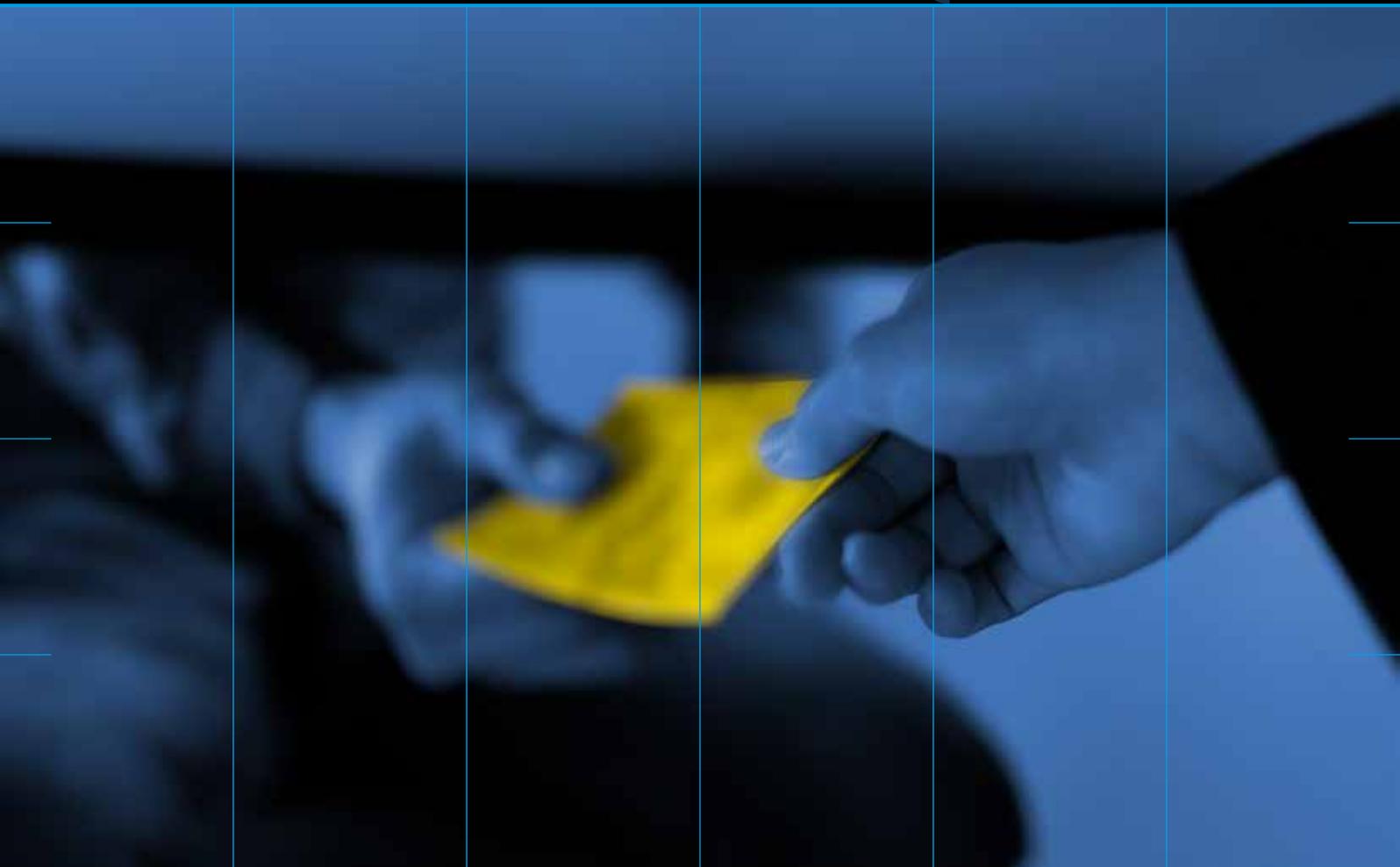




# **SHEDDING LIGHT ON THE SHADOWS**

**EXPLORING INFORMAL ECONOMY IN FOUR  
SOUTH EAST EUROPEAN COUNTRIES**



Title:

**Shedding Light on the Shadows:  
Exploring Informal Economy in the  
Four South-East European Countries**

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# EXECUTIVE SUMMARY

Shadow economy concerns policymakers around the world. No matter how developed a country is, a portion of its national output remains hidden. Shadow economy negatively affects the collection of public revenues and consequently the quality and availability of public services, as well as the efficiency of distributive policies. It also harms the principle of fair market competition.

Four South-East European countries: Bosnia and Herzegovina, Croatia, Montenegro, and Serbia face sizable shadow economy, estimated at 27.1% of GDP in Croatia, and approximately 30% for remaining three countries, which is significantly above the EU average of 17.9%.

We have explored informal markets in the selected economies, investigated drivers for engaging in informal activities and provided policy recommendations for reducing the informal sector. The study comprises findings of both primary and secondary research. Primary research included a quantitative survey on a representative sample of around 4 thousand respondents across four countries. Data collection was conducted in May and June 2019. A comprehensive review of the existing literature on the shadow economy has been conducted by national experts and the Centre for Policy and Governance (CPU) team. The methodology for this study builds upon work on Lithuanian Free Market Institute - Shadow Economies in the Baltic Sea Region from 2015.

We believe that data collected through the survey could be additionally assessed from variety of angles. Therefore, the CPU will make the database available for all researchers and organisations interested in pursuing further analyses.

The study is conducted prior to the outbreak of the COVID – 19 pandemics<sup>1</sup> which caused a significant shift in governments priorities. While governments are properly focusing on managing and mitigating health, social and economic risks and consequences of this pandemic in the short term, the recommendations provided here remain relevant for restoring economies and creating resistant and capable public services and inclusive markets in the mid-term.

A snapshot of shadow markets across the region:

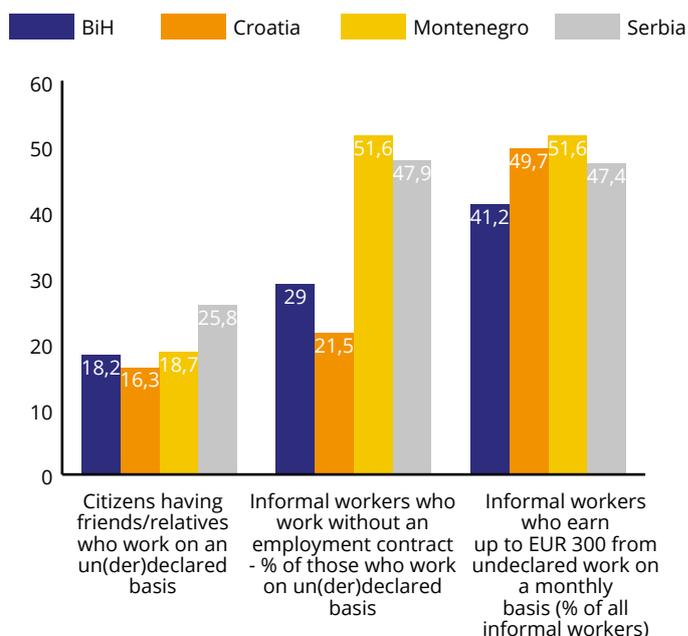
## Informal work

- 25.8% of citizens of Serbia have at least one person in near surrounding who evades taxes from labour

activities. In the remaining three countries, this share is below 20%, with Croatia being the best performer (16.3%).

- A portion of contacts work without an employment contract: in Montenegro (51.6%), Serbia (47.9%), BiH (29%) and Croatia (21.5%). Others mainly operate in the sphere of under-declared employment (where a part of the salary is not reported and on which taxes and contributions have not been paid), varying from 40.6% in Montenegro to 72.4% in Croatia.
- The highest portion of undeclared work is reported in wholesale and retail, except in Croatia which faces the highest un(der)declared work in construction and renovation sectors. Manufacturing, various repairs, transportation and storage, and catering and hotel services (the latter one especially in Croatia) are also the sectors with a high concentration of un(der)declared work.
- The majority of those who participate in the shadow labour market earn up to EUR 300 from undeclared work on a monthly basis. The share ranges from 41% in BiH to 52% in Montenegro. At the same time, undeclared economic activities represent a substantial source of income for many citizens of the observed countries.

Figure ES.1. Characteristics of informal work in respondents' surrounding

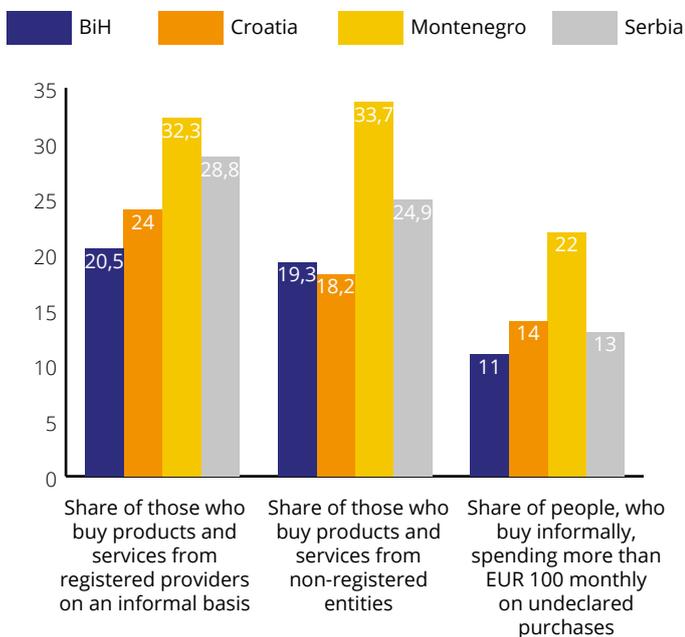


<sup>1</sup> The latest COVID-19 crisis showed the magnitude of vulnerability of informal sector and how it negatively affects the informal employment. Informal employees borne the brunt of the crisis. The initial, non-systematised, evidence shows that they were the first ones to be laid off. At the same time, informal workers were entirely invisible to governments' support measures (e.g. employment retention measures) to the labour market.

## Informal trade

- Share of those who buy products and services from registered providers on an informal basis varies from 20.5% in BiH to 32.3% in Montenegro. The share of those who buy products and services from non-registered entities varies from 18.2% in Croatia to 33.7% in Montenegro.
- Cigarettes are the most frequently informally purchased product in the region, except in case of Serbia. Among the population involved in undeclared purchases, the share of those who bought cigarettes without receipt or through informal channels varies from 15% in Serbia to 69% in Montenegro.
- Clothes are being purchased informally by between 29% (Croatia) and 52% (Montenegro) of population admitting their participation in informal purchases. People seem to be evading taxes most commonly when acquiring food, heating fuels, buying and repairing their vehicles, buying alcohol beverages and medical and beauty goods and services.
- The majority of people buying products informally spend small amounts of money on such purchases. At the other end, the share of people who spend more than EUR 100 monthly on undeclared purchases varies from 11% in BiH to 22% in Montenegro. Between 46.3% (BiH) and 66.4% (Croatia) population primarily attribute informal purchases to higher prices of formally acquired goods.

Figure ES.2. Characteristics of informal purchases/trading



## Shadow economy drivers and policy recommendations

### 1. Taxation

Increasing taxation leads to inflation of prices, expanding a price difference of goods and services (including labour)

traded formally and illegally. Main findings in this regard are comprised in the following lines.

Labour tax wedge in the four countries ranges from 38.8% in Croatia to 40.3% in Montenegro, which is above the OECD's average of 36.1%. Low progressivity of labour tax in observed economies, with exception of Croatia, represents a barrier for the formal employment of low-skilled workers.

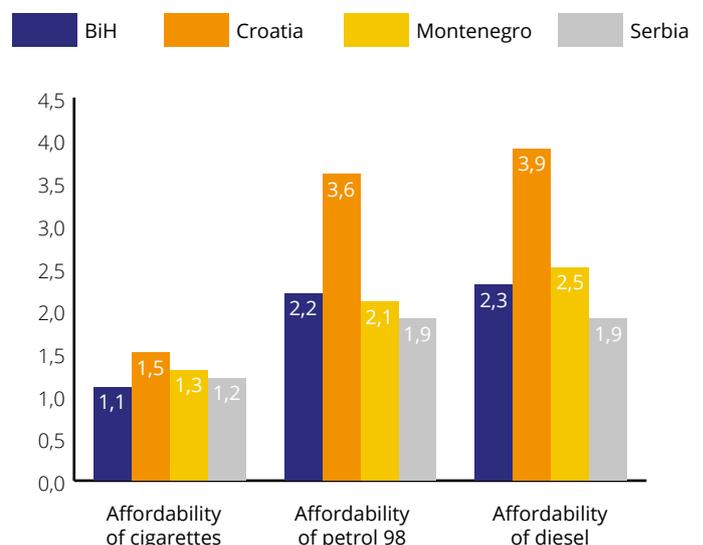
Higher labour taxes are one of the main drivers of un(der) declared work. Around 36% of the population perceive burdening labour taxation as the driver of informalities in this area. However, the observed countries mainly experienced no substantial tax wedge reduction in recent years.

More than 3/4 of the final price of cigarettes in the observed countries is comprised of taxes. The share of taxes in retail price of cigarettes is the highest in BiH, where taxes comprise 90.1% of the weighted average retail price (WAP), and the lowest in Montenegro (75.2%). Croatia (81%), Serbia (77.1%) and Montenegro, do not deviate substantially from the EU-28 average of 80.3%.

Between 1/2 and 2/3 of petrol retail price, and around 1/2 of diesel retail price is comprised of taxes, compared to the EU-28 average of 45%. Fuel is the most affordable in Croatia due to higher salary-based incomes, compared to other three countries. Affordability of fuel is the lowest in Serbia.

Cross-country differences in taxation and affordability of cigarettes fail to fully explain differences in levels of illicit trade in the observed countries. In case of fuel, cross-country differences in the incidence of informal purchase correspond to differences in the affordability of fuel.

Figure ES.3. Affordability of excise goods (average hourly net wage divided by the average price of the good)



## Recommendations

- Governments should consider decreasing the tax wedge on workers' salaries from the current levels to shares closer to the OECD average in order to boost employment and reduce incentives for un(der)declared work.
- Countries should not increase general VAT rates any further. Exception could be made in case of more comprehensive tax reform aimed at reduction of labour tax burden which would be compensated by consumption taxation. In such case, authorities should assess a room to reduce labour taxes under the current regime, considering a significant growth in indirect tax revenues before the COVID-19 crisis.
- Although countries committed to harmonizing excise levels with the EU, they should do it at pace and manner to yield intended results and avoid side effects. Continuous benchmarking of the affordability of excise duties against levels in the EU could be a useful tool.

## 2. Regulations and the business environment

Poor business climate is perceived as an important driver of the shadow economy in the region. Overregulation, lengthy and sluggish procedures, and high compliance push entrepreneurs in the shadow economy. Only Serbia has improved its Ease of Doing Business ranking over the period 2016-2020 and moved up by 15 places. Other three countries experienced deterioration in Doing Business rankings.

Rigid labour legislation, especially in Croatia and BiH, is an obstacle for intensifying formalization on labour markets. According to the assessment of labour market flexibility from the Global Competitiveness Report 2019, Montenegro (23<sup>rd</sup> place) performs a way better than other three countries. The rigidity of labour market is especially salient in Croatia (117<sup>th</sup> place) and BiH (107<sup>th</sup> place), while Serbia (53<sup>rd</sup> place) scored somehow in the middle of countries assessed. Over the last five years, Montenegro and Serbia have significantly improved their rankings at this index, while ratings of Croatia and BiH have dropped.

## Recommendations

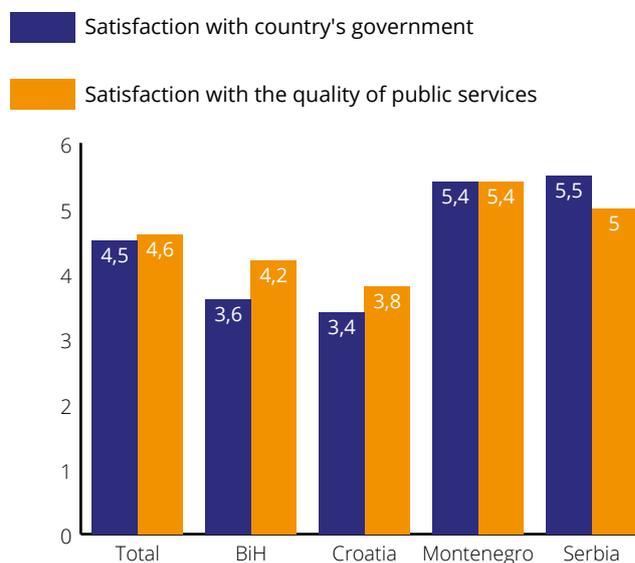
- Governments should prioritize improving the environment for doing business to reduce informalities. Considering relatively low performances of all four countries in the area of starting a business, this should be one of the obvious policy priorities. Additionally, among other areas, four observed countries need better regulations in the area of paying taxes.
- BiH and Croatia need to proceed further with reforms of the labour market in order to reduce rigidities and promote formal employment.

## 3. Quality of institutions and satisfaction with public services

There is clear connection between the quality of public institutions and the size of shadow economy. People expect governments to provide decent public services or they otherwise perceive that return on taxes paid is low and tend to question the benefits of paying taxes. Having low quality of public services reduces the incentive to pay taxes, while low tax revenues may lead to even poorer quality of services. According to the Global Competitiveness Report from 2019, BiH is ranked 114<sup>th</sup> out of 141 countries in terms of quality of institutions, while Montenegro is ranked as 53<sup>rd</sup>, Serbia as 75<sup>th</sup>, and Croatia as 77<sup>th</sup>.

On the basis of survey results it can be observed that the citizens in the region are more satisfied with the provision of public services than with the government's performance, apart from Serbia (5.5 satisfaction with the government and 5.0 satisfaction with public services on the scale 1-10, where 10 is the highest score). For Montenegro, both scores are equal (5.4), while Croatia reports the lowest level of satisfaction, both with the government (3.4) and the quality of public services (3.8). In BiH the scores are 3.6 and 4.2 respectively. Citizens across the region consider taxes to be high relative to the amount and quality of public services they receive.

Figure ES.4. Satisfaction with the government and quality of institutions (mean score); 1 – completely dissatisfied, 10 – very satisfied (CPU Survey, 2019)



Dissatisfaction with return on taxes paid in terms of the quality of public services positively correlates with disapproval of cheating on paying taxes (if one is presented with chance). It suggests that tax morale in the observed countries is not only a product of satisfaction with the government and public services but a broader and more complex phenomenon.

## Recommendations

- Although the study did not find a clear and strong connection between (dis)satisfaction with the public services and/or governments on one hand and tax morale or behaviour on the other, governments should pay more attention to improving public services and strengthening the trust of citizens toward institutions. Data obtained through the primary research suggests relatively low levels of satisfaction with the public sector in general.

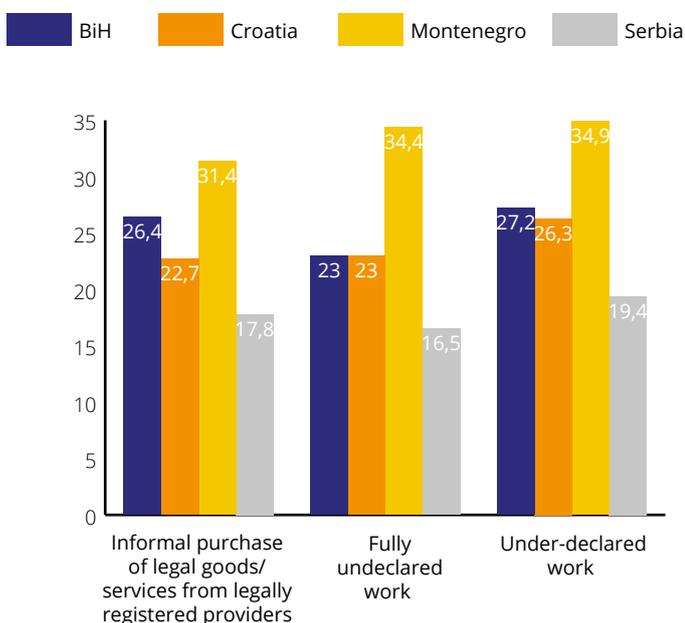
## 4. Tax morale and justification of shadow activities

Society's tax morale plays an important role in decisions to circumvent formal procedures. If one operates in a surrounding where justification of informalities is prevalent, they would be more likely to engage in the shadow activities.

Between 17.8% (Serbia) and 31.4% (Montenegro) of the population tend to justify purchasing goods or services from a legal shop when knowing that the seller will not declare payment. Smuggling and related illegal activities are also tolerated by many citizens. A share of respondents who justify such illegal activities ranges from 12.6% in Serbia to 28.9% in Montenegro. In case of participation in the shadow labour market, approval rating varies between 16.5% in Serbia to 34.4% in Montenegro.

When assessing general attitude towards non-declaration of taxes, 18.4% of people in BiH justify cheating/not declaring taxes, while this share accounts for 19.9% in Croatia, 22.6% in Serbia, and 30.8% in Montenegro. Less than half of citizens would keep operating in the formal economy if their income and financial situation severely worsened.

Figure ES.5. Share of population justifying informalities



Cross-country differences in tax morale are mainly consistent across the region, regardless of the type of shadow activity. Shares of the population justifying informalities are the highest in Montenegro and the lowest in Serbia.

## Recommendations

- Enhancements in this area need to be accompanied with substantial improvements in the quality of institutions, increased trust in governments and more favourable economic conditions
- Governments should consider awareness-raising campaigns about the negative effects of the hidden activities on individuals and society. An example of such campaigns is a receipt lottery to enhance compliance by nudging citizens to ask for a receipt when purchasing goods and services (introduced in Croatia, Serbia and Republika Srpska recently). Montenegro and Federation of BiH should consider similar promotional activities.

## 5. Deterrence

With an assumption that higher probability of detection and higher penalties would discourage engagement in informal activities, deterrence is a commonly used measure for combating the shadow economy. In the region, citizens perceive a relatively low probability of detection, regardless of their involvement whether in the purchase or in providing the undeclared goods and services.

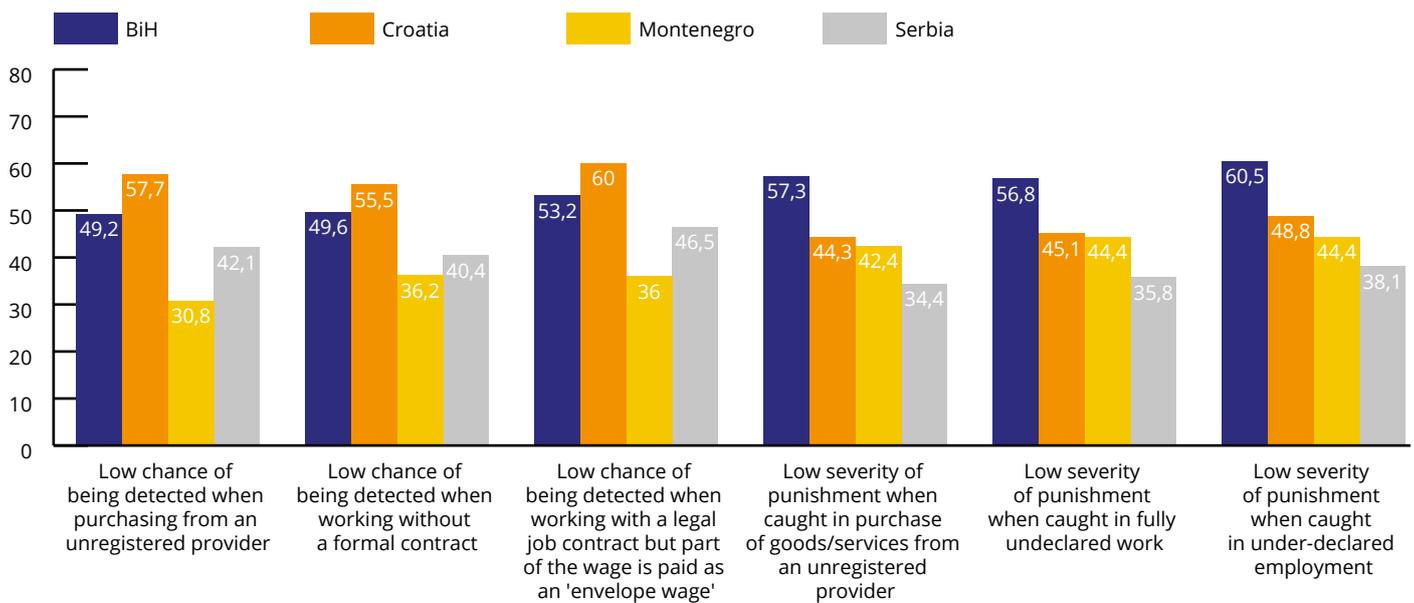
Shares of respondents highly confident in the capabilities of the repressive apparatus to detect purchases of undeclared goods and services range from 9.9% in Croatia to 24.4% in Montenegro. There is a share of population, ranging from 12.4% of in Croatia to 27.6% in Montenegro, believing in the realistic probability of detecting smuggling or illegal production and consumption of excise goods.

Risk of being detected for performing undeclared work is perceived as low by 55.5% of population in Croatia to 36.2% in Montenegro. Low risk of being penalised for under-declared work is perceived by high shares, ranging from 60% of citizens in Croatia, to 35.9% in Montenegro.

Shares of population ranging between 14.2% in BiH to 20% in Serbia expect the authorities to be quite harsh towards purchasing goods or services from illegal sources, while a considerable share of population (from 34.4% in Serbia to 57.3% in BiH) perceive the penalties for engaging in informal activities to be relatively mild.

Almost a half of population in Croatia and Montenegro (45.1% and 44.4% respectively), 35.8% in Serbia and 56.8% in BiH believe that sanctions will be either negligible or quite mild for workers who work without a formal contract. The situation is even more alarming when it comes to wage underreporting. Share of the population who finds sanctions mild varies between 38.2% in Serbia and 60.5% in BiH.

Figure ES.6. The share of the population who perceive the chance of being detected and the severity of punishment as low



## Recommendations

- Governments should continue to improve capacities of the inspectorates, and further develop the systems of monitoring and predicting illicit practices in companies. Stronger emphasis should also be placed on measures for detecting unregistered businesses.
- Governments should focus on increasing the trust in enforcement institutions, as well as to create a relationship between institutions and taxpayers where they would assume a role of partners. Formal institutions should be designed more as enablers and partners of entrepreneurs, rather than constraints.



# INTRODUCTION

**The shadow economy<sup>2</sup> concerns policymakers all around the globe.** No matter how developed a country is, a portion of its national output remains undetected by the authorities. It occurs in the shadows and stays unrecorded by fiscal receipts, invoices, tax forms and contracts. Although the nature and structure of the shadow economy differs from one country to another, it always makes some negative socioeconomic impact to a certain degree. It results in lower public budget revenues, which consequently lead to poorer quality of public services and social protection schemes, less efficient distributive policies, and also have the ability to negatively affect the stabilisation policies. Furthermore, it harms the principle of fair market competition (because evading taxes leads to lower prices or increased profit margins), and usually leads to poorer working conditions and safety standards for workers, among other things. Therefore, it is not surprising that scholars are eagerly trying to understand the roots, types, patterns and solutions for this omnipresent phenomenon.

**There is no consensus on the definition of the shadow economy among scholars.** Although all definitions assume that shadow economy is comprised of economic activities hidden from authorities, a broader conceptualisation of the term includes both unregistered legal and unregistered illegal activities (e.g. drug production and dealing) which remain unrecorded by the official statistics, while a narrower conceptualisation distinguishes the shadow economy from the criminal activities. The latter understanding is more prevalent in contemporary academic discourse.

**In the simplest manner, shadow economic activities could be defined as legal activities that “circumvent government regulation, taxation or observation”, i.e. as “all productive economic activities that would generally be taxable were they reported to the state (tax) authorities”<sup>3</sup>.** In that sense, criminal activities are not considered as the shadow activities, having in mind they cannot be formalised. Self-provisioning also falls out of the spectrum of the shadow economy and is usually not included in analyses and estimation of its size<sup>4</sup>. Such understanding and definition are therefore applied to this research. However, a set of questions on illegal trade (smuggling and illegal production) has been introduced in the survey, thus slightly deviating from the core definition,

done only to explore trade associated with excise goods, which are legal by nature, but often illegally produced and traded due to heavy taxation of these products. Still, activities such as drug dealing, prostitution, human trafficking and alike, are not considered as part of the shadow economy by this research, but rather as something which belongs to the sphere of criminal activities.

Shadow economy is a complex phenomenon which has its multiple causes. Informalities occur as a reaction on restrictions, primarily tax and regulatory burdens placed on legitimate economic activities<sup>5</sup>. In that sense, transactions in the shadow economy are undeclared in order to avoid payment of taxes or social security contributions (for monetary reasons) or to avoid meeting regulatory standards or complying with certain administrative procedures (for regulatory reasons)<sup>6</sup>. Institutional reasons (corruption, weak rule of law, etc.) are sometimes considered as the third group of causes<sup>7</sup>, but they should be observed as drivers of the shadow activities rather than the core causes of avoiding the formal sphere. Thus, by adopting classification deployed by Schneider & Buehn<sup>8</sup> and Žukauskas<sup>9</sup>, this report considers and discusses five main drivers of the shadow economy: (1) taxes and affordability of goods; (2) intensity of regulations and the business environment; (3) quality of institutions (i.e. satisfaction with the government and public services); (4) tax morale (justification of shadow activities) and (5) deterrence (likelihood of detection and level of punishment). Each of these drivers will be explained in more details in Chapter 4.

**Shadow economy is a phenomenon strongly evident in transition economies.** A shift from the planned to the market economy, tremendous changes in the structure of the economy, weak institutions and mistrust towards governments led people to find their own rules and channels for conducting economic activities, thus creating parallel markets unaccountable to any formal institution. In that respect, ex-Yugoslavian economies mainly deal with sizeable and harmful informalities, which is obvious from the example of four countries observed by the study: Bosnia and Herzegovina (hereinafter: BiH), Croatia, Montenegro and Serbia. As it will be presented later, in Chapter 3 of this report, all four economies have levels of the shadow economy above the EU average.

2 Terms 'shadow economy' and 'informal economy' have been used interchangeably (as synonyms) in this report.

3 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*, p. 4.

4 Ibid.

5 Žukauskas, V. (Ed.). (2018). *Shadow Economy: Understanding Drivers, Reducing Incentives*.

6 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*. Medina, L., & Schneider, F. (2018). *Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?*

7 Medina, L., & Schneider, F. (2018). *Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?*

8 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*.

9 Žukauskas, V. (Ed.). (2018). *Shadow Economy: Understanding Drivers, Reducing Incentives*.

**Despite the persistency and seriousness of the issue, the shadow economy is relatively under-researched in the observed countries.** This is especially true when it comes to research that would provide comparable insights for the region. Undeclared work/employment is a bit more explored aspect, considering that special attention has been put to labour-related challenges of these countries, primarily due to poor performances of their labour markets. On the other hand, a little has been published on the shadow goods market and causes of the shadow economy. Therefore, the report will contribute to reducing this gap and enriching the body of knowledge on this topic.

**The research presented in this report aimed to explore extents of the shadow goods market and the shadow labour market, as well as to assess the reasons why people engage in illicit activities in the observed countries.** The latter is primarily based on analysis of people's perception and attitudes toward the quality of institutions, levels of taxation, detection and punishment (deterrence) and their tax morale, i.e. justification of operating in the shadows. In this context, the report provides insight into drivers and motivation behind the participation in the shadow economy. For that pur-

pose a direct questionnaire survey was conducted during the period May-June 2019, as presented in Chapter 2.

**The main purpose of this research endeavour was to feed in the public debate on the shadow economies in the four countries with sound and comparable findings, thus helping decision-makers to tailor more effective policies for combating the shadow economy.** In that regard, primary empirical findings have been accompanied by a brief analysis of the policy context and recent policy developments which affect the shadow economy. On that basis, a set of high-level policy recommendations has been formulated in the report. Therefore, this report represents a contribution to policy discussions on the shadow economy in the region.

**The report is comprised of three main parts.** In the first part are presented findings related to the extent and nature of the shadow economy in the observed countries, placing them in the context of previous findings on this matter. The second part discusses the main drivers of the shadow economy, putting them in the perspective of the recent policy developments in relevant areas. The third part provides high-level policy recommendations.

# METHODOLOGY

**This study discusses the findings of both secondary and primary research.** Secondary data includes the previous research on the analysed topic, public documents and relevant databases. A comprehensive review of the existing literature on the shadow economy in the observed countries has been conducted and the main findings are included in this report, where relevant to complement or contextualise the primary research findings.

**Primary research assumed a quantitative face-to-face survey, using IPSOS Omnibus survey<sup>10</sup>.** The survey was performed at respondents' home using CAPI (Computer-assisted personal interviewing software). Data collection took place in May and June 2019 in all four countries.

**Survey included representative samples of the population (aged 18+) in the four countries (see Table 1a and Table 1b).** The sampling was based on the data from Census, with adjustments for the estimated population dynamics. The three-stage representative stratification procedure was pursued, as follows:

- Primary sampling units (PSU) were polling station territory in all countries except in Croatia where settlements were used as PSU.
- Secondary sampling units (SSU) were households: One household comprises people living in the same apartment/house and sharing the expenditure for food.
- Tertiary sampling units (TSU) were respondents: Respondent was an adult member of the household (18+ years) selected by quota.

Results presented in this report are obtained using post-stratification weights on raw data, so as to reflect the real the state of affairs within population.

Table 1a. Sample sizes

Country	Sample size
Bosnia and Herzegovina (BiH)	1,005
Croatia	1,000
Montenegro	1,024
Serbia	1,035

**Questionnaire used for this research is an adapted version of the instrument developed by the Lithuanian Free Market Institute for the study *Shadow Economies in the Baltic Sea Region* published in 2015.<sup>11</sup>** The questionnaire is enclosed in Annex 1 of

the report. Having in mind that research was conducted within the IPSOS Omnibus Survey, demographic data was collected through separate set of questions contained in Omnibus.

10 Therefore, a micro (survey-based) method has been used in this study. For a comprehensive description of micro and macro methods, please see Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*.

11 Žukauskas, V. (2015). *Shadow Economies in the Baltic Sea Region 2015*.

Table 1b. Demographic structure of the sample

Demography		Country				
		BiH	Serbia	Croatia	Montenegro	Total
Gender	Male	48.5%	48.1%	46.9%	48.4%	48.0%
	Female	51.5%	51.9%	53.1%	51.6%	52.0%
Education	Primary	28.1%	31.2%	27.7%	26.7%	28.5%
	Secondary	58.4%	50.6%	55.1%	54.9%	54.7%
	Faculty	13.4%	18.1%	17.2%	18.4%	16.8%
Age	18 – 35	31.8%	26.8%	29.3%	31.7%	29.9%
	36 – 50	26.5%	25.1%	22.1%	26.0%	24.9%
	51 – 65	27.3%	26.3%	30.6%	24.8%	27.2%
	66+	14.4%	21.9%	18.1%	17.4%	18.0%
Working status	Employed	36.9%	38.3%	45.4%	38.9%	39.8%
	Not in employment	63.1%	61.7%	54.6%	61.1%	60.2%
Type of settlement	Urban	42.8%	60.1%	61.4%	64.4%	57.2%
	Rural	57.2%	39.9%	38.6%	35.6%	42.8%

Findings presented in the study are mainly based on the descriptive statistical analysis. Graphs and tables presented in the report often contain "Total" as an additional category to the four observed countries. This category presents aggregate results for the whole sample (all countries). In that regard, data presented under this category represent unweighted regional averages, which have a function to indicate general regional trend. However, due to notable differences between the countries, this data should not be cited or interpreted alone, without including country-specific findings.

# THE EXTENT OF THE SHADOW ECONOMY AND ITS CHARACTERISTICS

# 3

## **The observed countries face sizable shadow economy, with levels notably above the EU average.**

Recent MIMIC<sup>12</sup>-based analyses for BiH estimate the size of the shadow economy in the country to 29.9%-30% of GDP in 2015 and 2016<sup>13</sup>. According to the MIMIC-based estimates, legal activities staying under the radar of the authorities in Croatia accounted for 27.1% of GDP in 2016<sup>14</sup>. There are no recent sound estimates on the size of the shadow economy in Serbia. The most detailed recent research on the shadow economy was conducted in 2010, when its size was estimated to be 30.1% of GDP, based on the MIMIC method<sup>15</sup>, and the same was found in 2012<sup>16</sup>. Some authors argue that the shadow economy in Serbia in 2017 remained at the similar level compared to the one in 2012<sup>17</sup>. Sound data is lacking for Montenegro as well, but some rough estimates suggest that its level is around 30% of GDP<sup>18</sup>. In all observed countries, levels of the shadow economy are much above the 2016 EU-28 average of 17.9%<sup>19</sup>.

## **Partial evidence suggests that the shadow economy has been slowly but constantly shrinking over the period 2006–2016.**

As available findings for BiH and Croatia show, there is a positive trend of the shadow economy declining during the observed period: it dropped by 3.5 and 2.5 percentage points (hereinafter: pp) respectively<sup>20</sup>. The downward trend has only been interrupted during the initial phase of the economic crisis when slight increase in levels of the shadow economy has been recorded. In that sense, the trend corresponds to overall trends in the EU<sup>21</sup>. Although time series for Montenegro and Serbia are not available, the aforementioned observations suggest that the countries probably did not experience expansion of the shadow economy relative to GDP.

## **To expand and complement existing knowledge on the shadow economy in the observed countries, this chapter explores its size and nature by focusing on both the shadow goods market (demand side) and**

**the informal labour market (supply side).** Our ambition is not to estimate its size relative to GDP, but rather to explore incidence, types and basic socio-economic context of such informal activities.

### **3.1. The shadow goods market**

#### **The results of the survey are mainly in line with the previous findings, indicating a high incidence of the informal transactions.**

However, the share of population buying legal products and services from registered providers on an informal basis, i.e. knowing or suspecting that the revenues are not officially declared, differs notably across the countries. It varies from 20.5% in BiH to 32.3% in Montenegro. In other words, in BiH, where the incidence is the lowest, one in five citizens buys goods informally from registered buyers occasionally or on a regular basis, while in Montenegro, where the incidence is the highest, such behaviour is present among every third citizen. However, notable portion of respondents failed to provide an exact answer to this question, especially in Serbia, which suggests that the real participation rate is probably somewhat higher (see Figure 1; the same is applicable to Figure 2).

#### **Even though many respondents who admitted their involvement argued it happened only once or twice during the twelve months preceding the survey, there is also a non-negligible cohort of citizens who repeatedly acquire goods and services under-the-table.**

With the exception of Croatia, more than half of respondents who buy goods informally do it occasionally (up to ten times) or on a regular basis (see Figure 1). Again, the share is the highest in Montenegro, where 9.2% population acquire goods informally on a regular basis and 12.7% up to ten times within the year, which, in total, consists around 68% of the total cohort of buyers involved in unaccounted purchases.

12 Multiple Indicators, Multiple Causes (MIMIC). For more details on this method, as well as on different approaches to estimating the size of the shadow economy, please see Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*.

13 Medina, L., & Schneider, F. (2018). *Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?*. Pašović, E., & Efendić, A. S. (2018). Informal Economy in Bosnia and Herzegovina - An Empirical Investigation. *South East European Journal of Economics and Business*.

14 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*.

15 Krstić, G. et al. (2013). *Siva ekonomija u Srbiji: Novi nalazi i preporuke za reforme*; Randelović, S. (2016). How to Boost Tax Compliance and Tax Morale in Serbia? *Ekonomika preduzeća*, 65.

16 Arsić, M., Randelović, S., & Altiparmakov, N. (2018). Kretanje sive ekonomije u Srbiji: 2012-2017. *Kvartalni monitor*.

17 Ibid.

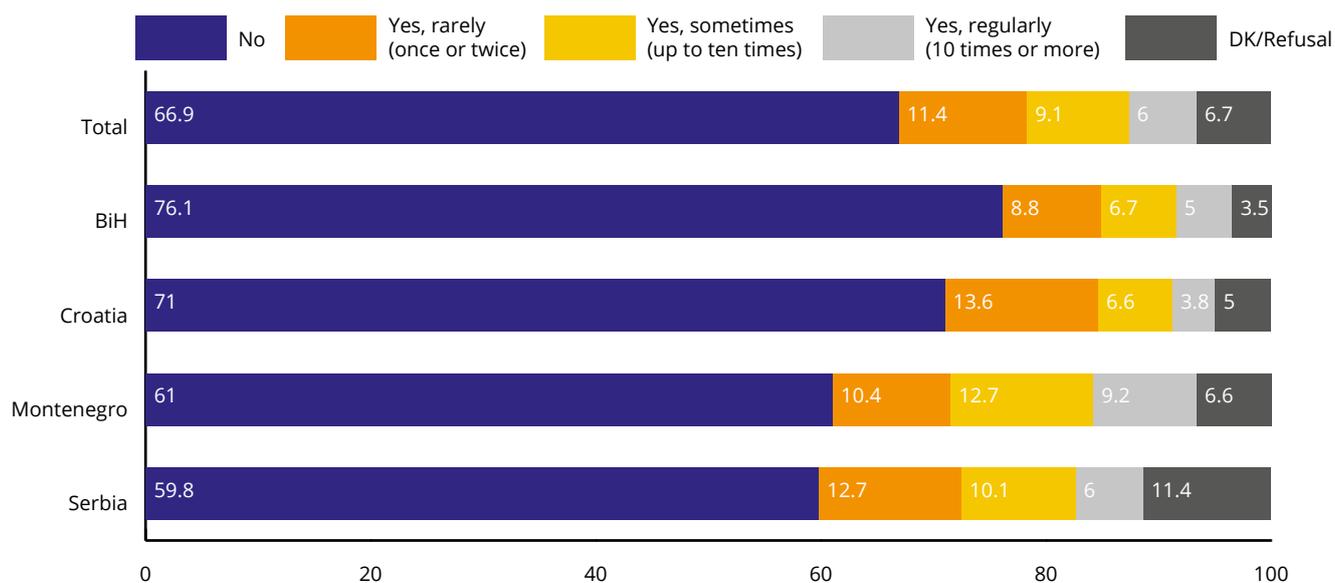
18 Ministry of Finance. (2018, December 31). *Intervju ministra Darka Radunovića za ND Vijesti: Planiramo ukidanje kriznog poreza 2020. godine*. MEF, & Kostić, V. (2014). *Informal Economy in Montenegro: The Enabling Environment for Sustainable Enterprises in Montenegro*.

19 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*.

20 Medina, L., & Schneider, F. (2018). *Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?* International Monetary Fund. Pašović, E., & Efendić, A. S. (2018). Informal Economy in Bosnia and Herzegovina - An Empirical Investigation. *South East European Journal of Economics and Business*, 13(2) Schneider, F. (2016). *Estimating the Size of the Shadow Economies of Highly-developed Countries: Selected New Results*. CESifo DICE Report (Vol. 14).

21 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*.

Figure 1. Purchase of legal goods/services from legally registered providers without getting a receipt over the period of last 12 months, % of population (CPU Survey, 2019)

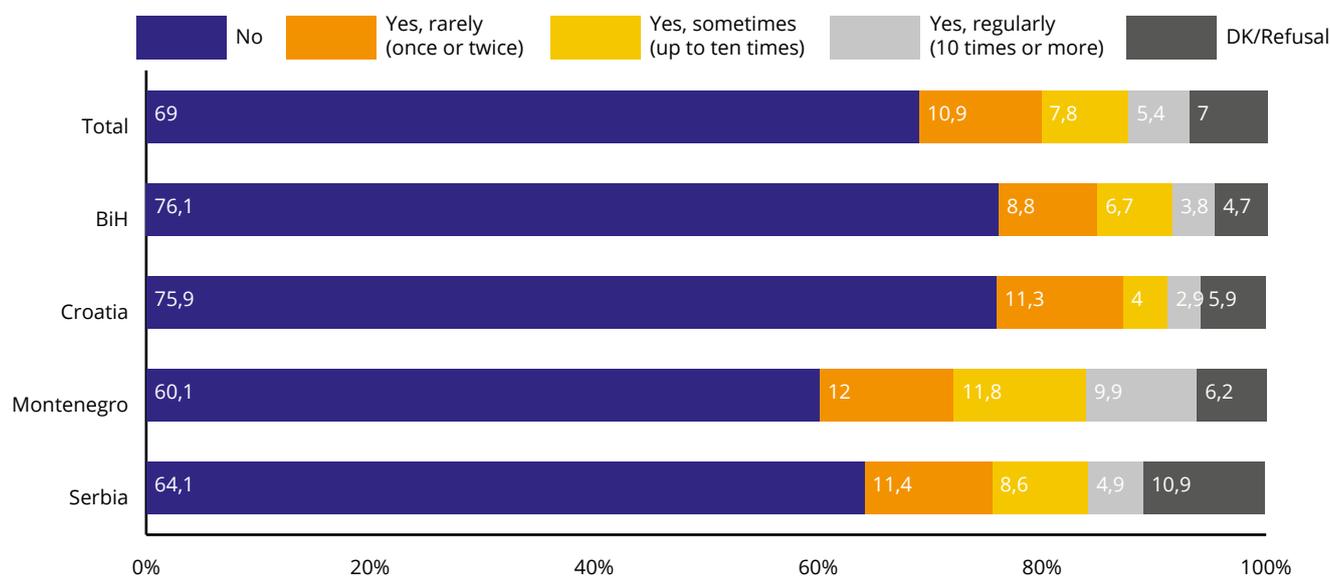


**Similar behaviour is noticeable concerning transactions concluded with unregistered providers.**

Share of respondents who buy products and services from unregistered entities, i.e. operate entirely in the shadows, varies from 18.2% in Croatia to 33.7% in Montenegro (see Figure 2). Slightly more than half of this cohort (54%) do it repeatedly in BiH, around 38% in Croatia and, notably above other three countries, around 64% in Montenegro (see Figure 2). In other words, every fifth citizen of

Montenegro repeatedly participates in transactions concluded with unregistered individuals or companies, every seventh in Serbia, every tenth in BiH and every fourteenth in Croatia. Higher incidence of informal purchases in Montenegro is driven by different factors, but to some extent may be explained by relatively high tax burdens, i.e. relatively low affordability of goods, combined with poor tax morale, as elaborated in Section 4.

Figure 2. Purchase of goods/services from providers who are not legally registered, % of population (CPU Survey, 2019)



**With the exception of Serbia, cigarettes are the most often informally purchased product in the observed countries.**

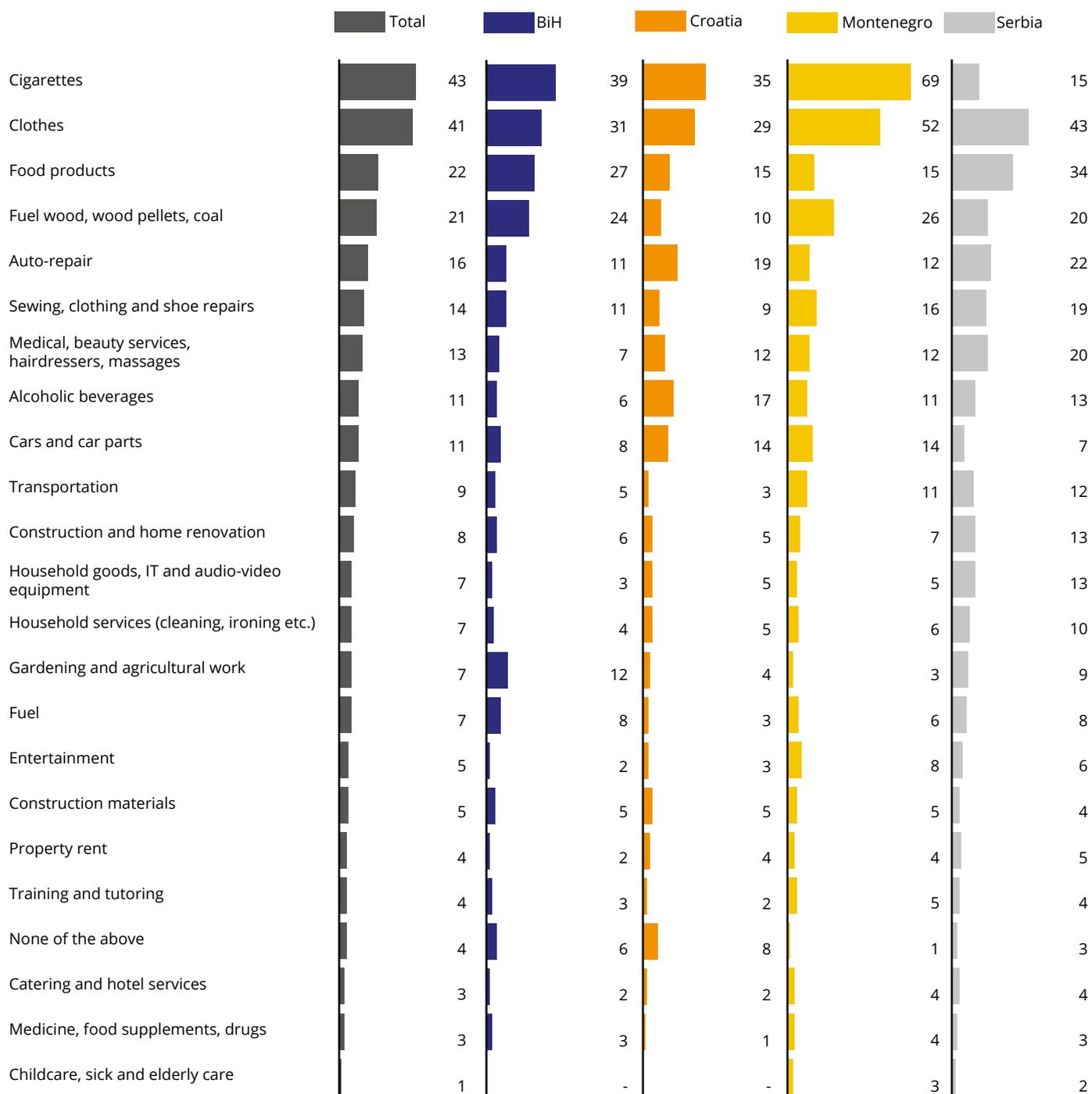
Thus, among population involved in undeclared purchases, the share of those who purchased cigarettes without receipt or by using informal channels (e.g. smugglers) in the period of 12 months preceding the survey varies from 35% in Croatia to 69% in Montenegro

(see Figure 3). In Serbia, cigarettes are positioned as 7<sup>th</sup> product by the share of respondents who buy it informally, comprising 15% of respondents who admitted informal purchases. However, this finding cannot be explained by cross-country differences in levels of excise duties or total taxation of the product, as explained in Section 4.1.

**Furthermore, clothes are traded informally to great extent in all four countries.** Between 29% (Croatia) and 52% (Montenegro) of those who buy informally reported acquiring this specific good. Although it can be assumed that one portion of these purchases is related to hand-tailored clothes (from unregistered sole traders) and bazaars, it can be also speculated that such high percentages reflect, to some extent, rapid expansion of online trade (primarily via social networks and informal e-shops).

**Along with cigarettes and clothes, people seem to most commonly evade taxes when acquiring food, heating fuels, buying and repairing their vehicles, buying alcohol beverages and medical and beauty goods and services.** Figure 3 provides a detailed overview of incidence of acquiring particular goods and services informally by those who admitted undeclared purchases.

Figure 3. Goods and services bought on an informal basis, % population admitting their participation (CPU Survey, 2019)

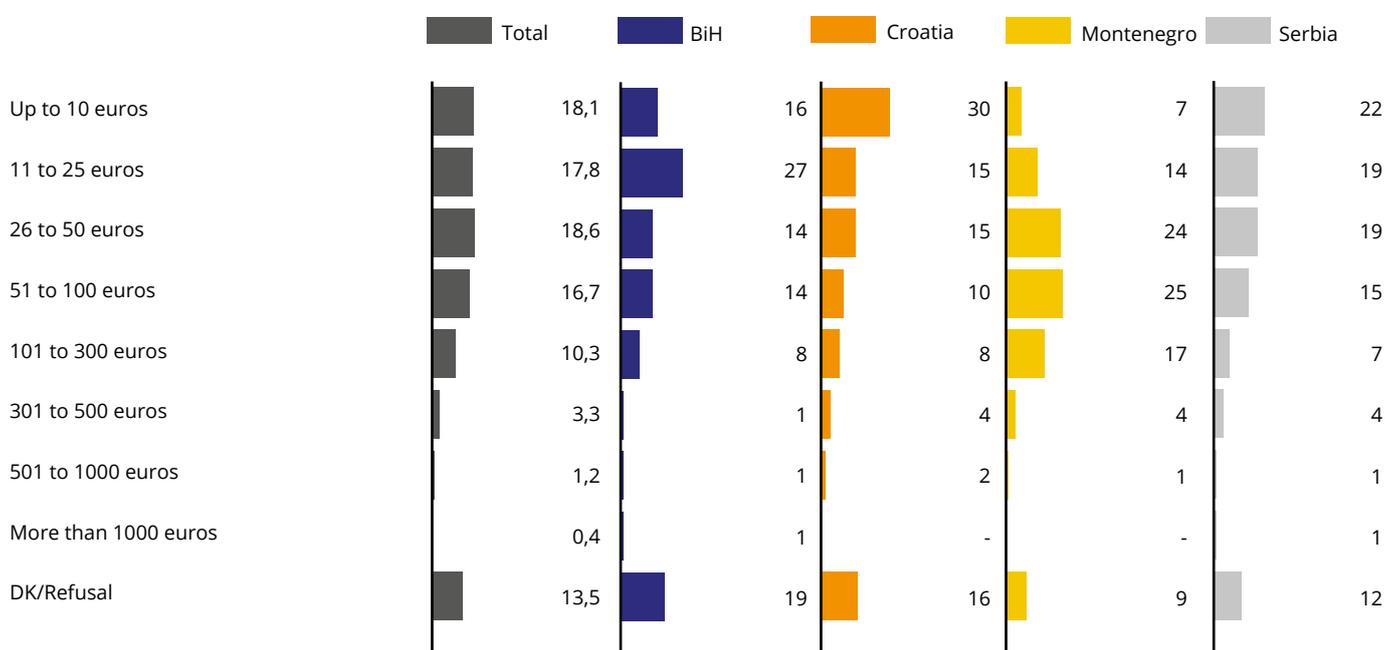


**Although majority of people buying products informally spend small amounts of money on such purchases, there is a non-negligible number of those who allocate more generous resources to undeclared purchases.** Thus, there is a substantial variety inside the population in terms of average spending within the shadow economy (see Figure 4), but cross-country differences are also notable. In Croatia, citizens dominantly have very small informal monthly purchases, as for instance 30% of them spent less than EUR 10. The opposite case is Montenegro, where only 7% of purchasers belong to this cohort (see Figure 4). The share of those with moderate levels of spending (EUR 11–100) varies from 40% in Croatia, 53% and 55% in Serbia and BiH, to 63% in Montenegro. Considering that the amount of EUR 100 represents, roughly, around 1/5 of an average month-

ly net salary in BiH, Serbia and Montenegro, and slightly more than 1/9 in Croatia, it is especially worrisome that this threshold is exceeded by non-negligible share of population. The share of people who spend more than EUR 100 on undeclared purchases vary from 11% in BiH, 13% and 14% in Serbia and Croatia, to 22% in Montenegro.

**Generally speaking, it is obvious from Figure 4 that reported levels of spending in Montenegro are more skewed toward higher amounts, compared to other countries.** In that sense, not only that the higher share of population in Montenegro is inclined to buy informally, but those who buy informally tend to spend more on informal purchases compared to other three countries. These findings hence clearly illustrate the true size of informal goods market in this country.

Figure 4. Average monthly amount spent on unregistered goods and services, % of survey respondents admitting their participation (CPU Survey, 2019)

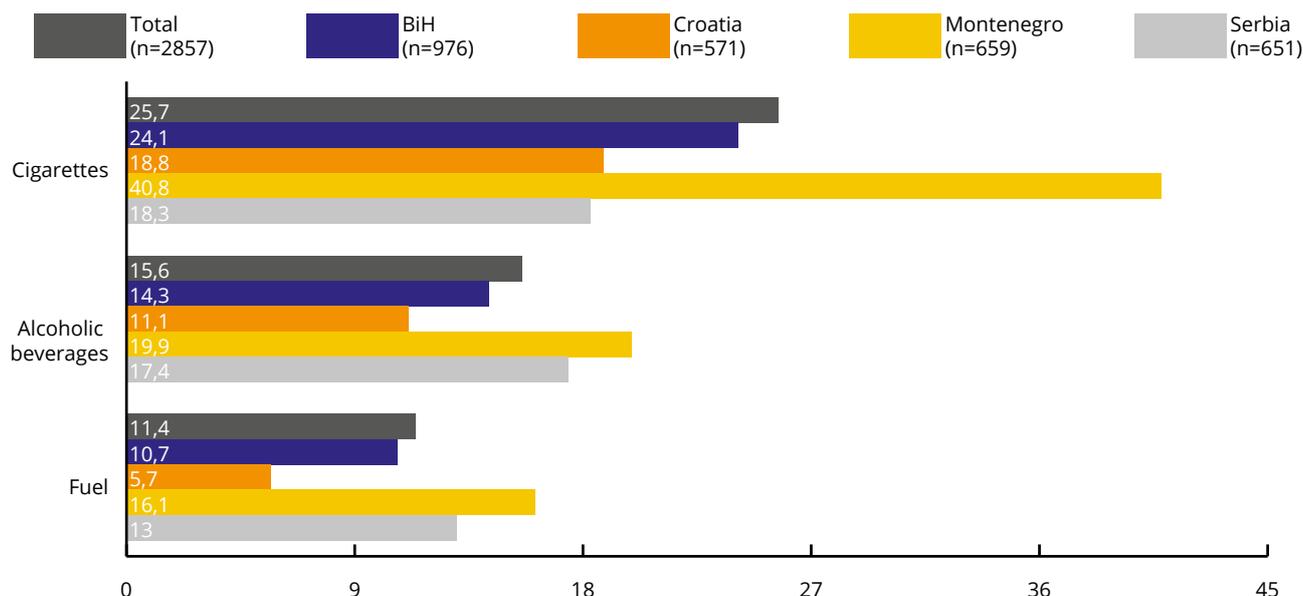


**Informal purchases comprise a significant portion of total consumption of excise goods.** Namely, survey participants were asked to estimate the share of informally acquired excise goods, cigarettes, alcoholic beverages and fuel, in the total consumption of these goods among their friends and relatives<sup>22</sup>. Findings summarised in Figure 5 suggest that such share is significant in the case of all three goods, but especially worrisome in case of cigarettes. When observed at the cumulative level of all four countries, it could be said that 1/4 of total consumption comes from illicit purchases. This share is the highest in Montenegro where it accounts for more than 40% of the total consumption. In other three countries, it varies

from 18.3% (Serbia) to 24.1% (BiH). When it comes to alcoholic beverages, the share ranges from 11.1% (Croatia) to 19.9% (Montenegro). Fuel is acquired informally on a much lower scale, as undeclared purchases of this commodity comprise between 5.7% (Croatia) and 16.1% (Montenegro) of consumption. As shown in Figure 5, Croatia faces the lowest incidence of illicit purchases of excise goods, while the issue is the most serious in Montenegro, which is consistent with findings presented in Figure 1 and Figure 2. Tax-related motives for purchasing excise goods on the informal market are elaborated in more details in Section 4.1.

22 To avoid possible under-reporting or refusal, the survey's participants were asked to estimate the consumption in their social surroundings. This also means that the participants who do not directly consume some of the listed goods had an opportunity to estimate the share of such consumption among friends and relatives.

Figure 5. Share of informally/illegally purchased excise goods in the total consumption of those goods among one's friends and relatives (CPU Survey, 2019)

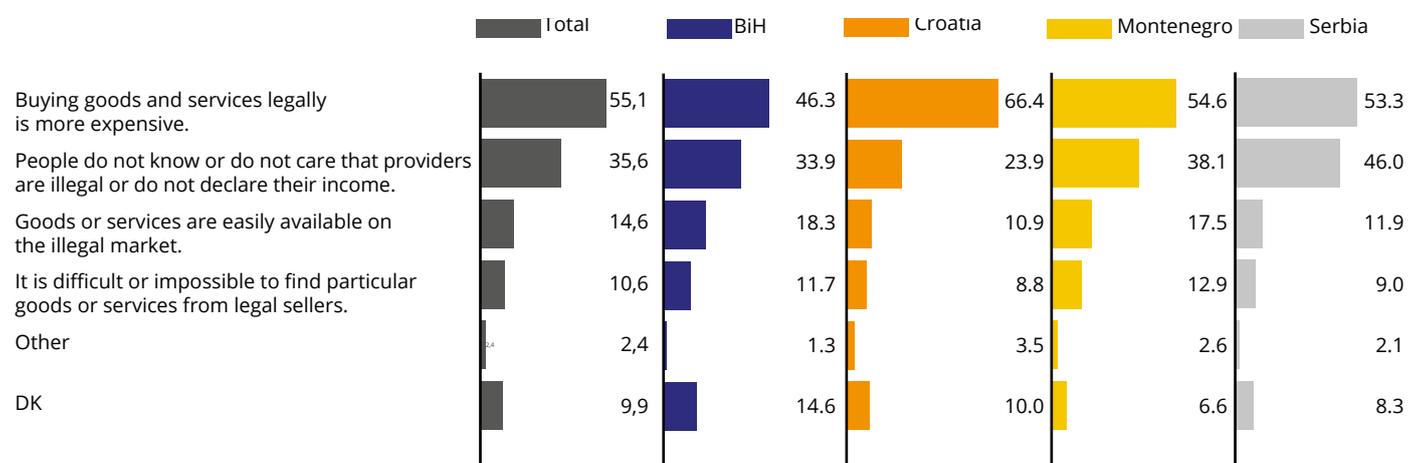


**It seems that citizens acquire goods and services informally primarily because they are less expensive, but also because they often do not care if providers are illegal or do not declare their income.** Namely, citizens of the observed countries primarily attribute informal purchases to higher prices of formally acquired goods: between 46.3% (BiH) and 66.4% (Croatia) perceive this as a reason (see Figure 6). Also, significant number of citizens believe that ambivalence of buyers regarding this matter is an important determining factor for undeclared purchases, varying from 23.9% in Croatia to 46% in Montenegro. The latter finding relates to low tax morale in Montenegro, as elaborated in Section 4.4. On the other hand, notable share of citizens – between 10.9% (Croatia) and 18.3% (BiH) – believe it is due to easy access to illegal markets, which, among others, indicates inefficient deterrence mechanism, as discussed in Section 4.5.

Interestingly, significantly higher share of citizens in BiH and Montenegro (18.3% and 17.5% respectively) perceive this as an important reason compared to Croatia and Serbia (10.9% and 11.9% respectively).

**A number of individuals argued that particular goods or services are difficult to be found on the formal market (see Figure 6).** This primarily indicates two things. Firstly, some goods or services are unavailable on the formal market due to high barriers for formalising their trade. Reasons may vary, from high taxes that reduce margins and profitability of producing or trading some goods to complex administrative standards and procedures to formalise production and/or trade. Secondly, it could suggest that some markets (e.g. trade with homemade food, beverages, etc.) have not been formalised at all – they traditionally exist as parallel, informal, markets.

Figure 6. Main reasons for purchasing informally or from illegal sources (CPU Survey, 2019)



## 3.2. The shadow labour market

### **Informal work is a persistent issue in the observed countries, but estimates of its levels vary largely, mainly due to differences in methodological approach and definitions of informal work / employment.**

For BiH, recent estimates usually vary between 20% and 30% of total paid employment<sup>23</sup>, while official statistics is lacking. According to a recent study which embraced a representative sample of 6,021 respondents from this country, 34% respondents gained an income through undeclared work. For 26% respondents this was the only source of income and for 8% this represented an additional source, along with the formal job<sup>24</sup>. When it comes to Croatia, the 2013 Special Eurobarometer Survey on undeclared work found that at least 7.3% of citizens of Croatia had been carrying out unregistered activities, while 8.3% of individuals in waged employment received wages higher than stated in their contract<sup>25</sup>. In Montenegro, based on 2014 survey, it is estimated that informal and quasi-formal employment comprise around 1/3 of total employment. Around 22.3% employees are undeclared workers (i.e. without a written contract), while additional 10.3% have under-reported salaries<sup>26</sup>. Recent estimates for Serbia, based on the official statistics, reveal that undeclared work and unpaid family work jointly comprise 18% of total employment, but without offering data for under-declared employment<sup>27</sup>. Having in mind the lack of comparable data, as well as inconsistency between sources, findings presented in this chapter of our study will provide a more comprehensive insight in the shadow labour markets in the observed countries.

### **Informal work is a sensitive topic and, therefore, it is challenging to measure its extent and characteristics by applying a direct approach.**

Respondents hesitate to disclose honest information on their involvement in fraudulent activities, making it difficult to produce reliable estimates on the basis of survey<sup>28</sup>. Therefore, we introduced two sets of questions on informal labour market in the questionnaire. The first was focused on the

experience of respondents' friends and relatives and the second on their own experience regarding informal work. The purpose of introducing a set of questions on informal work in one's surroundings is to bypass under-reporting, which could be caused by hesitation of the respondents to share sensitive private information.

#### 3.2.1. Informal work<sup>29</sup> in one's surrounding

To assess the scope and pervasiveness of informal labour market, every interviewee was asked whether any person from their close social circles (i.e. friends and relatives) carried out work on an un(der)declared basis. Respondents who answered positively were then inquired about the nature of the job their friends/relatives have been engaged in.

#### **Survey's findings indicate a high presence of un(der)declared work/employment in all four countries.**

Serbia has the highest share of individuals knowing someone employed in the shadow labour market; 25.8% citizens of Serbia have at least one person in near surrounding who evades taxes from legitimate labour activities. In other three countries this share is slightly below 1/5 (see Figure 7), with Croatia being the best performer in this regard (16.3%). However, having in mind sizable portion of invalid answers, varying from 19.6% in Serbia to 4.4% in Croatia (see Figure 7), the aforementioned shares should be perceived only as lower boundaries for the real state of affairs. In other words, high portion of invalid answers suggests that some respondents wanted to evade providing an answer due to sensitivity of matter, indicating that share of those who have un(der)declared worker in their close surrounding could be notably higher. In that sense, it could be more appropriate to say that in Serbia only 54.6% citizens strictly denied knowing anyone with such characteristics, in Montenegro and BiH this share accounted for 67.5% and 69.4%, respectively, while the denial rate was the highest in Croatia, accounting for 79.3% population (see Figure 7).

23 See: Pašović, E., & Efendić, A. S. (2018). Informal Economy in Bosnia and Herzegovina - An Empirical Investigation. *South East European Journal of Economics and Business*; European Commission. (2019). *Economic Reform Programme of Bosnia and Herzegovina (2019-2021): Commission Assessment*; Oruč, N., & Bartlett, W. (2018). *Labour Markets in the Western Balkans: Performance, Causes and Policy Options*. Shentov, O., Stefanov, R., & Todorov, B. (2016). *Shadow Power: Assessment of Corruption and Hidden Economy in Southeast Europe*. World Bank. (2015). *Rebalancing Bosnia and Herzegovina: A Systematic Country Diagnostic*.

24 Pašović, E., & Efendić, A. S. (2018). Informal Economy in Bosnia and Herzegovina - An Empirical Investigation. *South East European Journal of Economics and Business*.

25 European Commission. (2014). *Special Eurobarometer 402: Undeclared work in the European Union*. Franic, J., & Williams, C. C. (2014). *Undeclared work in Croatia: A baseline assessment*. GREY Working Paper No. 2.

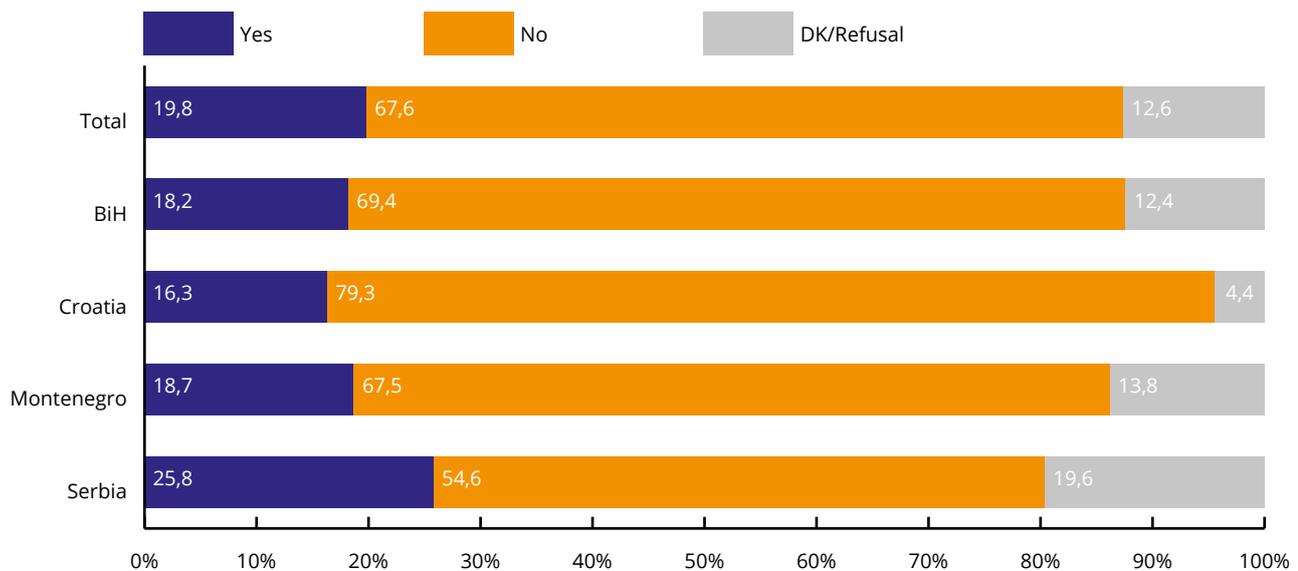
26 Katnić, M. (2016). *National Human Development Report: Informal Work: From Challenges to Solutions*; Katnić, M. (2018). *Policy Brief on Undeclared Work in Montenegro: Evidence and Policy Recommendations*.

27 Vidović, H. et al. (2019). *Western Balkans Labor Market Trends 2019*.

28 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*. Žukauskas, V. (2015). *Shadow Economies in the Baltic Sea Region 2015*.

29 In this report, informal work is understood as any type of non-criminal employment or work without a legal contract in both registered or unregistered firms (undeclared employment) or registered employment with part of the salary paid in an envelope (under-declared/quasi-formal employment). Self-provisioning is not treated as informal work.

Figure 7. Citizens having friends/relatives who work on an un(der)declared basis, % of population(CPU Survey, 2019)



**However, the number of informally employed acquaintances of an individual respondent varies notably across the countries.** Namely, respondents who stated they have such acquaintances were then asked to roughly state how many un(der)declared workers they know within the circle of their friends and relatives. The mean value is the highest in BiH, where respondents were able to identify 13 informal or quasi-formal<sup>30</sup> workers in their surroundings. In Croatia and Serbia, respondents knew 8 informal or quasi-formal workers, while in Montenegro an average was a bit lower (7). This sheds a new light on findings, having in mind that, by including

this metric, BiH become the country with the highest incidence of informal work (see Table 3). Although this metric is less reliable, considering the fact that it is hard for respondents to remember and precisely count the number of people with such characteristics, it does provide an order of magnitude and a good insight into peoples' perception of the presence of un(der)declared work in their surroundings. In this respect, it is clear from the results that cases of un(der)declared work are not isolated and occasional, but rather significantly present in the social environment.

Table 3. Un(der)declared work in one's surroundings (CPU Survey, 2019)

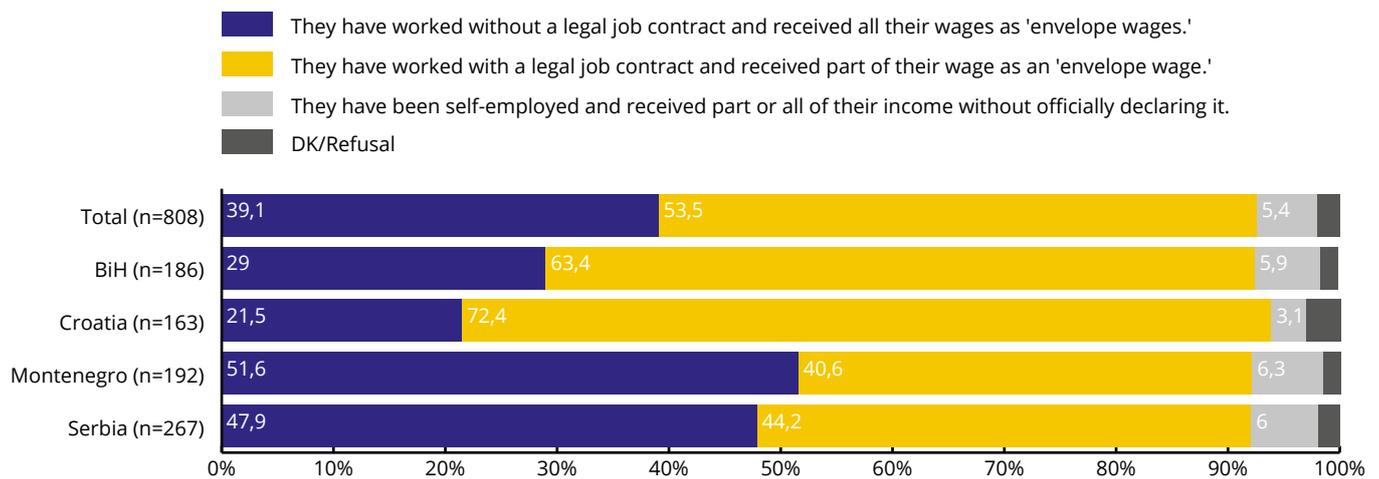
Country	Share of population knowing someone who works informally or quasi-formally	Average number of workers in un(der)declared work that respondents know
BiH	18	13
Croatia	16	8
Montenegro	19	7
Serbia	26	8

**The nature of undeclared activities varies across the observed countries. Serbia and Montenegro face much higher levels of employment without a formal contract compared to other two countries which predominantly deal with under-declared wages.** Namely, major shares of respondents having friends or relatives who participate in the shadow labour market in Montenegro and Serbia (51.6% and 47.9% respectively) stated that their acquaintances work completely informally, i.e. without a legal employment contract (see Figure 8). On the other hand, under-declared

employment is a predominant strategy to outsmart tax authorities in BiH and Croatia. Explicitly, 63.4% of respondents in BiH and 72% in Croatia argued that their friend/relative utilises exactly this tax evasion scheme. Informal self-employment seems to be less present misbehaviour, considering that shares of respondents who mentioned this option is around 3% in Croatia and varies around 6% in other three countries (see Figure 8).

<sup>30</sup> Quasi-formal employment is used as a synonym for under-declared employment in this study, i.e. type of informal employment when worker is employed on the contract but received part of the salary on an undeclared basis (in an envelope).

Figure 8. Type of activity conducted by a friend/relative, % of respondents confirming to know such persons (CPU Survey, 2019)

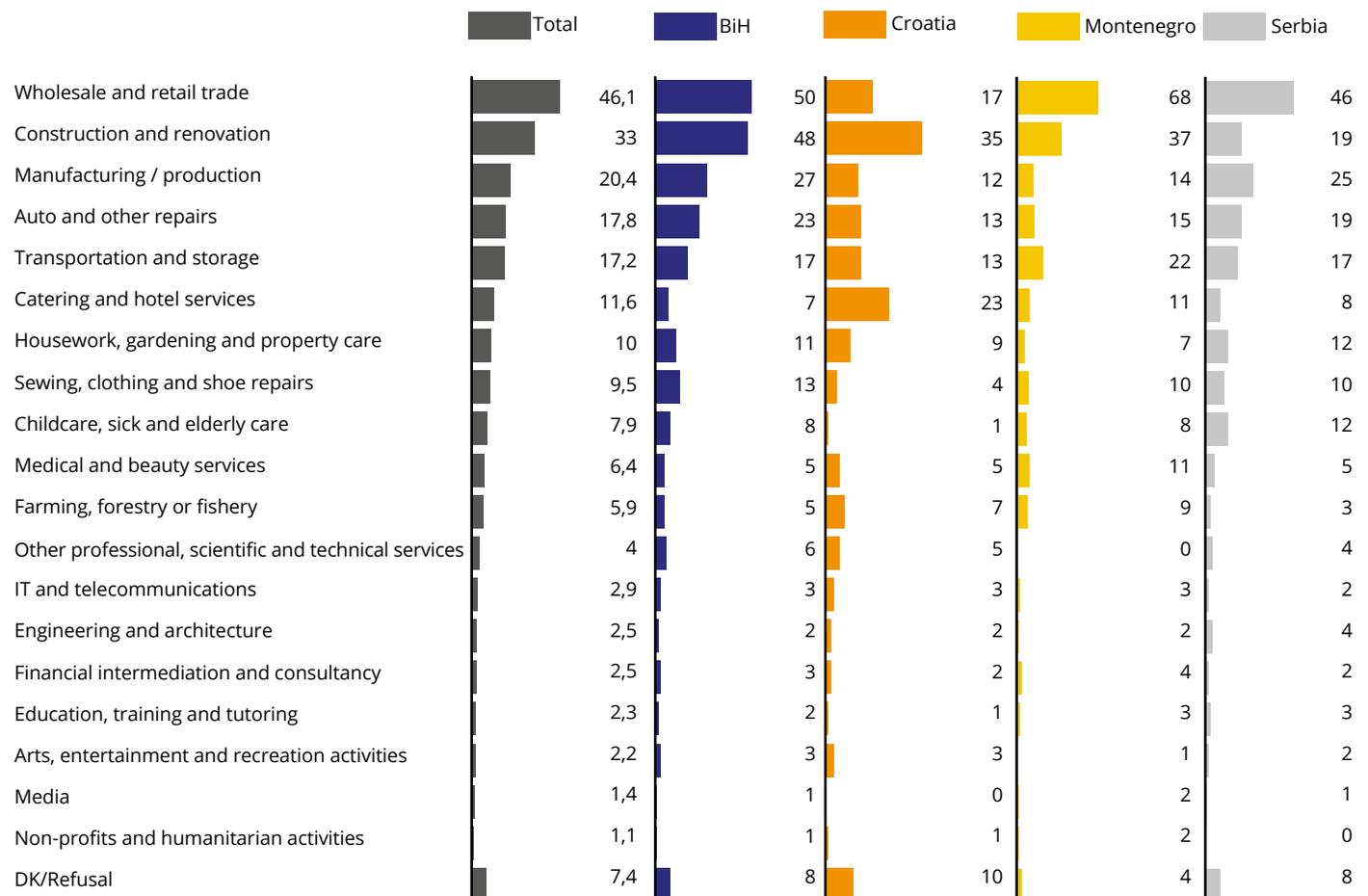


**All four countries face the highest un(der)declared work in the similar sectors, as obvious from Figure 9.**

While the remaining three countries mostly find informalities in the area of wholesale and retail trade, Croatia faces the highest undeclared and/or under-declared employment in construction and renovation. Manufacturing, various repairs, transportation and storage are also the sectors with high concentration of the shadow labour

market in the analysed countries. Still, it should be kept in mind that these sectors are also among the largest sectors in size, which increases the probability of having companies that do not fully declare employment. It is interesting to note that Croatia faces significantly higher concentration of un(der)declared work in the sector of catering and hotel services, which can be explained by sizable tourism sector.

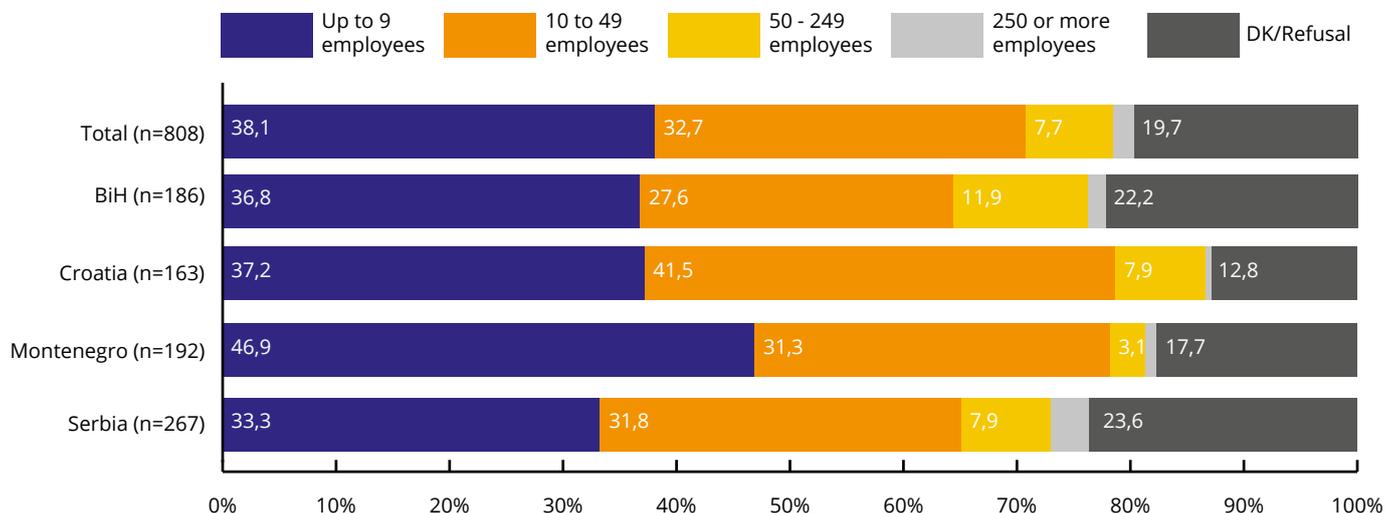
Figure 9. Areas of economic activity in which one's friend/relative performed undeclared activities, % of respondents confirming to know such people (CPU Survey, 2019)



**Micro and small-sized companies mostly employ un(der)declared workers from respondents' social networks (see Figure 10).** However, this does not mean that medium-sized companies (50-249 employees) are immune to this sort of misbehaviour. As a matter of fact,

between 4.2% (Montenegro) and 13.5% (BiH) of respondents knew an individual working informally in a company with more than 50 employees. However, these results could simply reflect the structure of the observed economies, dominated by micro and small enterprises.

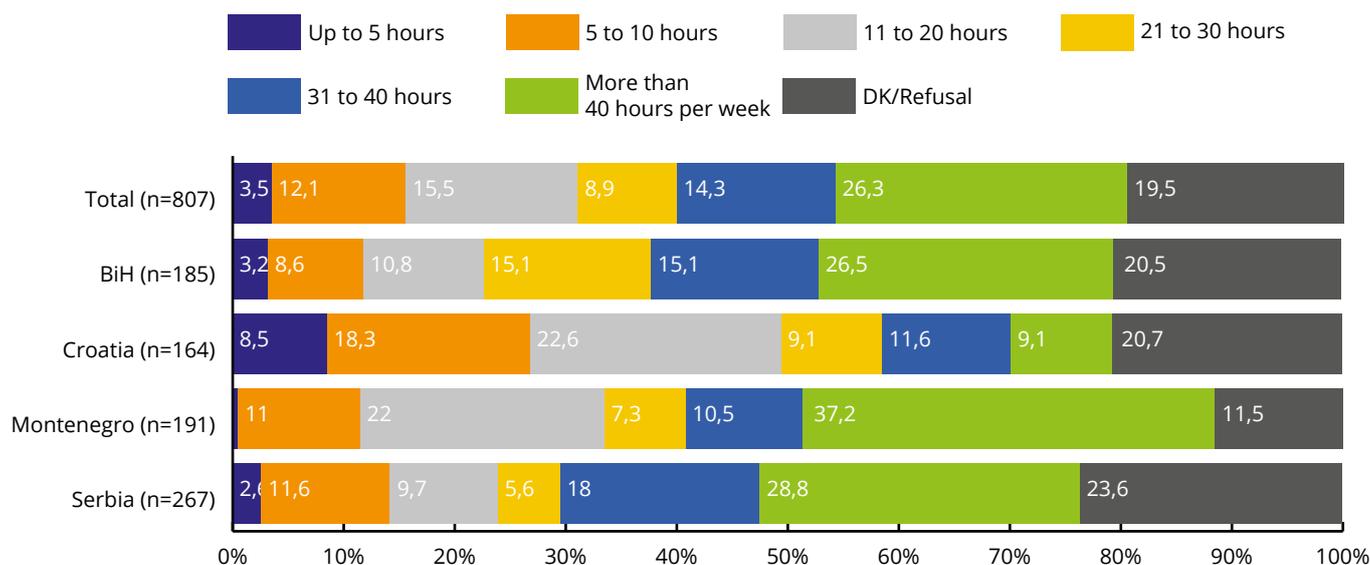
Figure 10. Size of the company in which their friend/relative work informally or quasi-formally, % of respondents to know such persons (CPU Survey, 2019)



**It seems that majority of the workers that operate in the shadows devote a notable portion of time to un(der)declared work.** Respondents from BiH, Montenegro and Serbia estimated that between 41.6% (BiH) and 47.6% (Montenegro) of their acquaintances spend 31 hours and more per week on informal work (Figure 11). This share is significantly lower in Croatia, amounting for 20.7%, which can be explained by under-declared work

being a dominant type of informality. That further endorses the notion of Croatia having a lower incidence of operating full-time jobs in the shadows. Finally, with the exception of Croatia (9.1%), significant share of undeclared workers allocates more than 40 hours per week on such activities, ranging from 26.5% in BiH to 37.2% in Montenegro.

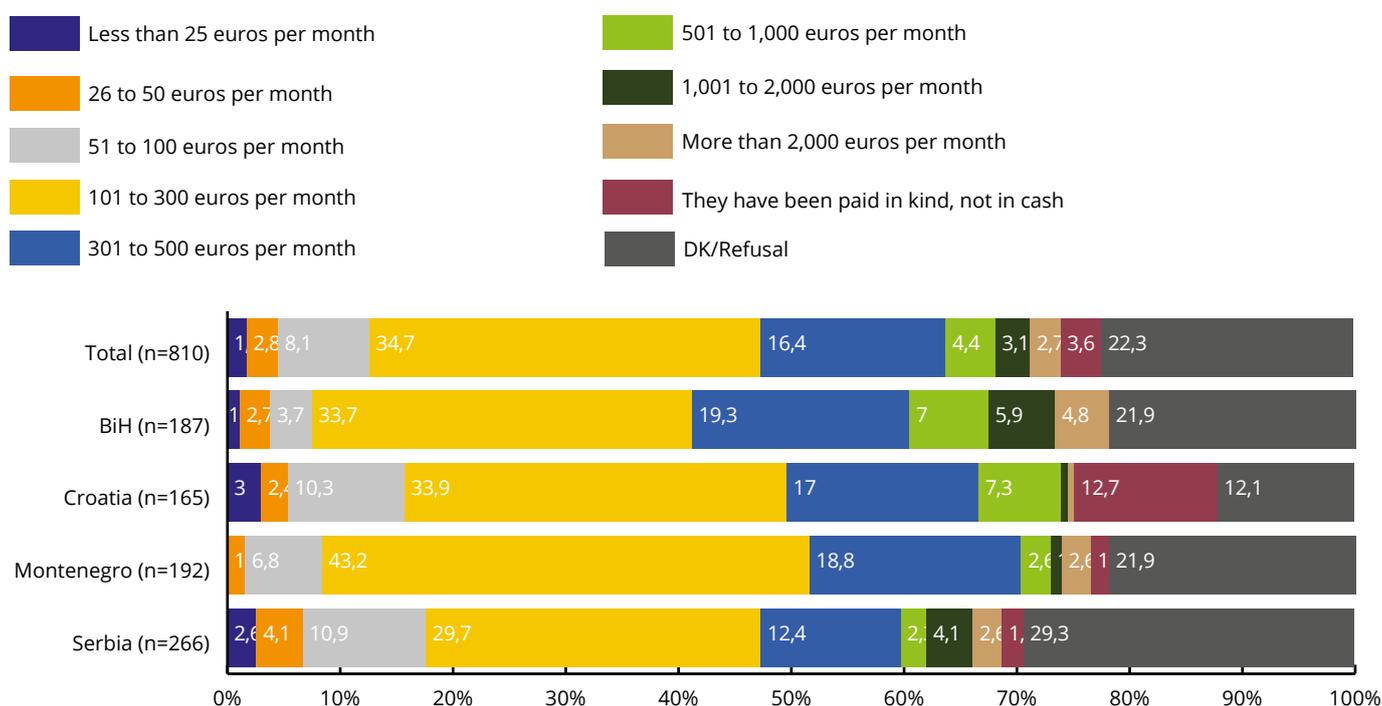
Figure 11. Average number of hours worked by a friend/relative, % of respondents confirming to know such persons (CPU Survey, 2019)



**Majority of those who participate in the shadow labour market earn up to EUR 300 from undeclared activities on a monthly basis.** Considering that the total share of individuals earning up to EUR 300 is 41% in BiH and range between 47% and 52% in other three countries (see Figure 12), it seems that citizens are often involved in undeclared activities either as a survival strategy or to top-up their income from other sources. However, the former is true only in cases where respondents described a person who work without a contract and receive the whole remuneration in an envelope. Such cases consist around 1/5 of the total cohort, i.e. 16.4% in BiH and approximately 20% in other three countries.

**Still, undeclared economic activities represent a substantial source of income for many citizens of the observed countries.** For instance, there is a non-negligible share of those who are believed to earn more than EUR 500 from undeclared activities, accounting for 6.3% in Montenegro, 8.5% in Croatia, 9% and Serbia, and 17.6% in BiH. This indicates that involving in informalities is not a coping strategy for a considerable number of citizens, but rather a way to keep more money in a pocket. The issue is especially pronounced in BiH, Montenegro and Serbia, where the average net salary is near or below EUR 500 (see Section 4.1. for more details on income and taxes). Finally, some workers that operate in the shadows are compensated in kind, rather than in cash. Such cases are negligible in all countries, except for Croatia where in-kind remuneration amounts for 12.7% (see Figure 12).

Figure 12. Average monthly earnings of a friend/relative, % of respondents confirming to know such persons(CPU Survey, 2019)

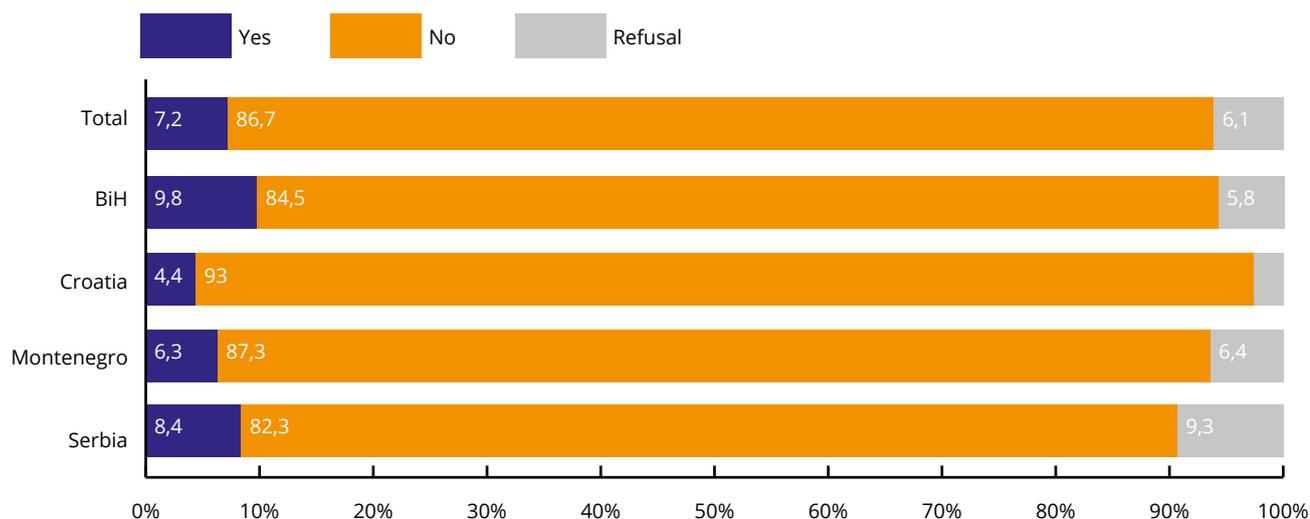


### 3.2.2. Direct experience with the shadow labour market

**Results on the exact experience with the shadow transactions reveal that this practice is probably not as pervasive as the above presented findings would suggest.** Share of respondents who admitted to be working informally or quasi-formally over the 12 months prior to the survey varies from 9.8% in BiH to 4.4% in Croatia (see Figure 13). A portion of the difference between these

results and ones where respondents had to answer about the informal work of their friends and relatives could be explained by caution and reluctance of people to admit their illicit behaviour. Notable share of respondents who refused to answer the question suggests that incidence of un(der)declared work is even higher. However, it is important to notice that incidence of informal work follows the same cross-country structure as findings on one's surrounding with incorporated metrics on number of informal and quasi-formal workers respondents know.

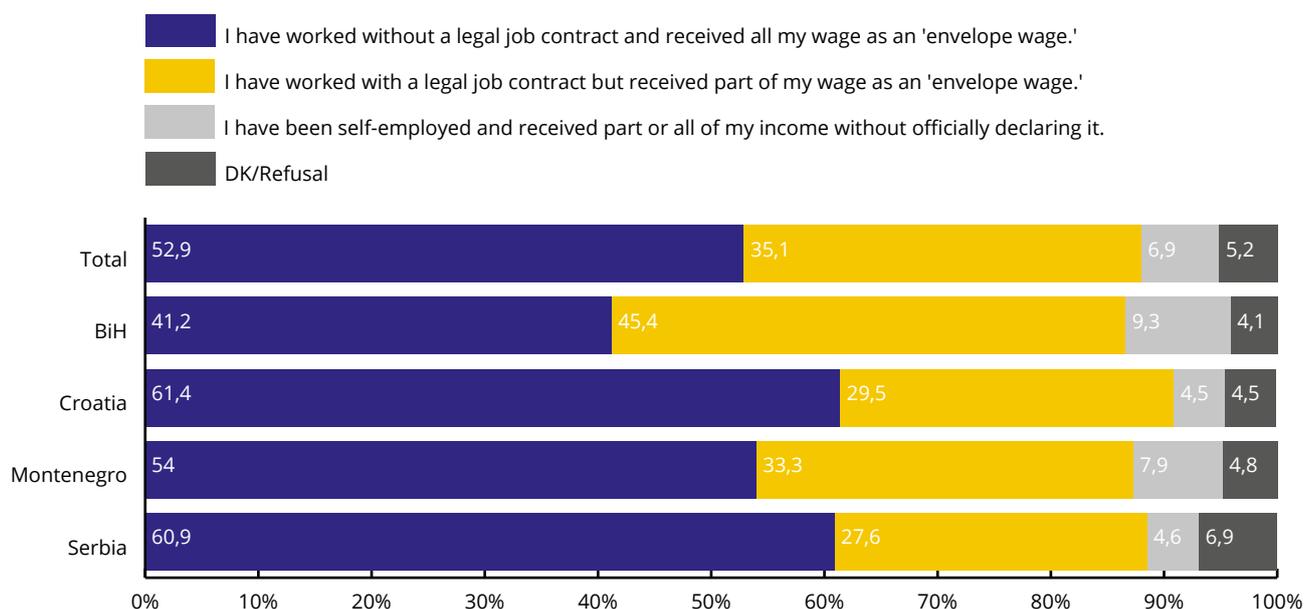
Figure 13. Participation in the shadow economy from the labour supply side (undeclared or under-declared employment), % of population (CPU Survey, 2019)



**Results on the type of the shadow activity performed in the past 12 months suggest a much higher presence of completely undeclared work than results on one's social circle.** The summary of findings provided in Figure 14 reveals a strong predominance of complete off-the-record work in all countries except BiH.

It is particularly interesting to see how this share is notably larger in Croatia. Namely, while findings on one's surrounding indicate that Croatia has the lowest share of completely undeclared workers, Figure 14 presents quite opposite results when it comes to the direct experience with the shadow labour market.

Figure 14. Type of activity within the shadow economy, % survey respondents admitting their involvement (CPU Survey, 2019)



### 3.2.3. Key reasons for working in the shadows

**The main perceived drivers for working in the shadows are low bargaining power of workers and relatively high tax burdens on the labour.** With the exception of Croatia, the most commonly perceived reason (43%–45% population) for working in the shadows is employers' insistence on paying undeclared wages (see Figure 15). This factor is positioned as the second in

Croatia, with 28% of citizens perceiving it as the key driver of un(der)declared work. These findings indicate a low bargaining power of workers, which could be to some extent explained by high unemployment rates<sup>31</sup> and poor mechanisms for protecting workers in such circumstances. In other words, many workers most probably accept to work informally due to a fear of losing employment opportunity if request its formalising. The second most commonly perceived reason is high taxation of the labour, which

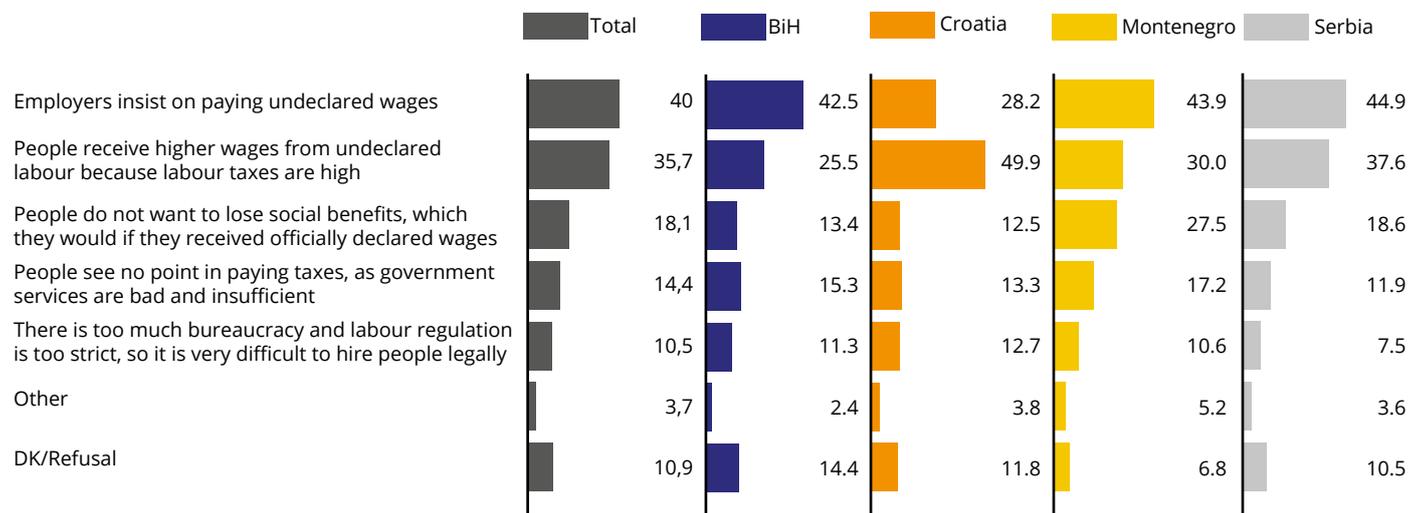
31 According to the latest comparable data for the observed countries (2018), unemployment rates (15+ age cohort) were 18.4% in Bosnia and Herzegovina, 7.6% in Croatia, 14.4% in Montenegro and 11.9% in Serbia, all above the EU-28 average of 6.8% in the same year. Vidovic, H. et al. (2019). *Western Balkans Labor Market Trends 2019*. For the link between poor labour market outcomes in SEE economies and the shadow economy, see SELDI. (2016). *Hidden Economy in Southeast Europe: Monitoring and Policy Implications for Good Governance*.

results in lower take-home earnings (see Section 4.1. for further discussion). This reason is especially relevant in Croatia, with almost a half of population recognising it as a driver of informalities on the labour market.

**As the third important reason, citizens of Montenegro and Serbia recognised the fear of losing social benefits on the part of workers.** This determinant has been recognised by citizens of BiH and Croatia

as well, with somewhat lower shares of respondents providing this answer (see Figure 15). Therefore, it seems that welfare schemes in the region are not sufficiently oriented toward activation and integration of beneficiaries into the formal labour market. Non-negligible shares of population think that people see no point in paying taxes, which has a lot to do with poor quality and availability of public services (see Section 4.3) and burdening labour regulations (see Section 4.2).

Figure 15. Key reasons for working in the shadows, % population (CPU Survey, 2019)



# ANALYSIS OF DRIVERS OF THE SHADOW ECONOMY IN THE OBSERVED COUNTRIES

# 4

*Findings presented in the previous section show high incidence and proportions of the shadow economy in the observed countries in terms of both informal purchases/trade and un(der)declared work. To better understand what motivates economic agents, companies, workers and consumers, in the observed countries to engage in informal activities, this section analyses the main drivers of the shadow economy by combining results of the primary research and secondary sources. Analysis of key drivers encompasses a brief overview of relevant policy developments affecting these drivers in the recent period (2014–2019).*

## 4.1. Taxation, income and affordability of goods

**Literature recognises taxation as an important driver of the shadow economy.** If taxation is tremendously high, it brings risks to lower profitability and affects growth prospects of businesses, thus making it more challenging for businesses to sustain and develop. Furthermore, high tax burdens on labour might discourage formal employment (and employment in general), as well as declaration of the full income to the authorities. As explained by Schneider & Buehn<sup>32</sup>, “the bigger the difference between the total labour cost in the official economy and after-tax earnings (from work), the greater the incentive to reduce the tax wedge and work in the shadow economy”. Finally, taxation of consumption makes goods and services more expensive. The larger the share of taxes in retail prices, the greater opportunity to reduce costs/price of goods/services by producing them and/or trading informally. In other words, taxation “creates differences between the prices of legitimate and illegitimate sales”, thus providing clear incentives to purchase goods from informal market<sup>33</sup>. However, it is important to bear in mind that higher corporate income taxes, parafiscal charges and other financial liabilities also inflate prices of goods and services, which makes them less affordable to end consumers.

**A range of studies have identified high tax burden as one of the most important drivers of the shadow economy in the observed countries, which is especially pronounced in case of labour taxation.** Majority of analyses recognized high taxation, particularly the high tax wedge on salaries, as the main and the most important determinant of the informality in BiH<sup>34</sup>. Similarly, according to 2017 *Flash Eurobarometer Survey on businesses’ attitudes towards corruption in the EU*, almost 85% of the company owners and managers in Croatia perceive high tax rates as

a serious obstacle<sup>35</sup>. This places Croatia on the top of the EU list regarding the negative perception towards tax regulation, alongside Greece and Italy. In addition, more than one half of participants in the 2015 survey on undeclared work and business environment in Croatia recognised high tax and social security contribution rates as a major impediment for their business, while only 13% were satisfied with the level of taxation<sup>36</sup>. Some recent evidence from Montenegro suggests that 34% of the working population consider taxes as one of the key factors motivating employers not to declare employment, while 75% of employers recognised this as a driver; it was positioned third out of six places, behind parafiscal charges and poor business results<sup>37</sup>. Similarly, companies in Serbia perceive burdensome taxation as the important driver of the shadow economy in this country: recent study on employers’ perception of shadow economy uncovers that 66% of respondents particularly point out high tax and social security contributions on salary to be the most important driver<sup>38</sup>. Still, majority of aforementioned evidence is based on perception, without establishing a clear causal link between tax levels and informal behaviour.

Therefore, this chapter analyses (1) taxation of consumption by investigating how value-added taxes (as the backbone of taxation of consumption) and excise policies (duties) affect affordability of goods and services and (2) labour taxation, by discussing tax wedge levels in the observed countries.

### 4.1.1. Taxation of consumption

**VAT rates notably vary between the observed countries, being the highest in Croatia (25%).** Croatia belongs to the EU countries with the highest VAT rates. Other three observed countries have VAT rates below the EU-28 average of 21.5%<sup>39</sup>. The rate is the lowest in BiH (17%); it is far below of the EU-28 average and, in that sense, Luxembourg is the only country in the EU with such a low rate. On the other hand, VAT rate is flat in BiH, thus burdening elementary food products, medicaments, education resources, etc. to higher degree than it is the case in other three observed countries. However, a simple comparison of VAT rates does not provide full picture on tax-related incentives for operation in the shadows as net income levels significantly determinate affordability of goods and differences in that regard.

32 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*, p. 6.

33 Žukauskas, V. (Ed.). (2018). *Shadow Economy: Understanding Drivers, Reducing Incentives*, p. 10.

34 See, for instance, IMF. (2015). *IMF Country Report No. 15/299: Bosnia and Herzegovina: Selected Issues*. Pandurević, M., & Domljan, V. (2015). *Siva Knjiga*.

35 European Commission. (2017b). *Flash Eurobarometer 457. Report Businesses’ attitudes towards corruption in the EU*.

36 Bejaković, P., & Williams, C. C. (2017). *Undeclared economic activities of Croatian companies: findings from a representative survey of 521 companies*. GREY Working Paper No. 13.

37 Katnić, M. (2016). *National Human Development Report: Informal Work: From Challenges to Solutions*.

38 NALED. (2019). *Godišnje istraživanje stavova privrede o svojoj ekonomiji*.

39 European Commission. (2019b). *VAT rates applied in the Member States of the European Union: Situation at 1st January 2019*.

Table 4. Overview of Value-Added Tax rates in the observed countries in 2019/January 2020

Country	General rate	Reduced rates
<b>BiH</b>	<b>17%</b>	<b>Flat rate</b>
<b>Croatia</b>	<b>25%</b>	<b>13%</b> - applied for meat, fruit, vegetables, restaurant services, artists' services, etc. <b>5%</b> - applied for medicaments, books, newspapers and magazines, bread, dairy products, etc.
<b>Montenegro</b>	<b>21%</b>	<b>7%</b> - mainly applied to basic food products, medicaments, prosthetic parts, books and educational materials, newspapers, public transport, accommodation, arts, etc. <b>0%</b> - export transactions and deliveries of medical supplies financed by the Health Insurance Fund.
<b>Serbia</b>	<b>20%</b>	<b>10%</b> - applied to basic food products, medicaments, prosthetic parts, books and educational materials, newspapers, some types of heating energy, public transport, accommodation, arts, etc.

**Despite relatively high taxation of consumption, Croatia performs better than other three countries in terms of affordability of goods, primarily due to higher net incomes.**

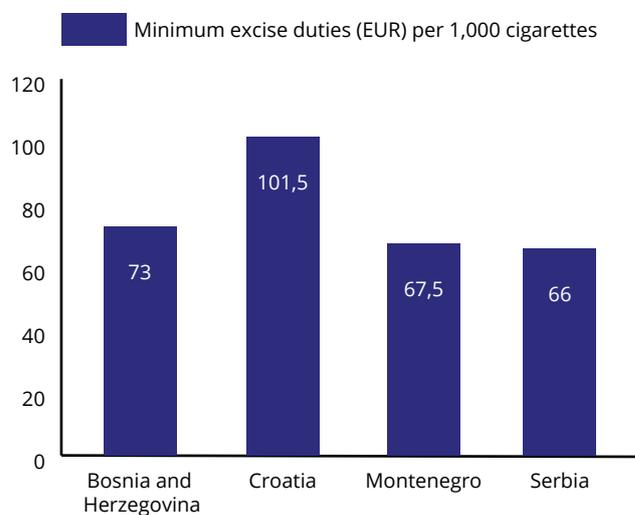
As could be seen from Figure 22, an average after-tax salary in Croatia is almost two times higher than in other three countries. This plays an important role in determining affordability of goods, which is especially obvious in the case of so-called excise goods. A special attention is paid to analysing affordability of key excise goods (cigarettes, fuel and alcoholic beverages), considering that additional taxation leads to inflation of prices of such goods (but also other goods in case of fuel, given that increase in the price of fuel induces increase in transportation costs across sectors) and thus creates a fruitful ground for development of informal markets. This assumption is confirmed by our survey, as presented and discussed in the previous chapter.

**Taxes comprise more than 3/4 of the final price of cigarettes in the observed countries.**

Namely, when observing absolute level of taxes, the minimum excise duties are by far highest in Croatia, EUR 101.5 per 1,000 cigarettes, compared to EUR 66 – EUR 73 in other three countries (see Figure 16). Similarly, absolute price of cigarettes is the highest in Croatia and the lowest in Serbia, thus corresponding to gradation of levels of absolute excise duties across the four countries. However, analysis of a degree to which cigarettes are burdened with taxes (VAT + excises) gives a bit different picture. Share of taxes in the retail price of cigarettes is the highest in BiH, where taxes comprise 90.1% of the weighted average retail price (hereinafter: WAP) and it is the lowest in Montenegro (75.2%) (see Figure 17a). In that regard,

Croatia has a slightly higher (81%), while Serbia (77.1%) and Montenegro lower share of total taxes in WAP than the EU-28 average of 80.3%<sup>40</sup>. Only two EU countries have higher shares of total taxes in WAP (Estonia 90.3% and the UK 91.6%) than BiH. Higher participation of taxes in retail price means that customers pay more and/or producers earn less, primarily as a price reduction strategy, thus incentivising informalities on both sides.

Figure 16. Minimum excise duties per 1,000 cigarettes, absolute values (EUR)<sup>41</sup>



**Cigarettes are the least affordable to consumers in BiH.**

Total tax rate levied on cigarettes inflates the price of the product, while an average net wage is relatively

40 European Commission DG TAXUD. (2019). *Excise Duty Tables: Part III - Manufactured Tobacco*.

41 Excise laws and related policies, authors' calculations for BiH and Croatia, while for Montenegro and Serbia data is adapted from Marquez, P. V., Krasovsky, K., & Andreeva, T. (2019a). *Montenegro: Overview of Tobacco Use, Tobacco Control Legislation, and Taxation: A Country Brief and Marquez, P. V., Krasovsky, K., & Andreeva, T. (2019b). Serbia: Overview of Tobacco Use, Tobacco Control Legislation, and Taxation: A Country Brief* respectively. **BiH:** Law on Excise Duties in Bosnia and Herzegovina, Official Gazette of Bosnia and Herzegovina no. 49/09, 49/14, 60/14, 91/17; Decree on establishing specific excise and the minimum excise on cigarettes and excise on tobacco in 2019 [Odluka o utvrđivanju specifične i minimalne akcize na cigarete i iznos akcize na duhan za pušenje za 2019. godinu], Official Gazette of Bosnia and Herzegovina no. 75/18. **Croatia:** Law on excise duties, Official Gazette of Croatia no. 106/18; Decree on levels of excises on cigarettes, fine-cut tobacco and other types of tobacco for smoking [Uredba o visini trošarine na cigarete, sitno rezani duhan za savijanje cigareta i ostali duhan za pušenje], Official Gazette of Croatia no 196/18; **Montenegro:** Law on excise duties, Official Gazette of the Republic of Montenegro, no. 76/08, 50/09, 78/10, 61/11, 28/12, 38/13, 45/14, 1/17, 50/17, 55/18. **Serbia:** Law on Excise Duties, Official Gazette of the Republic of Serbia no. 22/01, 73/01, 80/02, 43/03, 72/03, 43/04, 55/04, 135/04, 46/05, 101/05, 61/07, 5/09, 31/09, 101/10, 43/11, 101/11, 6/12, 43/12, 76/12, 93/12, 119/12, 8/13, 47/13, 4/14, 68/14, 142/14, 4/15, 5/15, 55/15, 103/15, 5/16, 108/16, 7/17, 18/18, 30/18, 4/19; Decree on weighted average retail prices and minimum excise on tobacco products [Odluka o iznosima prosečnih ponderisanih maloprodajnih cena i minimalnih akciza na duhanske preradevine], Official Gazette of the Republic of Serbia no. 12/19.

low in this country (see Figure 22). On the other hand, despite having by far the highest absolute price of cigarettes (by around EUR 1 compared to other three countries, which have similar prices) and high share of taxes in its retail price, affordability of this product is the highest in Croatia (Figure 17a) due to the higher average net salary (Figure 22). Figure 17b shows relationships between level of taxes and affordability of cigarettes, indicating that, except in case of Croatia, these two variables are in-

verse relationship, i.e. countries which have higher share of taxes in retail price also face lower affordability of cigarettes. That is obvious from the case of three countries (BiH, Montenegro and Serbia) which have relatively similar hourly net wages. Similar relationship was found when observing the same variables in six Baltic countries in 2018<sup>42</sup>. However, affordability of cigarettes is much higher in the observed Baltic countries, varying from 1.8 to 4.3 points (the same methodology applied).

Figure 17a. Taxes and affordability of cigarettes

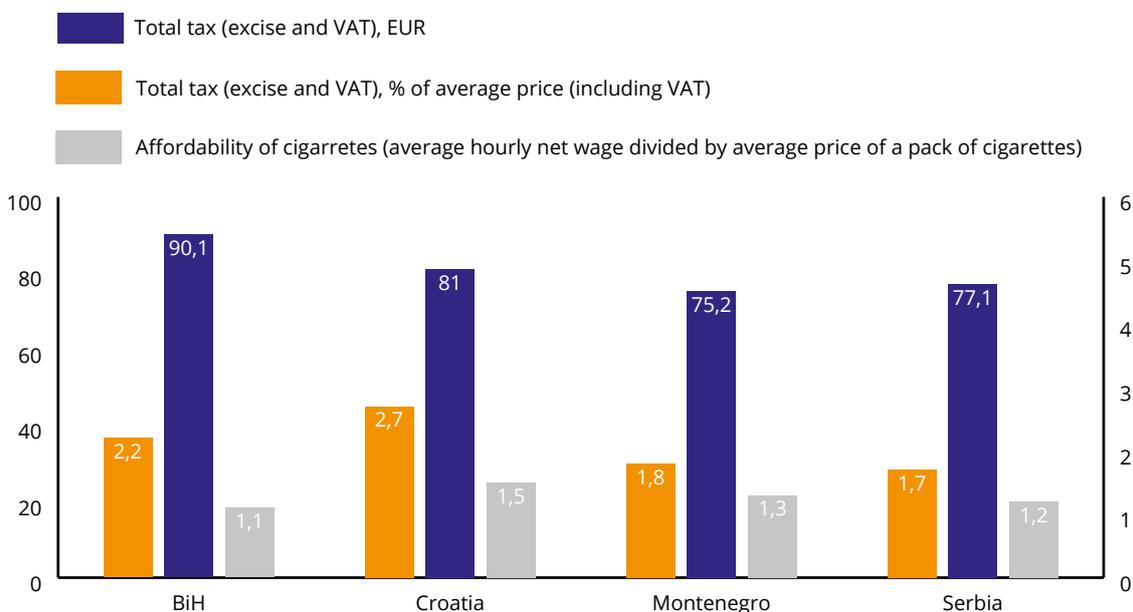
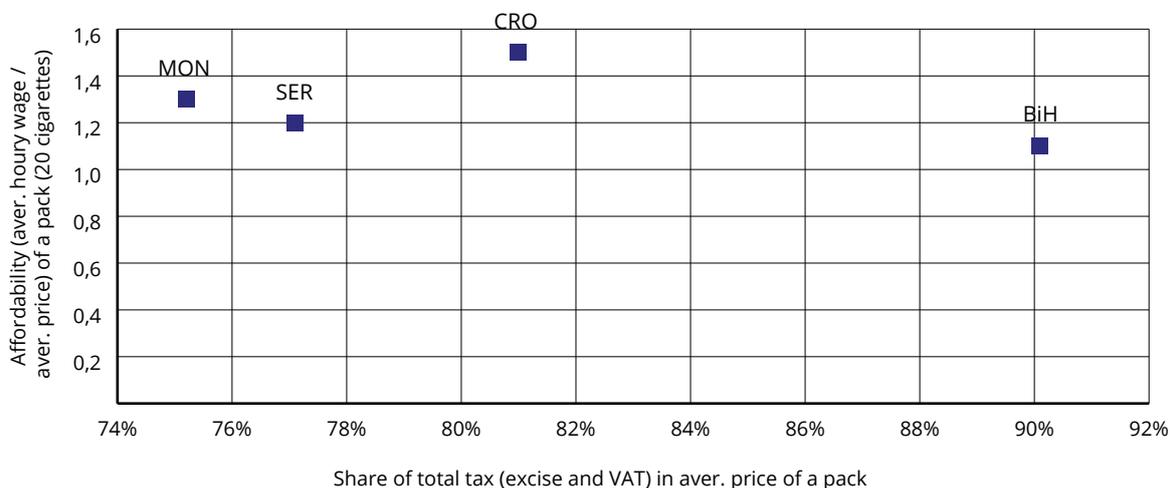


Figure 17b. Tax rates and affordability of cigarettes<sup>43</sup>



**However, cross-country differences in taxation and affordability of cigarettes do not fully explain differences in levels of illicit trade in the observed countries.** Namely, as discussed in Section 3, cigarettes are the most bought good on the shadow market in three countries, which can be attributed to high prices of the product. Therefore, it can be said that tax policy toward excise goods contributes to its illicit production and trade. However, level of taxes does not fully correspond to incidence of purchas-

ing cigarettes under the radar. For the sake of illustration, Serbia has only slightly lower absolute level of excise than Montenegro and BiH, higher share of total taxes in retail price of cigarettes than Montenegro, and relatively low affordability of cigarettes, but in the same time has the least challenging environment regarding illicit trade in this regard (see Section 3). Croatia, where affordability of cigarettes is the highest, performs worse, as presented in Section 3. This

42 Žukauskas, V. (Ed.). (2018). *Shadow Economy: Understanding Drivers, Reducing Incentives*.

43 Source: Ibid.

suggests that answers probably should be looked for in the other potential drivers explored in this study.

**Taxes consume a large portion of fuel retail price as well, comprising between 1/2 and 2/3 of the price in the case of petrol and around 1/2 of diesel price.**

Tax burdens, in the case of all three analysed types of fuel (diesel, petrol 95 and petrol 98), are the lowest in BiH, due to both the lowest VAT rate and the lowest excises. Relatedly, retail prices of fuel are the lowest in this country. When comparing tax rates levied on diesel between the observed countries and the weighted EU-28 average (45% of retail price)<sup>44</sup>, it could be observed that BiH is aligned with the EU average, while relative tax levels in other three countries are above the average (Figure 19). Croatia has the highest share of taxes in petrol prices, while Serbia has the highest ratio for diesel.

**Similarly, as in the case of cigarettes, fuel is the most affordable in Croatia, due to notably high-**

**er salary-based incomes compared to other three countries.** As evident from Figure 20, Croatia faces slightly heavier taxation of fuel, but drastically stands out from the other three countries in terms of affordability of fuel (petrol 98 and diesel). On the other hand, affordability of fuel is the lowest in Serbia; while having the lowest after-tax salary-based income among the observed countries, it also has relatively burdening taxation of petrol and the highest share of taxes in diesel retail price.

**Cross-country differences in incidence of informal purchase of fuel correspond to findings on differences in affordability of fuel.**

The highest affordability of fuel in Croatia is reflected in the lowest share of citizens who buy fuel informally (3%). On the other hand, the highest shares of population who bought fuel informally are in BiH and Serbia (8%) and these two countries have somewhat lower levels of affordability of fuel. This finding indicates importance of tax levels in determining incidence of illicit trade of fuel.

Figure 18. Taxes and affordability of petrol 98<sup>45</sup>

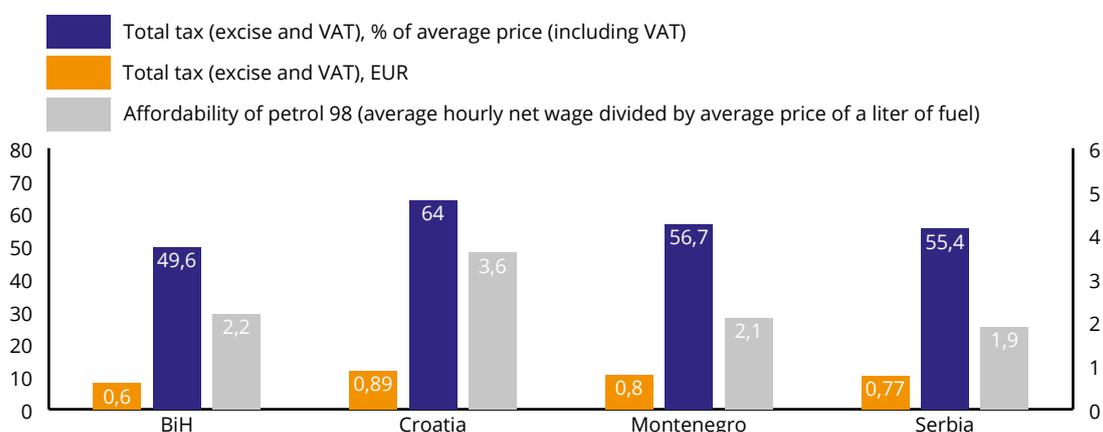
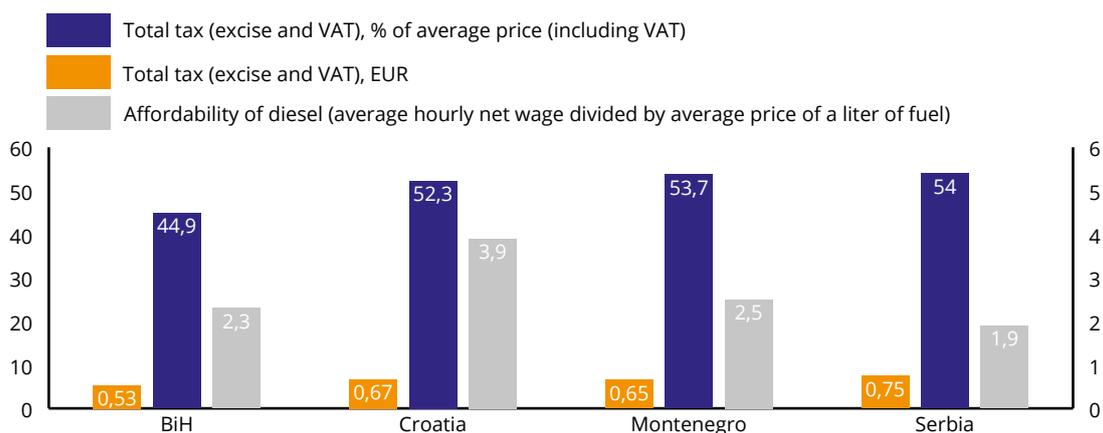


Figure 19. Taxes and affordability of diesel<sup>46</sup>

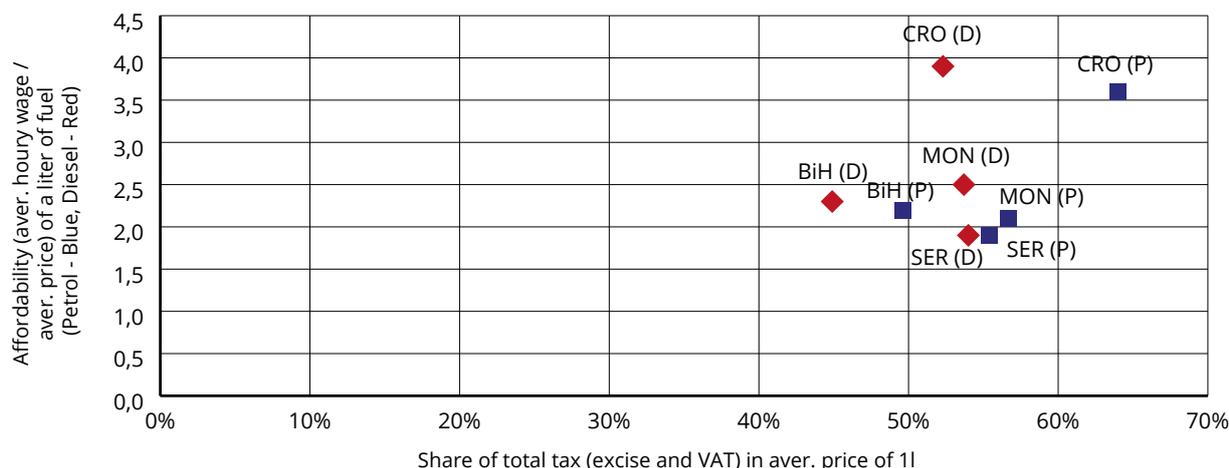


44 The last week of June has been taken into consideration to ensure comparability of data. Data available at: <https://bit.ly/34j7eUR>.

45 Excise laws and related policies andIRU. (2019). *Cijene goriva 26. sedmica 2019. godine*.

46 Ibid. and Figure 22.

Figure 20. Tax rates and affordability of fuel (petrol 98 in blue and diesel in red)<sup>47</sup>



**Considering notable incidence of informal purchases of alcoholic beverages, as presented in Section 3, it is important to take a look at taxation of alcohol.**

However, due to non-negligible asymmetries in ways how this area is regulated across the observed countries and the lack of reliable comparable data on prices of products, in-depth analysis of affordability of alcoholic beverages is not offered in this report.

Instead, only informative overview of excises on beer, wine and pure alcohol is presented in Table 5. Also, it is important to bear in mind that informal purchases of alcoholic beverages may be related to local home-made beverages, which cannot be solely attributed to high taxation.

Table 5. Overview of excise duties for alcoholic beverages in the observed countries

Type of alcoholic product	BiH	Croatia	Montenegro	Serbia
Pure alcohol (excise per litre)	<b>EUR 7.7</b> (BAM 15)	<b>EUR 7.1</b> (HRK 53)	<b>EUR 12.5</b>	N/A
Beer (excise per litre)	<b>EUR 0.13</b> (BAM 0.25)	<b>EUR 0.24 (est.)</b> (HRK 1.8) <i>(estimate based on legal provision that envisages excise of HRK 40 per 1% of share of alcohol in a hectolitre of beer; an average of 4.5% alcohol was used for making this estimate)</i>	<b>EUR 0.23 (est.)</b> <i>(estimate based on legal provision that envisages excise of EUR 5 per 1 litre of alcohol in a hectolitre of beer; an average of 4.5% alcohol was used for making this estimate)</i>	<b>EUR 0.22</b> (RSD 25.61)
Wine (excise per litre)	<b>EUR 0.13</b> (BAM 0.25)	<b>EUR 0.0</b>	<b>EUR 0.0</b>	<b>EUR 0.19</b> (RSD 22.41)

Source: Authors' analysis of the regulation

Policy developments in the observed countries over the period 2004–2019 mainly led to increase in the overall tax burden on consumption, but with some exceptions.

**VAT policies in three countries have undergone some changes in recent years.**

In Croatia, the most important one was lowering the rate for certain products and services. For instance, the VAT rate for drugs, daily newspapers and books was set at 5%, while fresh meat,

vegetables and fruits, restaurant and catering services are being taxed at 13%<sup>48</sup>. VAT rate in Montenegro has been increased by 2 pp, from 19% to 21%, in January 2018. In Serbia, general VAT rate has remained the same since the introduction in 2005, but a reduced rate has been increased from 8% to 10% in 2014. Finally, VAT policy in BiH has undergone no changes since its introduction in 2006.

47 Ibid.

48 Tax Administration of Croatia. (2019). *Porezne promjene od 1. siječnja 2019 [Changes in the tax system as of 1 January 2019]*.

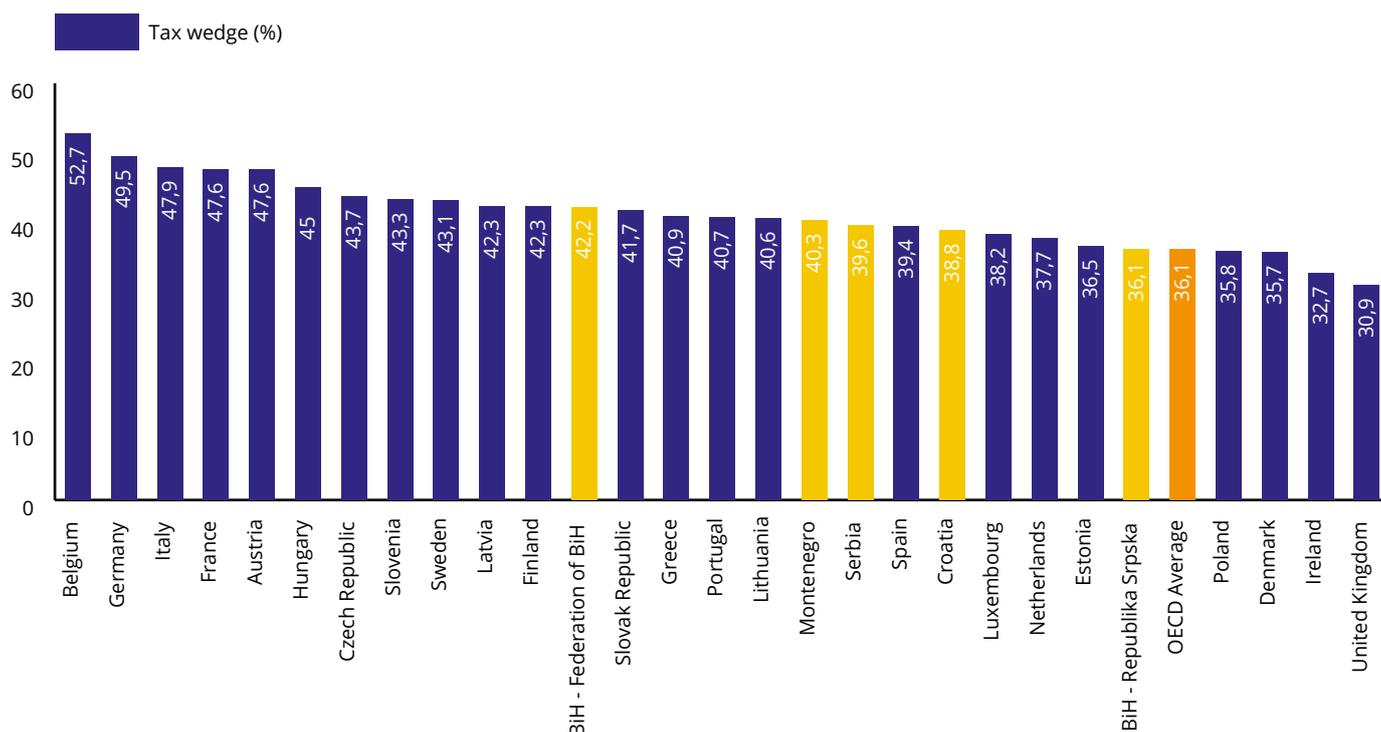
### Observed countries tend to gradually harmonise excise policies with the EU levels, mainly increasing excise rates on annual or semi-annual basis.

Serbia, for example, adapts excise on fuel annually, while excise charges on cigarettes are adopted every six months, both with a tendency of gradual increase in nominal value<sup>49</sup>. Croatia adopted new Law on Excise Duties in 2018. BiH adopted changes to the Law on Excise Duties that increased cumulative excise on fuel by EUR 0.08 per litre<sup>50</sup>, which encountered strong public resistance. This country adapts excise charges for cigarettes once a year, with a tendency of constant increase of minimum excise. However, faced with increase of smuggling and development of informal markets, Council of Ministers of BiH launched an initiative to impose moratorium on further increase of excise duties for cigarettes<sup>51</sup>, but this initiative has not been translated into concrete policy so far. On the other hand, Montenegro significantly reduced excise charges on cigarettes in September 2018 (by lowering specific excise from EUR 40 to EUR 30 per 1,000 cigarettes)<sup>52</sup>, as a reaction to expansion of the shadow economy induced by heavy increases of excises in the period prior to reduction.

### 4.1.2. Labour taxation

**Labour taxes are relatively high in the observed countries.** Tax wedge which represent the difference between worker's take-home pay and total labour costs expressed as the ratio of labour taxes to total labour costs is above the OECD average of 36.1% in all four countries (see Figure 21). It is notably high in one of BiH entities, amounting to 42.2% for a single worker who receives an average gross salary in the Federation of BiH. However, when observed at the state level, tax wedge is the highest in Montenegro (40.3%), considering that unweighted average in BiH is around 39.2%. When compared with the EU countries which are OECD members, it can be stated that four observed countries are comparable with the group of one third of the countries positioned in the middle of the spectrum (see Figure 21). This indicates that the observed countries do not belong to the group of countries with the highest labour taxation.

Figure 21. Tax wedge for a single worker who receives average gross salary in the observed countries (2019) and the EU countries which are members of OECD (2018)<sup>53</sup>



### High tax wedges especially affect take-home income in three countries observed in this study.

Namely, when differences in average salary-based incomes in the four countries are observed, it is obvious that workers in BiH, Montenegro and Serbia receive lower

net hourly wages (from EUR 2.62 in Serbia to EUR 2.97 in Montenegro) than Croatia (EUR 4.99). That means that citizens, in average, have less money available to afford goods and services, which makes them more likely to seek price-reducing solutions. However, differences in

49 Law on Excise Duties, Official Gazette of the Republic of Serbia no. 22/01, 73/01, 80/02, 43/03, 72/03, 43/04, 55/04, 135/04, 46/05, 101/05, 61/07, 5/09, 31/09, 101/10, 43/11, 101/11, 6/12, 43/12, 76/12, 93/12, 119/12, 8/13, 47/13, 4/14, 68/14, 142/14, 4/15, 5/15, 55/15, 103/15, 5/16, 108/16, 7/17, 18/18, 30/18, 4/19.

50 Law on Excise Duties in Bosnia and Herzegovina, Official Gazette of Bosnia and Herzegovina no. 49/09, 49/14, 60/14, 91/17

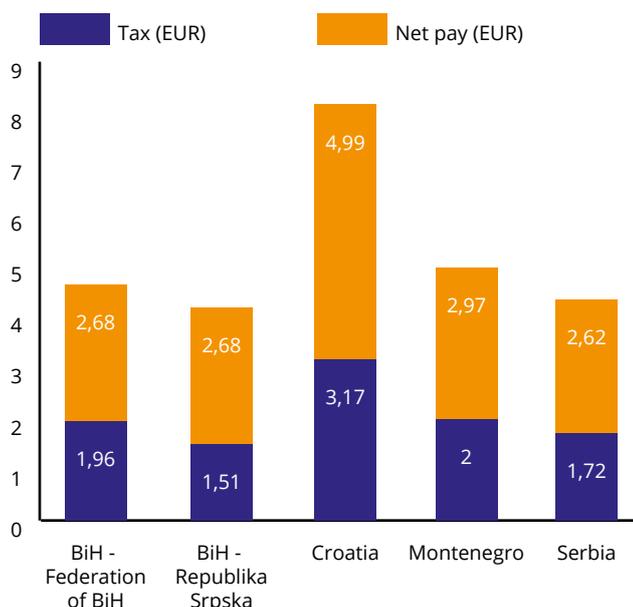
51 Council of Ministers of Bosnia and Herzegovina. (2018, December 31). *Održana 161. sjednica Vijeća ministara BiH: Moratorij na daljnje povećanje trošarina na cigarete [Council of Ministers of Bosnia and Herzegovina Holds Its 161st Session: Moratorium to further cigarettes price rise]*.

52 Law on excise duties, Official Gazette of the Republic of Montenegro, no. 76/08, 50/09, 78/10, 61/11, 28/12, 38/13, 45/14, 1/17, 50/17, 55/18.

53 Authors' calculations; Vidovic, H. et al. (2019). *Western Balkans Labor Market Trends 2019;* and OECD (2018)

purchasing power among countries are not observed, so Figure 22 should be considered as an indicative one.

Figure 22. Size of taxes in gross hourly wages in the observed countries, absolute values (EUR)<sup>54</sup>



**Furthermore, low progressivity of labour taxation in the observed countries, with the exception of Croatia, represents a barrier for the formal employment of low-skilled labour force.**

Namely, the difference in tax wedge for those who earn 67% and those who earn 167% of the average salary is only up to 3 pp in three countries (BiH, Montenegro and Serbia)<sup>55</sup>. This difference is notably wider in Croatia, amounting to 8 pp, which is close to the OECD average of 8.2 pp and 8.4 pp in the EU countries which are members of the OECD<sup>56</sup>. Low progressivity of labour taxation negatively affects low-wage earners who “do not earn much in terms of net take-home pay, but are still relatively costly to firms”<sup>57</sup>. In such circumstances, both employee and employer have an incentive to avoid formalising work relationship or avoid declaring a part of the salary, thus increasing worker’s income and/or decreasing labour costs.

**Findings of this study are consistent with the assumption that high labour taxes are one of the main culprits for occurrence of un(der)declared work.** As presented in Figure 15, around 36% of population perceive burdening labour taxation as the driver of informal-

ities in this area, believing that not declaring or under-declaring wages from employment is an income-increasing strategy. In that sense, this factor is positioned as the second most important, immediately behind employers’ insisting on paying undeclared wage (see Figure 15), which could be perceived as employers’ strategy of reducing production costs, again as a partial consequence of high labour taxes.

Considering that around 36% of population in the observed countries perceive labour taxation as the driver of informalities in this area, it represents an important area for policy improvements and require a special attention by decision-makers. However, the observed countries mainly experienced moderate decrease in levels of labour taxation.

**In BiH, one of entities, Republika Srpska, experienced some improvements of labour taxation policy.**

Republika Srpska went through a few relevant changes in labour taxation policies during the last decade and the latest one occurred in 2018. Personal tax-free allowance was increased from BAM 200 (EUR 102) to BAM 500 (EUR 256), lowering tax wedge and increasing nominal wages<sup>58</sup>. In that sense, after early 2010s, when both personal income tax and cumulative social security contribution rates were increased (personal income tax from 8% to 10% and contributions rate from 30.6% to 33% in 2011), there is a trend of relaxation of labour taxation in recent years<sup>59</sup>. It can be estimated that the tax wedge in Republika Srpska was reduced by the recent policy changes by around 3.6 pp compared to 2015<sup>60</sup>. On the other hand, the labour taxation system in Federation of BiH remained almost unchanged over the past decade<sup>61</sup>.

**Croatia has gone through dynamic reforms of labour taxation in the recent years.**

More precisely, personal income tax has undergone four rounds of reforms between January 2017 and January 2020. The key novelty introduced in the first round was the shift from three to two tax rates. Namely, the lowest rate of 12% was abolished, while the highest one was reduced from 40% to 36%<sup>62</sup>. This was accompanied with the adjustments of tax bases, with the lower rate of 24% being applied to amounts below HRK 17,500 (EUR 2,352). This limit was increased to HRK 30,000 (EUR 4,032) on January 1<sup>st</sup>, 2019<sup>63</sup>. To further reduce labour cost, the Croatian government also decided to eliminate the contributions for insurance against injury at work and occupational disease (0.5%) and unemployment insurance contributions (1.7%)

54 Authors’ estimates based on tax wedge data presented in Figure 21 and Institute for Statistics of FBiH. (2019). *Average monthly paid off net and gross wage of persons in paid employment by KD BiH 2010: June 2019.*, Republika Srpska Institute of Statistics. (2019). *Average Wages of Employees: June 2019.*, Croatian Bureau of Statistics. (2019). *Prosječne mjesečne neto i bruto plaće zaposlenih za lipanj 2019.*, Statistical Office of Montenegro. (2019). *Prosječne zarade (plate): Jun 2019. godine.*, Statistical Office of the Republic of Serbia. (2019). *Prosečne zarade po zaposlenom, jun 2019.*

55 Vidovic, H. et al. (2019). *Western Balkans Labor Market Trends 2019*, p. XIV.

56 Ibid.

57 Arandarenko, M. (2019, March 22). *A low-wage, high-tax trap in the Western Balkans.*

58 Vidovic, H. et al. (2019). *Western Balkans Labor Market Trends 2019.*

59 Ibid.

60 See Jusić, M., & Numanović, A. (2015). *Flexible Labor in an Inflexible Environment: Reforms of Labor Market Institutions in Bosnia and Herzegovina in a Comparative Perspective.*

61 Vidovic, H. et al. (2019). *Western Balkans Labor Market Trends 2019.*

62 Vlajić, D. (2017). Najznačajnije izmjene hrvatskog poreznog sustava [The most important changes of the Croatian tax system]. *Zbornik Radova Veleučilišta U Šibeniku*, 1-2.

63 Tax Administration of Croatia. (2019). *Porezne promjene od 1. siječnja 2019 [Changes in the tax system as of 1 January 2019].*

in 2019. However, at the same time, the healthcare contribution rate was increased from 15% to 16.5%.

**Taxation of labour in Montenegro has been changed in the area of personal income tax rate.** After being increased to 15% in 2013 for salaries higher than EUR 480 - due to adding so-called 'crisis tax' to earlier personal income tax rate of 9%, with the aim to amortize fiscal instabilities, cumulative personal income tax has been gradually reduced<sup>64</sup>. The overall decrease occurred due to reductions in the 'crisis tax' rate. Thus, cumulative personal income tax in 2019 amounted to 11% (out of which 'crisis tax' rate is 2%) for gross wages above EUR 766. For salaries below this threshold (approximately amount of an average salary), crisis tax is not applied.

**Finally, some changes in the labour taxation policy have been recently made in Serbia.** Namely, after the period 2007-2012 when personal income tax was 12%, it was decreased to 10% in 2013. However, this reduction was compensated by increasing employee pension contribution by 2 pp. Additional changes have been introduced to the structure of social security contributions in 2014 (the pension contribution rate was increased, while contribution rate for health insurance has been reduced) but with the overall neutral effect. Only in 2019, the real change in cumulative contribution rate has occurred: by abolishing the portion of the unemployment insurance contribution borne by employers, a contribution rate was reduced by 0.75 pp, from 37.8% to 37.05%<sup>65</sup>.

## 4.2. Intensity of regulations and the business environment

**Rigid, outdated and/or inefficient regulations also represent important rationales for avoiding formal sphere.** For instance, complex and time-consuming bureaucratic procedures which bring in additional costs, at the same time being perceived as unnecessary or senseless from the perspective of economic agents, will incentivise hiding particular economic activities from the au-

thorities. Additionally, if regulations are outdated and fail to properly capture technological advances, businesses will seek their own solutions to minimise restrictions by establishing parallel practices or trade channels. Similarly, regulations that end in procedural inefficiencies and/or slow down the business registration can also push agents into the shadows. If regulations limit economic freedoms, market agents may be discouraged to disclose some of the activities they perform. In that sense, "countries that are more heavily regulated tend to have a higher share of the shadow economy in total GDP"<sup>66</sup>.

**The observed countries are characterised by relatively rigid and inefficient regulations for doing business, with Serbia as relatively the best and BiH as the worst performer in the region.** Thus, World Bank *Doing Business* 2020 report, whose results are summarised in Figure 22, positions Serbia on 44<sup>th</sup> place, Montenegro is 50<sup>th</sup>, Croatia 51<sup>st</sup>, while BiH notably lags behind (90<sup>th</sup> place). Out of the four countries, only Serbia managed to improve its *Ease of Doing Business* (EODB) ranking over the period 2016–2020, while other three countries have experienced further drop in the ranking. Similarly, the *Global Competitiveness Report* for 2019 has recognized presence of regulation-related barriers and obstacles for doing business in the observed countries. While Montenegro and Serbia have been recognised as more favourable economies in terms of administrative requirements, thus being placed to the second quintile, Croatia has been placed at the third and BiH at the fourth quintile of countries according to this criterion (see Table 6). Ranking regarding the level to which government regulations are burdening for an economy is particularly alarming. Croatia and BiH were placed at the bottom end of the ranking list (see Table 6). Serbia has also been positioned relatively low (95<sup>th</sup> place), while Montenegro performs comparatively much better in this regard (32<sup>nd</sup> place). Finally, Index of Economic Freedoms classifies the observed countries as moderately free (third group of countries), with Serbia being notably ahead of other three countries (Table 6).

Table 6. Overview of intensity of regulations in the observed countries according to prominent indexes concerning business environment<sup>67</sup>

Country	Global Competitiveness Report							
	Doing Business		Business Dynamism: Administrative requirements		Burden of government regulation		Index of Economic Freedom 2019	
	Rank / 190	Score 0 – 100 (best)	Rank / 141	Score 0 – 100 (best)	Rank / 141	Score 0 – 100 (best)	Rank / 180	Score 0 – 100 (best)
Bosnia and Herzegovina	90	65.4	102	61.8	137	18.4	83	61.9
Croatia	51	73.6	64	71.8	139	15.8	86	61.4
Montenegro	50	73.8	39	79.9	32	50.0	92	60.5
Serbia	44	75.7	42	78.8	95	34.9	69	63.9

64 Vidovic, H. et al. (2019). *Western Balkans Labor Market Trends 2019*.

65 Ibid.

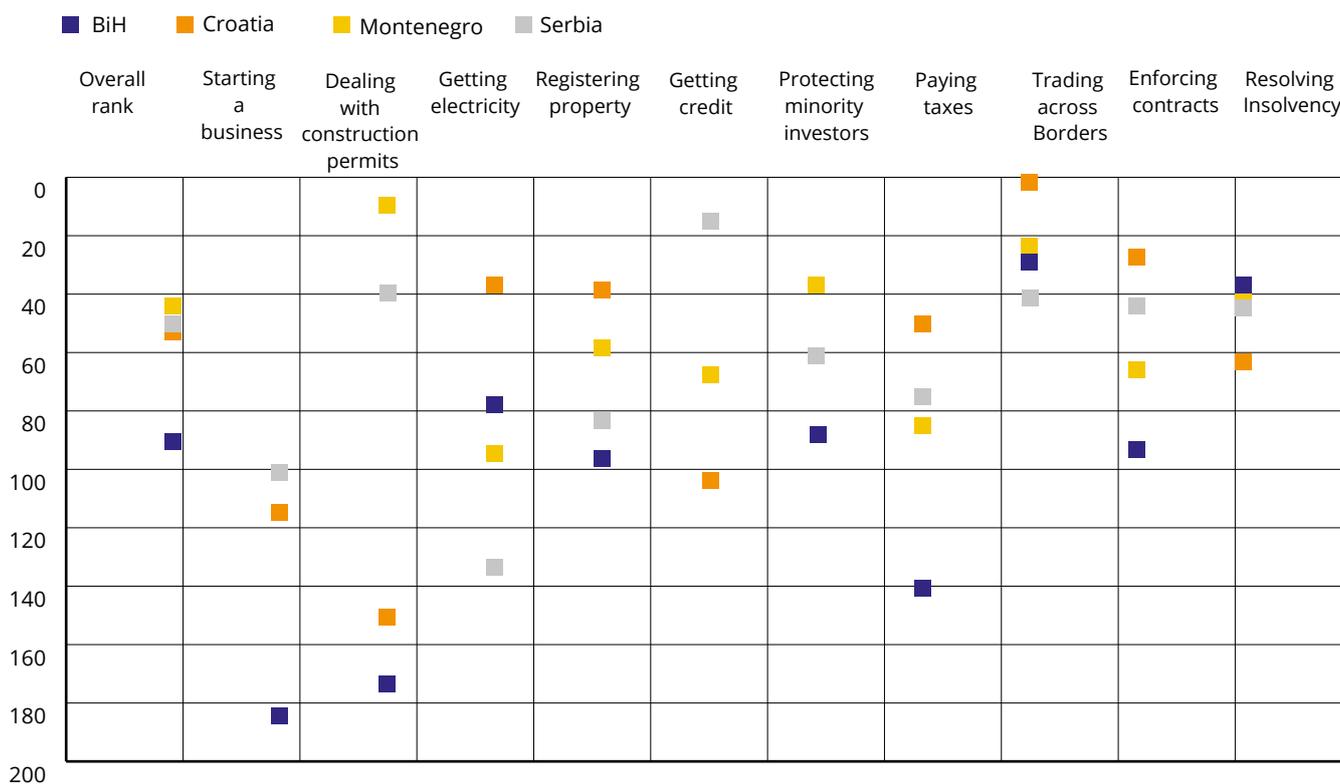
66 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*, p. 6.

67 World Bank. (2020). *Doing Business 2020: Comparing Business Regulation in 190 Economies*. Schwab, K. (2019). *The Global Competitiveness Report 2019*. Miller, T., Kim, A. B., Roberts, J. M., & Tyrrell, P. (2019). *Highlights of the 2019 Index of Economic Freedom*.

**Poor business climate is perceived as another important driver of the shadow economy in observed countries by many authors**<sup>68</sup>. Overregulation is one of the most significant challenges in that regard, „mostly concerning registration, licensing and permit regimes implementation”<sup>69</sup>. Additionally, many regulations are accompanied by lengthy and sluggish procedures, undermining expected flow in business registration and operations. For that reason “entrepreneurs engage in informal networking for various purposes, but most importantly to tackle business issues rising from formal institutional deficiencies and time-wasting procedures”<sup>70</sup>. However, many entrepreneurs use informalities as a cost-reducing strategy, thus boosting their profit and harming a principle of fair competition.

**High entrance barriers and high costs of starting and running a business push entrepreneurs in the shadow economy in the earliest phase of business operations**<sup>71</sup>. It is also obvious from Figure 22 that the observed countries perform especially low in the area of starting a business. In that regard, entrepreneurs plausibly launch their businesses in the shadows and formalise them only when the sustainability is ensured, not only due to high costs related to registering a business, but also due to the fact that in such situation it is also easier to cease the operations if the business is not profitable<sup>72</sup>. However, even if registered, many companies usually run a portion of their activities in the shadows to lower the costs of doing business, or to avoid regulative barriers and limitations.

Figure 22. Ranking on Doing Business 2020 per indicators (rank)<sup>73</sup>



**Still, the observed countries have achieved little in improving business climate during the last few years.**

Only Serbia improved its position on Doing Business over the period 2016–2020; its score enhanced by 7.3 points, so it moved up by 15 places (see Table 7). On the other hand, EODB scores in the remaining three countries only slightly improved compared to 2016, indicating that the policy environment for doing business did not deteriorate, but rather stagnated during the past years. The lower ranks could, therefore, be primarily attributed to improvements of other countries during that time.

**Deterioration in the area of starting a business has been recorded for three countries, while Serbia only slightly improved its score (see Figure 23).**

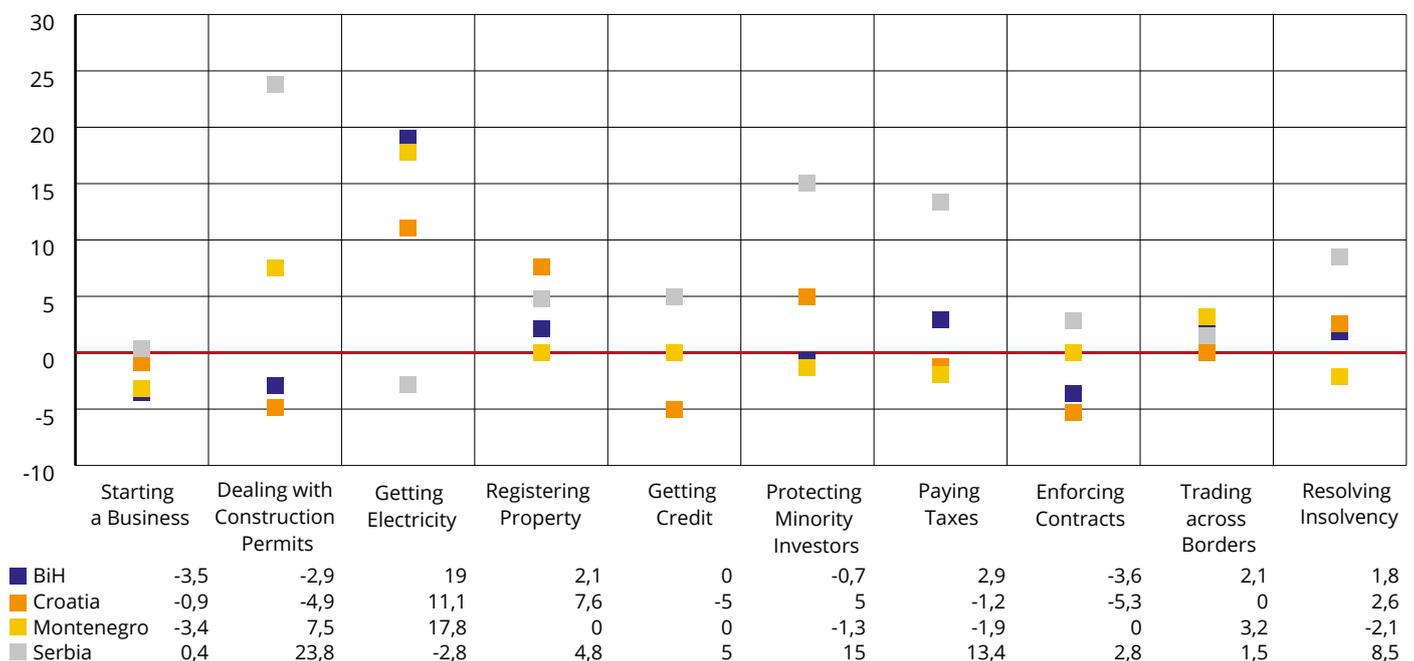
Furthermore, Croatia and Montenegro have faced deterioration in the area of paying taxes, Bosnia and Herzegovina has made moderate step forward, while Serbia has notably improved its policy framework in this domain. According to the 2018 World Bank Paying Taxes report, changes that have been made in Serbia brought a substantial advancement, i.e. significantly reduced cost of compliance (e.g. time for compliance was reduced from 279 hours a year in 2013 to 226 hours).

68 For instance, Shentov, O., Stefanov, R., & Todorov, B. (2016). *Shadow Power: Assessment of Corruption and Hidden Economy in Southeast Europe*; Efendić, A., & Ledeneva, A. (2018). *There is no free (informal) lunch: Cost of informal networking in the Western Balkans*.  
 69 Shentov, O., Stefanov, R., & Todorov, B. (2016). *Shadow Power: Assessment of Corruption and Hidden Economy in Southeast Europe*, p. 24.  
 70 Efendić, A., & Ledeneva, A. (2018). *There is no free (informal) lunch: Cost of informal networking in the Western Balkans*.  
 71 See Ibid.  
 72 See Efendić, N., Pašović, E., & Efendić, A. (2018). Understanding the informal economy in practice - evidence from Bosnia and Herzegovina. *Financial Internet Quarterly "e-Finance"*, 14(4).  
 73 World Bank. (2020). *Doing Business 2020: Comparing Business Regulation in 190 Economies*.

Table 7. Comparative overview of Ease of Doing Business' scores and positions of the observed countries in Doing Business 2020 and Doing Business 2016<sup>74</sup>

Country	2016		2020		Difference: 2016-2020	
	Score	Rank / 189	Score	Rank / 190	Change in score	Change in position
<b>BiH</b>	63.7	79	65.4	90	+ 1.7	- 11
<b>Croatia</b>	72.7	40	73.6	51	+ 0.9	- 11
<b>Montenegro</b>	71.9	46	73.8	50	+ 1.9	- 4
<b>Serbia</b>	68.4	59	75.7	44	+ 7.3	+ 15

Figure 23. Changes in the Ease of Doing Business' scores per main indicators (policy areas) over the period 2015-2019 (DB 2016 and DB 2020)



**An additional obstacle for formalisation is rigid labour legislation, especially in Croatia and BiH.** Both indexes analysed here, flexibility of the labour market according to the Global Competitiveness Report 2019 and labour freedom according to the Index of Economic Freedom 2019, lead to a similar conclusion in this respect. Montenegro performs far better than other three countries according to both assessments (Table 8). On the other hand, the rigidity of labour market is especially salient in Croatia; the country has the lowest Labour Freedom score (44.0) among the observed countries and is far below the median of all countries covered by the Index of Economic Freedom (59.9). In fact, Croatia also has the lowest-rank (117<sup>th</sup>/141) among the four countries by the Global Competitiveness Index. BiH stands only slightly better, taking 107<sup>th</sup> place. Serbia could be considered

as a country with moderate rigidity of labour regulation (Table 8).

**Rigidities are especially manifested through high costs of hiring workers, but also have a lot to do with expensive and complex dismissal procedures<sup>75</sup>.** It is mainly relevant in the cases of Croatia and BiH, which are positioned at the very end of tail among 141 countries (136<sup>th</sup> and 130<sup>th</sup> respectively). Given this, it is not surprising that many employers in these countries seek strategies to outsmart the system, with different forms of un(der)declared employment being the most common choices. However, some policy changes have been adopted by governments in the recent years, with the aim of improving efficiency of the labour market.

74 World Bank. (2016). *Doing Business 2016: Measuring Regulatory Quality and Efficiency*. World Bank. (2020). *Doing Business 2020: Comparing Business Regulation in 190 Economies*.

75 See, for example, Franic, J., & Williams, C. C. (2014). *Undeclared work in Croatia: A baseline assessment*. GREY Working Paper No. 2.

**All four countries invested some efforts in changing labour regulations during the recent years, but it seems that overall results and progress vary notably.** Thus, when analysed on the basis of the Global Competitiveness Report, it could be seen that three South-East European countries improved their positions within the indicator Flexibility of Labour Market,

with Montenegro and Serbia jumping dramatically on the ranking list, while the position of Croatia significantly deteriorated during the period 2015–2019 (see Table 8). It seems that hiring and firing practices were enhanced in Montenegro and Serbia during the observed period, while Bosnia and Herzegovina and Croatia experienced drop both in the score and position (Table 8).

Table 8. Overview of rigidity of labour regulations in the observed countries according to the Global Competitiveness Index 2019 and Index of Economic Freedom 2019<sup>76</sup>

Country	Flexibility of the labour market according to the Global Competitiveness Report 2019						Labour Freedom according to the Index of Economic Freedom 2019
	Overall position		Hiring and firing practices				
	2015 rank/140	2019 rank/141	2015 rank/140	2015 Score 1 – 7 (best)	2019 rank/141	2019 Score 1 – 7 (best)	
<b>BiH</b>	131	107	122	3.1	130	2.9	67.0
<b>Croatia</b>	105	117	129	2.8	136	2.6	44.0
<b>Montenegro</b>	74	23	72	3.8	49	4.1	73.4
<b>Serbia</b>	118	53	111	3.3	56	4.0	67.4

It can be concluded that, with the exception of Serbia, governments put insufficient efforts in addressing the poor business environment and rigidities in labour regulation, which are one of the drivers of the shadow economy, but also one of the roots of sluggish economic growth in the observed region.

### 4.3. Quality of institutions: Satisfaction with the government and public services

#### The quality of public institutions plays a significant role in the development of the shadow economy.

Rule of law, sound public policies, transparent and efficient government and provision of high-quality public services are necessary preconditions for efficient market economy. In that sense, informalities are occurring as a reaction on the failure of public institutions to create favourable conditions for efficient functioning of the market economy<sup>77</sup>. Studies have found that high presence of corruptive behaviour among government officials and public servants is associated with larger shadow economies, especially in post-communist and low-income countries<sup>78</sup>. On the other hand, strong rule of law and suppression of discretionary application of policies and measures creates benefits for being formal and discourage operating

in the shadows. Finally, governments should provide decent public services as otherwise citizens would perceive return on paid taxes as low and question the purpose of declaring taxes.

**Quality of institutions in the observed countries is generally low-to-moderate.** According to the 2019 *Global Competitiveness Report*, BiH is ranked as 114<sup>th</sup> out of 141 countries in terms of overall quality of institutions. Other three countries are positioned in the middle of the list. Montenegro is the best performer among them, being ranked 53<sup>rd</sup> in this regard. With the exception of Montenegro, countries are particularly poorly ranked in terms of efficiency of legal framework in challenging regulations (see Table 9), which measures how easy it is for private businesses to challenge government actions and/or regulations through the legal system. BiH and Croatia are positioned at the very bottom of the list. All four countries are also ranked pretty similarly in terms of ability to ensure a stable policy environment for doing business (Table 9). Finally, observed countries belong to the group of middle positioned countries in terms of incidence of corruption; BiH and Serbia are notably worse performers in this regard compared to other two countries.

76 Miller, T., Kim, A. B., Roberts, J. M., & Tyrrell, P. (2019). *Highlights of the 2019 Index of Economic Freedom*. Schwab, K. (2015). *The Global Competitiveness Report 2015–2016*. Schwab, K. (2019). *The Global Competitiveness Report 2019*.

77 Schneider, F., & Buehn, A. (2012). *Shadow Economies in Highly Developed OECD Countries: What Are the Driving Forces?*

78 See Johnson, S., Kaufmann, D., & Zoido-Lobaton, P. (1998). *Corruption, Public Finances and the Unofficial Economy*. Dreher, A., & Schneider, F. (2010). *Corruption and the shadow economy: an empirical analysis*. *Public Choice*; Schneider, F., & Buehn, A. (2012). *Shadow Economies in Highly Developed OECD Countries: What Are the Driving Forces?*

Table 9. Overview of performance of public institutions in the observed countries (ranks) according to the selected indicators of the 2019 Global Competitiveness Report<sup>79</sup>

Country	Institutions (overall rank)	Efficiency of legal framework in challenging regulations	Incidence of corruption	Government ensuring policy stability	Property rights
<b>BiH</b>	114	139	77	137	131
<b>Croatia</b>	77	138	54	132	111
<b>Montenegro</b>	53	46	58	47	72
<b>Serbia</b>	75	94	75	92	106

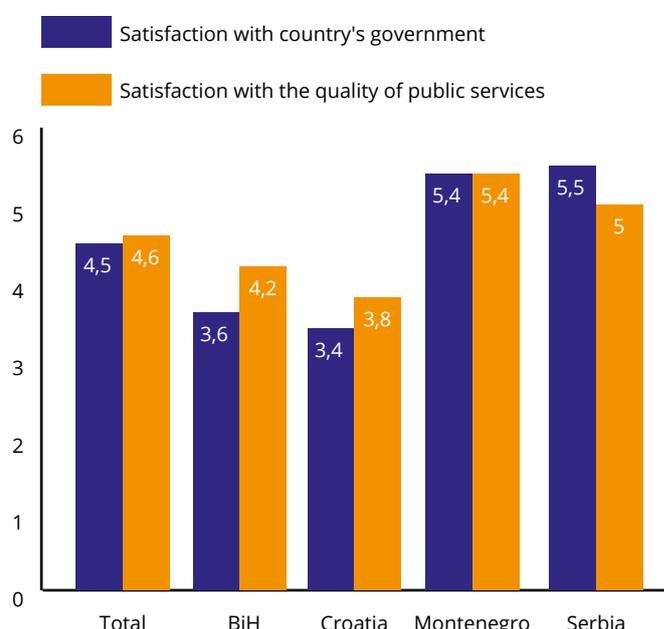
**As a result, public satisfaction and trust in institutions have been deteriorating in the observed countries.**

Some studies suggest that institutions in BiH are lacking credibility and social recognition, stating that lack of trust in formal institutions directs the citizens to rely on informalities<sup>80</sup>. This claim could be further supported by the empirical finding that more than 60% of citizens have no trust in government in BiH<sup>81</sup>. Similar findings are available for Croatia. According to the *Standard Eurobarometer Survey* on public opinion in the European Union conducted in 2019, only 13% of citizens tend to trust the central government and national parliament, while one in four is happy with the work of public administration<sup>82</sup>. According to some evidence, Montenegro also faces a huge mistrust towards the government and such attitude also negatively affects citizens' willingness to report informalities<sup>83</sup>. Explicitly, 10% of working population in Montenegro would not report undeclared activities due to the lack of trust in institutions.

To understand the role of satisfaction with institutions in the development and sustaining of the shadow economy, respondents of this study's survey were asked to grade to which extent they are satisfied with the work of government(s) and with the quality of public services on a ten-point scale (1-10), with larger values indicating a higher level of satisfaction.

**Satisfaction with institutions is relatively low in the observed countries, suggesting defiance as an important rationale for taxpayers to engage in informal economic activities.** In general, citizens are more satisfied with the provision of public services than with the work and performance of ruling elites (see Figure 24). The exception is Serbia where the opposite is true, while in Montenegro both are assessed with the same score. Croatia reports the lowest level of satisfaction, both with the government and the quality of public services (average rates of 3.4 and 3.8 respectively).

Figure 24. Satisfaction with the government and quality of institutions (mean score); 1 – completely dissatisfied, 10 – very satisfied (CPU Survey, 2019)



**It is, therefore, not surprising that citizens consider taxes as very high relative to the amount and quality of public services they receive.** Namely, when asked to express their opinion on the opposite scale from 1 to 10, with larger values designating a higher disproportion between liabilities and received benefits, citizens of the observed countries assessed taxes as high, with scores amounting, in average, between 7 in Montenegro and 7.9 in BiH and Serbia (see Figure 25). In other words, people mainly believe that their contribution to the public purse is not adequately compensated. It is important to notice that this finding does not fully correspond to the previous figure. Namely, citizens who assessed the quality of public services as lower compared to others also find a level

79 Schwab, K. (2019). *The Global Competitiveness Report 2019*.

80 Mujarić, M. (2017). *Institutional perspective of Bosnia and Herzegovina's tourism sector: The missing ingredient*.

81 Efendić, N., Pašović, E., & Efendić, A. (2018). Understanding the informal economy in practice - evidence from Bosnia and Herzegovina. *Financial Internet Quarterly "e-Finanse"*, 14(4).

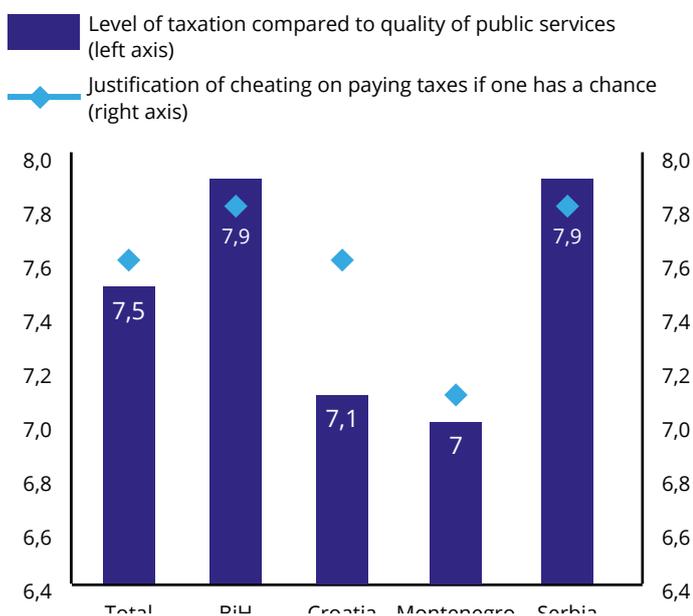
82 European Commission. (2019c). *Standard Eurobarometer 91. Public opinion in the European Union*. European Commission. (2017). *Standard Eurobarometer 88. Public opinion in the European Union*.

83 Katnić, M. (2016). *National Human Development Report: Informal Work: From Challenges to Solutions*.

of taxes more justifiable than citizens of those countries who assessed the quality of public services as better, and vice versa. For the sake of illustration, Croatian citizens are mostly dissatisfied with the quality of public services, while they at the same time consider the relative level of taxation as more justifiable compared to the unweighted average for the observed countries. The situation is opposite in case of Serbia, where satisfaction with public services is above the regional average, but level of taxations is less justified by citizens (see Figure 25).

**Interestingly, dissatisfaction with return on taxes, in terms of quality of public services, positively correlates with disapproval of cheating on paying taxes if one has a chance.** In other words, in countries where citizens perceive higher disbalance between the level of taxation and the quality of public services received there is also more pronounced disapproval towards tax frauds (see Figure 25). It suggests that tax morale in these countries is not a pure product of satisfaction with the government and public institutions, but should rather be understood as a broader and more complex phenomenon (see Section 4.4. for more elaborate findings on tax morale).

Figure 25. Attitudes towards tax burden and tax evasion (mean values); left axis: 1 – taxes are very low, 10 – taxes are very high (compared to the amount and quality of public services received); right axis: 1 – it can always be justified, 10 – it can never be justified (CPU Survey, 2019)



**However, low appraisal of public institutions/services represents a motivation for people to operate in the shadows, considering that sense of purpose**

**of declaring taxes in such environment is lower.** In this respect, when assessing the main reasons why people work without legal job contracts or with legal job contracts when part of their wages is paid as ‘envelope wages’, between 12% (Serbia) and 17% (Montenegro) citizens think that people see no point in paying taxes, as government services are poor and insufficient. Although this reason is ranked as fourth, the share of people who recognised it as a driver of informal work is not negligible.

#### 4.4. Tax morale: Justification of shadow activities

**Alongside with institutional (dis)incentives for operating in the shadows, society’s tax morale also plays a vital role in decisions to circumvent formal procedures.** If a person operates in a surrounding where justification of informalities is prevalent, he or she is going to be more likely and more comfortable to engage in the shadow activities. In that sense, people may act differently in relatively similar institutional setups and tax environment if levels of justification of informalities are different in their societies. Even though the quality and efficiency of public sector is one of key factors that influence tax morale in the society (the so-called psychological tax contract<sup>84</sup>), it is not the only determinant. Cultural norms and the mainstream philosophy in the society, patriotic sentiment, attachment to society/nation, historical circumstances and alike also influence values and levels of justification toward informalities<sup>85</sup>. On the other hand, higher incidence of informal behaviour leads to higher level of justification due to personal experience<sup>86</sup>. This creates a „dangerous positive feedback loop”, meaning that „a wider incidence of the shadow economy leads to more justification, and more justification may create better conditions for the shadow economy”<sup>87</sup>.

**Existing evidence indicates poor tax morale in the observed countries.** For instance, according to the survey of 1,246 individuals conducted in 2017, 42% households and 41% entrepreneurs in BiH justify tax evasion to some degree<sup>88</sup>. Likewise, results of a similar survey from 2015 reveal that a substantial share of citizens of Croatia have a benevolent attitude towards different types of tax evasion<sup>89</sup>. Permissiveness is particularly emphasised in the case of undeclared work by an individual for a household, given that only one half of the Croatian population opposes such behaviour. Likewise, only three out of four Croatians are against frauds related to income from waged employment and self-employment, while one in twenty finds them fully reasonable. Although receiving somewhat lower overall support, other types of undeclared work appear highly acceptable in the eyes of many citizens in Croatia as well<sup>90</sup>. Montenegro also strug-

84 See Feld, L. P., & Frey, B. S. (2007). Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation. *Law & Policy*, 29(1).  
 85 See Torgler, B. (2006). The importance of faith: Tax morale and religiosity. *Journal of Economic Behavior & Organization*, 61(1); Torgler, B., & Schneider, F. (2006). *What Shapes Attitudes Toward Paying Taxes? Evidence from Multicultural European Countries*; Lago, I., & Lago-Peñas, S. (2008). The Determinants of Tax Morale in Comparative Perspective: Evidence from a Multilevel Analysis. *SSRN Electronic Journal*.  
 86 Žukauskas, V. (Ed.). (2018). *Shadow Economy: Understanding Drivers, Reducing Incentives*.  
 87 Ibid., p. 16.  
 88 Pašović, E., & Efeđić, A. S. (2018). Informal Economy in Bosnia and Herzegovina - An Empirical Investigation. *South East European Journal of Economics and Business*, 13(2).  
 89 Franic, J., & Williams, C. C. (2017). *Illegitimate economic practices in Croatia. Findings from a representative survey of 2,000 citizens*. GREY Working Paper No. 9.  
 90 See Ibid.

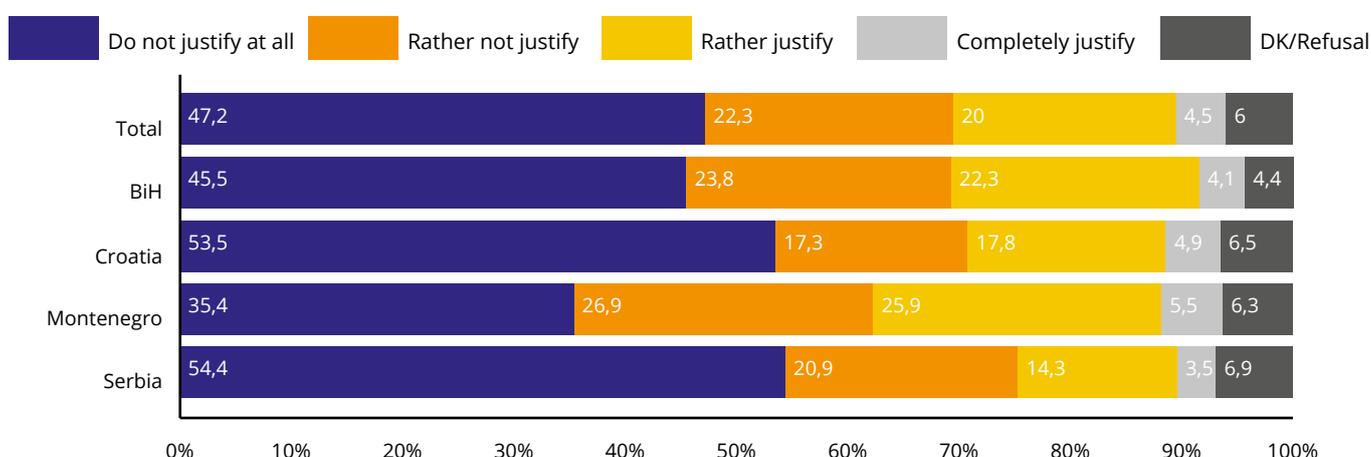
gles with weak tax morale. Some survey-based evidence suggests that for 80% of the working population it is unacceptable not to pay taxes and contributions, but more than half of citizens would not report informal work if they knew about it<sup>91</sup>. Finally, there are no recent and reliable empirical data on the attitudes toward evasion and/or tax avoidance among citizens of Serbia, but partial data suggests a similar state of affairs as in other three countries<sup>92</sup>.

In order to obtain a comprehensive insight into the tax morale of citizens, respondents of this study's survey were asked to declare to which degree they justify specific shadow activities and overall practice of tax evasion.

**Findings reveal there is a non-negligible share of citizens who tend to justify shadow trade activities.**

Although majority of the population in the observed countries partially or entirely opposes shadow practices, in average almost 1/4 of them justify to some extent purchasing goods or services from a legal shop when knowing that the seller will not declare their payment (see Figure 26). More precisely, between 17.8% (Serbia) and 31.4% (Montenegro) of citizens tend to justify informal payments for legitimately produced goods and services. It is important to emphasize that, in average, around 4.5% approve this practice wholeheartedly (see Figure 26). However, more than a half of the population in Croatia and Serbia (53.5% and 54.4% respectively), 45.5% in BiH and 35.4% in Montenegro do not justify such activities at all.

Figure 26. Attitude towards the informal purchase of legal goods/services from legally registered providers (seller is not declaring a payment), % of population (CPU Survey, 2019)

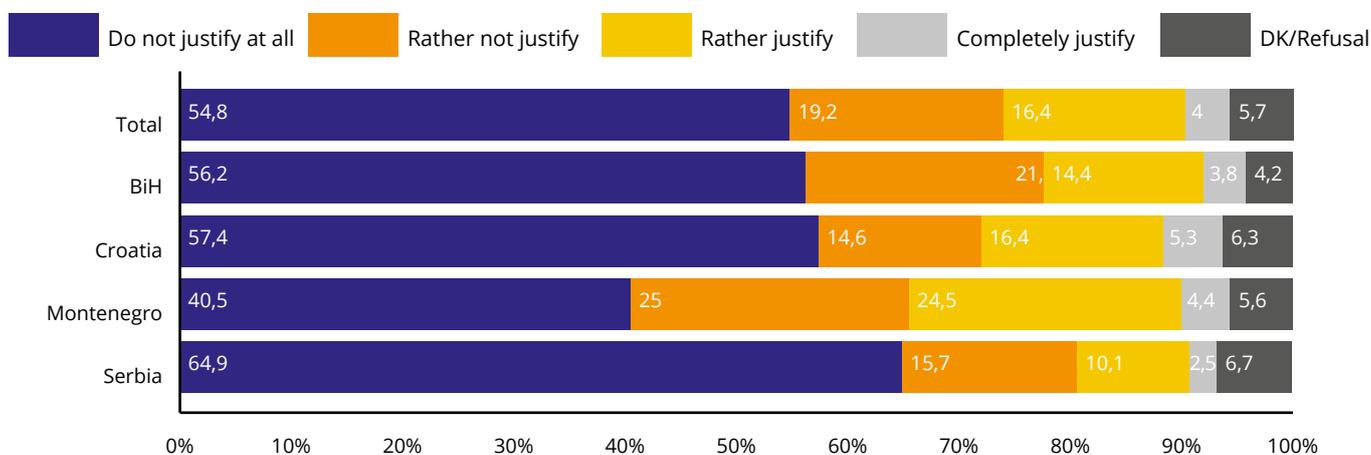


**Despite enjoying slight lower overall support, smuggling and related illegal activities are also tolerated by many citizens of the observed countries.**

Looking at the unweighted average for the observed countries, it can be noticed that 19.2% of citizens justify engagement in smuggling, illegal production or sales of cigarettes, alco-

hol products and fuel (see Figure 27). A share of those who justify such illegal activities ranges from 12.6% in Serbia to 28.9% in Montenegro. On the other hand, in Croatia there is a slightly higher share of those who wholeheartedly approve smuggling and related illegal activities (5.3%) compared to the case of informal payments (4.9%).

Figure 27. Attitude towards smuggling, illegal production or sales of cigarettes, alcohol products and fuel, % of population (CPU Survey, 2019)



91 Katnić, M. (2016). National Human Development Report: Informal Work: From Challenges to Solutions.

92 For a discussion on tax morale and tax compliance in Serbia, see Randelović, S. (2016). How to Boost Tax Compliance and Tax Morale in Serbia? *Ekonomika preduzeća*, 65

**Tendency of justification is similar, even higher, in the case of participation in the shadow labour market, especially when it comes to under-declared work.** In that regard, between 16.5% (Serbia) and 34.4% (Montenegro) of citizens tend to justify undeclared work (see Figure 28). Croatia and Montenegro have larger portions of citizens who completely justify such behaviour (6.1% and 7.2% respectively) compared to other two countries (2.9% in Serbia and 3.3% in BiH). The problem of rather low tax morale is even more evident in the case of attitudes towards under-declared employment. As it may be observed in Figure 29, under-declaring a wage is condemned by less than half of the total population in

the four countries. Between 19.4% (Serbia) and 34.9% (Montenegro) justify hiding part of the salary from authorities. Tendency to be more sympathetic toward participation in the shadow labour market could be partially explained by high share of population working themselves informally, having in mind that people involved in informalities would be more likely to justify them. Furthermore, overall finding that citizens of the observed countries are most inclined to justify under-declared work could also suggest that hiding the part of the salary is probably perceived as a practice imposed by employers or a reasonable strategy for ensuring more decent income (see Section 4.3.).

Figure 28. Attitude towards fully undeclared work (working without a formal job contract), % of population (CPU Survey, 2019)

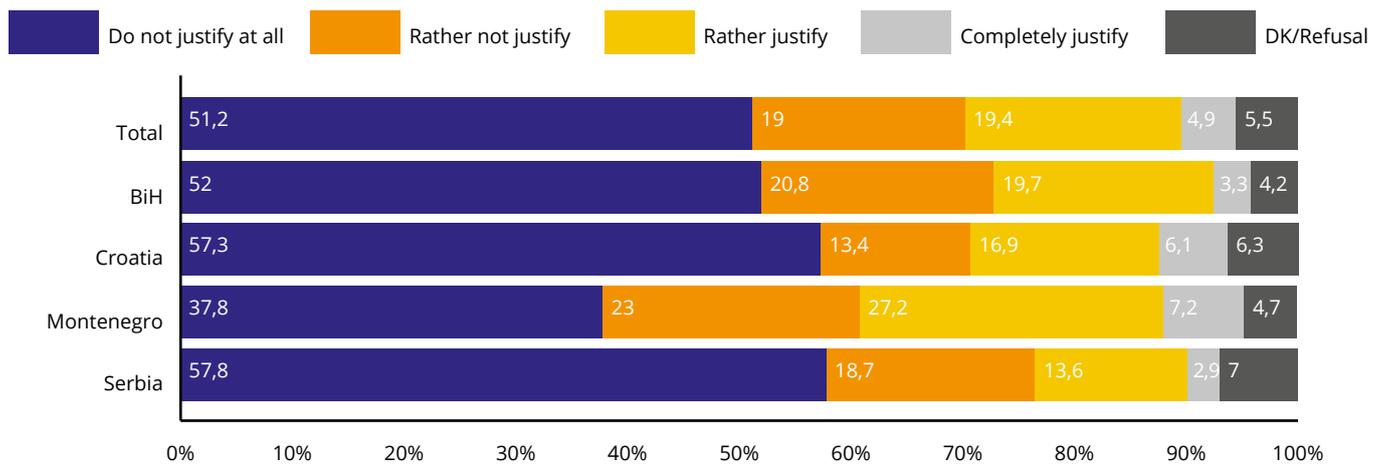
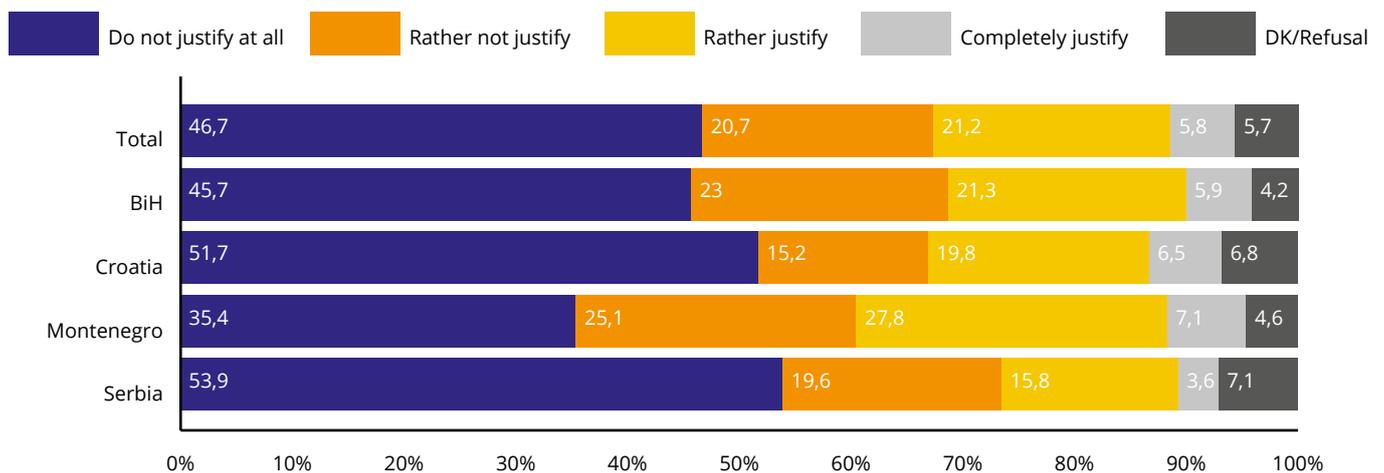


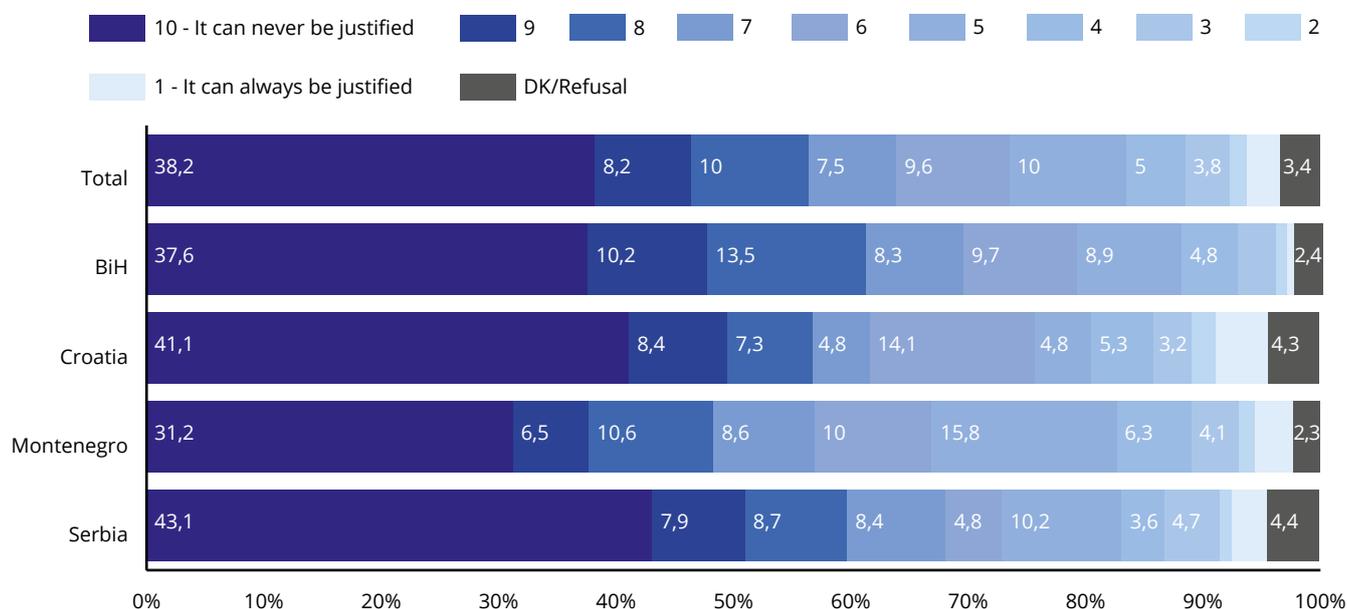
Figure 29. Attitude towards under-declared work (working with a formal job contract, but part of salary paid in envelope), % of population (CPU Survey, 2019)



**Relatively consistent findings were obtained when respondents were asked to assess if it could be justified to cheat on paying taxes if one has a chance. Majority of population oppose tax evasion practices but, again, there is a non-negligible share of those who justify this type of misbehaviour.** Significant share of population, ranging from 31.2% in Montenegro

to 43.1% in Serbia, is strongly convinced that tax evasion cannot be justified in any circumstances. However, almost every fifth citizen of BiH and Croatia (i.e. 18.4% and 19.9% respectively), almost every fourth citizen of Serbia (22.6%) and almost every third citizen of Montenegro (30.8%) are likely to justify the practice of not declaring taxes to some degree (see Figure 30).

Figure 30. Attitude towards cheating on paying taxes if one has a chance, % of population (CPU Survey, 2019)

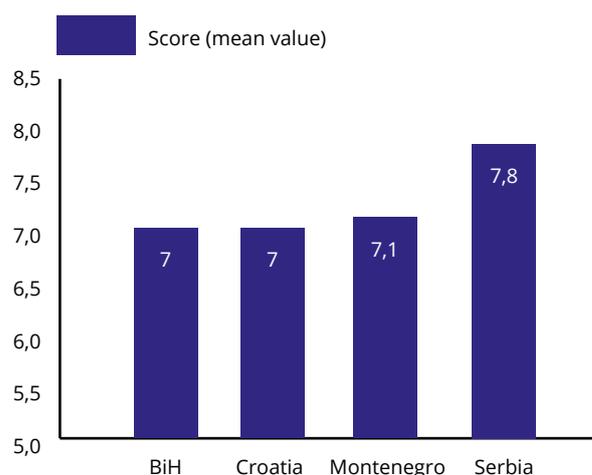


**Cross-country differences regarding tax morale are mainly consistent, regardless of the type of shadow activity. Shares of population who justify informalities are the highest in Montenegro and the lowest in Serbia.** Relatively higher shares of population who tend to justify informalities in Montenegro could be explained by the level of participation in the shadow economy. This country has the highest incidence of informal purchases compared to other three countries accompanied by relatively sizable informal labour market. Considering the fact that participants in the shadow economy are more likely to justify such misbehaviour, obtained results are not surprising.

**Persistently lower share of population to justify informalities in Serbia is harder to explain, having in mind high occurrence of the shadow economy in this country (Section 3), and widespread belief that taxes are high compared to the quality of public services received (Figure 25 in Section 4.3.).** This could have something to do with the sense of importance of belonging to the own nation, being somewhat more present among citizens of Serbia than it is the case with citizens from other three countries (see Figure 31). If considered as a cohesive factor, this could drive people to think more about the well-being of the nation and, therefore feel stronger responsibility and duty of paying taxes – at least nominally. Our analysis shows that there is a statistically significant and positive, but at the same time low-to-moderate correlation ( $r_s=0.291$ ,  $p<0.01$ ) between this variable

(i.e. degree of expressed sense of importance of belonging to a nation) and the degree of disapproval of evading taxes if one is presented a chance. However, it should also be noted that the difference between Serbia and other three countries is rather not substantial (0.7 pp).

Figure 31. Attitude towards importance of belonging to his/her nation, score (mean value)

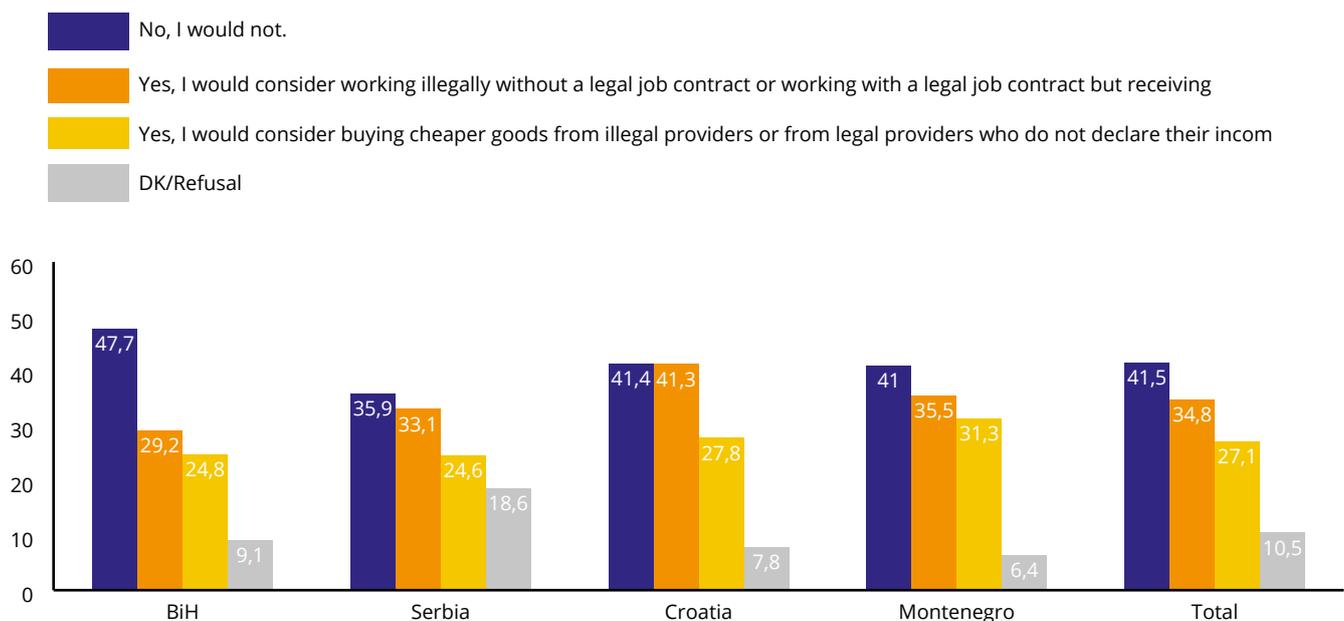


Scale, 1 – not important at all, 10 – very important (CPU Survey, 2019)

However, less than a half of citizens would stick to operating strictly in formal economy if their income drastically decreased or their financial situation severely worsened (see Figure 32). In that case, people are slightly more inclined to enter the informal employment than to buy goods informally. More precisely, approximately three out of ten citizens in these countries, with the exception of Croatia where incidence is a bit higher (four out of ten), represent potential undeclared workforce. In case of demand, the same (three out of

ten) is true for Croatia and Montenegro, while in BiH and Serbia two out of ten citizens express this tendency. The share of citizens who would resist to participate in the shadow economy is the highest in BiH, and the lowest in Serbia. The latter finding is surprising, having in mind that the current level of tax morale, as presented earlier in this chapter, is the highest in Serbia. However, this finding, apart from suggesting fragility of tax morale in the observed countries, also suggests that financial situation is an important determinant of tax-related values.

Figure 32. Considering participation in the shadow economy if one's income dramatically decreased and financial situation severely worsened, % of population (CPU Survey, 2019)



Findings on tax morale presented in this section clearly indicate that any endeavours to reduce the underground economy in the observed countries would hardly give desirable results unless the problem of high approval rates within society is properly addressed.

**Tax morale is a complex matter so it can hardly be altered with simple policy measures.** This would rather require improvement in many areas, including tax policy and the quality of institutions. However, governments tend to use different approaches and policy instruments to increase tax compliance and raise awareness about negative consequences of noncompliant behaviour and benefits of declaring and paying taxes. One of the popular measures in the past two decades is so-called a receipt lottery, which should stimulate consumers to ask for a receipt. In other words, the aim of the measure is to tackle the issue of tax evasion by raising awareness among citizens and encouraging them to demand receipts for bought goods and services. This way of nudging citizens does not necessarily improve, but certainly substitutes the lack of tax morale, as it changes their behaviour on the interest-driven basis. Such policy has been applied in many European countries.

**Accordingly, some of the observed countries introduced a receipt lottery in 2010s.** Croatia introduced this measure in 2013 and since then receipt lottery has been repeated on a regular basis. Four cycles of competition have been organized in 2019<sup>93</sup>. Receipt lottery was also introduced in Serbia in 2017 and the contest was repeated in 2018<sup>94</sup>. Finally, Republika Srpska, one of the entities in BiH, introduced a receipt lottery in 2019. Thus, the Government of Republika Srpska adopted Decree on approval to the rules of competition in July 2019<sup>95</sup>. However, it is not known at the moment if this measure will be perpetuated, or it was a one-off project. Similar measure was not introduced by other administrative units of BiH. A receipt lottery has not been introduced in Montenegro so far.

#### 4.5. Deterrence: likelihood of detection and the expected punishment

**Deterrence is one of the most commonly used policy measures for combating the shadow economy.** An assumption is that higher probability of detection of informalities and more severe punishment would discourage people to operate in the shadows. However, there is little empirical evidence endorsing positive influence of deter-

93 Croatian Lottery. (2019). *Nagradna igra "Bez računa se ne računa"*.

94 NALED. (2019b). *Uzmi račun 2018*.

95 Government of Republika Srpska. (2019, July 11). *Održana 28. sjednica Vlade Republike Srpske*.

rence on reduction of the shadow economy<sup>96</sup>. Some limited insights actually suggest that “size of the shadow economy can affect deterrence, instead of deterrence reducing the shadow economy”<sup>97</sup>, which could be mainly explained by widespread corruptive practices and deteriorated institutions in such contexts. However, there is no doubt that perceived risk of operating in the shadows will affect informal behaviour; if one assesses that potential costs of being caught exceed the benefits that hidden activities bring in, they will be less likely to enter the shadow economy or more likely to drop out from the informal market.

**Therefore, it is more important to understand how people perceive risk of being exposed and fined, instead of simply analysing policy framework in this domain.** To understand how the level of deterrence potentially influences the behaviour of citizens in that regard, our study explored public perception of the likelihood of being detected when operating in the shadows and perception of the severity of sanctions if caught by authorities.

**Although differences between the observed countries are not negligible, it can be stated that citizens perceive relatively low level of probability of detection in both the shadow goods market and the shadow labour market.** Explicitly, the share of citizens who are highly confident about the capacities and capabilities of the repressive apparatus ranges from 9.9% (Croatia) to 24.4% (Montenegro) in case of detecting purchases from unregistered providers, and from 12.4% (Croatia) to 27.6% (Montenegro), when observing the probability of detecting smugglers or illegal producers and consumers of cigarettes, alcohol products and fuel (see Figures 33 and 34). On the other hand, the share of citizens who observe those risks as low varies from 57.7% (Croatia) to 30.8% (Montenegro) in the former case, and from 51.1% (Croatia) to 29.6% (Montenegro) in the latter case (see Figures 33 and 34). In line with the findings, it can be stated that in all four countries smugglers and illegal producers are believed to be easier to detect than purchases from illegal sources.

Figure 33. Perceived chance of being detected when purchasing a good or service from an unregistered provider, % of population (CPU Survey, 2019)

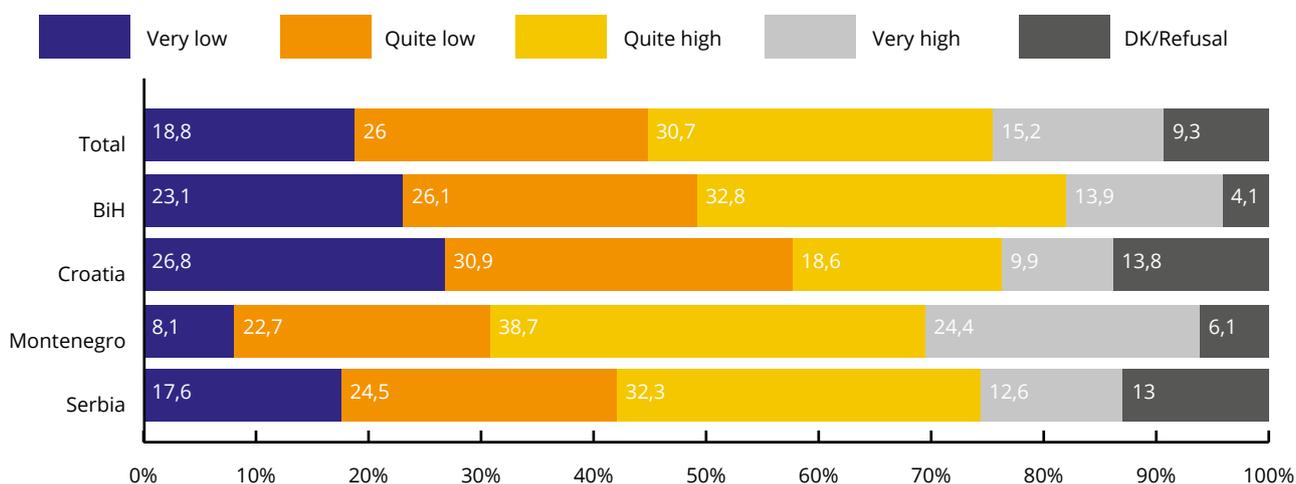
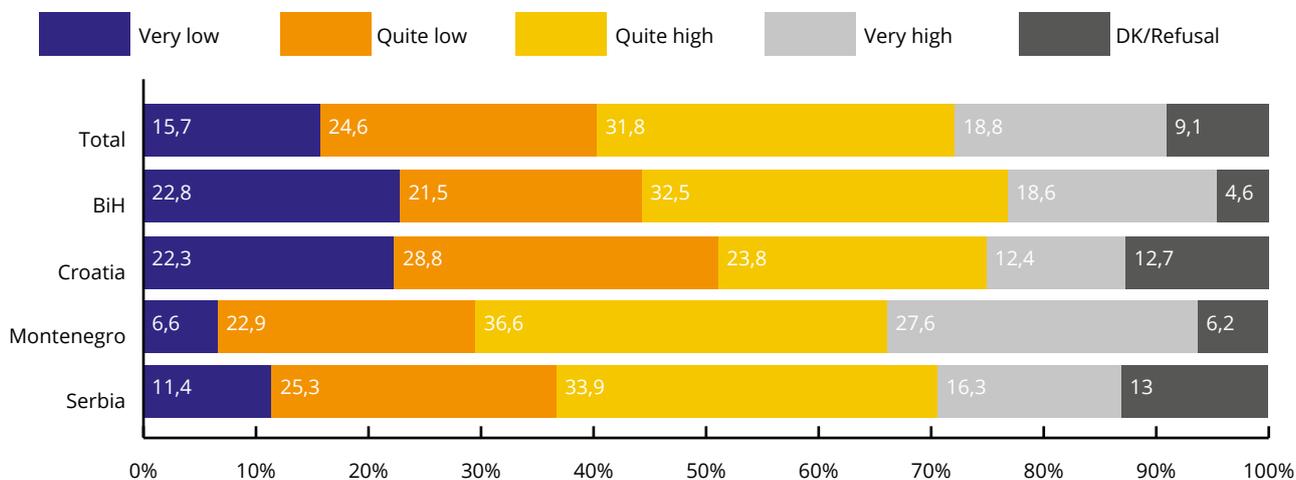


Figure 34. Perceived chance of being detected in the case of smuggling (contraband) or illegal production and consumption of cigarettes, alcohol products and fuel, % of population (CPU Survey, 2019)



96 Schneider, F., & Buehn, A. (2016). *Estimating the Size of the Shadow Economy: Methods, Problems and Open Questions*.

97 Ibid., p. 8.

**Generally, citizens of the observed countries believe that it is easier to detect informalities on the shadow goods/services market than on the shadow labour market and under-declared work is believed to be the hardest for uncovering.** Similar as in the case of demand side. Citizens of Croatia perceive the lowest probability of being detected when working

informally or quasi-formally, while the highest share of citizens who believe that such probability is relatively high is in Montenegro (see Figure 35 and Figure 36). Thus, in case of the undeclared work, the share of citizens who perceive those risks as low varies from 55.5% in Croatia to 36.2% in Montenegro, while for under-declared work shares vary from 60% (Croatia) to 35.9% (Montenegro).

Figure 35. Perceived chance of being detected when working without a formal contract (all the wage is paid as an 'envelope wage'), % of population (CPU Survey, 2019)

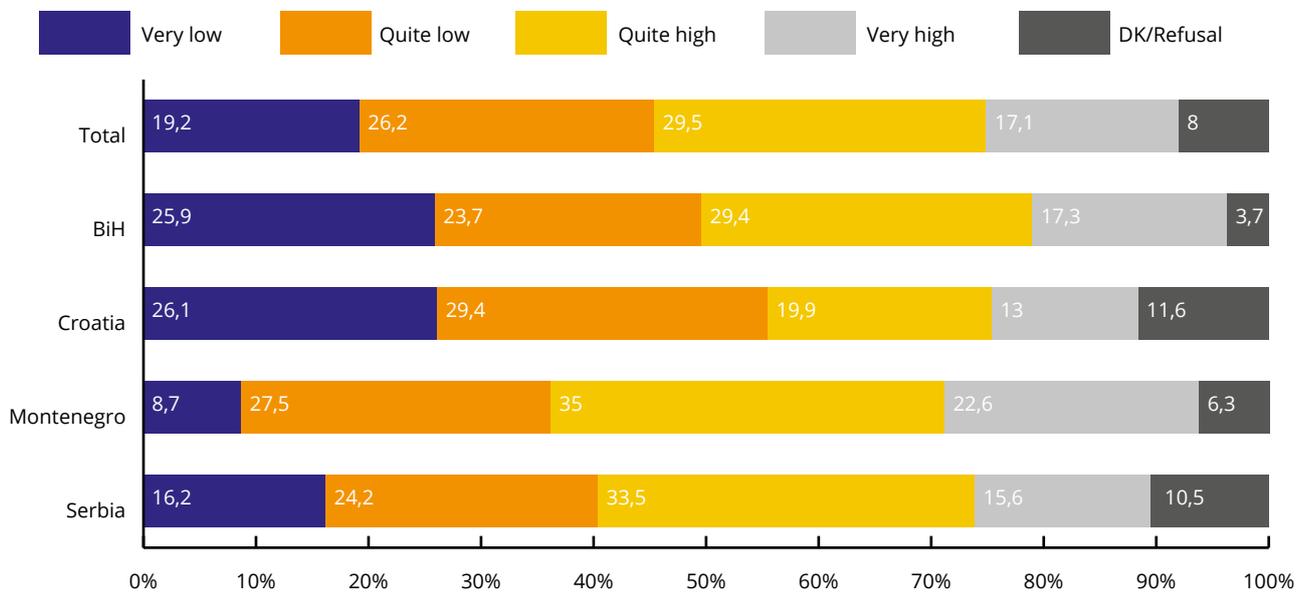
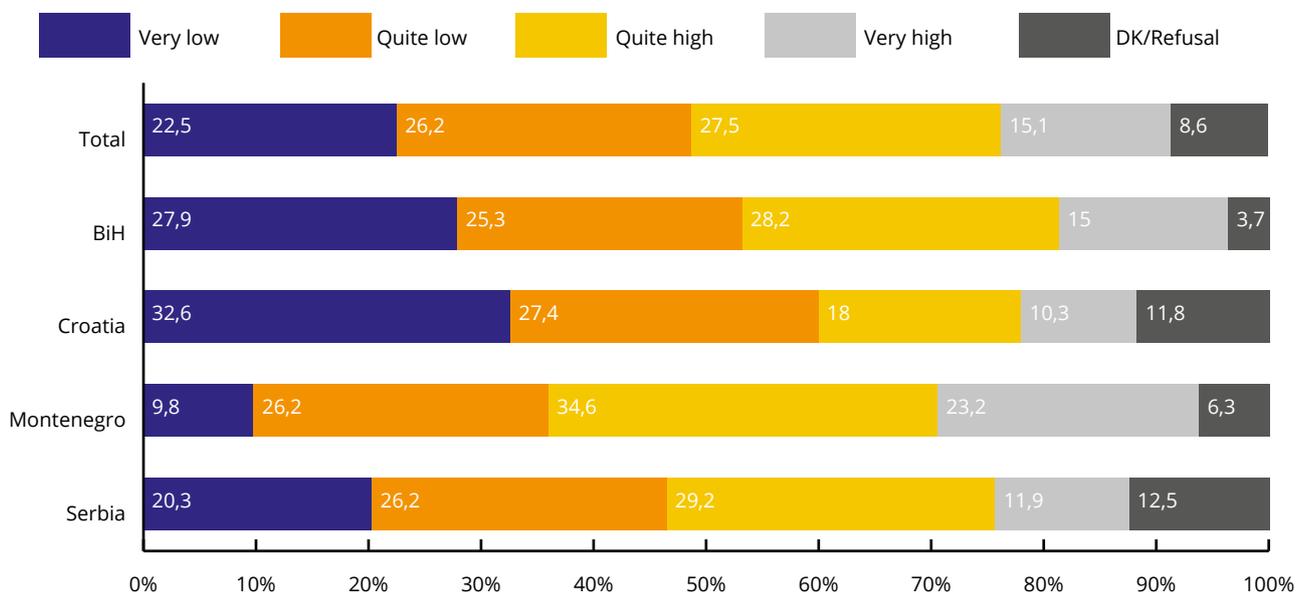


Figure 36. Perceived chance of being detected when working with a legal job contract but part of the wage is paid as an 'envelope wage' (under-declared employment), % of population (CPU Survey, 2019)



**Public perception regarding penalties for the shadow activities endorses the notion of rather low deterrence level in the observed countries.** Specifically, between 14.2% (BiH) and 20% (Serbia) citizens expect the authorities to be quite harsh towards purchasing goods or services from illegal sources, while a considerable share of the population (from 34.4% in Serbia to 57.3% in BiH) foresees relatively mild punishment (Figure 37).

Citizens of the four countries also seem to be equally pessimistic in terms of the expected sanctions for smuggling and illegal production of cigarettes, alcohol products and fuel. The share of citizens who believe sanctions are mild varies from 32.6% in Serbia to 51.5% in BiH, while in other two countries around 2/5 population shares the same attitude (Figure 38).

Figure 37. Expected severity of punishment when caught in purchase of goods/services from an unregistered provider, % of population (CPU Survey, 2019)

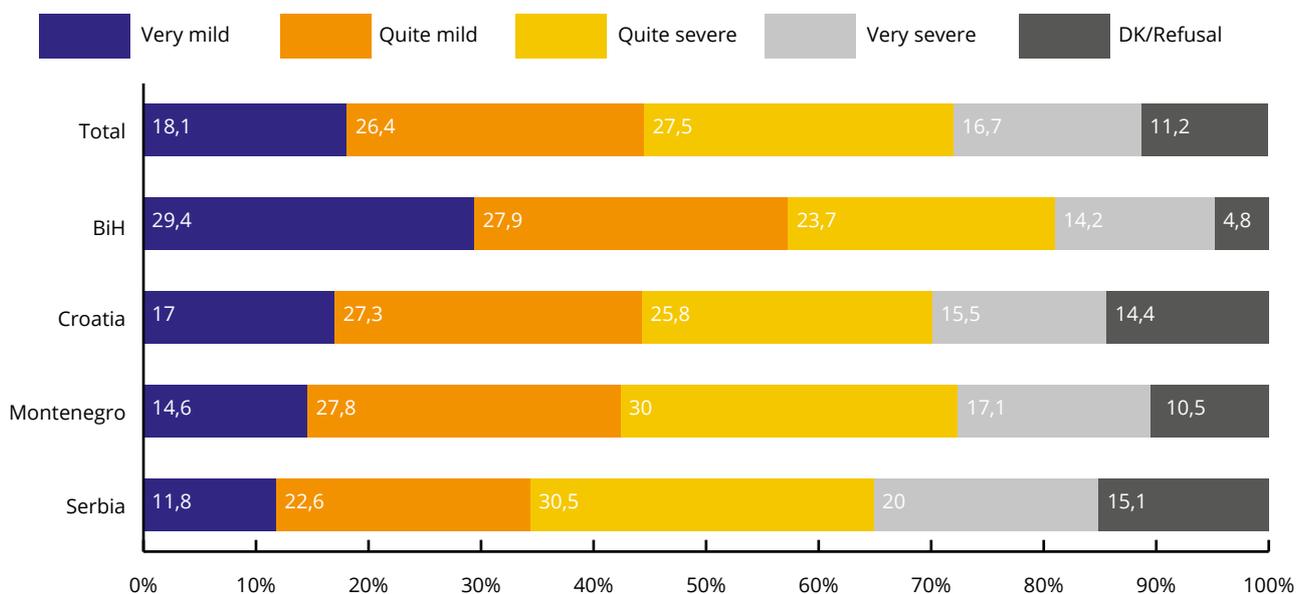
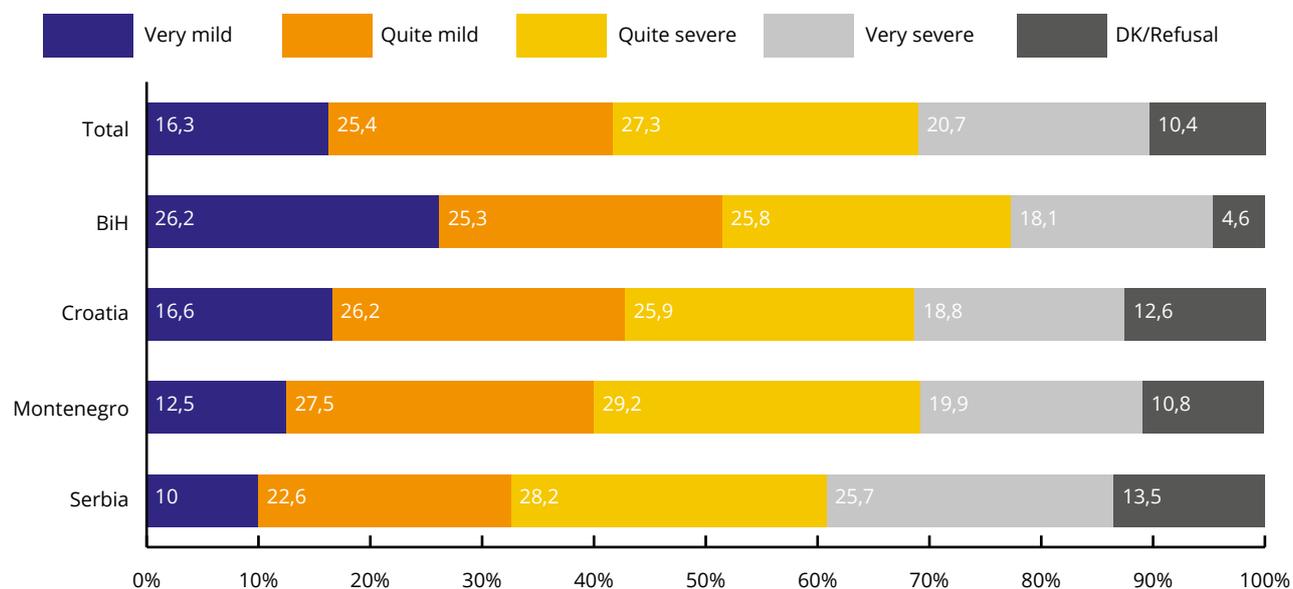


Figure 38. Expected severity of punishment when caught in smuggling, illegal production or consumption of cigarettes, alcohol products, and fuel, % of population (CPU Survey, 2019)



**The same is also true in case of expected sanctions for un(der)declared work.** Almost half of population in Croatia and Montenegro (45.1% and 44.4% respectively), 35.8% in Serbia and more than half (56.8%) in BiH think that sanctions will be either negligible or quite mild for workers who work without a formal contract (Figure 39). The situation is even more alarming in terms of wage un-

derreporting, considering the fact that the share of population who finds sanctions mild varies between 38.2% in Serbia and 60.5% in BiH (Figure 40). This share is again just slightly below one half in other two countries. Citizens of Serbia appear to be more deterred in this respect, while their counterparts from BiH expressed considerable disbelief in the rule of law in their country.

Figure 39. Expected severity of punishment when caught in fully undeclared work, % of population (CPU Survey, 2019)

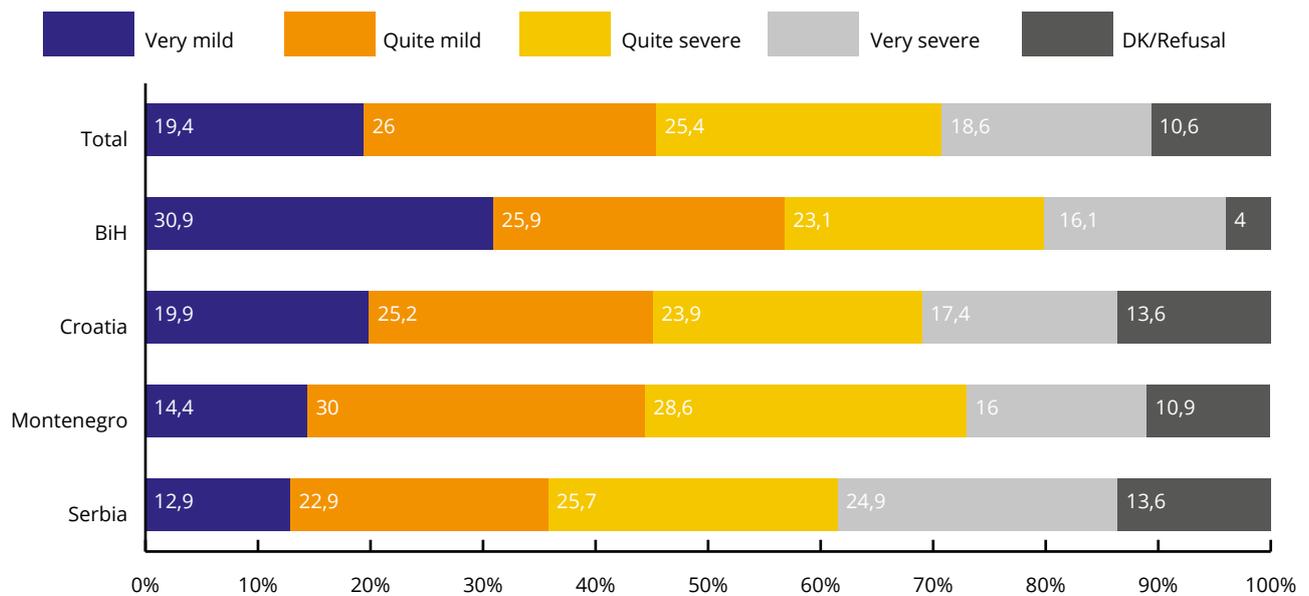
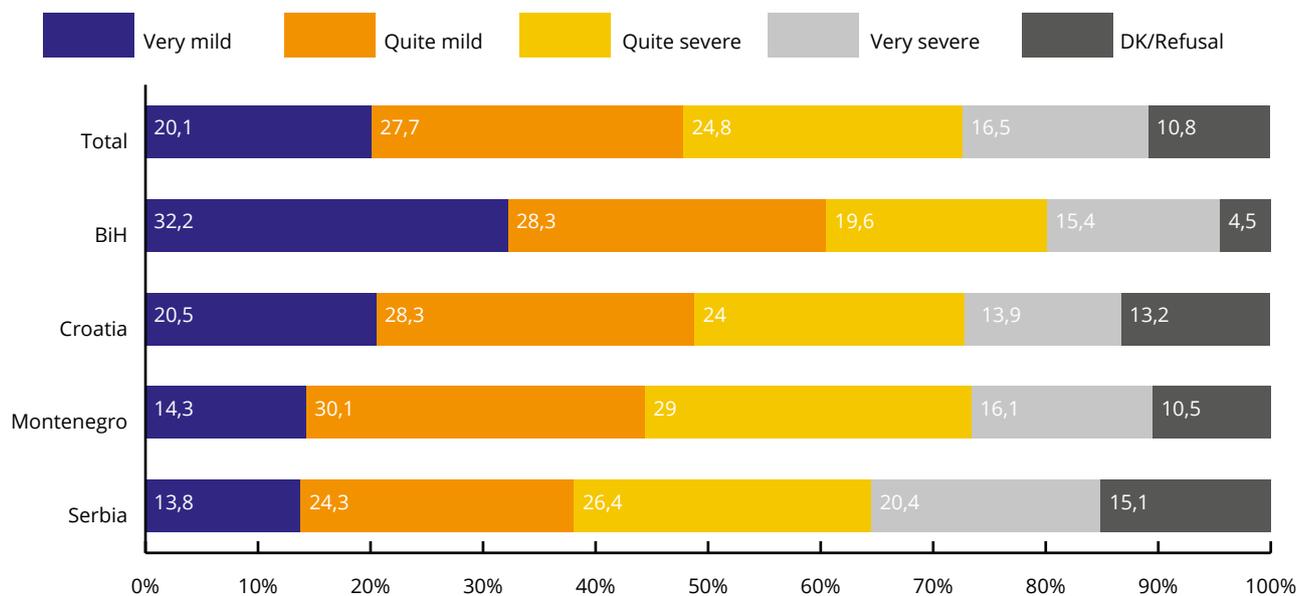


Figure 40. Expected severity of punishment when caught in under-declared employment, % of population (CPU Survey, 2019)



**It is also essential to emphasise quite large shares of invalid answers,** which are particularly evident in the case of Croatia, Montenegro and Serbia. Since this particular question cannot be classified as sensitive, these high faulty rates probably reflect a lack of knowledge about the real state of affairs on the part of taxpayers.

**Poor deterrence, together with other factors elaborated earlier, drives informalities in the observed countries.** Low probability of detection and mild sanctions for perpetrators, as perceived by citizens, encourage illicit behaviour and operating in the shadows. It is interesting to stress that aggregate results on incidences of informal behaviour, primarily informal purchases and informal work, are not in inverse relationship with the results on perceived probability of detection. Thus, in Montenegro, where the incidences of informal purchases are, according to survey findings, the highest and where

informal work is relatively high, perception of probability of detection is also higher compared to other observed countries. On the other hand, in Croatia, where the incidences of informal purchases and informal work are the lowest, perception of probability of detection is also the lowest (see Figure 41 and Figure 42). This counterintuitive finding could lead to conclusion that perceived probability of detection is driven by involvement in the shadow activities, meaning that operating informally makes people more cautious of being detected rather than vice versa. However, a closer look into data reveals that, with an exception of Bosnia and Herzegovina, there is a smaller portion of respondents who believe that possibility of detection is higher among those who are involved in informal activities compared to those who are not, indicating that informal behaviour is linked to the belief that such behaviour will not be detected (see Table 10).

Figure 41. Reported incidence of purchasing from unregistered/illicit sources (size of a bubble), likelihood of being detected (%) and severity of sanctions (%) (CPU Survey, 2019)

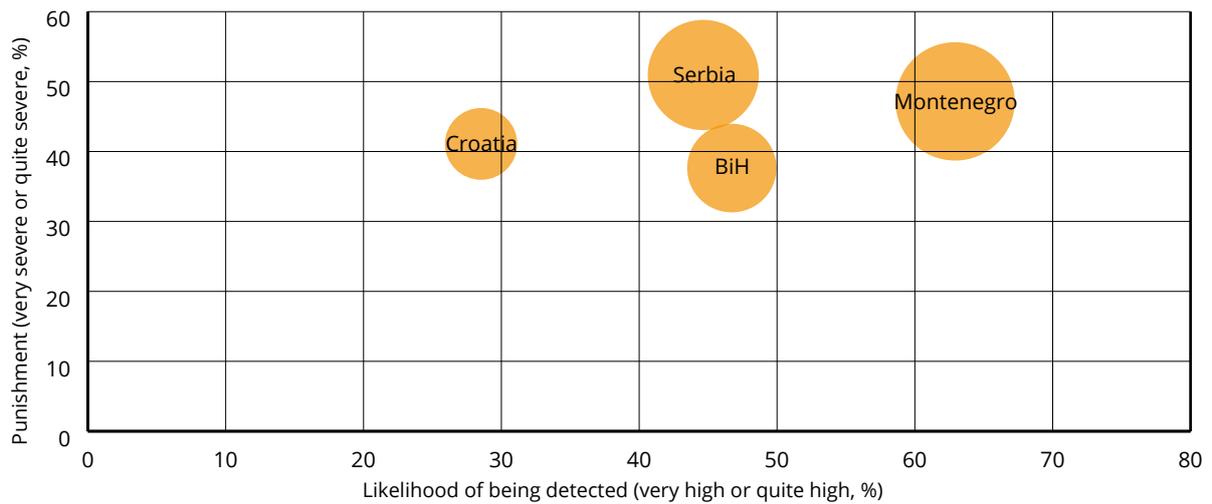


Figure 42. Reported incidence of working without a formal contract (size of a bubble), likelihood of being detected (%) and severity of sanctions (%) (CPU Survey, 2019)

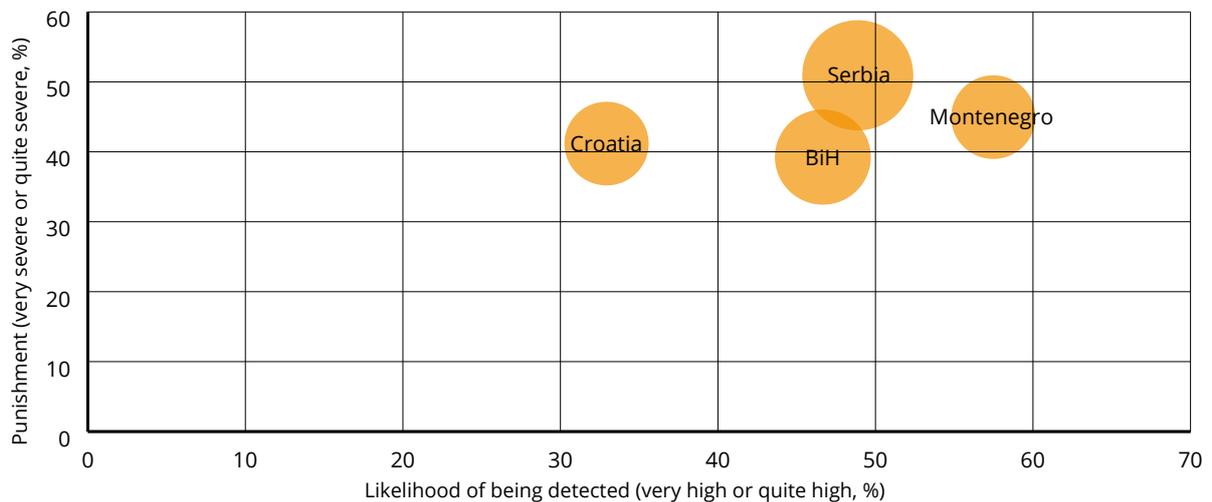


Table 10. Differences (percentage points) in share of those who perceive that possibility of detection is relatively or quite high between participants and non-participants (CPU Survey, 2019)

Country	Purchasing from illegal source: participants compared to non-participants	Undeclared work (without a contract): participants compared to non-participants
Bosnia and Herzegovina	13.0	5.3
Croatia	- 10.6	5.3
Montenegro	- 6.1	-16.4
Serbia	- 12.0	- 4.8

**The findings obtained by the survey are in line with the previous studies and discussions. Deterrence policy has flaws in its design, while the capacities of labour inspectorates are weak in all four countries.**

Entrepreneurs are confident that if they decide to operate informally, the chance of being caught is low<sup>98</sup>. For instance, it was found in the tourism sector in BiH that the possibility of being fined by inspectorates is higher for formal entrepreneurs, considering that formal businesses are more visible for inspectorates; also, when it comes to fines, “compared to informal entrepreneurs who can only be fined for operating informally, formal ones are facing seven pages of the Law detailing various fines for various law-breaching activities”<sup>99</sup>. Similar has been found in case of Montenegro<sup>100</sup>. According to 2015 econometric analysis of the mechanisms underlying informal economic activities in Croatia, neither detection risk nor expected sanctions exert any influence on the behaviour of citizens in this respect<sup>101</sup>. The main reasons for this can be found in low efficiency and weak capacities of the repressive apparatus, corruption and string-pulling practices<sup>102</sup>. Furthermore, recent research evidence from Montenegro suggests that 39% of employers who have employed workers informally and have been fined because of it, think that sanctions were lenient<sup>103</sup>. Furthermore, a quarter of employers, according to this research, believe that inspectors are susceptible to corruption. Finally, situation is similar in Serbia: despite significant legislative and institutional improvements regarding inspection oversight in 2014, inspectorates are insufficiently effective in combating shadow economy and such ineffectiveness primarily refers to the lack of human capacities and financial resources<sup>104</sup>. On the other hand, tax penalty schemes in Serbia are dominantly harmonised to the ones in European countries, while level of penalties are close the EU average<sup>105</sup>. However, in practice, the fine imposed by the Tax Administration are usually revised downwards by the court.

The observed countries have implemented some institutional and policy changes in this area, but evidence on the impact on the shadow economy is lacking.

**There has been some progress in strengthening effectiveness of inspectorates and enhancing detection in BiH.** In 2016, the Law on Inspection in Republika Srpska was amended with a set of new stipulations which enabled inspectors of all inspectorates to conduct controls over the legality of engaged workers, thus expanding the fight against the un(der)declared work to other

inspectorates<sup>106</sup>. On the other hand, there were no significant institutional or policy reforms in this domain in Federation of BiH. However, following commitments from the Economic Reform Programme 2016–2018, the major policy effort in combating the shadow economy was made in the area of enhancing controls of labour inspectorates over undeclared work. Thus, labour inspectorates in Federation of BiH significantly increased activities and improved efforts oriented toward combating undeclared work in 2017. As a result, a number of detected workers without the employment contract jumped by more than 4 times in 2017 and 2018 compared to previous years<sup>107</sup>. Similar actions were undertaken in Republika Srpska, but coherent data on the results of these activities are not available. However, weak capacities and disposable financial resources of inspectorates remained an unaddressed issue. For the sake of illustration, majority of budgets were spent on staff costs: in average, staff salaries consume between 85% and 88% of inspectorates’ budgets<sup>108</sup>.

**The State Inspectorate in Croatia has undergone two substantial, but also contradicting reforms since 2014.**

In 2014 the government decided to split it into separate units, which were then each placed under the direct jurisdiction of one of the five ministries<sup>109</sup>. This was justified by the desire to increase the efficiency of surveillance bodies, as all responsibilities and surveillance actions in a certain field were thus consolidated inside the governmental body competent in that area. However, in 2019 the new government re-established the State Inspectorate under the same argument of increased efficiency<sup>110</sup>. However, the last change did not resolve the problem with unclear division of tasks and often overlapping responsibilities in tackling the phenomenon. In the absence of a central body leading the fight against the shadow economy, every single ministry in Croatia defines its own strategic plans and conducts separate activities. Yet, there is an overall lack of coordination between them, which severely undermines the efficiency of the whole process.

**One of the key government efforts to improve enforcement mechanism in Serbia was the adoption of Law on Inspections Oversight was in 2014.**

The most important result of this Law refers to higher coordination among different inspectorates, better prioritisation of field visits based on risk assessment procedures and educative role of inspectors that facilitate and help companies to comply with the regulations. In the past, inspections focused primarily on punishing businesses, rather than pre-

98 Shentov, O., Stefanov, R., & Todorov, B. (2016). *Shadow Power: Assessment of Corruption and Hidden Economy in Southeast Europe*.

99 Mujarić, M. (2017). *Institutional perspective of Bosnia and Herzegovina's tourism sector: The missing ingredient*, p. 8.

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101 Williams, C. C., & Franic, J. (2015). Tackling the propensity towards undeclared work: some policy lessons from Croatia. *South East European Journal of Economics and Business*, 10(1)

102 Ibid.; Franic, J. (2017). *Envelope wage practices: underlying motivations from the perspective of workers*

103 Katnić, M. (2016). *National Human Development Report: Informal Work: From Challenges to Solutions*.

104 See Randelović, S. (2016). How to Boost Tax Compliance and Tax Morale in Serbia? *Ekonomika preduzeća*, 65

105 Ibid.

106 Amendments to the Law on Inspection, Official Gazette of the Republika Srpska no. 44/16.

107 Federal Department for Inspection Affairs. (2019). *Programi i izvještaji*.

108 Authors' estimate based on official 2018 data on budgets, all administrative units included.

109 Ministry of Finance, Ministry of Labour and Pension System, Ministry of Economy, Ministry of Tourism and Ministry of Agriculture. See Franic, J., & Williams, C. C. (2014). *Undeclared work in Croatia: A baseline assessment*. GREY Working Paper No. 2.

110 Government of the Republic of Croatia. (2019). *Uvodi se Državni inspektorat koji će objediniti 17 inspekcija iz osam ministarstava [The government introduces the State Inspectorate, which will unite 17 inspections from eight ministries]*.

venting violations and educating businesses on complying with regulations. On the other hand, even though the Law prescribes informal economy oversight, in practice inspectors tend to focus on registered companies. The overall results of the inspection oversight could be improved with increased investments in human capital and higher access to financial resources. However, the main factor of inspectorates' ineffectiveness refers to their lack of human capacities and financial resources. According to 2016 research, there are only 0.91 inspectorates employees per thousand inhabitants, which is, in relative terms, considerably below the CEE average (1.26 inspectors per thousand inhabitants) and the EU average (1.39)<sup>111</sup>.

**The establishment of the Commission for Suppression of the shadow economy is expected to be beneficial for deterrence in Montenegro.** The goal of the Commission, constituted in 2018, is to support the inspection bodies and to encourage the mutual co-operation of the inspections. Special quarterly reporting has been designed for the Commission, which includes an overview of the activities of the relevant institutions in suppressing the shadow economy in line with the Action Plan for combating the shadow economy. The focus will be on the establishment of more efficient monitoring of flows in the shadow zone, especially in the areas where the most pronounced informal activity in business operations - tourism, construction and the labour market.

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111 Randelović, S. (2016). How to Boost Tax Compliance and Tax Morale in Serbia? *Ekonomika preduzeća*, 65.

# CONCLUDING REMARKS AND POLICY RECOMMENDATIONS

# 5

**The observed countries face the sizeable shadow economy.** Share of population who purchase products and services on an informal basis range between 20.5% and 32.3% in case of registered sellers, and between 18.2% and 33.7% in case of unregistered sources in the observed countries. The non-negligible portion (ranging 11%-22%) of them spend monthly more than EUR 100 on undeclared purchases. Similarly, informalities are highly present on the labour market; around 1/4 in Serbia and slightly below 1/5 of the population in the other three countries know at least one person in un(der)declared employment/work. Those who are believed to earn more than EUR 500 from undeclared activities consist between approximately 6% (Montenegro) and 18% (BiH), suggesting that for many participation in the shadow economy is far more than a survival strategy. These findings are, in general, in line with previous evidence in this matter.

**This study has observed key drivers of the shadow economy, showing that determinants of operating informally are multiple and rather complex.** Low tax morale, insufficiently effective deterrence, relatively low affordability of goods and purchases, which can partially be attributed to tax levels, along with unfavourable business regulations and low trust in formal institutions, jointly contribute to the high incidence of the shadow economy. Therefore, to challenge informalities in the future, governments of the four countries should apply a holistic approach<sup>112</sup> and simultaneously address several areas. Based on the primary findings, evidence from the secondary sources and policy developments briefly presented earlier in the report, this section defines a set of high-level policy recommendations to decision-makers in the observed countries.

## 5.1. Taxation

### Taxation of consumption: VAT

With the exception of BiH, which has a relatively low VAT rate compared to others, countries should not increase general VAT rates any further. Government(s) in BiH may consider increasing VAT rate, only to reduce mandatory social contributions (to reduce tax wedge) and compensate consequent decrease of income of health insurance funds with public revenues obtained through VAT. On the other hand, financing part of healthcare through VAT should be accompanied with the introduction of universal

primary healthcare insurance for all citizens, regardless of the employment status or registration at social funds.<sup>113</sup>

### Excise duties

Having in mind that two countries, BiH and Montenegro, recently recognized that the policy of gradual but constant increase of excise duties harms the formal economy, i.e. boosts informalities, it could be advised to countries to rethink the approach and dynamics of adapting excises. Although countries committed to harmonise excise levels with the EU, they should do it at pace and manner that would not trigger unwished consequences and result in damaging effects for the economy and, more generally, society. Therefore, such policy should be well-paced and smartly managed to yield intended results and avoid side-effects. Continuous benchmarking of affordability of excise duties against levels in the EU could be an useful tool. To do so, governments are advised to strengthen monitoring and empirical analysis of trends on excise goods market, including analysis of effects of policy changes on public health, social funds and other relevant matters.

### Labour taxation

Governments should consider decreasing the tax wedge on workers' salaries from the current levels to shares closer to the OECD average, so as to boost employment and reduce incentives for un(der)declared employment. One of BiH entities, Federation of BiH, having the highest tax wedge (42.2%) compared to other observed countries and administrative units, should set reduction in labour taxation as one of policy priorities. Where relevant, countries also may think of increasing the progressivity of labour taxation, thus lowering barriers for formal employment of low-skilled labour force (low-wage earners).

## 5.2. Business climate

Governments should pay a special attention to improving policy framework for doing business so as to reduce informalities.

Considering relatively low performances of all four countries in the area of starting a business, it should be set as one of priority policy areas. Generally speaking, more efficient and less burdensome procedures for starting,

<sup>112</sup> However, the fight against the shadow economy in the observed countries in the past period was heavily focused on repressive (stick) measures. According to: Pašović, E., & Efendić, A. S. (2018). Informal Economy in Bosnia and Herzegovina - An Empirical Investigation. *South East European Journal of Economics and Business*, 13(2). Baric, M., & Williams, C. C. (2013). Tackling the undeclared economy in Croatia. *South-Eastern Europe Journal of Economics*, 1. Katnić, M. (2016). *National Human Development Report: Informal Work: From Challenges to Solutions*. However, the observed countries do not differ too much from other European countries, given that deterrence is by far most popular option among policymakers around Europe. See Dekker, H. et al. (2010). *Joining up the fight against undeclared work in Europe* and Williams, C. C., & Puts, E. (2017). *2017 Platform survey report: organisational characteristics of enforcement bodies, measures adopted to tackle undeclared work, and the use of databases and digital tools*.

<sup>113</sup> Centre for Policy and Governance (2019). Public Policies Recommendations for Mandate Period 2018 – 2022.

running and closing businesses, which will reduce administrative complexity, amount of time necessary to do paperwork and get necessary permits and, finally, lower the cost of procedures - are of great importance for creating conditions that will encourage formal and fully declared entrepreneurship. Along with procedures for starting a business, observed countries need better policies in the area of paying taxes. Besides aforementioned reductions in tax rates, countries should identify and address bottlenecks in protocols for declaring and paying taxes.

Similarly, some countries (primarily BiH and Croatia) need to proceed further with reforms of the labour market. Outdated regulations and rigid protection of the employment pose high entrance barriers to formally engaging labour force, i.e. for entering formal employment.

### 5.3. Quality of institutions

Reasonable strategic approach would also include making a step forward in addressing rather low government legitimacy, which was identified in this report as an important issue and incentive for operating in the shadows. A number of structural reforms is therefore required so as to convince the citizens it is worth contributing to the public purse. Above all this would assume increasing the efficiency of public administration, strengthening the rule of law, improving transparency in public spending and boosting the fight against corruption. Finally, it is also important to invest more efforts into improving the quality and availability of health services and securing the long-term sustainability of the pension system so as to reduce the attractiveness of wage underreporting.

### 5.4. Tax morale

Research findings are consistent with existing evidence indicating relatively weak tax morale in the observed countries. Although enhancements in this respect require a substantial improvement in the quality of institutions, increased trust toward governments, and more favourable economic conditions, governments should also undertake the following steps:

- Pay more attention and invest more into awareness-raising campaigns that would communicate negative effects of the hidden activities to individual people and society as a whole. Such campaigns should encourage citizens to develop a negative attitude toward non-compliance, but also to report on informalities they are familiar with. Another option worth considering is the introduction of specialised economic courses in elementary and/or high schools so as to improve financial literacy.
- Montenegro and Federation of BiH (BiH) should consider introduction of a receipt lottery to enhance

compliance by nudging citizens to ask for a receipt when purchasing goods and services. Although this measure does not address the very essence of tax morale and justification of informalities, it influences the behaviour of citizens (in an interest-based manner) and raise their attention on invoicing. However, such measure should be properly monitored and measured to enable assessing its effects, cost-effectiveness and improving its design (or abandoning the measure) in the future.

### 5.5. Deterrence

Governments should implement capacity building reforms of inspectorates, enable recruitment of more inspectors and further develop systems of monitoring and predicting illicit practices in the companies. It is also important to put stronger emphasis on developing strategies and methods for uncovering undeclared businesses, considering that inspectorates in the observed countries tend to control registered (formal) subjects strictly and repeatedly, while illegal business mainly remains undetected.

It is important to underline that the role of inspections is not only to ensure enforcement, but also to foster voluntary compliance. An important aspect refers to introducing an educative role of inspections by giving advice and disseminating information to firms that sometimes lack relevant regulatory knowledge. Thus, to increase the trust in deterring institutions and create more partner-like relationship between institutions and taxpayers, formal institutions have to be designed more as enablers and partners of entrepreneurs, rather than constraints. In other words, inspections should strive to be more collaborative than punitive, so advisory role of inspectorates should be further strengthened.

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