

# SHEDDING LIGHT ON THE SHADOWS

## EXPLORING INFORMAL ECONOMY IN FOUR SOUTH EAST EUROPEAN COUNTRIES



Centar za politike i upravljanje  
Centre for Policy and Governance

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.

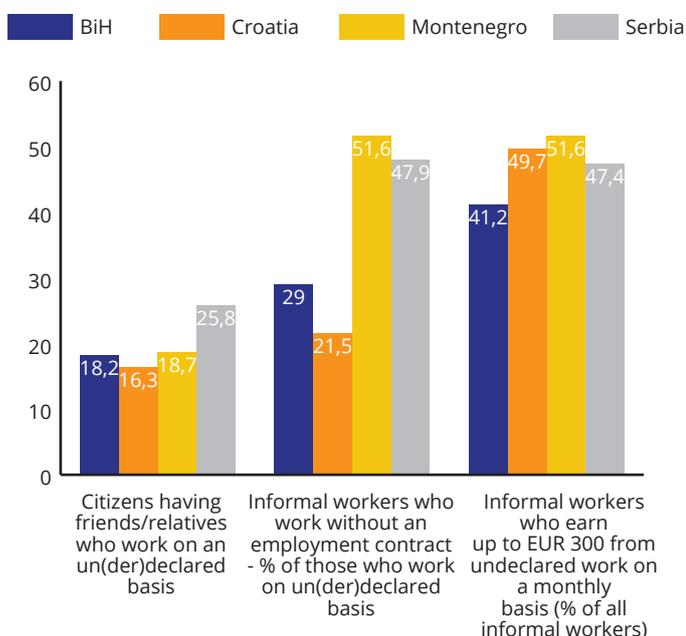
A snapshot of shadow markets across the region:

<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 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.

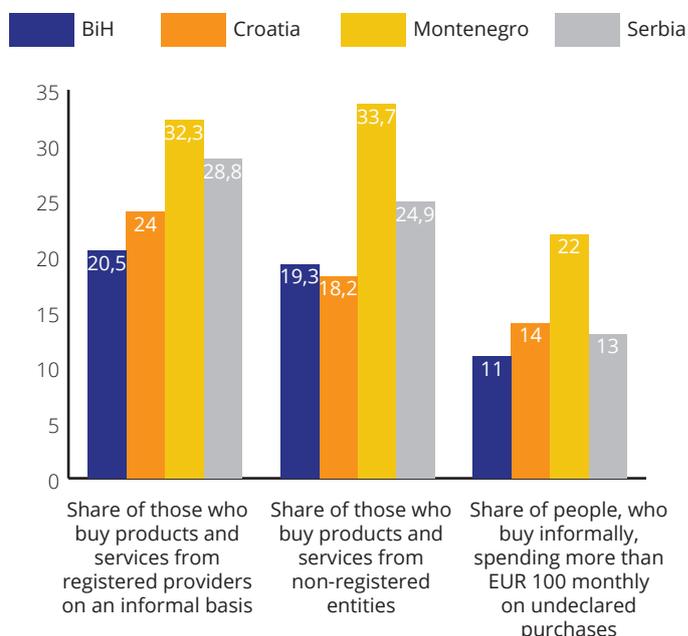
Figure ES.1. Characteristics of informal work in respondents' surrounding



## 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.

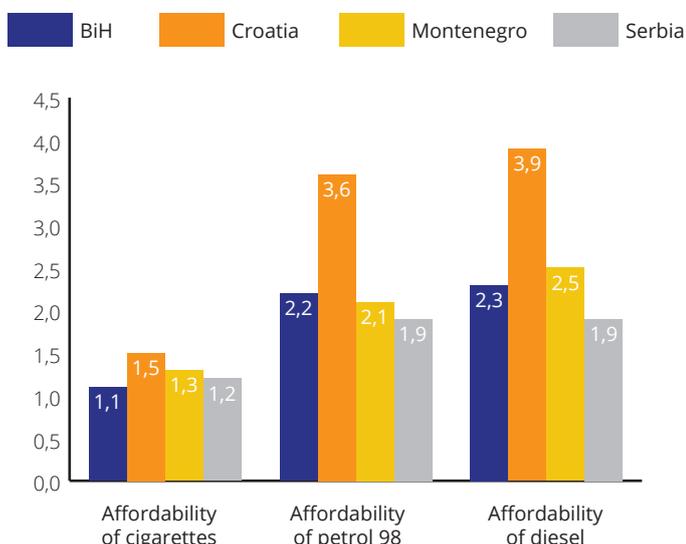
Higher labour taxes are one of the main drivers of un(der) declared work. Around 36% of the population perceive burdening labour taxation as the driver of informalities in this area. However, the observed countries mainly experienced no substantial tax wedge reduction in recent years.

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

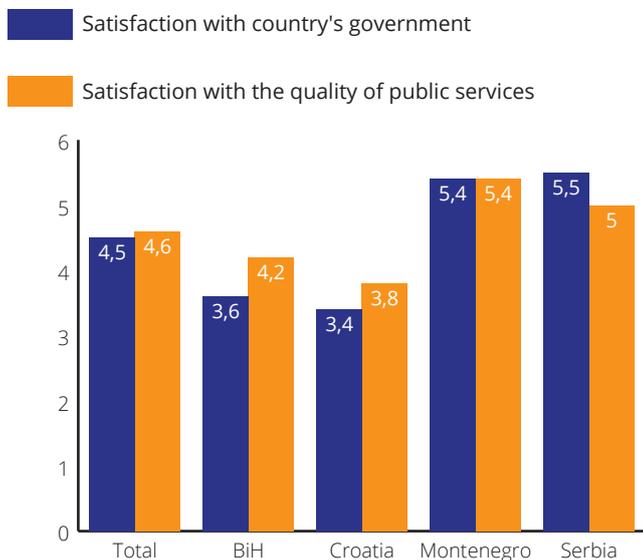
- Governments should prioritize improving the environment for doing business to reduce informalities. Considering relatively low performances of all four countries in the area of starting a business, this should be one of the oblivious policy priorities. Additionally, among other areas, four observed 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.

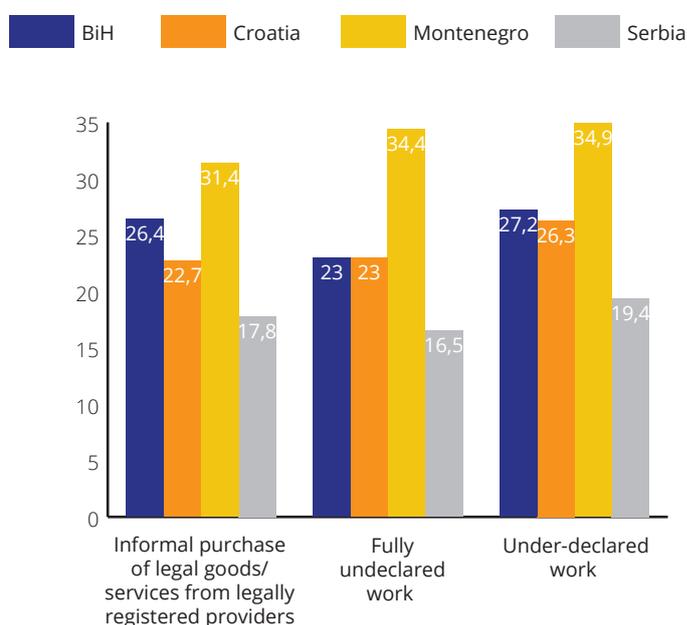
### 4. Tax morale and justification of shadow activities

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.

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.

### 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.

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.

## 5. Deterrence

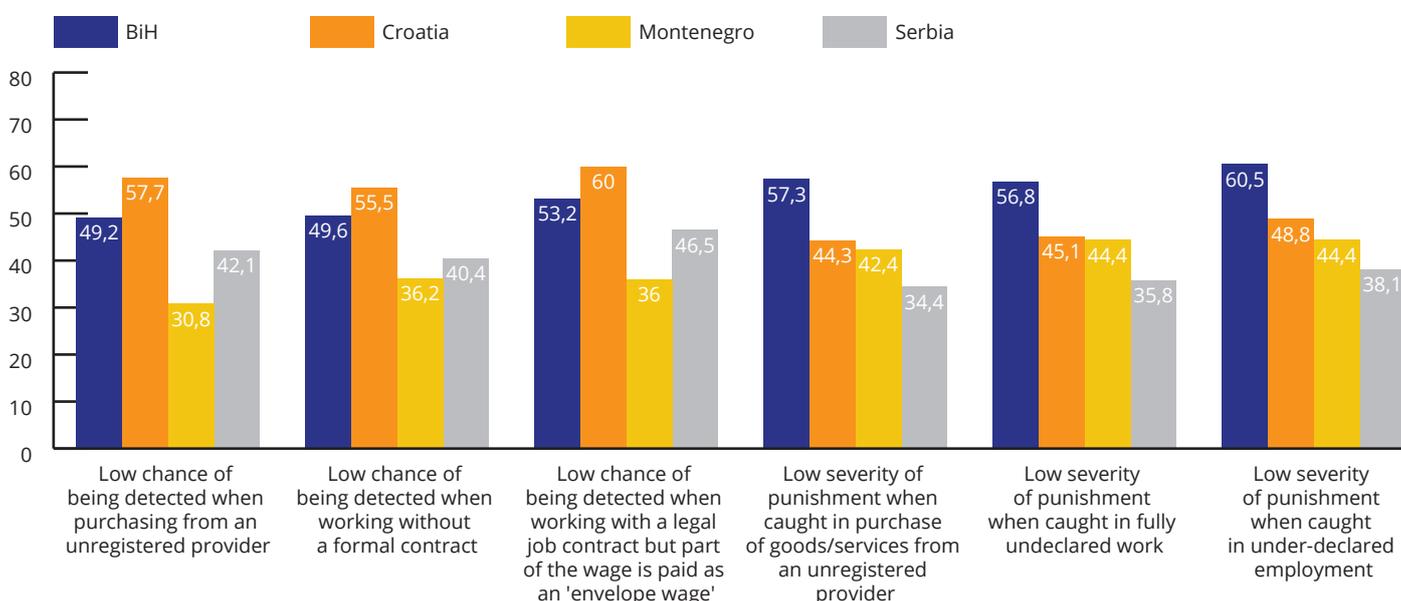
With an assumption that higher probability of detection and higher penalties would discourage engagement in informal activities, deterrence is a commonly used measure for combating the shadow economy. In the region, citizens perceive a relatively low probability of detection, regardless of their involvement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

### 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.

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



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