on suppression of undeclared work of foreign citizens is performed by police officers of border police in co-operation with labour inspectors on both regional and local level.

The Border Police (BP) are part of the entire Croatian Police within the Ministry of Interior. The controls are focused on foreigners staying in Croatia whether they are working or not. The BP are in charge of person controls in the whole of Croatia. The main topic of the controls is to find out whether foreigners stay legally in Croatia and to prevent illegal migration. The BP have their own information-gathering and additionally get information from the Croatian police. All collected information is stored in the database of the Croatian police. BP can retrieve data from this common database and use it for its own purpose.

Foreigners in Croatia have to be registered during their stay in Croatia. For tourists, registration is made by the accommodation facility. The data of foreigners is also available for the BP. In general, there are no common audits or inspections with other institutions. In specific cases there are common inspections with the Labour Inspectorate. On the border of Croatia, there are common controls with the customs administration. The Labour Inspectorate is partner no. 1 with a view to the controls of workers. In case of problems with working persons, the BP inform the Labour Inspectorate and apply for assistance.

Croatian Pension Insurance Institute

The Croatian Pension Insurance Institute (CPII) is one of the institutions directly involved and responsible for suppression of undeclared work and employment in the Republic of Croatia. The CPII makes considerable efforts to establish satisfactory and effective connection with a broad number of institutions (Ministry of Interior, Health Insurance Fund, Croatian Employment Service etc.). The CPII has at its disposal sophisticated and accurate data on active employers and employees, having in mind that good co-operation with other relevant institutions has an important role in decreasing the rate of undeclared work and employment.

In general, the Pension Insurance Institute (CPII) is responsible to perform the following tasks:

- Payment of:
  - old age-pension;
• accelerated old-age pension;
• disability pension;
• widow’s and orphan’s pension;
• accident pension;
• care allowance.

The employer is obliged to register the new worker with the CPII before the beginning of work according to the Act on Pension Insurance (OG 157/2013, 151/2014 and 33/2015). Therefore, a person who works at the employers’ premises without being registered to the social contribution system is considered to be an undeclared employee. It is obligatory to inform them on changes in labour relationship within 24 hours.

In the data base of CPII, the employees are stored with their personal identity number (OIB). Self-employed persons have to fulfil the same obligations. The pension insurance contributions are collected by the Tax Administration. It is quite common that the Tax Administration, the Labour Inspectorate and Customs Administration deliver their inspection protocols to the CPII. CPII checks if there is any kind of irregularity. In general, data queries from other institutions to CPII are asked and answered in written form. The Labour Inspectorate has a reading access to aspects of the database of the CPII, so this institution can check online whether employers and employees are registered in the system of the CPII or not.

_Croatian Health Insurance Fund_

The Croatian Health Insurance Fund (CHIF) is the one and only health insurance institution in Croatia. Practically all citizens with permanent residence are insured through CHIF. Persons who are insured are for example (the complete list is named in law):

• employees;
• self-employed persons;
• unemployed persons;
• farmers;
• students; and
• pupils.

It is also possible to choose an additional kind of health insurance on a voluntary basis. In that case, an additional contribution has to be paid. CHIF covers participation in health care costs unless medicines are on an additional drug list, as well as for rehabilitation and cure. Health insurance contributions are collected by the Tax Administration. Every employer is committed to fill in a tax application in which s/he has to calculate besides tax and other contributions their health insurance contributions (currently 15%). The employer is obliged to
pay all taxes and contributions for and in the name of the workers. As the basis for the calculation is the workers gross wage. Workers get their wage in net amount after all taxes and all contributions have been deducted.

The policy for supplementary health insurance for certain categories of insured persons, such as pupils, students or disabled people, is covered by the state budget. It is also possible to be insured without any contribution payment in the case a person in a household has a monthly income less than HRK 1,516.32, or in the case of singles HRK 1,939.39. Employees who are incapable to work because of illness, get sickness benefits from CHIF after a period of 42 days. Sickness benefits are compensated at 70% of the salary. People who lose their existing employment for any reason have to inform CHIF within 30 days. There is one exception for people who become unemployed, namely if they are reported as unemployed at the Croatian Employment Service, they will be further insured.

The CHIF shares its data only automatically with other institutions. There are also automatic cross-checks with the database of the Employment Service. No other institution has direct access to the database of the CHIF. The Tax Administration, the Labour Inspectorate and also the Customs Administration deliver their inspection protocols in some cases to the CHIF. Afterwards, the CHIF checks if there is any kind of irregularity. All kinds of data queries from other institutions to CHIF are asked and answered in written form.

**Croatian Employment Service**

Based on the Act on Employment Mediation during the Unemployment Period (OG 80/2008, 121/2010, 25/2012, 118/2012, 12/2013 and 153/2013) the Croatian Employment Service ceases to keep records on an unemployed person if this person is working without a certificate, contract or decision on work. Summarized, the Croatian Employment Service (CES) has to perform the following tasks:

- paying unemployment benefit;
- organisation and financing of professional development and qualification;
- job seeking / unemployment service; and
- temporary additional payment for employees who earn low or more specifically insufficient wages.

The customers of the CES are unemployed persons who are aged between 15 and 65 years and who are capable of work. These unemployed persons have to make a request to the CES and have to appear personally at one of the 22 local offices of the CES.

These customers become registered at the CES and get an unemployment benefit if the following conditions are fulfilled:

- the current monthly income does not exceed HRK 1,817;
- the unemployed person has been working no less than 9 months within a period of 24 months; and
- the termination of the employment contract is not the fault of the employee.

Self-employed persons who have paid unemployment insurance fees enjoy the same rights as employees. Payment of unemployed benefits can be cancelled in case of refusing an acceptable job, practising undeclared work or any other case of gross misconduct. There is no obligation to be registered as unemployed at CES. The registration is also not a condition to get health insurance benefits. Motivation for registration to CES is for example to get assistance in finding a job, to get unemployment benefits and to get payment for necessary qualification measures. Some cities (Zagreb, Rijeka, Split and Osijek) also offer free public transport for unemployed persons.

The CES uses only its own database for its daily work. Its own database, however, is fed with shared data from the other Croatian institutions. The Labour Inspectorate and Customs Administration deliver their inspection protocols to the CES local offices. CES checks if there is a case of undeclared work or granted unemployment benefit despite working. In this case, the unemployed person will be erased from the records from the day of the inspection surveillance performed and the entitlement ceases also from the date of the inspection. The person erased from the unemployment records can be recorded again as an unemployed person after 6 months from the date of record keeping cessation. Consequently, the Croatian Employment Service co-operates with the Labour Inspectorate and is one of the important stakeholders of this project, since an increase of the effectiveness of the inspection surveillances is connected to the reduction of the number of bogus unemployed persons and the number of the unemployment benefit users.

**Ministry of Economy, Entrepreneurship and Crafts**

The Ministry of Economy, Entrepreneurship and Crafts (MEEC) is a policy making body and also responsible for the legal framework against undeclared work in line with the Act on Prohibition of and Prevention of Unregistered Activities (OG 61/2011) with branches in 20 counties (županija) of Croatia, Zagreb city and other smaller cities. One of its main tasks is conducting administrative tasks for small and large business.

The tasks regarding registration, deregistration and changes of registration of trades and crafts is done by a special branch of the municipalities or city councils (Counties State Administration Offices) all over Croatia and stored afterwards in the Trade and Craft Register of Republic of Croatia named ‘portor’. All these procedures can be made by personal appearance of the “customer” in one of the above named branches or also online. The MEEC has access to the ‘portor’ database, but does not conduct registration process by himself.
Through webpage **portor.hr**, everyone gets the possibility to check the legality of trade- or craftspeople. The MEEC is supervising the Counties State Administration Offices related to registering of trades and crafts. MEEC has no responsibility to conduct its own inspections. Actually approximately 80,000 crafts and tradespeople are registered in the ‘portor’ database. 61 occupations need master’s certificate to conduct their craft. MEEC supervises branches and controls registration procedures. In case of doubt whether permission for a trade or crafts is needed, MEEC as monitoring and supervising body takes the final decision. Among other verifications, an extract of the court register guarantees reliability of traders or craftspeople. When banned because of unregistered activities, the persons or companies are excluded from registration.

The MEEC usually gets no information about findings from any other institutions. It was assumed by the MEEC that this information is mostly forwarded directly to the municipal offices without notice to the MEEC itself. The municipal offices forward this information for their part also to the responsible institutions which are capable of making inspections or audits.

In the context of policy making, MEEC often needs more data than is stored in its own database. Because of non-existing direct access, the MEEC must formally requested such information from other institutions. For example, in the case of limited liability companies, the Financial Agency (FINA) keeps financial reports and MEEC must pay for this information. Even for analysis in own matters, MEEC is reliant on figures provided by other ministries. Due to legal provisions, Customs Administration is in charge of controlling unregistered activities. Unfortunately, the MEEC gets very little information from CA regarding this issue. There is no data exchange foreseen by law. So this lack of information concerning unregistered trades and crafts affects negatively the work and policy of MEEC on this issue.

**Ministry of Demography, Family, Youth and Social Policy**

The Ministry of Demography, Family, Youth and Social Policy (MD), established in 2016, performs administrative and professional tasks related to social care, social services, child benefits, child allowance, fostering and so on. There are 35 branches and 80 service centres (centres for social affairs) throughout Croatia under the authority of the ministry. Most of the staff are social workers.

As one problem in Croatia appears to be fraud of social benefits, per definition the Ministry has to provide counselling measures and support to people who are able to work, but do not work. To tackle misuse of state subsidy, an “Action Plan” and a “Strategy Plan” came into force. Before granting social benefits, the applicant has to give evidence that s/he has no...
or only low income and requires state support. Existing laws concerning social welfare provide exact provisions which have to be strictly followed by the centre of social affairs.

The Ministry of Demography operates an internal web service which is called ‘SOCSKRB’. The ‘SOCSKRB’ can be only accessed by entitled persons. It contains data from nine databases, for example the OIB database, EDIP, database of Employment Service, FINA, REGOS and some more. There is an automated daily cross-check of the data with the Croatian Employment Service in the case when one of the both institutions grants some benefits to somebody. In all other cases the data has to be requested manually. The MD has no direct access to databases of other institutions. If undeclared work is discovered within their own inspections, the information will be reported to the Labour Inspectorate in written form. Close co-operation especially in form of data exchange allows the ministry to receive relevant information concerning income, earnings and property of a person. Automatic data reconciliation from various databases run by other state bodies like tax administration, employment service and financial agency, enables them to decide if entitlement is justified. A close co-operation with Customs Service minimizes the gap of missing automatic data exchange with that state body. In the case of controls, the Customs Administration sends an official note for the required information in written form to the MD. There the data is checked in the Ministries database to prove if benefits are granted. In the case of a hit, the responsible centre for social affairs is informed to control the beneficiary. The same procedure of making official requests applies to co-operation with the police and municipal entities.

**Ministry of Tourism**

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

### 3.2 The role of social partners

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

The interest of employers in the ESC is represented by the Croatian Employers’ Association, the chief employers’ organisation established in 1993. On the other hand, there are four major trade unions included in the work of this body: the Independent Croatian Trade Unions of Croatia, Association of Croatian Trade Unions, Croatian Workers Trade Union Association and Union of Autonomous Trade Unions of Croatia. These four unions encompass about 90% of all trade union members in the country. The government has six representatives in the ESC, while the Employers’ Association and Unions have four representatives each. There is an alternation among these three groups of stakeholders in the position of the president and two vice-presidents, who are each elected on one-year mandates.

The ESC has five committees: a Committee for Wage Policy, Tax System and Living Standard, Committee for Social Policy, Committee for Employment, Education and Harmonisation of the Education System with the Labour Market, Committee for Legislation, Collective Bargaining and Protection of Rights and Committee for Sustainable Development, Energy, Climate Change and Stimulation of the Economy.

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

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

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

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

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

Since 2011 there is a possibility to carry out a local tripartite social dialogue by establishing local and regional economic and social councils. There is also an option for bipartite social dialogue between employers and trade unions through sector social councils. The main purpose of these bipartite councils is to facilitate collective bargaining, as well as to intervene and mediate in the case of disputes between employers and workers. In line with this, six different sector social councils have been established since 2010. The Social council for the textile, footwear, leather and rubber sector, established on 20 April 2010, was the first among them, followed by the Social council for the sector of forestry and wood industry (established on 6 December 2010). Other sector councils include Social council for the road transport (established on 9 December 2011), Social council for the railway transport (established on 30 May 2012), Social council for the construction industry and Social council for tourism (both established on 26 September 2012).

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

One such conflict in 2010 resulted in trade unions withdrawing from the ESC for ten months. This was a response to the unilateral decision of the government to limit the so-called ‘prolonged application of collective agreements’\(^6\). However, after the trade unions launched a campaign for collecting signatures in order to request a referendum on this issue\(^7\), the government withdrew its decision. Although the members of the ESC have continued with their regular meetings since March 2011, there was no significant improvement in the social

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\(^6\) The extension of an expired collective agreement until a new one is signed.

\(^7\) According to legislation, the Parliament has to organise a referendum if 10% of constituency sign a petition.
dialogue. Nestić, Rubil, Stubbs, and Tomić (2013, p. 24) argue that “relations between social partners remained strained, and there is an impression that they have recently become more conflictual”.

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

Meeting with social partners – summary

During a meeting with the Employer Association and the Trade Union the following statements have been made:

The Trade Union states that their members are employees within a wide area. For example, their members work in public services, education, kindergarten, medical treatment and also for the police. The membership is voluntary. They only have indirect influence on legislation. Usually they should get law-designs from the government to comment on some of the issues regarded. The Trade Union also provides information for their members regarding different areas, also for example regarding the important topic “undeclared work”. There have been also free publications provided by the Trade Union for everybody. In 2005 the Trade Union started a campaign whose aim was to raise awareness of undeclared work.

The Employers’ Association states that it actually has between 6,000 and 7,000 members in 32 different areas of work. The membership is also voluntary. Most members are medium sized employers. Most of the so called “micro-companies” in Croatia are not members because of the costs. The Employers’ Association also provides publications with information regarding many different themes to their members. Also it provides training for members regarding problems like undeclared work. The Employers’ Association also gets law-designs for commenting.

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8 The Office for Social Partnership was introduced in 2001 with the aim of providing professional and logistic support to the Council, as well as to act as an intermediary in the case of disputes.
During the discussion with both institutions, the following major findings or problems regarding the ‘Croatian system’ have been made:

- no payment for overtime work (no documentation of overtime work);
- envelope wages;
- people have no motivation to be formal (because of a lack of trust in the administrative system);
- the largest part of undeclared work and undeclared entrepreneurship is found in the construction sector, tourism (tips) and services;
- Employers Association co-operates with ministries in every case of legislative action;
- the Trade Union participates in legislation creation in most, but not in all cases;
- envelope wages are a most common problem in smaller companies up to 10 employees;
- undeclared work of seasonal workers from other countries;
- inadequate implementation of a government program for combating undeclared work (memorandum regarding combating undeclared work was provided by the Trade Union to the government, but nothing happened after that);
- low budget for administration;
- the attitude of people towards moonlighting is also a problem;
- fragmentation of inspection authorities and non-sharing of data from various institutions (there are many databases and many independent inspectorates);
- different interpretation of competences of inspectors in different regions;
- employers have no, or only minimum, possibilities to change the law;
- law changes very often, also new regulations;
- it is necessary to raise awareness and education for employers and also employees;
- it is not necessary to raise the fines, but it would be useful to add some kind of a fining range (in most laws there is no intended range for fines, so everybody gets the same fine, regardless of whether it was just a small case or a real criminal case);
- the Employers’ Association sees also the problem of hyper-regulation for employers.
4. Enhancing Existing Policy Approaches and Measures in Croatia

4.1 Typology of policy approaches for tackling undeclared work

It is now widely accepted across the globe that the aim of governments is not to eradicate the undeclared economy, but to move undeclared work into the declared economy (Dekker et al., 2010; Eurofound, 2013; European Commission, 2007a; ILO, 2015b; Small Business Council, 2004; Williams, 2014; Williams and Nadin, 2012a,b, 2013, 2014).

Figure 7 displays the full range of tools available for transforming undeclared work into declared work. On the one hand, there are direct tools. These transform undeclared into declared work by ensuring that benefits of operating in the declared economy outweigh the costs of working in the undeclared economy. This is accomplished either by using deterrence measures to increase the costs of non-compliance (‘sticks’) and/or by making the conduct of declared work more beneficial and easier (‘carrots’). On the other hand, there are indirect tools. These shift away from using ‘sticks’ and ‘carrots’, and instead focus on dealing with the formal institutional failings so as to repair the social contract between the state and its citizens in order to foster a high trust high commitment culture.

**Direct controls**, therefore, seek to reduce the costs and increase the benefits of operating on a declared basis (OECD, 2008). Viewing the non-compliant as rational economic actors who engage in undeclared work if the pay-off is greater than the expected cost of detection and punishment, the objective is to change the cost/benefit ratio facing those participating or considering participation in undeclared work (e.g., Allingham and Sandmo, 1972; Hasseldine and Li, 1999; Richardson and Sawyer, 2001). This can be achieved in two ways:

- **Deterrence measures** detect and punish non-compliance. This is achieved by firstly, raising the perceived or actual likelihood of detection and/or secondly, increasing the penalties and sanctions for those caught. This ‘negative reinforcement’ approach thus seeks behaviour change by using ‘sticks’ to punish non-compliant (‘bad’) behaviour.

- **Incentive measures** seek to make it easier to undertake, and reward, compliant (‘good’) behaviour (i.e., declared work). To achieve this, one can use either:
  - Preventative measures to stop people moving into the undeclared economy in the first place (e.g., by simplifying compliance, using tax incentives to make declared work beneficial, providing support and advice about how to start-up legitimately); or
  - Curative measures to incentivise workers and businesses to make the transition to the declared realm. These can be either (a) supply-side incentives targeting businesses and workers in the undeclared economy or (b) demand-side incentives targeting their customers with rewards for using declared goods and services.
Figure 7: Policy approaches and measures for tackling undeclared work

Direct controls
- Deterrents ('sticks')
  - Improved detection
  - Increased penalties
  - Supply-side
- Incentives ('carrots')
  - Demand-side
  - Service vouchers, targeted direct taxes, targeted indirect taxes
  - Change informal institutions (values, norms and beliefs)
  - Change formal institutions (laws, regulations and codes)
  - Tax education, normative appeals, education and awareness raising of benefits of declared work
  - Procedural fairness and justice, distributive fairness; wider economic and social developments

Indirect controls
- Reduce asymmetry between formal and informal institutions
- Data matching and sharing, joined-up strategy and operations
- Increasing sanctions, advertising penalties
- Simplify compliance, direct and indirect tax incentives, support and advice to start-ups
- Tax education, normative appeals, education and awareness raising of benefits of declared work
- Procedural fairness and justice, distributive fairness; wider economic and social developments
The problem with using these direct tools is that those operating on an undeclared basis are not always rational economic actors purely calculating the costs and benefits. They can be also social actors who engage in undeclared work because there is lack of alignment between their own morality and the laws and regulations, such as due to a lack of trust in the state and what it is seeking to achieve.

Indirect controls, therefore, seek to deal with the formal institutional failings and repair the social contract between the state and its citizens so as to create a high trust high commitment culture (Alm et al., 1995; Torgler, 2003; Wenzel, 2002). The intention is to seek a voluntary commitment to compliant behaviour rather than force citizens to comply using threats, harassment and/or incentives (Kirchler, 2007; Torgler, 2007, 2011). Undeclared work occurs where formal institutional failings lead to citizens’ norms, values and beliefs differing to the laws and regulations, meaning that what formal institutions deem illegal activities are seen as socially legitimate in the eyes of citizens. To tackle undeclared work therefore, there is a need to address the formal institutional failings and repair the social contract. To align citizen morality with state morality, one can either:

- **Change the informal institutions** – to change the norms, values and beliefs of citizens regarding the acceptability of undeclared work, so that these are in symmetry with the laws and regulations, one can use awareness raising campaigns and educational initiatives about the costs of undeclared work and benefits of declared work.

- **Change the formal institutions** – this is particularly important in societies in which there is a lack of trust in government, such as due to public sector corruption (European Commission, 2014) or in societies where citizens do not believe that they receive back from government what they expect. This can involve either:
  - Changes in the internal processes of the formal institutions to improve the perception amongst citizens that there is procedural and distributive fairness and justice; and/or
  - Change in the products of formal institutions by pursuing wider economic and social developments (e.g., increased social expenditure levels, more effective social transfers).

The emerging evidence base is that the ‘best practice’ when tackling undeclared work is to *combine direct and indirect tools* (Williams, 2014a; Williams and Renooy, 2013). For example, governments may pursue greater social expenditure to provide a welfare ‘safety net’ and culture changes in government departments towards a more customer-oriented approach, and introduce publicity campaigns to elicit greater commitment to compliance, but may also simplify regulatory compliance and introduce incentives (e.g., amnesties, tax deductions) to enable undeclared labour to move into the declared realm. At the same time, and in relation to those failing to comply, they may also pursue improvements in the probability of detection.
and tougher sanctions for those subsequently caught. The debate therefore is not over whether it is best to use either indirect tools or direct tools. The emergent evidence base is that both are required to effectively tackle undeclared work. Rather than debate is over how to combine and sequence the various direct and indirect measures. Two contrasting approaches exist for doing this:

- **Responsive regulation** – this envisages a regulatory pyramid, sequenced from the least intrusive indirect controls at the bottom and used first, to the most intrusive direct controls at the top. The idea is that an authority does not need in most cases to pursue the coercion option at the top of the pyramid to win compliance. Instead, it can start with the commitment measures at the bottom of the pyramid and if these fail to elicit behaviour change with some groups, then the level of intrusiveness escalates up the pyramid until it reaches the intervention that elicits the desired response. The outcome is recognition of a continuum of attitudes towards compliance and different policy responses that can be temporally sequenced starting with commitment measures, then incentives and only after these fail are sanctions used (Braithwaite, 2002, 2009). The Australian government for example has adopted this ‘responsive regulation’ approach. In the first instance, indirect controls facilitate voluntary self-regulated compliance, followed by persuasion and only then punitive measures to tackle non-compliance (Braithwaite, 2009; Job et al., 2007).

- **Slippery slope framework** – this argues that citizens abide by the law either because they fear detection and fines due to the power of authorities (enforced compliance) or because they feel a commitment to be honest because they have trust in the authorities (voluntary co-operation). When there is effective enforced compliance as well as high voluntary co-operation (i.e., both power and trust), undeclared work is absent. When there is ineffective enforced compliance and little voluntary co-operation, undeclared work is extensive (Kirchler et al., 2008; Kogler et al., 2015).

This recognition that both effective enforced compliance and high voluntary co-operation are essential for tackling undeclared work is now being seriously considered by authorities in various countries (OECD, 2013). Indeed, it is this analytical framework and policy approach that is the basis for this report.

### 4.2 Overview of current policy approach and measures in Croatia

To evaluate the current policy approach and measures adopted in Croatia, both desk-based research was conducted as well as meetings with a wide array of stakeholders (see Appendix A for a list of the organisations with whom meetings were held). Table 2 summarises the current policy measures used in Croatia and compares this with the range of policy measures pursued in European Economic Area (EEA) as reported by Dekker et al. (2010). This reveals
that Croatia focuses upon using deterrence measures to stamp out undeclared work. Only a narrow range of incentive measures are currently being used in Croatia, in contrast to EEA countries that are changing the ‘benefits’ side of the equation by adopting measures to make it easier and more beneficial to operate in the declared economy. Moreover, although in some EEA countries there is a shift from purely the ‘direct controls’ (enforced compliance) approach which changes the cost/benefit ratio confronting suppliers and purchasers and towards an ‘indirect controls’ (voluntary co-operation) approach that seeks to engender a commitment to operating on a declared basis, this is largely absent in Croatia.

Table 2: Policy measures used in Croatia and 31 other European countries to tackle undeclared work

<table>
<thead>
<tr>
<th>Policy</th>
<th>Use in Croatia</th>
<th>% of EEA nations</th>
<th>% of EEA stakeholders stating measure is:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Effective</td>
</tr>
<tr>
<td><strong>DIRECT CONTROLS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deterrence</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Penalties:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Administrative sanctions for purchasers/companies</td>
<td>√</td>
<td>87</td>
<td>46</td>
</tr>
<tr>
<td>Administrative sanctions for suppliers/employees</td>
<td>√</td>
<td>83</td>
<td>41</td>
</tr>
<tr>
<td>Penal sanctions for purchasers/companies</td>
<td>√</td>
<td>74</td>
<td>59</td>
</tr>
<tr>
<td>Penal sanctions for suppliers/employees</td>
<td>√</td>
<td>52</td>
<td>53</td>
</tr>
<tr>
<td>Measures to improve detection:</td>
<td>100</td>
<td>64</td>
<td>34</td>
</tr>
<tr>
<td>Data matching and sharing</td>
<td>√</td>
<td>83</td>
<td>72</td>
</tr>
<tr>
<td>Workplace inspections</td>
<td>√</td>
<td>100</td>
<td>75</td>
</tr>
<tr>
<td>Registration of workers prior to starting work or on first day of work</td>
<td>√</td>
<td>74</td>
<td>74</td>
</tr>
<tr>
<td>Co-ordinating strategy across government</td>
<td>57</td>
<td>56</td>
<td>44</td>
</tr>
<tr>
<td>Certification of business, certifying payments of social contribution and taxes</td>
<td>√</td>
<td>65</td>
<td>62</td>
</tr>
<tr>
<td>Use of peer-to-peer surveillance (e.g., telephone hotlines)</td>
<td>√</td>
<td>39</td>
<td>20</td>
</tr>
<tr>
<td>Co-ordination of operations across government</td>
<td>61</td>
<td>64</td>
<td>36</td>
</tr>
<tr>
<td>Co-ordination of data sharing across government</td>
<td>65</td>
<td>82</td>
<td>19</td>
</tr>
<tr>
<td>Mandatory ID in the workplace</td>
<td>√</td>
<td>65</td>
<td>70</td>
</tr>
</tbody>
</table>

**Enabling compliance**
### Use in Croatia, % EEA nations, % of EEA stakeholders stating measure is:

<table>
<thead>
<tr>
<th>Policy</th>
<th>Use in Croatia</th>
<th>% EEA nations</th>
<th>Effective</th>
<th>Neutral</th>
<th>Ineffective</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Preventative measures:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduce regulations</td>
<td>√</td>
<td>90</td>
<td>45</td>
<td>43</td>
<td>12</td>
</tr>
<tr>
<td>Simplify compliance procedures</td>
<td>√</td>
<td>87</td>
<td>62</td>
<td>38</td>
<td>0</td>
</tr>
<tr>
<td>Technological innovations (e.g., certified cash registers)</td>
<td>√</td>
<td>43</td>
<td>73</td>
<td>27</td>
<td>0</td>
</tr>
<tr>
<td>New categories of work (e.g., for small or mini-jobs)</td>
<td>√</td>
<td>35</td>
<td>59</td>
<td>33</td>
<td>8</td>
</tr>
<tr>
<td>Direct tax incentives (e.g., exemptions, deductions)</td>
<td>√</td>
<td>61</td>
<td>57</td>
<td>33</td>
<td>10</td>
</tr>
<tr>
<td>Social security incentives</td>
<td>√</td>
<td>35</td>
<td>62</td>
<td>15</td>
<td>23</td>
</tr>
<tr>
<td>Ease transition from unemployment into self-employment</td>
<td>√</td>
<td>65</td>
<td>29</td>
<td>63</td>
<td>8</td>
</tr>
<tr>
<td>Ease transition from employment into self-employment</td>
<td>√</td>
<td>44</td>
<td>15</td>
<td>77</td>
<td>8</td>
</tr>
<tr>
<td>Changing minimum wage upwards</td>
<td>√</td>
<td>48</td>
<td>24</td>
<td>59</td>
<td>18</td>
</tr>
<tr>
<td>Changing minimum wage downwards</td>
<td></td>
<td>9</td>
<td>0</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Training &amp; support to business start-ups</td>
<td>√</td>
<td>61</td>
<td>50</td>
<td>46</td>
<td>4</td>
</tr>
<tr>
<td>Micro-finance to business start-ups</td>
<td>√</td>
<td>52</td>
<td>48</td>
<td>52</td>
<td>0</td>
</tr>
<tr>
<td>Advice on how to formalise</td>
<td>√</td>
<td>61</td>
<td>33</td>
<td>67</td>
<td>0</td>
</tr>
<tr>
<td>Connecting pension schemes to formal labour</td>
<td>√</td>
<td>61</td>
<td>47</td>
<td>41</td>
<td>12</td>
</tr>
<tr>
<td>Introducing supply chain responsibility</td>
<td></td>
<td>17</td>
<td>78</td>
<td>0</td>
<td>22</td>
</tr>
<tr>
<td>Restricting free movement of (foreign) workers</td>
<td>√</td>
<td>43</td>
<td>29</td>
<td>53</td>
<td>18</td>
</tr>
<tr>
<td><strong>Curative measures:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stimulate purchasers to buy declared:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Service vouchers</td>
<td>√</td>
<td>26</td>
<td>58</td>
<td>42</td>
<td>0</td>
</tr>
<tr>
<td>Targeted direct tax incentives</td>
<td>√</td>
<td>61</td>
<td>65</td>
<td>29</td>
<td>6</td>
</tr>
<tr>
<td>Targeted indirect taxes</td>
<td></td>
<td>17</td>
<td>63</td>
<td>25</td>
<td>13</td>
</tr>
<tr>
<td>Stimulate suppliers to formalise:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Society-wide amnesties</td>
<td></td>
<td>9</td>
<td>10</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Individual-level amnesties for voluntary disclosure</td>
<td></td>
<td>17</td>
<td>75</td>
<td>25</td>
<td>0</td>
</tr>
<tr>
<td>Formalisation advice to business</td>
<td>√</td>
<td>30</td>
<td>44</td>
<td>56</td>
<td>0</td>
</tr>
<tr>
<td>Formalisation support services to businesses</td>
<td></td>
<td>30</td>
<td>57</td>
<td>29</td>
<td>14</td>
</tr>
<tr>
<td>Targeted VAT reductions</td>
<td></td>
<td>17</td>
<td>43</td>
<td>43</td>
<td>14</td>
</tr>
<tr>
<td>Free record-keeping software to businesses</td>
<td></td>
<td>13</td>
<td>50</td>
<td>50</td>
<td>0</td>
</tr>
</tbody>
</table>
Citizens abide by the law either (1) because they fear detection and fines due to the power of authorities (enforced compliance) or (2) because they feel a commitment to be honest and have trust in the authorities (voluntary co-operation). In Croatia, much of the emphasis until now has been on pursuing enforced compliance, not voluntary co-operation. Moreover, enforced compliance has been largely sought not by providing incentives to operate in the declared economy but by increasing the perceived and/or actual costs of working in the
undeclared economy. This has been achieved firstly, by raising the penalties and sanctions for engaging in undeclared work and secondly, increasing the perceived and/or actual risk of detection.

4.3 Direct controls: penalties and sanctions

Analysing the actual penalties and sanctions for undeclared work, the past years have seen alterations. The new 2014 Labour Act (Official Gazette, 2013b) reduced the number of penal provisions from 140 to 87, which is a reduction of 53 violations. This might be seen in the light of an increase of the financial penalty related to undeclared work. On the other side, administrative sanctions were introduced. These changes gave labour inspectors the opportunity to order some activities or to prohibit specific activities instead of having the possibility only for financial sanctions.

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

Table 3: Overview of financial penalties imposed by Labour Inspectorate in HRK, based on legislation valid in February 2017

<table>
<thead>
<tr>
<th>Act and Article</th>
<th>Businesses</th>
<th>Responsible person in the business entity</th>
<th>Physical persons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labour Act – Article 229⁹</td>
<td>61,000 – 100,000</td>
<td>7,000 – 10,000</td>
<td>7,000 – 10,000</td>
</tr>
<tr>
<td>Minimum Wage Act</td>
<td>60,000 – 100,000</td>
<td>7,000 – 10,000</td>
<td>7,000 – 10,000</td>
</tr>
<tr>
<td>Foreigners Act – Article 226</td>
<td>50,000 – 100,000</td>
<td>10,000 – 50,000</td>
<td>7,000 – 15,000</td>
</tr>
<tr>
<td>Pension Insurance Act – Article 171</td>
<td>5,000 – 50,000</td>
<td>1,000 – 10,000</td>
<td>1,000 – 10,000</td>
</tr>
</tbody>
</table>

Note: Based on the EU-SILC, the average annual gross income in 2015 was HRK 41,667.
Source: Presentation Labour Inspectorate, 24 January 2017

⁹ Article 14, §3 – §5: … for failing to deliver to the worker a letter of engagement prior to the start of employment, where the employer fails to conclude a written employment contract with the worker, or for failing to deliver to the worker a copy of the application for mandatory pension and health insurance within the stipulated deadline (Article 14, paragraphs 3 and 5) failing to deliver to the worker a letter of engagement prior to the start of employment, where the employer fails to conclude a written employment contract with the worker, or for failing to deliver to the worker a copy of the application for mandatory pension and health insurance within the stipulated deadline (Article 14, paragraphs 3 and 5).
During meetings, some stakeholders argued that the current penalties are too harsh for the offense, or have a disproportionate impact on the firm, because inspections in small offending firms may result in an end to their business activity. This is not necessarily a desired outcome if transforming undeclared work into the declared economy is the goal.

Indeed, financial penalties related to undeclared work have doubled in the most recent version of the Labour Act (Article 229). While in the previous edition, fines for engaging in undeclared work imposed on businesses ranged from HRK 10,000 to HRK 50,000 (HRK 5,000 HRK – HRK 20,000, for natural persons)\(^1\), in the new version of the Labour Act financial penalties increased to a minimum of HRK 61,000 and maximum of HRK 100,000 for businesses (HRK 7,000 – HRK 10,000 for physical persons).

Obviously, there is a certain un-proportionality regarding the fines to be imposed for violations of the labour law. Offences of different seriousness are sometimes punished with the same amount of fine, whilst the severity of the violation differs, and with regard to intents and purposes of justice it would require a more distinct punishment, exactly taking into account the seriousness of the offence. As for example, failing to keep records on workers and working times is a most serious offence under art. 229 Labour Act where the offender, as shown in Table 3, is punishable by a fine ranging from HRK 7,000 to HRK 10,000 (employer-natural person) resp. HRK 61,000 to HRK 100,000 (employer-legal person). This very narrow range of minimum and maximum fine does not allow one to adequately treat cases of different seriousness (e.g., non-recording of the working hours of a worker with the offence committed over a short or a long period of time).

It can be recommended to focus upon this issue since courts are always bound to decide on the base of justice and principles of proportionality, and can be reluctant to impose almost the same fine (in the example mentioned, the minimum fine is already 70% resp. 61% of the maximum; providing very small margin for an appropriate fine) for violations of the law that may differ markedly as to their seriousness and implications. This problem has been shown using the example of non-recording the working hours but the reflections on the issue apply to most offences under the laws mentioned in Table 3. Although stakeholders voiced concerns regarding the level of penalties, not least with respect to proportionality, i.e., being too harsh, it is here argued that penalties are not in need of reduction as this might negate the power of authorities and thus the ability of the state to pursue enforced compliance.

On the other hand, the survey developed and conducted under activity 4.3 of this twinning project has established that most individuals questioned suggested to introduce higher fines and stricter punishment for both employers and employees; obviously in

expectance of a deterring and more punitive effect towards individuals engaging in undeclared work. Indeed, research has detected that fines and punishment do not exert a negative influence on undeclared work, while the subjectively perceived risk of detection does (Schneider et al., 2016).

Since previous research (Grasmick et al., 1980) has also shown that there is no association between the perceived severity of punishment and the likelihood of participating in illegal activities (regardless of the kind of crime, be it homicide or tax evasion; a conclusion that is therefore to be deemed valid for undeclared work as well), but that involvement in illegal behaviour is inversely related to the perceived certainty of punishment; the focus of attention regarding alterations in the sanctions system should not be to simply raise the minimum fines. Instead, besides the need to improve the current policy on detection measures and thereby to improve the certainty of detection, it is to be considered to only widen the spread of fines; which may be done by only raising the maximum fine but not the minimum fine, in order to give the deciding bodies a more broadly conceived margin to impose penalties which will be perceived to be more just by the public. In addition to that, there is a need to give more emphasis to improving trust in authorities and therefore voluntary compliance, discussed later.

Aside from satisfying the need of improvement of detection measures, an approach that will be argued on in the next chapter, one of the foci regarding sanctions for participation in undeclared work ought to be on accelerating misdemeanour proceedings, since misdemeanour proceedings related to undeclared work have proven to be protracted as well as inefficient with regard to the outcome – as the Labour Inspectorate reported in several meetings. This may be done by changing the way the proceedings are initiated and brought to court. Currently, if misdemeanours are detected during labour inspections, the Labour Inspectorate will refer the case to the Misdemeanour Court by bringing an indictment. The court’s decision will usually be made months or even years later and frequently fines are reduced or suspended or court proceedings are even terminated due to limitation.

As an alternative model for handling such proceedings, as is done in misdemeanour cases within the Tax Authority’s field of competence, these cases should be referred to a Panel for Misdemeanour Proceedings within the Labour Inspectorate, which should be endowed to decide whether legal provisions have been breached and misdemeanours have been committed, and to decide what fine to impose by delivering a written penalty notice to the perpetrator. It would then be up to the offender whether s/he makes use of his or her right to appeal (e.g., to the LI’s Central Office) or through initiating court proceedings. Using this model would speed up the process of penalising and therefore increase the certainty of punishment.
The current legal framework related to undeclared work does not provide any stipulation that penalises employees who work undeclared (besides the general provisions of the Misdemeanour Code regarding incitement and aiding and abetting). It is self-evident that this does neither provide an effect of deterrence nor an incentive to law-compliant behaviour. Especially with regard to workers registered unemployed and receiving social benefits while indeed not being unemployed but working undeclared, a lack of regulation was detected. While in other European countries such behaviour is penalised at least as a misdemeanour or even as a crime (as is fraud), in Croatia there is no special provision punishing the unduly receipt of unemployment benefits and the provision of the Criminal Code regarding fraud is not applied on employees when detected during an inspection. Since – as figured out above – the likelihood of compliant behaviour does not necessarily correlate with the severity of the prescribed penalties, priority does not absolutely have to be with introducing a new fine for such behaviour, but with regard to the situation that Croatia is in, other measures seem to be more urgent to be introduced.

As reported by the stakeholders, in cases of workers unduly receiving unemployment benefits being detected during an inspection, further payment usually will be stopped; but even when detecting that benefits have been unduly received for a long period of time, not only a penal sanction is not applied but even a reclaim will not be made. This does not only represent a practice that seems to be inappropriate in a state under the rule of law, but is also an incentive to undeclared work where the perpetrator does not have to fear any consequence but stopping of the allowance that s/he illegally receives; and since the risk of detection is quite low at the moment (due to a low number of inspections), this incentive to perform undeclared work is even enlarged. It is therefore necessary to not only stop further payment, but also to immediately assess and reclaim all benefits unduly received in the past. Following these thoughts, attention should be paid to dispossessing the perpetrator – be it employer or employee – of any material gain respectively any pecuniary advantage obtained through illegal behaviour, as is mandatory under Croatian criminal as well as misdemeanour law. This refers to the financial advantage the employer generates by employing workers without contract or residence permit instead of employing them in a manner respecting the law, or by non-registering his or her employees to social security and tax, and refers as well to employees unduly receiving social benefits as stated above. The legal framework to assess and seize these values already exists in Croatia and therefore just needs to be applied.

Definitely, attention should be paid to using this instrument as it represents a highly effective tool of enforcing compliance on employers and employees, giving a disincentive to

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engage in undeclared activates since perpetrators face the loss of all material gains they derived by breaching the law; a consequence that may be more deterrent than a penal sanction. Obviously, this requires greater resources to be dedicated to it, and the use of such measures on a regular basis requires a process of co-ordination and the application of procedural rules between the bodies detecting the misdemeanour (be it Labour Inspectorate, Tax Authority or others) and those competent for the forfeiture proceedings. For that reason, it can only be proposed to take into consideration the use of such measures in future policy on undeclared work. Besides providing the deterrent effect figured out, if this occurs, the tax base for example can be broadened, enabling future decreases in tax rates.

Overall, therefore, altering the sanctions and penalties by simply raising or lowering them should not be the focus of attention of a national action plan for tackling undeclared work. However, given that the perceived risk of detection is significantly correlated with the likelihood of participation in undeclared work, improving the probability of detection does require attention.

4.4 Direct controls: detection measures

Until now in Croatia, the vast majority of measures pursued to tackle undeclared work have been focused on improving the perceived and actual risk of detection. Enforced compliance has been sought, therefore, not by providing incentives to operate in the declared economy, but by increasing the perceived and actual risks of detection, so as to increase the perceived and actual costs of working in the undeclared economy.

To evaluate the overall effectiveness of these measures to increase the risk of detection, the 2013 Eurobarometer survey examines how Croatian citizens view the perceived risk of detection. This reveals that despite all the efforts, the perceived risk of being detected and punished among Croatian taxpayers is still quite low. According to the 2013 Eurobarometer survey on undeclared work, 59% of respondents see this risk as small or fairly small (see Figure 8). On the other hand, only 9% think the risk is very high, while 24% think it as fairly high. As such, the perceived risk in Croatia is slightly below the EU27 as a composite, where 53% of respondents perceive it as small or fairly small.

A perception of the authorities as an all-knowing and all-seeing ‘big brother’ is therefore absent in Croatia. Put another way, the emphasis until now on increasing the perceived and actual risk of detection does not seem to have had the desired effect. The majority of Croatian citizens perceive there to be little risk of detection. Here, therefore, the measures so far pursued are reviewed, and various means of improving the perceived and actual risk of detection advocated.
Figure 8: How people perceive the risk of being detected, comparison of Croatia and EU27, in %

Source: European Commission (2014b)

**Data mining, matching and sharing**

Data mining refers to the set of automated techniques used to extract buried or previously unknown pieces of information from large databases. Data matching refers to the large-scale comparison of records or files collected or held for different purposes, with a view to identifying matters of interest. By data matching two or more sets of collected data are compared. Data sharing, meanwhile, is the process of making data available to other users (De Wispelaere and Pacolet, 2017). In recent years, the detection of undeclared work has turned increasingly to these processes of data mining, data matching and data sharing. The perception is that this is a more effective means of detecting undeclared work. With a view to data mining, matching and sharing it can be pointed out that a huge amount of data-sharing and data exchange takes place between all the institutions and authorities in Croatia.

On the first point, it can be noted that the Tax Administration is the major ‘holder’ or ‘keeper’ and recipient of data throughout Croatia together with the Pension Insurance Institute. The Tax Administration hosts the so called “OIB-Database”, a database of personal-identification numbers of every Croatian citizen and legal person. Also, it receives the JOPPD-form and shares data out of this form inter alia with the Croatian Employment Service, the Health Insurance Fund and the Pension Insurance Institute. The Pension Insurance Institute receives this data-set from the Tax Administration on the other hand, but also gets information with a registration form, which the employer has to provide to the Pension Insurance Institute before an employee starts working. It shares some of this data inter alia with the Tax Administration, the Health Insurance Fund and the Labour Inspectorate. Secondly, the Croatian Employment Service, the Ministry of Demography, the
Health Insurance Fund receive data from the above mentioned two institutions and vice versa share some of their own data electronically between all or some of the Croatian institutions.

Additionally, some institutions do not share, do not share electronically, or share only a small amount of their data, with other institutions. These institutions are the Customs Administration, the Border Police and also the Labour Inspectorate. More precisely, the Labour Inspectorate for itself do not participate in electronic data-sharing at all, but is capable in accessing parts, respectively from the Pension Insurance Institute, of the data through web-interfaces which are needed to perform its own tasks. A reason for this kind of data-exchange is the lack of powerful IT hardware. When the Labour Inspectorate detects violations which also impacts on other institutions, this information is shared in paper form.

**Existing databases and data sharing across government**

*Labour Inspectorate (LI)* – The Labour Inspectorate does not share its own digital data with anybody. Furthermore, the LI only have access to different other databases which can be accessed through the internet (public databases) or via web-interface (LANA, HZMO-UPIT). In cases where no digital data access is possible, or in cases where detailed information is needed, the LI have to write an inquiry by letter or email to the relevant institutions. If the LI find irregularities throughout an inspection, they usually inform the other authorities by email or letter when it is perceivable that the information is also important for this institution.

*Tax Administration (TA)* – The server environment of the TA hosts in total the most important databases for Croatia. Inter alia it hosts the OIB-Database and the “EDIP-Database/Application” which includes data out of the JOPPD-form. The TA is on the other hand responsible for hosting these databases or applications, but also for sharing the data regarding the other authorities and institutions. Since only the tax administration receives the so called JOPPD-form and the fact that this form includes information not only for the TA, but also for all other relevant institutions, data sharing is crucial and indispensable.

*Croatian Pension Insurance Institute (CPII)* – Similar to the Tax Administration, the OIB-System and the JOPPD-form serve as major sources for the database used at the CPII. Another very important source is the registration form, which the employer has to provide to the CPII before an employee starts working. In this document, data about the employer, employee, details about the work (what kind of work, starting date, ending date, full-time or part-time, etc.) is included. This form has to be provided in digital form. Only employers with three or less employees are allowed to submit it manually in paper form. After the data is submitted by the employer, the data is cross-checked with other databases, especially the Tax Administration (JOPPD) and the Croatian Employment Service.
The CPII actually shares data with the Labour Inspectorate, the Croatian Employment Service, the Health Insurance Fund, the Tax Administration, REGOS and the Bureau of Statistics. The CPII states that data-sharing was established to make the administrative-system in Croatia easier to use on the whole and understandable for everybody. Before this, every employer and also every citizen of Croatia had to submit the relevant data to every institution separately. This was an enormous amount of bureaucracy which has vanished nowadays.

Throughout the second meeting at the CPII, the experts were shown a perfectly prepared presentation, which is actually one of the best possibilities to understand the whole Croatian database system. It is not only tailored for the CPII, moreover it gives a perfect overview about data-sharing within the major authorities and institutions in Croatia. Figure 9 shows an example of the presentation:

Figure 9: Scheme of data-sharing between relevant Croatian institutions

The CPII has provided also the information that an authority or institution in Croatia is only allowed to share its own data. If somebody requests access to this data, each institution checks for itself if the access could be granted or not within the legal framework. Data which has been shared or accessed from others is not allowed to be shared with somebody else. So if for example the Labour Inspectorate asks the CPII for information about an employee and its income, the CPII will share their own information about the employee, but not the
information about his or her income. This is the case, because the Tax Administration is the owner of that part of the data.

**Customs Administration (CA)** – the Customs Administration has actually no access to the databases of other authorities. Also there is no data provided online to other authorities. Data is shared only on paper or email as stipulated by the legal framework. One standard procedure is data-sharing with the Tax Administration, the Social Service and the Croatian Employment Service. After an inspection has taken place, copies of the whole case are forwarded to these three institutions by paper. This has to be done by law.

**Border Police (BP)** – The police as part of the Ministry of Interior have its own database and share nothing at all. This database includes information about every case the Police has ever had. It also contains information about court decisions, violations and even some kind of risk management. Through this database, the Police are capable to co-ordinate operations in a good strategic way. The Police receive information from many different institutions. For example, the Ministry of Tourism sends data when someone rents a holiday apartment. The owner has to collect the personal data of the person who will live in his or her apartment and transfer it to the Police. Also hotels and other institutions are obliged to transfer this data instantly.

**Ministry of Demography, Family, Youth and Social Policy (MD)** – The Ministry of Demography operates an internal web service called “SOCSKRB”. The “SOCSKRB” can be only accessed through entitled persons. It contains data out of nine databases throughout Croatia, for example the OIB-database, EDIP, database of Employment Service, FINA, REGOS and some more. This web service has the purpose to help social workers and the Ministry of Demography to make the right decisions regarding the payment of social benefits or the allocation of assistance services. There is an automated daily cross-check of the data with the Croatian Employment Service in the case when one of the both institutions grants some benefits to somebody. In all other cases, the data has to be requested in writing. Due to the highly sensitive data which is stored inside the SOCSKRB, an entitled person can only see the data which is crucial for his or her actual case. The data is rated so highly sensitive because it contains data-sets about whole families, pictures of their living situation and also cases of child-abuse.

**Ministry of Economy, Entrepreneurship and Crafts (MEEC)** – The MEEC operates the so-called ‘Trade and Crafts Register of the Republic of Croatia’. Every trading and crafting company has to be registered in this electronic register. If somebody wants to register their company, s/he has to visit one of the local municipal offices or register online (available only in some regions). S/he has to provide all kinds of data, such as personal data, business purpose and business addresses. After that registration they have to register within eight days also with the Tax Administration (JOPPD-form/see Tax Administration). The MEEC also operates a
Website portor.hr where anybody can make online queries about registered companies. As a result of a query, the user gets the available public information about a specific company. These online queries could be made directly via or.minpo.hr/pretraga.htm. Data like notes of the MEEC itself, bank account information or personal contact information are not public available and can be only accessed through the MEEC. The MEEC shares some information with the Ministry of Regional Development and the Official Gazette. Both are rather unimportant for the purpose of tackling undeclared work.

If the MEEC needs additional data about a specific company, it has to make queries in paper form (or email) to each respective institution. The MEEC has actually no online connection to other authorities. It also gets no information about findings from any other institutions. It was assumed that that information is mostly forwarded directly to the municipal offices without notice of the MEEC itself. The municipal offices forward that information for their part also to the responsible institutions which are capable of making inspections or audits.

*Croatian Employment Service (CES)* – The Croatian Employment service is actually connected to many different databases. The major important databases are REGOS, OIB and their own database. There are also connections to the Ministry of Demography (especially the Family Institute). It is intended in the near future to share data also with the Ministry of Education regarding working students, who also get benefits from the Croatian Employment Service. The Croatian Employment Service actually has no connection to the EDIP-database, but gets information when somebody starts working legally and does get benefits from the Employment Service.

*Croatian Health Insurance Fund (CHIF)* – Similar to the other institutions the OIB-System and the JOPPD-form serve as major sources for the database used at the CHIF. The CHIF operates also its own data base. Certain institutions like the CPII and TA that work with related data have access to this data. They can see data just related to their competences related to acquiring health protection.

*Improving data mining, matching and sharing.*

Despite the development of these databases across the bodies responsible for tax, social security and labour law compliance, there currently remains a lack of a fully co-ordinated approach to data sharing. A central database on employment status and employment relations in Croatia does not exist and, although there are about 200 different databases or registries on this issue, there is no adequate interconnection among them. However, there has been some minor improvement in this field since the introduction of personal identification numbers for citizens and companies in 2009 (Bejaković, 2012).
Two key reforms that aim at increasing the effectiveness of the social welfare system were conducted recently. Firstly, a new information system that interconnected databases of Ministry of Social Policy and Youth, Ministry of Interior, Tax Administration, Croatian Employment service and Financial Agency was introduced in January 2014. Apart from data about income, the system also enables insight into the ownership of bank accounts, real estate and stocks. As such, this application enables authorities to check one’s eligibility for benefits and easily eliminate from the welfare program all those who were falsely claiming benefits. Until now, there is no official data on results of this innovation.

Another more integrated and comprehensive approach is to create one specialist unit that gathers information and conducts data mining investigations into undeclared work. This unit would produce reports on the undeclared economy and investigate using data mining specific organisations and persons suspected of engaging in undeclared work at the request of other organisations, such as the labour inspectorate, Ministry of Finance and social security institutions. This unit would have the power to obtain information from the authority that requests the compliance report. The unit would not charge for the preparation of compliance reports and would be entitled to obtain the necessary information free of charge. A compliance report can be used only for the requested purpose, although it can be used as basis for another report requested by the same authority on the same subject (see Box 1).

Box 1: Joining-up data mining

**Initiative:** Grey Economy Information Unit *(Harmaan talouden selvitysyksikkö)*, Finland  
**Aim:** To join-up the previously fragmented function of data-mining  
**Description:** In Finland, data mining is the responsibility of the Grey Economy Information Unit *(Harmaan talouden selvitysyksikkö)*. Established on 1 January 2011, this specialist unit within the tax administration (in the Ministry of Finance) gathers information and conducts investigations into undeclared work. This unit produces reports on the undeclared economy and investigates specific organisations and persons suspected of engaging in undeclared work at the request of other organisations, such as the police, customs bureau and Finnish Centre for Pensions as well as authorities dealing with work safety, debt recovery and bankruptcies. The unit has the power to obtain information from the authority that requests the compliance report. A compliance investigation can also be a general phenomenon report. The unit does not charge for the preparation of compliance reports and is entitled to obtain the necessary information free of charge. A compliance report can be used only for the requested purpose, although it can be used as basis for another report requested by the same authority on the same subject. The Grey Economy Information Unit is authorised to keep a database within the meaning of the Data Protection Directive *(95/46/EC, 1995)*, containing information necessary for the preparation of reports. The data controller is the tax
Evaluation: Its budget in 2011, the unit’s first year, was €1.6 million and €1.9 million in 2012. Some 20 persons are employed. After a year and a half of operation, the unit completed over 40 information gathering and dissemination tasks. It also produced approximately 11,000 compliance reports to other authorities (this mandate started in July 2011). During 2011, 732 tax audits were conducted on information provided, resulting in €42 million of undeclared wages and €65 million in undeclared sales being recovered (Virtanen, 2013).

Notification letters

Another method to deter engagement in undeclared work is to use notification letters that notify businesses that they may be inspected in the near future, so as to encourage voluntary compliance without the need for a workplace inspection, or that they may be audited in future after submitting their tax return. These may also contain normative information on why it is important to be compliant and not to use undeclared work. For example, in 2008, the Estonian Tax and Customs Board sent notification letters to companies with low wage levels compared with the average level in the region and the respective business sector. These notification letters informed the employers of the low competitiveness of their wage levels compared with average wage levels. As a result, 46 per cent of the companies receiving these letters adjusted their wage levels and increased their tax payments. After four months, the notification letters had brought an additional EEK 10 million (about €640,000) of tax income, including EEK 8.8 million from notifications sent to enterprises and EEK 1.2 million from those sent to individual employees (Anvelt, 2008; Levit, 2008; Rum, 2008; Tubalkain-Trell, 2008).

This could be more widely applied. Although it is not a substitute for labour or tax inspections, it is a cheap means of deterring engagement in undeclared work that could be more commonly used to prevent on-going participation in the undeclared economy. Indeed, notification letters may be particularly useful when used as a follow-up to a data mining exercise to identify businesses who are found to be ‘outliers’ on various indicators (e.g., who have higher than average expenses, higher ratios of credit card to cash payments compared with other similar businesses, lower than average wage levels, or a relatively low number of registered employees for their turnover). Indeed, in some inspectorates, the use of dynamic benchmarking, such as the UK and Belgium, where the data determines what the norm is, is being used to identify outliers to whom notification letters are sent. An example is the hotel sector in the UK where turnover to credit card transaction ratios are being used to identify outlier hotels where turnover is closer to the total credit card transactions than is the norm. This dynamic benchmarking of the hotel sector can also occur on an individual city level or for a particular type of accommodation provider, since credit card to turnover ratios are higher.
in large London hotels than in smaller hotels in smaller towns. This then enables very targeted notification letters where the evidence can be presented. Indeed, based on this dynamic benchmarking approach, the UK tax administration authority (HMRC) has used its databases to identify and send 460,000 notification letters to outliers in order to ‘nudge’ behaviour towards tax compliance.

Indeed, this use of notification letters to ‘nudge’ changes in behaviour has become ever more popular, with Australia, Canada, France, the United States and Switzerland among the countries to have followed the example above of the UK where a ‘nudge unit’ was established in 2010. However, the evidence of the effectiveness of ‘nudge’ letters is far from convincing. In Canada, Beeby (2017) reports how 8,000 taxpayers who had been assessed as owing up to $950 in taxes but had not paid were in 2014 targeted. A half received friendly encouragement ‘nudge’ letters and a half were threatened with punishment. They found that the friendly nudge letters collected 12 per cent more taxes owed than the standard punitive letter. However, in March 2016, a similar campaign involving 6,877 taxpayers failed, with those receiving the punitive notification letter paying more than those receiving the friendly nudge letter. The cost of the 2016 experiment, nevertheless, was low at $17,400. There is a need, therefore, for much more experimentation with the use of notification letters before any firm conclusions can be drawn.

*Improving the effectiveness of workplace inspections*

One of the most prominent and common measures used to increase the perceived or actual likelihood of detection is the workplace inspection. This is a core tool for increasing the perceived and actual probability of detection. To improve the effectiveness of workplace inspections as a tool for increasing the perceived or actual risk of detection in Croatia, several initiatives are required.

*Firstly*, there is a need to make greater use of data mining and matching to identify both ‘at risk’ sectors and businesses, perhaps using dynamic benchmarking so as to identify anomalous/outlier cases (e.g., by identifying those with lower than average wage levels, or a relatively low number of registered employees for their turnover). This information can then be used to conduct more targeted inspections of individual businesses. If this is pursued, this will require a division of labour of staff within the LI with some staff with suitable capabilities and skills to devote their time to data mining and matching.

*Secondly*, the use of notification letters should be developed. Pilot studies should be conducted comparing the use of notification letters with positive ‘nudge’ messages about the benefits of declaration and the use of notification letters with more stern warnings. This could be combined with pre-announced inspection visits, which might also be used in particular localities and/or sectors whereby businesses are informed that a visit from the inspection
authorities is to occur. Such targeted inspections, nevertheless, should not entirely replace regular random inspections since these have a strong deterrent effect.

Thirdly, there is currently a lack of training of inspectors in the realm of tackling the undeclared economy. This applies not only to labour inspectors but also to tax and social security inspectors. A national training policy for labour inspection, for example, is required which should be part of the strategic plan and policy. One way forward in this regard is to make use of the ILO training package for labour inspectors in tackling undeclared work, which is a free training package available to the Croatian labour inspectorate (see http://www.ilo.org/labadmin/info/inst/WCMS_422044/lang-en/index.htm).

Fourthly, the Labour Inspectorate suffer from a lack of inspectors: Despite art. 6 § 4 Labour Inspectorate Act providing the number of inspectors to be approx. one inspector per 4,000 to 5,000 workers (while on average approx. 1.5 million persons work in Croatia), and although stated by the Regulation on the Internal Organisation of the MoLPS (Official Gazette, 2017) the number of LI officials should be 277, less inspectors are appointed in fact. According to the Report on the work of the Labour Inspectorate in 2016 (Labour Inspectorate, 2017), by the end of 2016 there were only 224 inspectors and 11 other officials; 120 of whom working in the field of undeclared work. The decreasing number of inspectors (256 in 2013 dropped to 224 in 2016) in the last years among other factors resulted in a decrease in inspections (15,665 supervisions in the year 2012 dropped to 8,444 in 2016).

Referring to the facts stated above, hiring additional labour inspectors should be taken in consideration, resulting in the Labour Inspectorate’s capability to conduct a higher number of inspections. Currently, it can be argued that there is potentially a lack of sufficient state budgetary funds granted to the Labour Inspectorate. However, it needs to be recognised that this not a cost but an investment since additional funds will lead to a higher number of inspections which will lead to an overall budgetary surplus by increasing the social contributions collected, a broadened tax base and economic subjects transited from undeclared activities to declared work by means of increasing risk of detection.

An immense impediment for hiring new inspectors – besides being non-budgeted – is the Labour Inspectorate Act’s requirement of a law degree for all applicants. In general, besides being regarded as some kind of sacrosanct heritage in the administrative culture of Croatia, no specific need can be defined for each inspector to be a graduate in law. Especially as labour inspection is not only about dealing with most challenging legal issues and since based on years of experience in other countries, where even though only a small number of labour inspectors holds a law degree, good work results are achieved, it should be considered to open the occupation of labour inspector to undergraduates or to institute a career of assistants to labour inspectors, to whom could be appointed tasks like inspections in the field (including establishing workers’ identity, fetching the necessary documents in inspected
businesses) as well as assistant work as clerks or secretaries in the inspectorate etc.; while labour inspectors could focus on more challenging tasks; e.g., preparing indictments and final reports, assessing the results of inspections performed by their assistants etc. An additional task to be performed by others than labour inspectors may be the job of accountant officers, able to audit the accounting of employers; a task of huge significance in connection with the introduction of a risk-based approach towards inspections.

For the labour inspectors, applying the principle of a division of labour should be considered a means of relief from routine tasks, allowing them to concentrate on more difficult tasks and increasing the number and quality of inspections they can perform. There is also a need for the appointment process of labour inspectors to be considered in terms of the length of time it takes for new labour inspectors to be appointed, since actually – as stakeholders reported – it takes a labour inspector up to 12 months from application to appointment. Therefore, recruitment and application process of new inspectors should start during their last year of university studies and not afterwards.

Fifthly, there is currently an under-emphasis on the educational or promotional function of labour inspectors to increase awareness among businesses and workers about the rules on undeclared work and how such situations can be avoided or regularised. Instead, they largely view themselves as enforcers handing out fines and penalties. The overall balance between preventive and enforcing services is not systematic or based on strategic objectives, even though such a balance is important for promoting a culture of compliance. Currently, it does not appear that notifications and/or warnings (e.g., improvement or compliance orders) are used to their full potential or in a more regular way. A greater focus upon the preventative role of the labour inspectorate (and tax and social security inspectorates) rather than the enforcement role would therefore be a useful development. This could include the development of educational materials on the benefits of declared work, a FAQ section on their websites and a more customer-friendly approach, all of which would facilitate the further development of their more facilitative preventative role.

Sixth and finally, and from a business perspective, joint inspections of the various inspectorates responsible for labour law, tax, pensions and health insurance, would be a customer-friendly development. At present, however, this is rarely undertaken. There are very few co-ordinated inspections. Data mining, matching and sharing, however, could provide the basis not only to better target the visits but also to elaborate a co-ordinated joint visit plan (taking into consideration the economic sectors, the seasonality of tourism, the local realities etc.).
Supply chain responsibility

Enhancing the risk of detection does not always have to be government-led. It can also be social partner led. Some 17% of European countries have introduced supply chain responsibility in an attempt to tackle undeclared work. In those countries which have done so, 78% of stakeholders view it as an effective policy instrument and the remaining 22% as ineffective. To see how this operates in practice, a case study is provided of the implementation of supply chain responsibility in Finland (see Box 2). This can also be undertaken on a voluntary basis by employers. Employer representative organisations in Croatia might wish to pursue such a voluntary initiative within the context of their corporate social responsibility agendas so as to provide a ‘demonstration effect’ of how they are taking the problem of undeclared work seriously.

Box 2: Introducing supply chain responsibility

Initiative: Contractor's Obligations and Liability Act, Finland

Aim: To reduce the presence of undeclared work in supply chains

Description: The 2006 Contractor’s Obligations and Liability When Work Is Contracted Out Act requires that the party responsible for a construction project obtains necessary guarantees that subcontractors fulfil their various obligations. The law has been in effect since 2007, but obligations in construction sector expanded in 2012. The 2006 legislation originally exempted established subcontracting relationships from a background check, but this hampered the enforcement of the legislation. These have now been included, as has accident insurance been included on the list of items that now needs checking. The objective of the original legislation as well as the 2012 amendments has been to combat the undeclared economy and promote fair competition between companies, particularly in the construction sector. Long subcontracting chains lead to situations where work is carried out without withholding employee taxes, making VAT payments, making pension payments, or observing conditions laid out in collective bargaining agreements. The legislation placed the responsibility on the users (which tend to be larger businesses) of subcontractors and temporary work agencies that these subcontractors and employment agencies meet their obligations. Contracting parties are required to ask for and obtain documents that verify certain registrations and payment of taxes as well as a reference to applicable collective bargaining agreements or corresponding conditions. Depending on the results of the background check, contracting may be subject to a penalty. The contracting party must inform its employee representatives of subcontracting or the use of employment agency workers. The act is limited to work taking place on the premises or site of the contracting party by employees of a subcontractor or an employment agency.
Evaluation: An early evaluation of the measure found that the law and its contents were known, although this questionnaire-based evaluation also revealed some companies were unaware of them (predominantly small companies). There was more uncertainty of the law’s applicability in different sectors and situations, but most respondents regarded it as useful in raising the issue of employer obligations in contracting decisions so as to avoid undeclared work occurring. One problem identified by the respondents of the early evaluation was the additional work required by contracting companies. So too was getting the required information on foreign companies identified as a problem, the penalties were viewed as too low for some situations and the omission of accident insurance from the documents to be requested was considered a problem. This feedback was taken into account in the 2012 amendments. This set the penalties higher at between €16,000 and €50,000 depending on the size of the contract, included accident insurance on the list of documents to be collected, and dropped existing business relationships from exemption because of the prior difficulties of verifying this. In 2010, there were 872 investigations by the authorities (50% in the construction sector). In total, 2541 contracts were examined and half found to contain violations. By March 2011, penalties totalling €302,500 had been imposed based on the 2010 investigations (Alvesalo and Hakamo, 2009; Työ-ja elinkeinomisteriö, 2011).

Certified cash registers

In order to reduce the possibility for non-compliance, the Croatian government introduced certified cash registers on 1 January 2013. The system is quite similar to those in other countries: every receipt for a cash transaction is electronically signed and delivered automatically to the Tax Administration by using specialised cash registers (Official Gazette“, No. 133/12).

Although this measure applies to the majority of the subjects that are obliged to issue a receipt for delivered goods and services, there are some activities exempted from the law. For instance, activities such as the sale of home-grown agricultural products on a bazaar, sale of travel and lottery tickets, or the provision of banking and postal services are not included. Since 1 July 2017, the obligation to issue a receipt using a certified cash register is extended to all subjects issuing receipts for delivered goods or services.

In order to enhance enforcement of this measure, the Tax Administration launched a special website where citizens can check whether the receipt they received for purchased goods and services was declared to the authorities. There is also a free phone line for reporting violations concerning the issuance of fiscal cash receipts. Shortly after introducing

12 http://apps.jutarnji.hr/fiskalizacija/
13 http://www.provjeri-racun.hr/
the obligatory certified cash registers, the measure was supported also by a nation-wide receipt lottery.

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

This survey also shows that 32% of respondents changed their behaviour after the introduction of fiscal cash registers, i.e., while they did not have a practice to take receipts in stores, restaurants etc. prior to the introduction, now they do. That increase is certainly a result of the high media coverage that accompanied this innovation, and also the lottery providing a rationale for requesting a receipt. In that light, the introduction of certified cash registers was certainly an important measure to tackle undeclared work in Croatia, not only in a preventative way, but also from the perspective of awareness rising.

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

\textit{Joining-up strategy}

As shown above, there is little or no co-ordinated strategy across government so far as the fight against undeclared work is concerned. Instead, a departmental ‘silos’ approach is adopted with each Ministry and agency working separately on the issue with no joined-up strategic approach. Neither are there common cross-cutting targets or goals. Rather, these are fragmented.

Consideration, therefore, needs to be given to a more joined-up strategic approach which might involve one single agency or co-ordinating body being responsible for tackling undeclared work (given its importance nationally). Whether this body is implemented or not, there is a need for more joined-up government where common shared targets are set at the level of strategy and operations. The recent decision to establish the State Inspectorate bringing together many of the inspectorates into one body is a move in this direction, although
not all inspectorates will be included. There is also a need to consider how governance is joined-up, such as the extent to which employer federations, trade unions, private and voluntary sector organisations, as well as local government, are involved as partners at every level in this joined-up governance.

This joining-up is further required due to the establishment in 2016 of the EU Platform on tackling undeclared work since there is a need to organise at the national level a vehicle for feeding up and down into/from this EU-level platform.

4.5 Direct controls: supply-side incentives

All of the measures so far reviewed are deterrents which seek to increase the costs of operating undeclared work by increasing the penalties or risks of detection. Another way of changing the cost-benefit ratio confronting those considering participation in undeclared work is to provide incentives for, or increase the benefits of, declared work. These measures can be either supply-side incentives or benefits that encourage people to engage in declared rather than undeclared work, or demand-side incentives that reduce the purchase of undeclared goods and services by providing rewards for purchasing on a declared basis. In this sub-section, the focus is upon supply-side incentives.

White registry

A ‘white’ registry of compliant business is one way forward. Introducing such a registry would provide an incentive for businesses to operate legitimately. To do this, one could introduce business certification schemes and payment certification of tax and social contributions so as to create a ‘white list’ of compliant businesses, which a business needs to be listed on in order to tender for public procurement contracts (see Box 3).

An opposite approach has been so far adopted in Croatia (‘black’ registry). The Tax administration is publishing a list of employers “not paying wages”. Here individuals can find all the employers who did not fulfilled their obligations towards their employees in terms of wage or social contributions[^14] in the past years.

[^14]: [https://www.porezna-uprava.hr/bi/Stranice/Neisplatiteljiplaca.aspx](https://www.porezna-uprava.hr/bi/Stranice/Neisplatiteljiplaca.aspx)
Box 3: Business certification schemes

**Initiative:** Certification scheme for cleaning companies, Norway

**Aim:** To reduce the use of undeclared workers in cleaning businesses

**Description:** In Norway, the Confederation of Norwegian Enterprise (Næringslivets Hovedorganisasjon, NHO) developed a voluntary certification scheme for cleaning businesses known as ‘clean development’ (Ren utvikling). All participating cleaning businesses had to provide documentation that their accounts and tax records were in order. User companies were then provided with a list of service providers in the cleaning industry whose activities are in order in relation to the existing rules and standards on tax as well as the working environment and workers’ rights.

**Evaluation:** In 2008, however, there were just 27 certified businesses, which was a tiny fraction of all businesses in the cleaning industry (Sissel et al., 2011). In 2012 therefore, the certification scheme was made compulsory for Norwegian cleaning companies (Godkjenningssordningen for renholdsbedrifter) and it was made illegal to purchase cleaning services from companies not approved by the labour inspectorate. This scheme ensures that any approved business has documented that it meets the requirements for residence permits for all employees and the registration and reporting obligations on public registers for all employees. The companies also need to document that they fulfil important requirements related to health and safety, and that all employees carry identity cards that they receive from the labour inspectorate. A central register lists the approved companies that customers can use. In 2012, the government allocated NOK 20 million (€ 2.69m) to implement this approval scheme (Sissel et al., 2011).

**Simplify compliance**

Another supply-side incentive is to simplify compliance. Simplifying compliance is not the same as reducing regulations (i.e., de-regulation). Simplifying compliance is about pursuing good governance, not de-regulation. The problem in Croatia is that the regulatory framework is complex, not least due to regulations on undeclared work being added continuously in various legal acts on issues often only partially related to tax, labour and social security law. The result is a complex array of legislation which is difficult for the layperson to understand, let alone comply with. A result is unintentional non-compliance. One option to overcome this is to provide better information and advice on the existing laws, regulations and codes to help them comply (e.g., FAQs on the websites of ministries, or software based on decision-trees that enables a business or citizen to ensure that they are being compliant).
A good insight into the institutional obstacles in the process of starting and running a business in Croatia is provided by the World Bank Doing Business Survey. Conducted on an annual basis in 189 countries, the survey evaluates the effectiveness of national legislation in 11 different areas concerning the life cycle of a business: starting a business, paying taxes, dealing with construction permits, registering property, getting electricity, getting credit, protecting investors, trading across borders, enforcing contracts, resolving insolvency and employing workers. Apart from rankings in individual areas, an overall country ranking is provided which enables us to analyse how Croatia stands in comparison with other surveyed countries, especially with EU28 members. In the Doing Business 2014 survey, Croatia is ranked 89th out of 189 countries (World Bank, 2014a). At the same time, the EU27 as a composite was ranked 40th (World Bank, 2013b) which suggests that it is more difficult to start a business and operate in Croatia in comparison with the EU27 as a composite. Detailed insight shows that Malta is the only EU country where starting and running a business is harder than in Croatia (Figure 10).

Figure 10: How economies in the European Union rank on the ease of doing business

Source: Based on World Bank (2013a) and World Bank (2013b)
An analysis of the individual factors presented in Figure 11 reveals that it is harder to start a business in Croatia (ranked 80th) than in the EU27 as a composite (ranked 70th). Starting a business in Croatia takes 8 days, requires 6 procedures, costs 9.3% of income per capita and requires paid-in minimum capital of 10% of income per capita (World Bank, 2013a).

On the other hand, paying taxes is the area where Croatia ranks best15. In fact, in comparison to the EU27 which is ranked 63rd, paying taxes is much easier in Croatia (ranked 34th). Nevertheless, this is distorted by poor achievement in other areas, especially when it comes to protecting investors (157th), dealing with construction permits (152nd) and registering property (106th).

Figure 11: Doing Business rankings, comparison of Croatia and EU27

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

Another area where a significant improvement has been achieved during the last few years is a simplification of procedures for starting a business. The first and the most essential

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15 Apart from the number of tax payments and time required to comply during the year, the criteria for evaluation in this area also includes a total tax rate which embraces profit/corporate income tax, social contributions, labour taxes paid by the employer, property taxes and property transfer taxes, financial transaction taxes, capital gains taxes and other existing taxes.
A step in this field was taken in 2005 by launching an online platform called ‘hitro.hr’. Apart from enabling quick communication of enterprises and citizens with the authorities, this platform also provides all relevant instructions and other important information for starting a business. In order to further simplify procedures in this field, in 2009 the Government launched an online service (e-Company) for quick registration, as a part of the hitro.hr platform. This service, similar to the one-stop shop services in other European countries, enables online registration for limited liability companies with procedures lasting no more than 24 hours.

Further simplification of procedures for small businesses was introduced by the possibility for the establishment of the ‘simple limited liability company’ (Official Gazette, 2012a). This allows up to three applicants to establish a company with minimum capital of only HRK 10 (€ 1.30). The fact that 8,062 new simple limited liability companies were registered in the first eleven months after these changes came into force suggests that entrepreneurs recognised this opportunity. Nevertheless, no detailed analysis on business results and sustainability of these companies is available.

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

Another perhaps more preferable option is to simplify the regulatory compliance framework itself. An example would be to simplify tax administration for small businesses (e.g., the number of tax forms and returns, pursuing an integrated approach to audit with a single visit to inspect records rather than separate inspections) and improve support and education to help firms comply. Simplifying regulatory compliance however, need not solely concern relatively minor administrative changes such as simplifying the number of procedures and forms. Measures might also include fundamental changes. This has already occurred for employees with the ‘pre-filling’ of tax returns. On pay-as-you-earn accounts, this information is inserted, as is bank interest inserted on all accounts and from next year, so too will be dividends. Lease property revenue is not yet included. A similar simplification has not yet occurred for the self-employed and small businesses. One example would be introducing a ‘standard deduction’ for the self-employed (see Box 4).

http://www.poslovna.hr/
Box 4: Measures to simplify compliance

**Initiative:** A ‘standard deduction’ for the self-employed

**Aim:** To facilitate a higher level of tax compliance by simplifying the compliance system so that it is easy to understand and use, with few loopholes

**Description:** In many countries, the self-employed have to complete detailed (often self-assessed) tax returns that require a great deal of time and effort, as well as psychological stress. Indeed, all income has to be recorded, receipts kept for all expenditures and detailed calculations made for all tax deductible items, so that net profit can be calculated. A major change proposed by Elffers and Hessing (1997) is to introduce one overall standard deduction to replace the current complex process (see also Slemrod and Yitzhaki, 1994). This would not be simply a fixed deduction on specific standard tax-deductible items but an overall standard deduction that the self-employed person would deduct from their income to take account of the expenses. This could be either a fixed amount or a percentage of gross income. If implemented, it would eradicate the whole process of deductible items, the keeping and logging of receipts from expenditures and significantly decrease the complexity of the tax system. The usual argument against such a measure is either that it will not work or that it is unfair towards those taxpayers who really do have high costs. The latter could be overcome by allowing taxpayers not wishing to opt for the overall standard deduction to retain the right to continue with the current process if they so wish.

**Evaluation:** The advantage for the taxpayer of applying this overall deduction, which has operated in the US federal income tax system for many years, is that: this is a safe and certain option; it saves time and trouble; there is no need to pay for a tax advisor; and it reduces uncertainty. The higher the standard deduction, the greater is the chance that they will use this system rather than seek to specify all tax deductible items. Indeed, the fact that this is an attractive option for taxpayers is its take-up in countries where introduced. Gross (1990) reports that in the US in 1990, 71% of taxpayers opted for the standard deduction, in the form of a fixed amount. For tax authorities meanwhile, from the revenue-to-costs viewpoint, it is wholly ineffective to check deductible items claimed on each self-assessment form; it is a matter of small sums of money, which takes tax officials much time to check, let alone discuss and correct. If there were fewer claims with deductible items, this would make an enormous difference to the workload of tax offices. It would also release time either to check those specifying deductible items in more depth or for shifting resources towards enabling compliance rather than detecting non-compliance.

Various options exist for implementing this overall standard deduction. One option is to start by applying it to those filing self-employment tax returns. To estimate the effects on revenue collected under a standard deduction system, three variables require consideration.
Firstly, there are the revenues lost or gained by introducing the standard deduction. Secondly, there is the number of taxpayers opting for the overall standard deduction, and third and finally, there is the reduction of work involved for the tax administration. The level of this standard deduction, either a fixed amount or percentage of gross income, so that it is revenue-neutral, could be calculated by auditing existing tax returns across various industries and occupations for the mean or median deductions claimed. It could then be either universally applied (which would be simplest for the tax filer) or applied in the first instance only to those sectors and/or occupations where the shadow economy is rife.

The advantage of opting for a ‘standard deduction’ for the self-employed in Croatia is that a great deal of time of staff in the revenue administration is currently spent assessing taxes owed. A ‘standard deduction’ would make considerable inroads into overcoming the problem of tax collection. There would be a simple standard deduction based on their reported income, which would prevent appeals and allow a more efficient use of resources in the tax administration.

**Indirect tax incentives**

Another way forward would be to improve *indirect taxes on consumption*, but existing space for this kind of policy in Croatia is rather limited. In 2014 the implicit tax rate on consumption in Croatia was the fourth highest in the EU28. In contrast, the implicit tax rate on labour was one of the lowest (sixth lowest out of EU28).

*Figure 12: Implicit tax rates on labour and consumption in the EU28 countries (based on 2014)*

Source: Authors’ calculations using Eurostat data
**VAT gap estimations for Croatia**

The VAT gap is a measure of one form of tax non-compliance. The estimates of VAT tax are typically estimated for all EU member states, while other types of tax gaps (Personal income tax – PIT or the Corporate income tax – CIT) are not typically covered (EC, 2016). In theory a wider concept of tax-gap could be applied, but in practice, it is always represented by the revenue loss (there could be different sources of loss, e.g., compliance loss, administrative loss, policy loss). This revenue loss can be described as the amount of tax liability incurred but not paid in a given period. There are two main approaches (bottom-up and top-down) with several methods widely used in recent years to estimate its size. The VAT gap is estimated as the difference between the VAT really received, and the VAT that should be received, also called VAT Total Tax Liability (VTTL). The VTTL should also take into account lowered potential revenue due to exemption, special regime, reduce rates, etc. (EC, 2016 b).

**Bottom-up approach**

The bottom-up approach has typically a microeconomic background based on using individual (administrative or survey) data. The main advantage of this approach is that it can provide a more detailed structural overview about sources of non-compliance (sectors, type of companies, households) and thus the tax administration is able to see misbehaviour. On the other hand, different quality and sources of microdata can provide biased results for individual tax components, and it is heavily data dependent (quality and extent). In the bottom-up methodologies, the components of the gap are estimated separately for different taxpayer groups and types of non-compliance, using data of individual cases. The data is usually gathered by the tax administration. The data gathering methods include audits, surveys and enquiry programs (EC, 2016).

**Top-down approach**

This approach is widely used because of its relative simplicity. The method is based on the assumption that the data source used for tax gap estimation covers the full tax base and thus using generally available macroeconomic data (national accounts and macro models). There are different approaches to applying top-down method to estimate tax compliance. The relatively simple method is used by OECD by enumerating the VAT Revenue Ratio – VRR. VRR is in this case calculated as the share of actually collected VAT on the “potential VAT base” represented by final consumption (subtracted by the actual VAT paid) multiplied by the standard VAT rate. Thus, the denominator is equal to the amount of VAT paid from final consumption taxed by the full standard VAT tax rate. This potential VAT gain is referred as “pure VAT regime” (OECD, 2016). Despite that this method has significant methodological limitations, it could provide sufficient information about tax compliance. We applied OECD
methodology for all EU member states and a few selected countries. The results are presented in Figure 13. In theory, if the VAT system in the specific country is closer to a “pure VAT regime”, then the VRR is getting closer to 1. The difference between 1 and actual VRR value represents various “imbalance” factors, such as effects of lower VAT rates, exemptions, failure to collect tax or tax avoidance. One can easily conclude that the lower gap between VRR and 1 represents the lower potential level of tax avoidance, even when the share of avoidance component in this gap could be relatively high. In some cases (specific tax regimes), the value of VRR could also exceed 1 (as is the case for Luxembourg). A broader description of these causes can be found in OECD (2016). Despite that Croatia is using besides the core rate (25%) two reduced VAT rates (13% for accommodation, food and newspapers and lower (5%) for selected foodstuffs, books and medical equipment, the VRR ratio remains one of the highest in EU member states. The low VRR ratio close to 0.8 thus implies that these factors including tax avoidance are relatively lower in comparison to other European countries.

Figure 13: VAT Revenue Ratio (VRR) for EU members and selected countries (2015)

Despite that the average VRR for the EU28 remains relatively stable, there is in most of the countries visible significant decreases during the crisis. Our panel data analysis on 32 European countries between 2007 and 2015 confirms that there is a strong positive correlation between GDP growth and VRR value and strong negative effect on increasing VAT rate. In 30 observed countries in Europe over a period of 2007-2016 there were 36 times increased standard VAT rate (mainly as a reaction to the crisis) and only 6 times there was observed a
reduction of core VAT rate. Only seven countries did not change the rate during this period. In average, the weighted average VAT rate in EU28 has increased by 2 percentage points in this period. Croatia has increased the standard VAT rate during this period twice, in 2010 from 22% to 23% and in 2012 to 25%. As one of the effects of generally increased VAT rate, there are only 7 EU28 countries, in which we can observe higher VRR ratio in 2015 in comparison to pre-crisis value (2007). On average, the VRR ratio is 5% lower in 2015 than in 2007. On the other hand, since 2011, the VRR ratio in Croatia is steadily increasing, which means general improvement in VAT collection in recent periods.

Figure 14: Development of VAT Revenue Ratio (VRR) in selected countries

Despite that Croatia has increased the standard VAT rate since 2007 twice, the major decrease in VRR could be observed just in 2009 as the effect of the crisis. In 2012, there has been introduced standard VAT rate at 25%, which belongs together with Denmark and Sweden (both 25%) and Hungary (27%) as the highest in the EU. Despite that, Croatia is struggling with long-term recession since 2009 and a real decrease of final consumption, the VRR ratio is still slightly increasing. From the relevant policies which can be taken into consideration with direct effects on VRR, only introducing of fiscal cash registers since January 2013 is currently perceived as significant and efficient.
The more precise study about VAT gap and taxation also utilising top-down method was conducted by EC (2016). The methodology assumes more precise calculation about weighted VAT rates for each member states (Figure 16). In comparison to other countries regardless standard VAT rate, Croatia also has one of the highest effective VAT rates among

**Figure 16: Comparison of standard VAT rates and weighted average rates in EU member states (2014)**

Source: Authors’ calculations and EC (2016a) – (1) Calculations of EC based on ratio of VTTL and related tax base
In line with the previous observations, the estimated VAT Gap for Croatia as a percentage of VAT total tax liability (VTTL) belongs to the lower end. This EC approach should provide better and slightly different results than the OECD approach, mainly because VTTL takes into consideration different taxation of all goods and services including exemptions. The problem is that Croatia was not included in previous EC estimations and therefore it is difficult to assess the VAT Gap development under this approach.

Figure 17: VAT gap as % of VTTL (VAT total tax liability) in EU countries (2014)

As described above, both approaches have some advantages and disadvantages. The top-down approach is often used as a first and easily comparable approach to estimate the size of the tax gap. It usually provides the upper threshold of tax avoidance. On the other hand, the bottom-up approach can provide more insight about sources of this misbehaviour and the effect of applied policies. On the other hand, it is significantly reliable to the high amount of high-quality data. Despite the significantly higher costs, EC (2016)\textsuperscript{17} is stressing the advantages of using both/a combined approach to provide more precise results suitable for assessing policies.

\textsuperscript{17} EC (2016), page 54: Using more than one approach to tax gap estimation can provide options for sense checking and quality assurance of estimates. Also, while the top-down methodologies of VAT gap estimations can offer a ‘comprehensive’ estimate of the total revenue losses, the bottom-up methodologies can provide insights as to which parts of these revenue losses can be tackled with an envisaged reform method. Such a case might be the ex-ante assessment of the fiscal effects of major tax reform options. An impact assessment for a comprehensive VAT reform requires a comprehensive gap analysis, including both tax gap and policy gap, to break down the ‘total VAT gap’.
The above analysis of the VAT gap in Croatia confirms that VAT avoidance in Croatia is relatively low among EU member states. Croatia should continue in improving prevention and revealing indirect tax evasion, but the primary focus in combating the undeclared economy should be aimed at more problematic issues, such as undeclared work, envelope wages, increasing public awareness and confidence in government (value for money).

To reduce the VAT gap, it is sometimes argued that there should be simply reductions in the level of VAT for those goods and services where the undeclared economy is prevalent. However, this has much wider consequences. For this reason, a more tailored approach is usually adopted. One such tailored approach is to use reverse charges for VAT whereby the buyer, not seller, must file and pay the VAT. Until now, reverse VAT charges have been introduced in several European countries in the construction industry (see Box 5). This could be applicable to Croatia and introduced in a range of sectors where undeclared work is rife.

**Box 5: Reverse VAT charges**

**Initiative:** Reverse charges in the construction industry, Sweden

**Aim:** To tackle VAT fraud and undeclared work in the construction industry

**Description:** To tackle VAT fraud and undeclared work in the construction industry, the Swedish government introduced a law on reverse charges for VAT effective from 1 July 2007. A reverse charge means that the buyer, not the seller, must file and pay the VAT. A company selling construction services more than on a temporary basis must pay VAT for its sub-contractors. If the purchaser is not a construction company, the vendor shall add VAT to the invoice. If the purchaser is a construction company, the vendor shall not add VAT to the invoice. Instead, the purchaser will be responsible for reporting the output VAT. Reverse VAT liability does not apply to sales which consist solely of materials.

**Evaluation:** According to a survey by the Swedish Tax Agency (2011), around 39% of the surveyed companies believed that the reverse charge reduced undeclared work in the construction sector. The Swedish Tax Agency does not find support for this argument when investigating a possible increase in reported payroll taxes. However, it does not preclude that the measure may have affected the prevalence of the undeclared economy concluding that the reverse charge has had positive effects in terms of increased reporting of output tax in the construction sector at SEK 700 million (£82.3 million) in 2008 (Swedish Tax Agency, 2011).

**Initiative:** Reverse VAT in the construction industry, Finland

**Aim:** To tackle VAT fraud and undeclared work in the construction industry
Description: In April 2011, Finland similarly introduced reverse VAT where VAT is paid by the buyer (main contractor) rather than seller (subcontractors). This was deemed effective because the tax liability does not as easily disappear into the subcontracting chain and the main contractors tend to be large, established and reputable companies. Subcontractors do not charge VAT to the main responsible party. If there is a chain of subcontracting, as is typical, all invoicing excludes VAT, which is only disbursed at the top of the chain. The reverse system only applies to construction services, not materials, and private individuals as buyers are excluded.

Evaluation: The tax administration estimated that during the first three years the reverse system would annually require 60 work-years to implement, followed by 30 work-years in each subsequent year. In the legislative proposal, the increase in VAT revenue was estimated at €80-120 million. The disbursement of VAT has been shifting towards the main contractors as intended. Information from a few tax audits based on it have been analysed and reported. They have uncovered both honest mistakes and suspicious activity. There are no reports however, of suspected appearances of ‘front’ organisations as fraudulent main contractors.

New categories of declared work
To make it easier to work on a declared basis, another approach is to introduce new categories of declared work in order to allow economic activity currently conducted as undeclared work, often out of necessity due to the complex compliance regulations involved, to move into the declared realm. Overall, one-third of the European countries surveyed in 2010 had introduced such measures. Of those adopting this measure, 59% viewed it as effective, 33% as neither effective nor ineffective, and just 8% as ineffective (Dekker et al., 2010). Here therefore, and to see how new categories of declared work can be introduced to make it easier to move work currently conducted out of necessity in the undeclared economy into the declared realm, an example is taken from Hungary where the Simplified Employment Act has made it easier for people to undertake small jobs in the declared economy which would have been impossible beforehand and would be necessity have been undertaken on an undeclared basis, such as doing a small computer repair job for an acquaintance (see Box 6).

Box 6: New forms of declared work

Initiative: Simplified Employment Act (Egyszerűsített foglalkoztatási törvény) 2010, Hungary

Aim: To bring small mini-jobs into the declared economy that would otherwise be conducted on an undeclared basis
**Description:** In 2010, the Hungarian government introduced the Simplified Employment Act to make seasonal and temporary employment easier to conduct on a declared basis. Before this act, it was necessary to complete in duplicate an official attendance sheet with 18 pieces of information for every single seasonal worker. This act frees both the employee and employer of such administrative burdens, and enables the mutually agreed simplified work contract to be notified either by: a simple text message (SMS) or electronically via the Client Gate System after they are registered and in the system. It distinguishes two categories of simplified employment: seasonal agricultural work, including seasonal tourism services, and other casual/temporary work (i.e., domestic work). In the first case the employer has to pay taxes of HUF 500 (€ 1.75), in the second case HUF 1000 (€ 3.50), on a daily basis. All obligations are fulfilled by entering two codes into the text message or into the Client Gate System.

**Evaluation:** According to data from the Hungarian National Tax and Customs Administration, between April and May 2010, 505,621 simplified employment cases were registered at the tax authority, of which 417,937 entries were for ad hoc/casual employment, 15,877 for seasonal agricultural employment, 6,393 tourism employment, 761 at non-profit organisations, and 10,326 in plant cultivation. Of these jobs, 499,987 lasted less than five days and 2,169 longer than five days. By July 2011, there were 512,000 temporary or seasonal jobs registered as simplified employment from 370,000 employers. Between 1 August 2010 and 31 December 2011, around 12.5 million working days were registered across these 17 months and HUF 8 billion (€ 28 million) flowed into the state’s treasury (Rindt and Krén, 2013).

**Direct tax incentives**

Another supply-side incentive is to use social security and direct tax incentives to prevent citizens and businesses entering the undeclared economy. Since 1 January 2017, new legislation on personal income tax has been implemented in Croatia. The originally identified three income levels were restricted to two. Until the end of 2016, first HRK 2,600 (apx. € 350) of personal income was taxed at 12%, next HRK 11,000 (apx. € 1,484) was taxed at 25%, income over HRK 13,600 (apx. € 1,835) was taxed at 40%. Since January 2017, the first HRK 17,500 (apx. € 2,362) is taxed at 24% and all personal income above this threshold at 36%. The minimum non-taxable income has increased to HRK 3,800 (apx. € 512) with an additional allowance depending on the number of dependent children.

The recent change has restricted the progressiveness of the personal income tax system. The government claims to have reduced the effective tax rate on personal income from 7.6 to 6.3; strengthening the position of Croatia among the countries with the lowest tax on personal income. Such a step could be seen to result in a decline in the individuals’ motivation to work.
undeclared, although as highlighted, there is no evidence that reducing personal taxes leads to a reduction in the prevalence of the undeclared economy.

Nevertheless, social contributions remain relatively high with no relief for low-income groups. Employers, when employing a person under 30 years of age on an unlimited working contract, are exempted from paying health contributions, contributions for employment and contributions for occupational health and safety at work for the first 5 years of the working contract. Such a measure might reduce the amount of ‘bogus self-employment’ in Croatia, although there is as yet no evidence that this is the case.

Although many of the policy initiatives discussed until now have been government-led initiatives, there are many opportunities for both employer and employee representative organisations to develop social security measures to tackle the undeclared economy, as a Romanian measure displays. This seeks to provide social protection for workers so that they do not need to turn to the undeclared economy and at the same time, provides rewards for those workers who operate on a declared basis so as to make work in the declared economy pay relative to work in the undeclared economy (see Box 7). Given the low unemployment benefits in Croatia, this could well be applicable and transferable to the Croatian context.

**Box 7:** Social security incentives

**Initiative:** Builders Social House, Romania

**Aim:** To introduce incentives to workers to operate in the declared rather than undeclared economy by providing them with social security during the off-season.

**Description:** In Romania, ‘The Construction Sector Social Agreement for 2007-2009’ (Acordul Social Sectorial Pentru Construcţii 2007-2009) estimates that some one-third of the active workforce operates in the undeclared economy and highlights the importance of tackling this sphere. The Builders Social House (Casa Socială a Constructorilor, CSC) is one prominent initiative used to enable this work to take place in the declared rather than undeclared economy. The CSC was established in 1998 as a privately run welfare organisation, to which the representative trade unions and employer organisations in the construction and building materials sector contribute in equal measure. It provides welfare payments during the cold season (1 November - 31 March), when the construction sector slumbers, to workers in registered declared employment and in doing so, provides an incentive for workers to be in the declared economy rather than working in the undeclared economy in the construction and building materials sector. CSC members are construction companies and manufacturers of building materials. Entitlement to welfare payments during these winter months is only available to declared employees, that is, those with employment contracts recorded with the local labour inspectorates, and whose social security
contributions due by both the employer and employee have been paid. Corporate contributors pay 1.5% of their turnover into the CSC scheme, and employees contribute 1% of their gross base salary.

**Evaluation:** In 2008, CSC had 573 member organisations accounting for 40% of all declared employment in the construction and building materials industries. During the 2007-8 winter period, 102,387 declared workers benefited from this scheme as recipients of welfare payments (Eurofound, 2013). This is potentially transferable both to other economic sectors where work is largely seasonal, such as agriculture and forestry, and other countries. Importantly moreover, it shows what can be achieved by employer and employee representative organisations working together, and without reliance on governments, so far as implementing policy measures to tackle the undeclared economy is concerned.

**Support and advice on formalisation**

A further supply-side incentive to encourage declared work is the provision of **support and advice on formalisation** both by government and by social partners. Although there is some support and advice for business start-ups and businesses seeking to expand, what has become increasingly recognised is that bespoke support and advice services are required for undeclared entrepreneurs seeking to formalise. This has been explored in Italy (e.g., Caianello and Voltura, 2003; Meldolesi and Ruvolo, 2003), the UK (e.g., Barbour and Llanes, 2013; Evans et al., 2006; Small Business Service, 2004; Williams, 2004a, 2005, 2006c), Europe more generally (Renooy et al., 2004), the USA (e.g., Jurik, 2005) and Nigeria (Sutter et al., 2017).

The rationale for a bespoke support and advice service is that the business advice and support required by those formalising their business ventures differs from that required by start-ups or formal businesses seeking to expand (Caianello and Voltura, 2003; Copisarow, 2004; Copisarow and Barbour, 2004; ILO, 2002; Meldolesi and Ruvolo, 2003; Williams, 2005). It is also widely acknowledged that support and advice is generally not widely available about how to formalise (Barbour and Llanes, 2013; Copisarow and Barbour, 2004; Small Business Council, 2004; Williams, 2005).

In Croatia, simple advice about how to formalise a business venture, for example in the form of flow charts of what needs to be done, is not available. Neither is advice available on how to start-up a venture legitimately available again in the form of simple flow charts. Instead, entrepreneurs are often confronted with the citation of complex labour and tax codes when approaching labour and tax administrations, which is not at all helpful to entrepreneurs seeking to establish legitimate business ventures.
Smoothing the transition from unemployment to self-employment

There is also a need to enable people to move seamlessly from unemployment to self-employment. Unless mechanisms are put in place, then citizens will by definition have to ‘test trade’ their business venture whilst still officially unemployed.

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

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

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

A further example of an initiative to smooth the transition from unemployment to self-employment was recently introduced by the municipality of the capital city of Zagreb. The City office launched a project under the name ‘Work cleanly – be employed’. Analyses show that the average household per week spends about 6 hours on cleaning, showing strong demand for cleaning jobs, but about 90% of cleaning jobs are affected by the undeclared economy. In order to provide better working status for people working in cleaning, this project is designed for unemployed persons (registered at the Croatian Employment Service) to enable them to start their own business. The City office gives non-refundable support to unemployed people to start the activities of cleaning and maintaining the landscape. The grant is up to HRK 20,000 (apx. € 2,700) and covers the costs of registration of trades, social contributions payments for 12 months, payment of bookkeeping services and fiscal cash registers. The project started with the Public Invitation on March 29, 2017, and lasts until all the funds are spent. Collecting requests is on-going, and the City ‘Blue Office’ will also organise workshops for potential beneficiaries.
This is in effect a pilot project for smoothing the transition from unemployment to self-employment. It should therefore be subject to an evaluation study. If it is found to be successful in transitioning people from unemployment to self-employment, then there are opportunities to not only replicate this policy initiative in other sectors of the economy where undeclared work is rife, such as wider home improvement, maintenance and repair work, but also to expand it beyond the city of Zagreb into other towns and regions.

A similar example to this was undertaken in Germany, namely the start-up premium (Gründungszuschuss, GZ). In 2002, the Commission on ‘Modern services in the labour market’ (known as the Hartz Commission) proposed a new public subsidy for business start-ups (Existenzgründungszuschuss). The subsidy, known as the ‘Ich-AG’, or ‘Me PLC’ scheme, was criticised for performing the same function as a second existing scheme, the ‘bridging grant’ (Überbrückungsgeld). In August 2006, therefore, the two were fused in the ‘start-up premium’ (Gründungszuschuss) scheme. Available to recipients of unemployment benefit wanting to start up their own business, these entrepreneurs receive in addition to their unemployment benefit a monthly grant of €300 in the first six months. If after six months the recipient can prove intense business activity and initial success, an additional €300 is received for another nine months. Bernhard and Wolff (2011) find that the scheme tends to attract more women than men, whilst Caliendo et al. (2011) also show that GZ participants are older and have higher educational qualifications. As Bernhard and Wolff (2011) note, between 119,000 and 147,000 recipients of unemployment benefit enrolled annually in the GZ scheme between 2007 and 2010. Although there is no evidence regarding whether it reduced informal entrepreneurship, Caliendo et al. (2011) reveal a high survival rate of GZ participants’ businesses. Some 19 months after start-up, 75-84% of former GZ recipients were still in business. This scheme, therefore, appears to help smooth the transition from unemployment to formal entrepreneurship, and to reduce participation in informal entrepreneurship by the unemployed.

A further example of the provision of a different form of support to encourage businesses to formalise is found in Greece. The ‘Business walking routes’ of the Hellenic Confederation of Commerce and Entrepreneurship (ESEE), co-financed by Greek and European funds, provides maps to citizens and visitors of six walking routes in the city centre of Athens, each themed for specific goods. Only businesses are included which are formal registered businesses that have no compliance issues outstanding. This provides an incentive for businesses to be formal by providing them with free marketing for their business, and could be significantly extended to other countries and applied to various districts and sectors.

Other types of support that at present are not so far as is known made available to businesses in Croatia, that could facilitate their formalisation, include: the free provision of
record-keeping software to businesses, fact sheets on record-keeping and free advice or training on record-keeping.

**Providing the possibility to attain impunity by voluntary disclosure**

Provisions regarding voluntary disclosure exist in many different countries, mostly as part of tax law. Using such provisions in tax systems aims at giving taxpayers an opportunity to legalise their unduly gained assets and income by voluntarily disclosing the information relevant for taxation to the authorities while at the same time attaining impunity for tax evasion. With regard to Croatia, where the tax authority is responsible for not only levying tax but also collecting the social security contributions, voluntary disclosure should also be made applicable concerning these contributions to pension, health and unemployment insurance.

For that reason, as an incentive to return to a legally compliant behaviour without fear of punishment, it should be considered to institute a possibility for employers having employed undeclared workers by implementing the instrument of voluntary disclosure into Croatian law. Voluntary disclosure does not necessarily have to lead to complete criminal impunity but may also be limited to lead to a mitigated sanction where the scope of this reduction of penalty may depend on several circumstances, such as the extent of evaded contributions, the time the disclosure has been made and the reimbursement of the owed levies with or without interest to be charged. Implementing this instrument into law may be done by:

- adopting a legal provision which will be valid and enforceable in general and without time limit; or
- by installing an amnesty programme where employers or employees may denounce themselves within a given time frame (usually several months up to one year).

### 4.6 Direct controls: demand-side incentives

Besides providing supply-side support and incentives to operate in the declared economy, recent years have witnessed the expansion of demand-side incentives to encourage the purchase of declared goods and services. An example is the launch in 2013 by the Croatian tax administration in collaboration with the Croatian Lottery of a competition whereby every citizen who sent in 20 receipts could win money prizes (Tax Administration, 2013a). The problem nevertheless, is that such incentives are in effect bribes offered to citizens precisely because they would not otherwise comply with the codified laws and regulations (i.e., state morality). The medium-term approach should be to align civic morality with state morality, which will be far more effective and cost-efficient than continuously offering bribes to conform.
Another demand-side option is to use **service voucher schemes**. In many countries, service vouchers have been used to encourage those who would otherwise use undeclared labour to acquire certain services to use declared labour. By providing service vouchers to those employing labour, which pays a portion of the fee given to the worker, the intention is to encourage them to purchase services using the service voucher rather than on an undeclared basis. Indeed, this is one of the few curative incentives to have been introduced in Croatia.

In order to reduce undeclared work in agriculture, in 2012, the government introduced a voucher scheme for seasonal and occasional work in this sector (Official Gazette, 2012c). This scheme entitles unemployed and pensioners to work up to 90 days per year on various jobs in agriculture, for a minimum daily wage of HRK 72.08 (apx. € 9.72). Liabilities concerning social contributions for individual employees in this case depend on the number of daily vouchers they receive. This is a significant change in comparison to the previous situation when social contributions had to be paid for the whole month, regardless of the number of days the seasonal employee really worked. The price of the daily voucher covering all taxes and contributions for a seasonal worker is HRK 20.82 (apx. € 2.82), thus the implicit taxation on agriculture seasonal worker is 28% at most. Still, unlike voucher systems in many other member states, in this case no public subvention on the labour cost is provided. Despite that, 99,741 contracts (booklets for the vouchers) for the seasonal work in agriculture were sold to potential seasonal workers during 2012 and 2013. From 18 June to 31 December 2012 a total of 325,295 vouchers were bought by 3,363 business subjects. In 2013, 517,183 vouchers were sold to 3,371 subjects. A slightly decreasing trend in using the vouchers can be observed since 2014. In 2014, 493,672 vouchers were sold to 2,703 subjects and in 2015 480,453 vouchers to 2,286 subjects. However, it is difficult to know whether the introduction of service vouchers in agriculture indeed accomplished its purpose without knowing the overall number of people working on this type of jobs in Croatia. Based on the interviews with stakeholders, we may assume that the lowering uptake of seasonal vouchers is related to a low-perceived risk of being caught while employing undeclared seasonal workers. The agricultural high-season collides with the tourist season, where labour inspections are primarily aimed. Additionally, according to the opinion of local stakeholders, farmers and seasonal workers have a lack of information about the voucher scheme and its benefits.

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

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

**Direct tax and social insurance incentives**

A popular assumption is that reducing taxes and social contributions will reduce the size of the undeclared economy. However, there is no evidence that this is the case, and the problem with using such general tax reforms is that they have much broader impacts. For this reason, more targeted measures are required.

Many of those starting-up businesses secure their venture capital from informal sources such as family, friends and acquaintances. These loans are frequently relatively informal and this can result in an attitude being adopted from the outset that informal practices are part of the culture of the business venture being established. To address this, the Netherlands introduced a scheme, *Tante Agaat-regeling* (‘Rich Aunt Agatha Arrangement’), later renamed the Venture and Start-up Capital Tax Rules Scheme. This provides the lenders with a tax incentive to declare the loan. By exempting lenders from certain taxes, these loans become known to the tax administration, making it less likely that businesses will view themselves as engaged in informal funding arrangements, which might well spill over into their trading practices (Renooy et al., 2004; Williams, 2004b). The loan had to be for a minimum of € 2,269 and a maximum of € 50,000. No formal evaluations were conducted.

Another demand-side option is to give straightforward income tax relief, claimed on tax returns, to customers using declared labour to do specific tasks (e.g., roof maintenance, outside painting, domestic cleaning) commonly conducted in the undeclared economy, so that the wage costs of employing workers on a declared basis become equivalent or better than the wage costs of employing somebody on an undeclared basis (see Box 8).
Initiative: Tax deductions for household work, Sweden

Aim: To use direct tax incentives to bring domestic services provided in the undeclared economy into the declared realm

Description: Since 8 December 2008, Swedish citizens have been able to apply for a tax deduction amounting to 50% of the labour cost for the renovation, conversion and extension of homes (ROT), and also for household services (RUT), including cleaning, laundry, basic gardening and babysitting. The maximum annual tax deduction that can be applied for is SEK 50,000 (€ 6,000) for each individual. In the government bill from 2007 where the RUT deduction was proposed, the measure was estimated to cost SEK 1.3 billion per year (€ 155 million). The ROT-deduction was in the spring budget bill in 2009 and was calculated to cost SEK 13.5 billion per year (€ 416 million) (Swedish Tax Agency, 2011). As of 1 July 2009, companies performing household services charge the customer the costs of materials and half the labour costs, including VAT. The company performing the work then requests the outstanding sum from the Swedish Tax Agency. As a result, the customers only pay half of the labour cost at the point of purchase of the service.

Evaluation: Comparing data from 2005 and 2011, the Swedish Tax Agency (2011) display that undeclared work has decreased by about 10% within the categories of jobs covered by the ROT and RUT-deduction. In the autumn of 2011, the Swedish Federation of Business Owners (Företagarna) conducted a survey of 2,447 construction companies. The results show that nearly 90% felt that the ROT-deduction had a positive impact on reducing undeclared work in the sector compared with 78% in 2009. In 2010, 1.1 million people bought household services with a tax deduction (RUT and ROT) and the Swedish Tax Agency paid out SEK 1.4 billion (€ 166 million) in RUT deductions and SEK 13.5 billion (€ 1.6 billion) in ROT-deductions. This means that around 7.6 million hours of cleaning and household (ROT) services and 53 million hours of renovation work (ROT) were performed using these schemes (Brunk, 2013c).

Initiative: Home-job plan, home-job tax deduction, Denmark

Aim: To use direct tax incentives to bring domestic services provided in the undeclared economy into the declared realm

Description: Since 1 June 2011 until the end of 2013, it has been possible for each member of the household over 18 years of age to deduct from their taxes up to DKK 15,000 (€ 2,000) the costs of employing craftspeople and domestic helpers under a pilot project called ‘Home-Job Plan’ (Bolig-Jobplan). The major difference compared with the Swedish scheme
therefore, is that whilst Sweden has a maximum tax deduction of €6,600, the cap is €2,000 in Denmark. The activities covered include cleaning, indoor-outdoor maintenance of the house, gardening and babysitting. The cost to the government is estimated to be DKK 1 billion (€134 million) in 2011 and around DKK 1.75 billion (€234 million) in 2012 and 2013. The expenses and the company involved is informed digitally by the buyer of the services to the tax authorities in a special template, who then deduct 15% of the amount in the yearly tax or fiscal income. The action involved for the buyer of these services resembles an ordinary payment transfer, and the system does the rest.

**Evaluation:** Relative to expectations, the pilot project has so far been a success. Some 270,000 people used the deduction in 2011 and most of the work involved home improvement, maintenance and repair. They have on average reported deductions of DKK 9,800 (€1,315) per person. In total, the deductions reported constitute DKK 2.7 billion (€362 million). The tax value of those deductions is around DKK 900 million (€121 million) (Jørgensen, 2013).

**I incentivising electronic payment systems and deterring cash payments**

Given that many transactions can be in cash, deterring cash payments and incentivising electronic payments is another policy solution. This measure has been actively encouraged by the large global multinational corporations involved in electronic payment systems. Several options exist for countries pursuing this demonetisation approach. An international consulting company based on the demand for MasterCard, produced impact evaluations of cashless transactions supporting policy measures. Estimates were produced for the countries of central and south-eastern Europe.

**Table 4: Impact of the measure on government revenue (VAT and CIT) (% of GDP)**

<table>
<thead>
<tr>
<th>Measure</th>
<th>Estimations for the Central and SE Europe countries</th>
<th>Croatia</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obligation to make an electronic payment of wages and salaries</td>
<td>Min 0.003, Max 0.051, Croatian estimates NA</td>
<td>In practice since Ordinance on Income Tax 10/2017</td>
<td></td>
</tr>
</tbody>
</table>

20 Value Added Tax (VAT) and Corporate Income Tax (CIT)
<table>
<thead>
<tr>
<th>Measure</th>
<th>Estimations for the Central and SE Europe countries</th>
<th>Croatia Croatian estimates</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obligation to make an electronic payment of unemployment benefits</td>
<td>0.0004 0.003</td>
<td>NA</td>
<td>In practice</td>
</tr>
<tr>
<td>Obligation to make an electronic payment of pensions</td>
<td>0.03 0.12</td>
<td>0.07</td>
<td></td>
</tr>
<tr>
<td>Threshold for consumer cash payments – threshold no. 3</td>
<td>0.39 1.04</td>
<td>Positive</td>
<td>In practice in a weaker form: € 14,100 / HRK 105,000</td>
</tr>
<tr>
<td>Obligation to possess cash registers</td>
<td>0.12 0.13</td>
<td>Positive</td>
<td>In practice since 2013</td>
</tr>
<tr>
<td>Obligation to operate POS terminals all passive shadow economy sectors</td>
<td>0.01 0.27</td>
<td>Positive</td>
<td></td>
</tr>
<tr>
<td>Tax incentive for consumers – optimal tax relief</td>
<td>0.1 0.63 1.047</td>
<td>Tax relief at the level of 1.9% of the card payment value</td>
<td></td>
</tr>
<tr>
<td>Tax incentive for merchants – optimal tax relief</td>
<td>0.02 0.25</td>
<td>Positive</td>
<td>Tax relief at the level of 0.8% of the card payment value</td>
</tr>
<tr>
<td>Restrict the presence of no-fee automated teller machines (ATMs)</td>
<td>NA NA NA</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: (EY, 2016a) (EY, 2016b)

Since 2017, based on the Ordinance on Income Tax (10/2017), all salaries in the country have to be paid electronically to personal bank accounts. Old age pensions are dominantly paid electronically, but the option to receive them via mailed cheques refundable at post offices remains in practice. Switching to exclusively electronic distribution of old age pensions could, based on the EY report, contribute to a 0.31% decline in the passive undeclared economy and a 0.07% increase in the public budget revenue due to an increase in indirect taxation.

To support the shift from cash to electronic payments, one of the easiest options is for governments to introduce a ceiling for cash transactions. A threshold set to consumer cash transactions exists in Croatia, but it remains relatively high and allows several exceptions. It has been set at HRK 105,000 (€ 14,100) (Vanderseypen et al., 2013).

Another policy option is to make point-of-sale (POS) terminals available across all sectors, such as bars and taxis. Introducing them could reduce the use of cash. No clear policy

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21 Passive undeclared economy covers the types of financial transactions when consumer is not aware of being participating in the undeclared activity. For example when he/she buys a good without a receipt.
intention in this area is present in Croatia. Based on the EY report, such policy could yield positive impact on reducing the passive undeclared economy and thus increase the public budget revenues.

Another option is to provide incentives for using cards at the points-of-sale. Many day-to-day transactions, especially those worth less than €15, remain cash-based. Developing incentives for individuals to use cards is a way forward. Argentina for example, offers a 5% VAT discount on debit card transactions and 3% on credit card purchases. The EY report estimated the optimal level of government supported discount for customers when paying electronically to be around 1.9% of the total payment. Based on EY simulations, the net increase of the State budget revenues resulting from such measure could be around 1%. The optimal level of support, if stimulating the side of merchants would be lower, only 0.8% of the total payment. The net increase in the state revenue would be positive, but lower than in stimulating the side of buyers. Currently, in Croatia, refunds of expenses are provided to consumers paying electronically with the MultiPlusCard to the clients of the Zagrebačka Banka and Croatian retail Konzum.

The last option is to discourage easy access to cash. The presence of no-fee automated teller machines (ATMs) provides uninhibited access to cash and subsequent cash payment at the point-of-sale. Such interventions always present a violation of individuals’ freedom, which could in the end result into further worsening of the population’s trust in government.

4.7 Indirect controls: education and awareness raising

Until now, all the measures proposed have been direct controls which seek to change the cost/benefit ratio confronting businesses and citizens when considering participation in undeclared work either by increasing the costs of undeclared work or the benefits of declared work. However, business and citizens are not always simply rational economic actors. They are also often social actors who do not comply because they either lack trust in the state, or do not understand or believe in what the state is seeking to achieve (i.e., they lack ‘vertical’ trust), or they believe that many others are operating undeclared so see no reason that they should operate on a declared basis (i.e., they lack ‘horizontal’ trust).

To tackle undeclared work, the root causes that lead to the values, norms and beliefs of citizens not being aligned with the laws and regulations, needs to be tackled. This is what indirect controls seek to achieve by dealing with the formal institutional imperfections and failures that lead to the decision to engage in the undeclared economy. Until now, Croatia has paid little if any attention to such indirect controls as a means of tackling the undeclared economy. No explicit strategy has been developed to foster trust in government and to align the norms, values and beliefs of citizens regarding compliance with the codified laws and regulations. Two sets of initiatives are required to achieve this. Firstly, initiatives can be
pursued to alter the norms, values and beliefs of citizens so that they align with the laws and regulations and secondly, and in order for this to be achieved, it is also necessary to deal with the formal institutional failings and imperfections so as to foster greater self-compliance in the population.

Many citizens do not fully understand why they pay their taxes and/or what these taxes are used for by governments; they do not fully make the connection between the public goods and services they receive (e.g., hospitals, schools, transport infrastructure) and the taxes they pay. Until now, governments have generally undertaken very little marketing to help citizens make this connection. However, if the norms, values and beliefs of many in the population are to become better aligned with the codified laws and regulations of formal institutions and voluntary co-operation is to ensue, educating citizens about this is important. The advantage of pursuing voluntary co-operation, rather than enforced compliance, is that this is potentially a far cheaper, more effective and sustainable means of tackling violations of tax, social security and labour law related to undeclared work than having an army of inspectors to police non-compliant behaviour and using incentives to effectively ‘bribe’ the population to operate on a declared basis.

To achieve such voluntary co-operation, two broad forms of education are required. On the one hand, and to prevent unintentional non-compliance, citizens need to be educated and informed about what the current system requires of them. On the other hand, and more broadly, citizens need to be educated about the benefits and value of paying tax and being compliant with labour law and social insurance regulations, by educating them about the benefits of paying taxes and social insurance contributions, and complying with labour law, in order to develop their intrinsic motivation to do so and facilitate greater self-regulation.

The first type of education requires the provision of easily understood information regarding their responsibilities with regard to the tax, social security and labour law. A significant portion of non-compliance is unintentional, arising from both the complexity of the compliance system as well as a lack of knowledge, misunderstanding and ambiguous interpretation of tax and labour law (Hasseldine and Li, 1999; Natrah, 2013). In consequence, one way forward is to provide greater information to citizens (Internal Revenue Service, 2007; Vossler et al., 2011). At present, few if any initiatives in this regard have been pursued in Croatia. Besides simplifying compliance, a frequently asked questions (FAQ) section on ministerial websites might be helpful.

The second and perhaps more important type of education is that which seeks to educate citizens about the benefits and value of being compliant with labour, tax and social insurance regulations. One potential and partial remedy, therefore, is to educate citizens about the activities on which their taxes are spent, and the value of pensions and abiding by labour law. If citizens are informed and knowledgeable about the current and potential public goods and
services which they are receiving for their money, and the value of having a pension, they may be more willing to pay their taxes and social contributions (Bird et al., 2006; Saeed and Shah, 2011). One direct way of doing this is to provide information to tax payers regarding where their taxes are being spent and how much they are contributing to which activities of government. This sets out what portion of their taxes is spent on which public goods and services. Another simple way of doing this is to display signs such as ‘your taxes are paying for this’ on public construction projects (e.g., new roads), on ambulances, in doctor’s waiting rooms, in hospitals and schools, which convey a clear message to the public that the taxes they pay are being used to provide these public goods and services.

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

These education and awareness raising campaigns, moreover, and as the 2013 Eurobarometer report reveals, could be usefully targeted at the self-employed, the unemployed people, unmarried people and living in small/middle sized towns, whilst for individuals operating in the informal economy, such campaigns could be targeted at Zagreb and younger people.

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

We should also add that the Ministry of Labour and Pension System launched the project ‘2014 – the year of the fight against undeclared work’ (Ministry of Labour and Pension System, 2014). Apart from campaigns focused on raising public awareness about the
consequences of undeclared work, the Ministry also announced greater endeavours in detection, as well as an increase of penalties for carrying out these activities. As a part of this action, in March 2014 the Ministry established a free phone line for citizens to report (anonymously) employers who hire workers on undeclared basis or in any other way violate employers’ rights.

In Canada for example, the Tax System Learning Unit provides information about the tax system as well as how the government spends the tax dollars collected. This Unit until now has targeted junior and high school students so as to educate citizens before they start participating in the tax system. While the initiative has enjoyed success in getting participation from education institutions, its impact on compliance has not been measured, since there is no mechanism to track the compliance behaviour of those taking the modules against a control group who have not. Austria has adopted a similar initiative targeted at schools whereby tax officials provide training on future responsibilities for compliance, as have the Internal Revenue Service in the USA (Internal Revenue Service, 2007).

Although information and advice is provided by telephone, email or during inspection visits, no concerted awareness raising campaign has been launched about the costs of undeclared work and benefits of declared work. It is more information on obligations that is provided by the tax, labour and social security bodies. An awareness raising campaign, meanwhile, can either: inform those working in the undeclared economy of the costs and risks of doing so; inform potential users of undeclared labour of the risks and costs; inform those working in the undeclared economy of the benefits of being legitimate, and/or inform potential users of undeclared labour of the benefits of formal labour.

There is tentative evidence that emphasising the benefits of working declared rather than the costs and risks of engaging in undeclared labour is more effective. As Thurman et al. (1984) explain, publicising the adverse consequences of engaging in undeclared labour is ineffective because those working in the undeclared economy tend to neutralise their guilt, such as by seeing themselves as small players with little impact compared with the big players. If an awareness-raising campaign does decide to focus upon the costs of undeclared work, therefore, then it will need to ensure that these rationalisations are not available to participants in the undeclared economy, such as by advertising the average level of non-compliance so that people will not view their own activity as ‘minor’ compared with others.

For a campaign to be effective however, it has to use tailored advertisements that will need to vary in form and content depending on the audience targeted. The language, media used, word style and slogans that will be effective for one population group such as younger people, will not be for another group such as the elderly. Similarly, effective media for one target group, such as newspaper adverts for older people, will not be for the internet-oriented younger generation. As shown in other realms of advertising, harnessing the power of
celebrities can also be effective in influencing the target audience. In the USA in 2007 for example, the Internal Revenue Service made use of the internet via YouTube during the filing season, sponsoring a rap video contest, with an award of $25,000 for the best tax video. The contest was introduced in a rap video called Turbo Tax Mojo by Vanilla Ice (available at http://www.youtube.com/watch?v=eMudXTz4NuQ), which urged people to pay their taxes on time and to use Turbo Tax to do so.

If celebrities and/or opinion leaders are used by administrations, then as Lessing and Park (1978) identify, it is necessary to differentiate three types of campaign. These are firstly, information campaigns where citizens lacking knowledge refer to opinion leaders for information, such as highly respected economic experts via television commercials, talk shows and newspaper articles, secondly, utilitarian campaigns when citizens are motivated by hearing about others rewarded or punished, such as when names are published of those who pay taxes and do not and, third and finally, value-expressive campaigns when citizens are encouraged to associate themselves with positive role models, such as by publicising the tax payments of famous television and movie stars, athletes, scientists, politicians and business tycoons, holding them up as role models for the law-abiding citizen to follow.

Moreover, it does not always have to be governments leading such awareness raising campaigns. It can also be social partners such as employer or employee representative organisations either independently or in co-operation with the state. In Sweden for example, employers have led campaigns to tackle the undeclared economy and undeclared labour in both the construction industry and the taxi-driving sector. The Bulgarian Industrial Association, meanwhile, has run an ‘In the Light’ (www.nasvetlo.net) campaign since 2007 and sought to encourage greater awareness of the negative implications of the undeclared economy and undeclared labour, whilst in Canada, a national awareness advertising campaign, ‘Get it in Writing’, to inform purchasers of undeclared labour of the risks involved in dealing with home repair and maintenance contractors has been developed in partnership between the tax administration and the Canadian Home Builders’ Association.

### 4.8 Indirect controls: reforming formal institutions

There is little point in seeking to change norms, values and beliefs, however, unless one addresses the formal institutional failings that cause the non-alignment of citizen morality with state morality, and thus the prevalence of undeclared work. To tackle these formal institutional failings so that citizens become more committed to being compliant, therefore, two broad approaches are required. On the one hand, the processes of formal institutions need to be changed. On the other hand, the products of formal institutions need to be addressed. These related to tackling formal institutional voids (e.g., a lack of welfare protection). Here, each is considered in turn, starting with the processes of formal institutions.
Modernising the processes of formal institutions

Changing the processes of formal institutions addresses two key types of formal institutional failure. On the one hand, changing the processes of formal institutions tackles formal institutional inefficiencies, or resource misallocations by formal institutions, such as when formal institutions seek to protect or maximize economic rents for elites, or when state capture occurs by such elites, resulting in the majority not receiving a fair share in return for their contributions, or suffering from overly burdensome taxes, registration and licensing regulations and costs. On the other hand, changing the processes of formal institutions tackles formal institutional weaknesses and instability, manifested in their lack of capacity and capability to enforce legislation and/or there are continuous changes in the formal ‘rules of the game’ about what is acceptable, which leads citizens to reject the continuously changing formal rules of the game in favour of their own more stable unwritten socially shared rules. These malfunctions lead to a non-alignment between state morality and citizen morality. To change this, processes need to be altered to ensure that there is procedural justice, procedural fairness and distributive fairness. This net result will be a shift in public institutions away from a ‘cops and robbers’ approach and towards a more customer-friendly orientation. Each is here considered in turn.

**Procedural justice.** The extent to which citizens perceive government to treat them in a respectful, impartial and responsible manner significantly effects whether citizens engage in voluntary co-operation (Hartner et al., 2008; Murphy et al., 2009; Torgler and Schneider, 2007). Leventhal (1980) formulated the following six rules regarding procedural justice:

(i) The consistency rule - procedures should be consistent across people and time; nobody should be favoured or disadvantaged;

(ii) bias suppression rule - egoistic intentions and prejudice on the part of the decision-makers should be avoided;

(iii) accuracy rule - all relevant sources of information should be exhausted, in order that decisions are based on well-founded information;

(iv) correctability rule - the possibility of the adjustment or revision of decisions made;

(v) representativeness rule - the opinions and interests of all parties should be considered; and

(vi) ethicality rule - procedures should align with the prevailing moral and ethical values.

Leventhal’s rules deal primarily with the decision-making process. However, Bies and Moag (1986) argue that it is also important to consider interpersonal interactions and whether there is respectful and fair treatment (i.e., interactional fairness). Compliance is significantly higher when citizens perceive there to be interactional fairness. Being treated politely, in a dignified manner and with respect, being given a say, and having genuine respect shown for one rights and social status all improve compliance (Gangl et al., 2013; Hartner et al., 2008).
Consequently, it is necessary for the state to move towards a customer-oriented service approach that treats citizens with respect and dignity. This shift from a coercive to cooperative approach seeks to reduce the need for enforced compliance. The more regulatory interactions are grounded in trust, the greater is the likelihood of self-regulation or voluntary compliance.

**Procedural fairness.** People who receive procedurally fair treatment by an organisation will be more likely to trust that organisation and will be more inclined to accept its decisions and follow its directions (Murphy, 2005). If one citizen caught violating the law pays no fines, but others caught have to pay, s/he will view themselves as being treated unfairly. Fairness is one of the most important determinants of compliance (Hartner et al., 2011; Kirchgässner, 2010, 2011; Molero and Pujol, 2012). If citizens feel that they are not receiving fair treatment, non-compliance increases (Bird et al., 2006). Where grievance exists either in absolute terms (e.g., those who feel that taxes are too high, those who feel that public funds are wasted) or in relative terms (e.g., the suspected level of others’ tax evasion), the result is greater non-compliance. Indeed, and as shown above, citizens can justify their own non-compliance in the perceived non-compliance of others. If the undeclared economy is perceived as extensive, then this justifies citizens engaging in non-compliant behaviour themselves. This obviously has implications for administrations. If the authorities advertise that the undeclared economy is extensive, then they create the conditions for widespread grievance and for greater participation in the undeclared economy of those who might not have otherwise done so. Similarly, if an offender believes that administrations are communicating disapproval to them through disrespect or stigmatising them, such as by labelling them with negative identities (e.g., thief, tax cheat), re-offending results since the individual externalises the blame and feels alienated (Murphy and Harris, 2007).

**Distributive fairness.** Whether a citizen adheres to the codified laws and regulations and does not engage in the undeclared economy is heavily determined by whether they believe that they receive the goods and services they deserve given the taxes they pay (Richardson and Sawyer, 2001). Taxes, after all, are prices for the public goods and services provided by the government. If citizens view their interests as properly represented in formal institutions and they receive what they view as appropriate public goods and services for the taxes they pay, their identification with the state increases and their willingness to contribute is greater. If citizens do not receive the goods and services that they think they deserve given the taxes they pay, non-compliance increases. This may occur for example, when corruption is extensive and the citizen has little trust in formal institutions. In such situations, there will be a low incentive to co-operate. Corruption generally undermines the willingness of citizens to comply, causing them to become frustrated. Citizens will feel cheated if they believe that corruption is widespread and their tax burden is not spent well (Torgler, 2007, 2012). As
Kirchgässner (2010, p. 28) thus puts it, ‘If the willingness to pay taxes is to be enforced, a responsible use of tax revenue by the public authorities is necessary as well as a partnership relation (and not a magisterial one) between them’. The result is that governments need to educate citizens about where their taxes are spent. In situations where citizens do not know, or do not fully understand that public goods and services are due to taxes, then compliance will be lower than in situations where citizens are fully aware of the public goods and services they receive for their taxes and agree with how their taxes are spent (Lillemets, 2009). It is therefore important that the Greek government explains to taxpayers how their money is spent.

**Changing the products of formal institutions**

It is not purely changes in the processes of formal institutions which are required to increase voluntary compliance. As outlined earlier, broader work and welfare regimes influence the size of the undeclared economy in a country. Larger undeclared economies are associated with lower levels of GDP per capita, a low quality of bureaucracy and higher levels of perceived public sector corruption, lower levels of expenditure on social protection, less effective social transfer systems and greater inequality and deprivation. Tackling the undeclared economy, therefore, is not solely about changing the penalties and risks of detection, or providing incentives and making it easier to work in the declared economy. It also requires changes in the macro-level economic and social conditions, if it is to be reduced. Unless this is achieved, there will continue to be an asymmetry between the informal and formal institutions in a country and undeclared work will remain rife.
Appendix A – List of meetings with stakeholders

During the different activities of this component, besides numerous meetings which were held with the main beneficiaries of this twinning project, which are the Ministry of Labour and Pensions System and the Labour Inspectorate, the following meetings were held with other stakeholders:

Table 5: List of meetings with stakeholders

<table>
<thead>
<tr>
<th>Date</th>
<th>Stakeholder</th>
<th>Topic</th>
</tr>
</thead>
<tbody>
<tr>
<td>24/1/2017</td>
<td>Tax Authority (Tax Administration) (PU)</td>
<td>Data collection, sharing and matching, joint operations</td>
</tr>
<tr>
<td>25/1/2017</td>
<td>Croatian Pension Insurance Institute (HZMO)</td>
<td></td>
</tr>
<tr>
<td>26/1/2017</td>
<td>Ministry of the Interior (Police) (MUP)</td>
<td></td>
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<tr>
<td>20/2/2017</td>
<td>Ministry of Economy, Entrepreneurship and Crafts (MinGo)</td>
<td></td>
</tr>
<tr>
<td>21/2/2017</td>
<td>Tax Authority (Customs)</td>
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<tr>
<td>20/2/2017</td>
<td>Tax Authority (Tax Administration) (PU)</td>
<td></td>
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<tr>
<td>21/2/2017</td>
<td>Ministry of Demographics, Family, Youth and Social Policy (MSPM)</td>
<td></td>
</tr>
<tr>
<td>22/2/2017</td>
<td>Croatian Pension Insurance Institute (HZMO)</td>
<td></td>
</tr>
<tr>
<td>24/2/2017</td>
<td>Ministry of Administration (MU)</td>
<td></td>
</tr>
<tr>
<td>7/3/2017</td>
<td>• Ministry of Labour and Pension System (MRMS)</td>
<td>The extent and nature of undeclared work in Croatia</td>
</tr>
<tr>
<td></td>
<td>• Labour Inspectorate</td>
<td>Policy approaches and measures for tackling undeclared work</td>
</tr>
<tr>
<td></td>
<td>• Tax Authority (Tax Administration) (PU)</td>
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<td></td>
<td>• Tax Authority (Customs)</td>
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<td>• Ministry of the Interior (Border Police) (MUP-UG)</td>
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<td></td>
<td>• Croatian Employment Service (HZZ)</td>
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<td></td>
<td>• Croatian Pension Insurance Institute (HZMO)</td>
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<td></td>
<td>• Croatian Health Insurance Fund (HZZO)</td>
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<td></td>
<td>• Ministry of Economy, Entrepreneurship and Crafts (MinGo)</td>
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<td></td>
<td>• Croatian Chamber of Trades and Crafts (HOK)</td>
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<td></td>
<td>• Croatian Employers’ Association (HUP)</td>
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<td></td>
<td>• Independent Croatian Trade Unions (NHS)</td>
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<td>• Association of Independent Trade Unions of Croatia (SSSH)</td>
<td></td>
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<tr>
<td></td>
<td>• Association of Croatian Trade Unions (MHS)</td>
<td></td>
</tr>
<tr>
<td>8/5/2017</td>
<td>Institute for Fiscal Policy (IJF), Dr Josip Franić</td>
<td>Informal economy and undeclared work</td>
</tr>
</tbody>
</table>


Appendix B

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