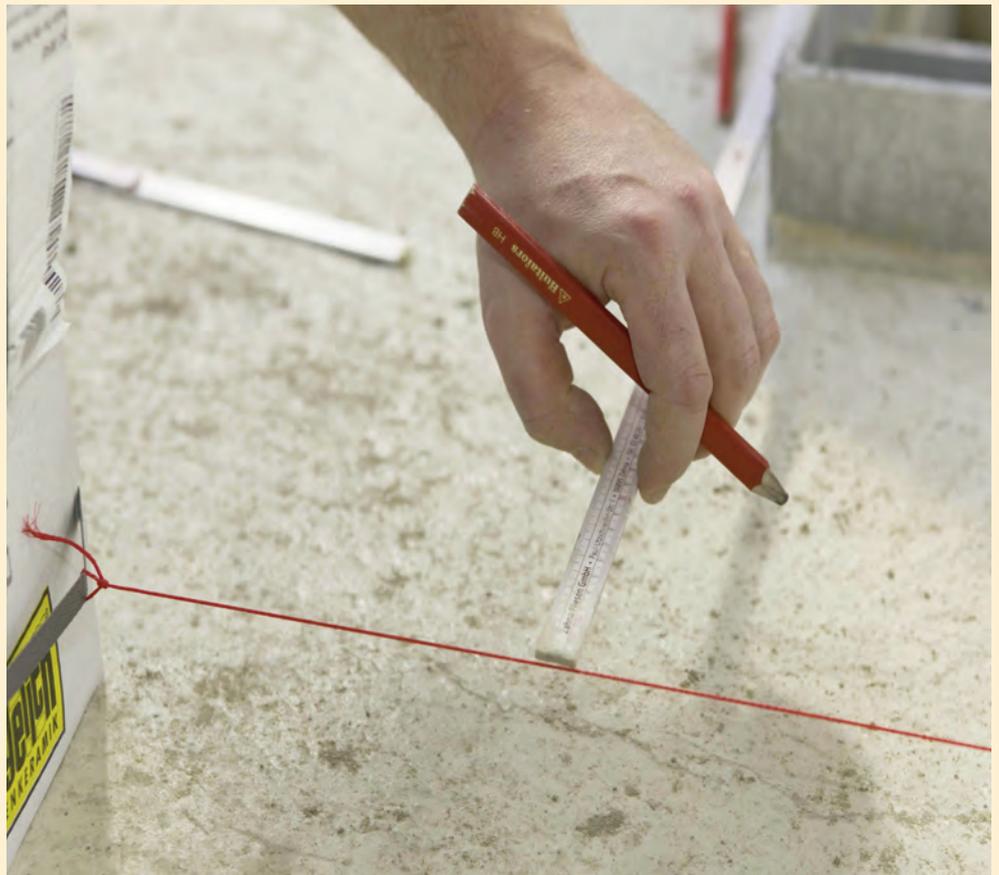




Eurofound

# Tackling undeclared work in Croatia and four EU candidate countries





## Tackling undeclared work in Croatia and four EU candidate countries

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Eurofound (2013), *Tackling undeclared work in Croatia and four EU candidate countries*, Eurofound, Dublin.

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**Research project:** Measures for tackling undeclared work in the EU, the candidate countries and Norway since the crisis



Eurofound

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# Executive summary

## Introduction

The aim of this report is to provide a systematic overview of the extent and nature of undeclared work, and how it is being tackled, in Croatia and four EU candidate countries: Iceland, the former Yugoslav Republic of Macedonia, Montenegro and Turkey. The objectives are to analyse the magnitude and character of undeclared work in these countries, to show how the fight against undeclared work is organised and to outline the relevant policy approaches and measures that these countries are adopting. Throughout the report, the five countries are compared with the 27 EU Member States (EU27) where feasible.

## Policy context

### Extent and nature of undeclared work

Whatever method of measurement is used, the common finding is that the size of the undeclared economy in Iceland is below the average size in the EU27, whilst Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Turkey have undeclared economies larger than the EU27 average.

The nature of undeclared work varies across different regions of the EU27. So far as can be determined, these five countries generally mirror the broad European regional variations in undeclared work regarding the sectors in which it is concentrated; the types of work conducted; who conducts such work; and their motives for doing so. The situation in Iceland reflects that of the Nordic countries, while the situation of the remaining four countries mirrors the south-eastern European Member States. However, this requires further validation. One way forward would be for the five countries to implement the Eurobarometer survey, or for the European Commission to include them in any potential second wave Eurobarometer survey.

### Barriers to formalisation

The annual World Bank Doing Business surveys analyse how easy or difficult it is for a local entrepreneur to open and run a small-to-medium-sized business when complying with relevant regulations. The composite results for the EU27 as a whole in 2012 placed it 38th out of 183 surveyed countries. This is lower than both Iceland (ranked 9th) and the former Yugoslav Republic of Macedonia (ranked 22nd). In Montenegro (ranked 56th), Turkey (ranked 71st) and Croatia (ranked 80th), however, doing business is more difficult than it is in the EU27 as a whole, implying that compliance needs to be made easier in these countries.

In terms of ease of starting a business, the EU27 as a composite was ranked 66th out of 183 countries. By contrast, the former Yugoslav Republic of Macedonia was ranked 6th easiest country in which to start a business, even higher than the best EU performer, Ireland, which was ranked 13th. Iceland was ranked 37th, while Montenegro, Turkey and Croatia were ranked 47th, 61st and 67th, respectively. None of the five countries performed as poorly as the worst EU27 performer on this issue, the Czech Republic, which was ranked 138th out of the 183 participating countries.

In terms of ease of paying taxes, the EU27 as a composite was ranked in 71st place, compared to the former Yugoslav Republic of Macedonia at 6th place, Croatia at 32nd and Iceland at 35th. None of the five countries performed as well as the best performer of the EU27 in this category, however; Ireland was ranked 5th. Complying with regulations when paying taxes is more difficult for small-to-medium-sized businesses in Turkey (ranked 79th) and Montenegro (ranked 108th), although neither emerged as poorly as the worst performing EU27 country in this survey, Romania, which was ranked 154th.

## Key findings

### Organising the fight against undeclared work

Unlike 26% of European Economic Area (EEA) countries and Switzerland, none of these five countries has a single compliance agency or a central coordinating committee responsible for coordinating different departments involved in the fight against undeclared work. Instead, and to varying degrees, they take a more fragmented approach. In three, one state body has been designated with lead responsibility for coordinating the fight against undeclared work: the Revenue Administration in Turkey, the Labour Inspectorate in the former Yugoslav Republic of Macedonia and the Internal Revenue Directorate in Iceland. In Croatia and Montenegro, responsibility is more fragmented, with no lead body and each department pursuing its own targets.

The involvement of the social partners in relation to tackling undeclared work also varies, although some level of tripartite social dialogue takes place in all five countries. In Croatia, the Economic and Social Council has been in place since 1994 and the Office for Social Partnership was established in 2011. Despite this, the trade unions withdrew from the Economic and Social Council in 2010 for six months in protest at the weak dialogue. In Montenegro, the Social Council involves social partners. In the former Yugoslav Republic of Macedonia, Turkey and Iceland, no formal council exists to facilitate such dialogue in relation to undeclared work, although social partners participate in policymaking through their involvement in campaigns and initiatives.

### Policy approaches towards undeclared work

Tackling undeclared work has been traditionally dominated in the EU27 by a repressive approach that seeks to stamp it out. Recently, however, there has been a call from the European Commission to pursue more enabling measures that prevent people entering the undeclared economy and help those already working undeclared to legitimise their operations. Although repressive measures continue to have considerable importance attached to them in the EU27 when tackling undeclared work, and enabling policy measures are generally viewed as less important, regional variations exist in the extent to which enabling measures are being incorporated into the repertoire of measures used. This is also the case in the countries examined in this study. In Iceland, more importance is attached to enabling measures than in the four south-eastern countries, and this reflects the situation in its neighbouring Nordic countries. The four south-eastern countries, like the southern EU27 Member States, have been generally slower to recognise the importance of an enabling approach, although variations do exist between the former Yugoslav Republic of Macedonia, Croatia, Montenegro and Turkey in terms of the breadth, depth and effectiveness of the enabling measures they have adopted. Overall, however, curative measures are less common in the five countries than in the EU27, and 'soft' measures to foster commitment to tax morality are relatively new.

## Policy pointers

The five countries need to give more prominence to a fuller range of 'hard' incentive measures to prevent and effectively address undeclared work, as well as 'soft' measures that foster commitment to tax morality. A strong correlation has been identified between countries with greater labour market intervention, social protection, redistribution and equality and smaller undeclared economies. Indeed, this perhaps tentatively explains why in Iceland the size of the undeclared economy is below the EU27 average, whilst in Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Turkey the undeclared economy is larger than the EU27 average.

# Introduction

Europe's economic crisis and historically high unemployment levels have put the issue of tackling undeclared work high on the political agenda, not least due to the significant impact it has on public finances and employment participation rates. The aim of this report is to provide a systematic overview of the extent and nature of undeclared work, and how it is being tackled, in Croatia<sup>1</sup> and four EU candidate countries: Iceland, the former Yugoslav Republic of Macedonia, Montenegro and Turkey. The objectives are to analyse the magnitude and character of undeclared work in these countries, show how the fight against undeclared work is organised and outline the relevant policy approaches and measures that these countries are adopting. Throughout this report, the intention is to compare the extent and nature of undeclared work and how it is being tackled in the five countries with the situation in the EU27. The main questions being addressed are:

- What is the extent and nature of undeclared work in the five countries and how does it compare with the EU27?
- What are the institutional structures and policy approaches employed in the five countries for tackling undeclared work and how does this compare with the EU27?
- Which specific policy measures have been adopted in the five countries that have been effective in tackling undeclared work?
- What lessons might be learned from the EU27 in terms of policy measures when tackling undeclared work in the these countries?
- What lessons can the EU27 learn from practices in the these countries?

A mixed-method approach was adopted. Firstly, a comprehensive literature review including academic, governmental and social partners' and statistical sources was undertaken. This comprised:

- *A review of surveys on undeclared work in the five countries:* As with many EU27 countries, these countries are often included in cross-national databases such as the World Bank's Enterprise Surveys and Doing Business Surveys, and in many cross-national surveys using indirect measurement methods (for example, Schneider, 2011; European Commission, 2009). National-level survey reports and 'grey literature' reporting on the extent and nature of undeclared work are also available, and where feasible, these are compared with the situation in the EU27.
- *A desk-based survey of institutional approaches to fighting undeclared work in these five countries:* Published and 'grey' literature on the organisational approaches employed by these countries to fight undeclared work is reviewed. Structures are compared with the EU27 using earlier typologies developed for comparing the EU27 Member States (Dekker et al, 2010).
- *A desk-based survey of policy measures:* The range of policy instruments used in these countries, including those undertaken by social partners and sector-specific organisations, are reported and compared with those of the EU27.

Secondly, to provide both up-to-date information and further detail to fill the gaps in understanding, an online survey and telephone interviews have taken place with a minimum of three key stakeholders in each of the five countries, including senior officials in government departments involved in the fight against undeclared work, expert academics and representatives of social partner organisations. Information was sought on the extent and nature of undeclared work in the country, the state bodies used to fight undeclared work and the policy approaches and measures used, along with

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

their perceived effectiveness. A survey recently applied across the EU27 was used here (Dekker et al, 2010), enabling comparative data to be collected. Thirdly, a validation workshop took place in November 2012 with experts and representatives of key stakeholders from the five countries.

The outcome of this research is a study of the extent and nature of undeclared work in five countries, which compares how undeclared work is being tackled in these countries with how it is being addressed in the EU27.

# Research background 1

Although no official definition of undeclared work exists in the EU27, the widely accepted definition is that it covers ‘any paid activities that are lawful as regards their nature, but are not declared to the public authorities, taking into account the differences in their regulatory systems between Member States’ (European Commission, 2007a, p. 2). Since the turn of the millennium, important research has been undertaken for the European Commission on both the extent and nature of undeclared work in the EU27 and how it is being and might be tackled. A considerable body of research and policy documents now exists that aims to understand, conceptualise, measure and tackle undeclared work in the EU27, against which the situation in the five countries examined by this study can be compared.

The studies *Undeclared labour in Europe* (Mateman and Renooy, 2001) and *Undeclared work in an enlarged Europe* (Renooy et al, 2004) provided some of the first estimates of undeclared work in the Member States, as well as insights into its character. The European Employment Observatory review for Autumn 2004 included an overview of the subject, entitled ‘Fighting the immeasurable? Addressing the phenomenon of undeclared work in the European Union’ (EEO, 2004). In more recent years, with the aim of improving understanding of the extent and nature of undeclared work, both a direct survey (European Commission, 2007b) and a review of indirect survey methods (GHK and Fondazione Brodolini, 2009) have been undertaken.

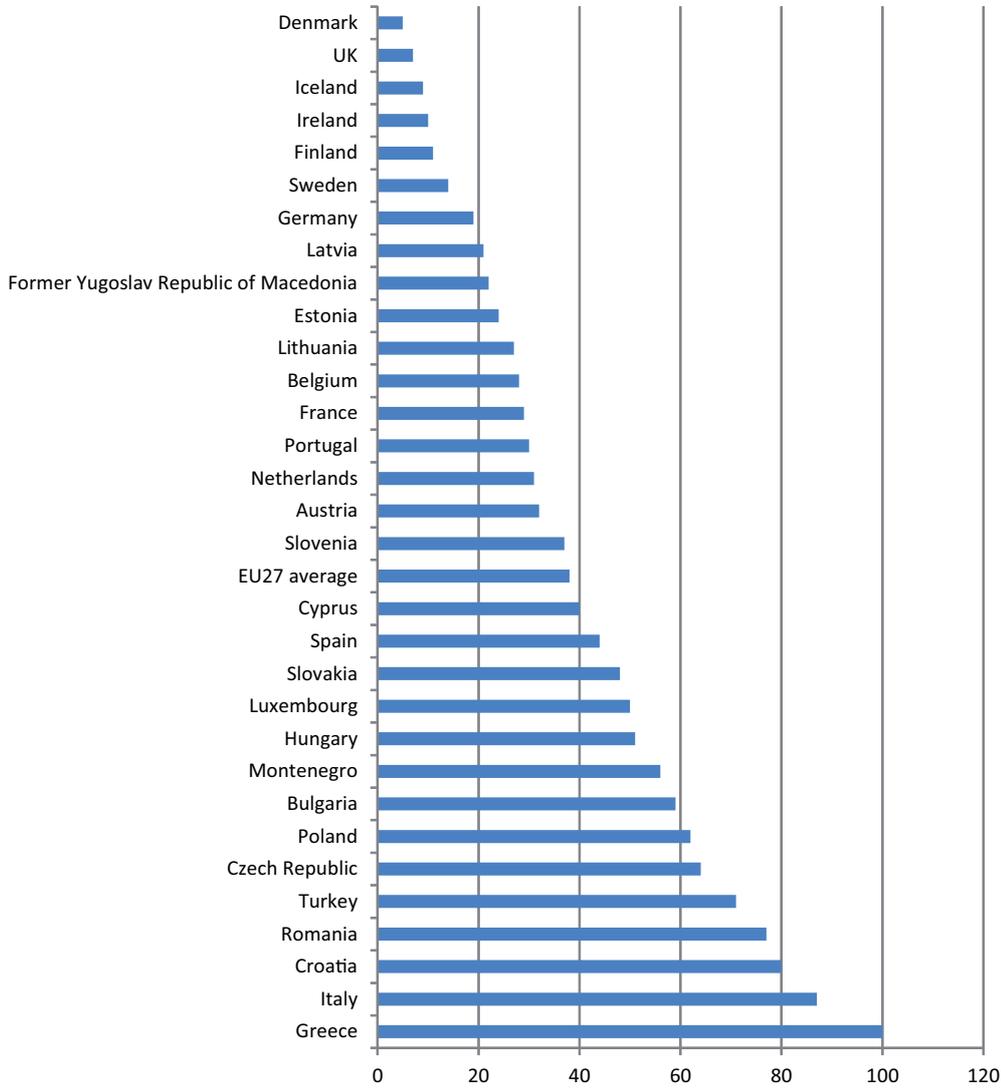
Meanwhile, significant shifts in policy approach have occurred. In 2003, the European Commission’s Employment Policy Guideline No. 9 on undeclared work called for a move away from deterrence and towards transforming undeclared work into regular work, rather than simply eradicating it. This approach was reiterated in the European Commission’s second communication on undeclared work, *Stepping up the fight against undeclared work* (European Commission, 2007a). Since then, a number of initiatives have taken place. Eurofound published studies in both 2008 (five Member States) and 2009 (EU27 and Norway) to identify how this might be achieved and it has set up a knowledge bank of good practice policy measures (see <http://www.eurofound.europa.eu/areas/labourmarket/tackling/search.php>). The European Commission evaluated the feasibility of establishing a European platform to develop an integrated approach in the fight against undeclared work across the EU27 (Dekker et al, 2010).

All this research provides a solid evidence base against which the extent and nature of undeclared work in the five countries, and how it is being tackled, can be compared. Figure 1 provides an introductory overview of these countries using information from the World Bank’s Doing Business survey for 2012. This report analyses an economy’s regulatory environment for business. A good place to start is to examine how it compares with the regulatory environment in other economies. The Doing Business survey provides an aggregate ranking on the ease of doing business based on indicator sets that measure and benchmark regulations applying to domestic small-to-medium-sized businesses throughout their life cycle. Economies are ranked from 1 to 183 by the ease of doing business index. For each economy, its ranking is based on the simple average of its percentile rankings on each of 10 topics: getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. The ranking on each topic represents the simple average of the percentile rankings on its component indicators. Figure 1 provides the overall ranking of the five countries in terms of the ease of doing business in 2012. It shows that whilst the EU27<sup>2</sup> as a composite would be ranked 38th out of 183 countries, Iceland is ranked 9th, and is one of the countries in which it is easiest to do business in the world, as is the former Yugoslav Republic of Macedonia (22nd). In Montenegro (56th), Turkey (70th) and Croatia (80th), doing business is a relatively more difficult proposition compared with the EU27 as a whole.

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<sup>2</sup> This excludes Malta, which was not included in the 2012 Doing Business survey.

Figure 1: Ease of doing business ranking for the EU27\* and the five study countries



\* Excluding Malta, which was not included in the 2012 Doing Business survey.  
 Source: *World Bank Doing Business survey, 2012*

# Nature and extent of undeclared work 2

Several cross-national surveys enable comparison of the extent and nature of undeclared work in the five countries with the situation in the rest of Europe and beyond. These include cross-national firm-level surveys, such as the World Bank's Enterprise Surveys and Doing Business surveys, which ask whether the formal firms surveyed were informal in the past and whether competition from informal competitors is a threat to their operation. Table 1 outlines the data available for Croatia, Iceland, the former Yugoslav Republic of Macedonia, Montenegro and Turkey. Other surveys have sought to measure undeclared work using indirect measurement methods that employ various proxy indicators or to seek statistical traces of undeclared work in data collected for other purposes (for example, Schneider, 2011), as well as numerous individual national-level surveys of undeclared work.

Table 1: *Surveys on undeclared work in the five countries*

Country	Enterprise Surveys	Doing Business surveys
Croatia	2002, 2005, 2007	Annually, 2004–2012
Iceland	Not applicable	Annually, 2004–2012
Former Yugoslav Republic of Macedonia	2002, 2005, 2009	Annually, 2004–2012
Montenegro	2009	Annually, 2004–2012
Turkey	2002, 2004, 2005, 2008, 2013	Annually, 2004–2012

## Extent of undeclared work

For each of the countries, many estimates exist of the size of the undeclared economy, and these vary greatly according to the measurement methodology employed. It is important, therefore, to be aware of the measurement methods that underpin any estimate of the size of the undeclared economy in these countries.

Table 2 reports the findings of the World Bank Enterprise Surveys, which involve interviews with firm owners and use the same questions across many countries. Specifically, Table 2 reports comparative results for four of the five countries. It shows that whilst nearly three-quarters (73.9%) of firms in the former Yugoslav Republic of Macedonia asserted that they have to compete against unregistered firms, this is the case amongst only a half (52.4%) of surveyed firms in Turkey, well under one-third of firms (31.7%) in Croatia and one-quarter (27.3%) in Montenegro. The clear intimation is that the undeclared economy appears to be more of a problem in the former Yugoslav Republic of Macedonia and Turkey than in Croatia and Montenegro. Indeed, this is reinforced when analysing the share of firms that reported that the practices of competitors in the informal sector are a major constraint on their business. Again, this is shown to be a more widespread problem in the former Yugoslav Republic of Macedonia (where 54.9% of firms report that competitors in the informal sector are a major constraint) than in Turkey (32.2%) and Croatia (25.0%). It is even less of a widespread problem in Montenegro (10.7%).

Table 2: Competition with the undeclared economy in four study countries and selected Member States

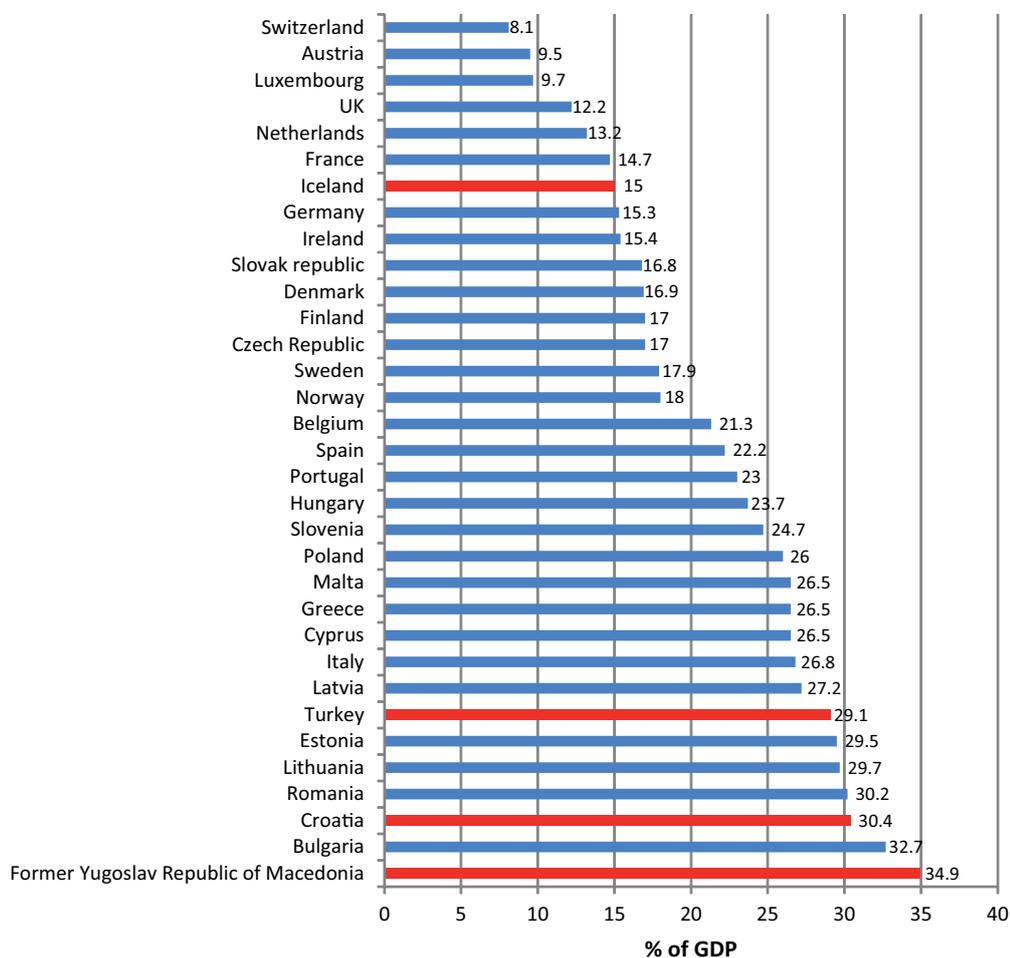
	Competing against unregistered firms (%)	Practices of informal sector competitors identified as major constraint (%)	Formally registered when started operations in country (%)	Years operating without formal registration
Former Yugoslav Republic of Macedonia	73.9	54.9	99.2	0.0
Bulgaria	54.1	28.1	98.5	0.1
Turkey	52.4	32.2	94.0	0.4
Lithuania	50.1	29.4	97.1	0.3
Hungary	49.0	26.6	100.0	0.0
Czech Republic	42.9	21.5	98.0	0.1
Latvia	41.7	27.1	98.5	0.1
Slovakia	40.3	17.8	100.0	0.0
Romania	35.1	24.9	98.7	0.1
Poland	32.7	27.6	99.3	0.0
Croatia	31.7	25.0	98.1	0.0
Slovenia	27.3	12.2	99.8	0.0
Montenegro	27.3	10.7	95.5	0.2

Source: World Bank Enterprise surveys (not applicable for Iceland)

Comparing these results with EU Member States, where comparative data is available, reveals that these four south-eastern European countries are polarised at the two ends of the spectrum. In the former Yugoslav Republic of Macedonia and Turkey, a greater proportion of businesses state that they have to compete against unregistered firms than in the EU Member States for which comparative data is available. In Croatia and Montenegro, a much smaller proportion of businesses compete against unregistered firms than in most of the current EU Member States surveyed. The same trend emerges when analysing the proportion of businesses that identify the practices of competitors in the informal sector as a major constraint. Again, a polarisation of these countries can be observed, with a higher proportion of businesses in the former Yugoslav Republic of Macedonia and Turkey stating that informal competitors are a major constraint than found in all the EU Member States surveyed. In stark contrast, a much lower proportion of businesses in Croatia and Montenegro state that informal competitors are a major constraint on their business than in the vast majority of EU Member States for which comparative data is available.

A similar hierarchical ordering of these countries exists in relation to the relative size of the undeclared economy. The Multiple Indicators Multiple Causes (MIMIC) measurement method of Schneider (2011) indicates that the size of the undeclared economy is greater in the former Yugoslav Republic of Macedonia than in Croatia and Turkey (consistent with the World Bank Enterprise survey above). Schneider (2011) does not include Montenegro in his estimates though he does include Iceland, which is shown to have an undeclared economy at 15% of GDP, somewhat smaller than most EU27 Member States. The undeclared economies of the other countries (Croatia, Turkey and the former Yugoslav Republic of Macedonia), however, are larger than most EU Member States. Indeed, the undeclared economy in the former Yugoslav Republic of Macedonia, at 34.9% of GDP, is larger than that found in any EU27 Member State, while only Bulgaria within the EU27 has an undeclared economy larger than Croatia, and the undeclared economy in Turkey is again larger than the vast majority of EU27 Member States (see Figure 2). The clear indication is that although the undeclared economy in Iceland is relatively small compared with the EU27, Turkey, Croatia and the former Yugoslav Republic of Macedonia have sizeable undeclared economies relative to EU27 Member States.

Figure 2: Undeclared economy as % of GDP by country



Source: Schneider (2011)

What are the trends regarding the magnitude of the undeclared economy? Are the undeclared economies of the five countries growing whilst the undeclared economy of the EU27 is declining? Is the opposite the case? Or are they growing or declining in tandem? Table 3 provides a partial answer to these questions. It shows that in the EU27, the size of the undeclared economy has been steadily declining from 22.3% of GDP in 2003 to 18.4% of GDP in 2012. In four of the five countries for which estimates have been produced (Croatia, Turkey, Iceland and the former Yugoslav Republic of Macedonia), the same decline is being witnessed. Overall, according to the measurement method of Schneider (2011), the undeclared economy is slowly contracting as a percentage of official GDP across not only the EU27 as a composite but also Croatia, Turkey, Iceland and the former Yugoslav Republic of Macedonia.

Table 3: *Undeclared economy of EU27 and four study countries, 2003–2012 as % of official GDP*

Year	EU27	Croatia	Turkey	Iceland*	Former Yugoslav Republic of Macedonia*
2003	22.3	32.3	32.2	15.9	38.4
2004	21.9	32.3	31.5	15.5	37.4
2005	21.5	31.5	30.7	15.1	36.9
2006	20.8	31.2	30.4	15.0	36.0
2007	19.9	30.4	29.1	15.0	34.9
2008	19.3	29.6	28.4	-	-
2009	19.8	30.1	28.9	-	-
2010	19.5	29.8	28.3	-	-
2011	19.2	29.5	27.7	-	-
2012	18.4	29.0	27.2	-	-

Sources: *Schneider (2011)* and *Buehn and Schneider (2012)* for those marked \*; these studies did not include Montenegro.

## Nature of undeclared work

Studies have been conducted on the nature of undeclared work both in the five countries of this study and the EU27 Member States. They have addressed issues such as the sectors in which undeclared work is concentrated, who conducts undeclared work, the motives underpinning participation and the types of work undertaken. The problem is that often the results are not comparable because different measurement methods are used.

The World Bank Enterprise surveys provide one of the few comparative datasets; each survey asks the same question across all participating countries. The results reveal similar patterns in terms of who is affected by undeclared work not only across the EU candidate countries but also the various EU27 Member States. As Table 4 summarises, large firms and exporting and foreign-owned businesses, are less affected by unregistered businesses, and less likely to view them as a major constraint, than smaller and medium-sized businesses and non-exporting and domestically owned businesses.

Table 4: *Proportion of firms competing against informal firms in four European countries*

Country	All firms	By firm size (no. of employees)			By exporting status		By ownership	
		Small (5-19)	Medium (20-99)	Large (100+)	Direct exports*	Non-exporter	Domestic owned	Foreign owned
Former Yugoslav Republic of Macedonia	73.9	77.8	67.8	57.8	61.3	77.9	75.4	57.0
Turkey	52.4	51.8	52.5	55.3	47.9	53.6	53.2	25.3
Croatia	31.7	32.5	33.0	20.0	18.8	34.3	32.6	10.2
Montenegro	27.3	25.6	35.1	23.3	2.1	29.3	24.3	82.4

Note: \* exports comprise 10%+ of sales; Iceland was not included in these surveys.

Source: *World Bank Enterprise Surveys*

Beyond this dataset, however, there is a lack of comparative data on who conducts undeclared work, the motives underpinning participation and the types of work undertaken in the five countries compared with the EU27. Further research is badly needed to understand how the study countries compare with the EU27.

In 2007, a survey of undeclared work was conducted across the EU27. Special Eurobarometer No. 284 ('Undeclared work in the European Union') was undertaken as part of wave 67.3 of the Eurobarometer. This involved 26,659 face-to-face interviews, ranging from 500 in smaller Member States to over 1,500 interviews in larger ones. The findings provide comparative data on who engages in undeclared work, their motives for doing so and the types of undeclared work they conduct. It also provides baseline data against which the character of undeclared work in the five countries can be compared.

As Table 5 shows, of the 8.6% (1 in 11) of the population surveyed who reported participating in undeclared work in the previous year, 31.3% were formal employees who received undeclared 'envelope wages' from their formal employer in addition to their declared wage. (Indeed, 1 in 18 formal employees surveyed received an additional undeclared wage from their declared employer, amounting on average to one-quarter of their gross salary.) The remaining two-thirds (68.9%) had participated in wholly undeclared work, of which 18% was wholly undeclared waged employment, 16.9% was undeclared self-employment and 39.7% involved paid favours for close social relations, such as kin, friends, acquaintances and neighbours.

Table 5: *Character of undeclared work in the EU27, by % of all reported undeclared work*

Country	All undeclared work (%) that is:				Ratio of waged to own-account undeclared work
	Envelope wages	Waged undeclared employment	Undeclared self-employment	Paid favours	
<b>EU27</b>	<b>31.3</b>	<b>14.4</b>	<b>14.4</b>	<b>39.7</b>	<b>45.9: 54.1</b>
<b>Nordic countries</b>	11.1	13.0	11.3	64.7	24.1: 75.9
Finland	25.0	6.7	1.7	66.7	31.7: 68.3
Sweden	14.1	12.3	14.0	59.6	26.4: 73.6
Denmark	4.5	15.6	12.8	67.2	28.1: 71.9
<b>Western Europe</b>	<b>17.0</b>	<b>15.1</b>	<b>13.3</b>	<b>54.6</b>	<b>32.1: 67.9</b>
Belgium	31.0	16.7	11.9	40.5	47.7: 52.3
Austria	26.6	12.7	13.9	48.1	39.3: 60.7
United Kingdom	20.6	23.5	8.8	47.1	44.1: 55.9
Germany	18.6	16.3	11.6	53.5	34.9: 65.1
Ireland	17.2	14.3	22.9	45.7	31.5: 68.5
Luxembourg	11.5	7.7	15.4	65.4	19.2: 80.8
France	9.8	12.7	11.3	66.2	22.5: 77.5
Netherlands	7.4	17.6	14.7	60.3	25.0: 75.0
<b>East-central Europe</b>	<b>41.2</b>	<b>13.7</b>	<b>16.9</b>	<b>28.2</b>	<b>54.9: 45.1</b>
Romania	73.5	3.7	5.9	16.9	77.2: 22.8
Bulgaria	55.3	22.3	12.5	9.8	77.6: 22.4
Poland	46.4	15.9	18.3	19.5	62.3: 37.7
Lithuania	42.3	8.5	24.6	24.6	50.8: 49.2
Latvia	38.5	11.9	21.7	27.9	50.4: 49.6
Slovakia	36.8	10.5	17.9	34.7	47.3: 52.7
Hungary	31.5	23.1	16.8	28.4	54.6: 45.4
Slovenia	27.4	11.3	9.7	51.6	38.7: 61.3
Estonia	25.2	15.8	27.3	31.7	41.0: 59.0
Czech Republic	21.3	20.0	2.5	56.3	41.3: 58.7

Country	All undeclared work (%) that is:				Ratio of waged to own-account undeclared work
	Envelope wages	Waged undeclared employment	Undeclared self-employment	Paid favours	
EU27	31.3	14.4	14.4	39.7	45.9: 54.1
Southern Europe	35.5	18.0	20.1	26.3	53.5: 46.5
Cyprus	72.8	0.0	9.1	18.2	77.8: 22.2
Italy	42.5	6.4	23.4	27.7	48.9: 51.1
Spain	40.4	17.0	17.0	25.5	57.4: 42.6
Portugal	32.4	24.3	18.9	24.3	56.7: 43.3
Malta	22.2	66.7	11.1	0.0	88.9: 10.1
Greece	18.6	20.9	25.6	34.9	39.5: 60.5

Source: 2007 Eurobarometer survey on undeclared work

This dataset also displays variations in the character of undeclared economies across the EU27 and allows a classification of countries according to the configuration of their undeclared economies. It shows that more than half of all undeclared work in the EU27 is conducted on an ‘own-account’ basis, rather than for an employer. This means the EU as a whole can be classified as an own-account undeclared economy. More specifically, it could be described as a solidarity-oriented own-account undeclared economy. Solidarity-oriented undeclared work takes the form of working informally for family members or friends, in return for some form of remuneration. This is because more than half (70%) of the own-account undeclared work is in the form of paid favours. This, however, is not universally the case across all Member States.

As Table 6 summarises, all 11 Nordic and western European Member States are own-account undeclared economies in that more than half of all undeclared work is conducted on an own-account basis. Of the 16 southern and east-central European Member States, in contrast, 10 are waged undeclared economies and 6 are own-account undeclared economies, although all of the latter have relatively substantial waged realms compared with Nordic and western European Member States. A clear divide exists, with eastern and southern Member States more likely to have waged undeclared economies, and western and Nordic Members States more likely to have own-account undeclared economies. All waged undeclared economies are envelope wage economies, with the exception of Malta which is a ‘whole wage’ undeclared economy. All own-account undeclared economies are ‘solidarity-oriented own-account’ undeclared economies. None is a ‘market-oriented own-account’ undeclared economy, although Italy is fairly close with 46% of own-account work conducted on a more market-oriented basis. This is also the case with Lithuania; although a waged undeclared economy because 50.8% of undeclared work occurs in the waged realm, it has an own-account sector in which there is a 50/50 split between market-oriented and solidarity-oriented own-account work.

Table 6: *Typology of undeclared economies across the EU27\**

Types of undeclared economy	Sub-types of undeclared economy	Member States
<b>Waged undeclared economy</b> (>50% of undeclared work is waged)	<b>Envelope wage</b> (>50% of waged work is envelope wages)	Romania, Bulgaria, Poland, Hungary, Latvia, Lithuania, Cyprus, Spain, Portugal
	<b>Wholly undeclared wage-oriented</b> (>50% waged work is wholly undeclared waged work)	Malta
<b>Own-account undeclared economy</b> (>50% of undeclared work is own-account work)	<b>Market-oriented own-account</b> (>50% own-account work is undeclared self-employment)	N/A
	<b>Solidarity-oriented own-account</b> (>50% own-account work is paid favours)	Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece Italy, Luxembourg, Netherlands, Slovakia, Slovenia, Sweden, UK.

\* Excludes Ireland

If this geographical trend holds true, then it might well be the case that Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Turkey have waged undeclared economies in general, particularly envelope wage economies, akin to their EU counterparts in the south-east of Europe. Iceland, like western and Nordic Member States, will have an own-account undeclared economy with a high degree of solidarity-oriented undeclared work. The limited empirical evidence available so far on each of the study countries implies that this is indeed the case. Findings from the four south-eastern European countries suggest that these are waged undeclared economies in general, involving a high level of envelope wage undeclared work. One way to test this would be to repeat the Eurobarometer survey among the five countries. If a second wave of the Eurobarometer survey takes place, they should be included in addition to the EU27. Data could then be collected to allow comparisons between the five countries and the EU27 on the sectors in which undeclared work is concentrated, who conducts undeclared work, motives underpinning participation and the types of work undertaken.

If this hypothesis is correct, the strong implication is that the nature and incidence of undeclared work in a country is correlated with what might be seen as the maturity of its market economy. In Nordic countries such as Iceland, where undeclared waged employment is minimal due to regulatory systems in place there and self-employment is targeted by the state, much undeclared work is solidarity-oriented. In south-eastern European countries, including Croatia, Montenegro, the former Yugoslav Republic of Macedonia and Turkey, where institutional structures are less robust, the state weaker and less trusted, and tax morality lower, waged undeclared economies in general and, more particularly, envelope wage economies, tend to prevail.

### Barriers to formalisation

Until now, few have evaluated the barriers to the formalisation of undeclared work. This is a serious shortcoming. Unless the barriers to formalisation are evaluated, appropriate policy measures cannot be identified. Future research will need to pay far greater attention to evaluating the barriers to formalisation and how they can be tackled.

In an attempt to synthesise the findings of studies so far conducted, Schneider (2012) identifies the main causes of the undeclared economy, highlighting the barriers to formalisation of undeclared work. His analysis reveals that the major contributory factor is the increase in tax and social security burdens. This relates not only to the amount paid but also to the ease of, and difficulties involved in, paying such tax and social security contributions, thus suggesting that reductions in the undeclared economy are to be achieved by simplifying compliance. He finds that this influence accounts for anywhere between 35%–52% of the undeclared economy. Tax morality accounts for a further 22%–25% of it. The quality of state institutions, including the presence of perceived distributive justice and tax fairness, accounts for 10%–17% of the undeclared economy. Specific labour market regulations account for 7%–9%, while the quality of public services accounts for 5%–9% of it. The strong suggestion is that dealing with tax and social security contributions, and improving tax morality, might well address the principal barriers to formalisation of undeclared work.

Table 7: *Main causes of the increase in the undeclared economy*

Factors influencing the undeclared economy	Average values of 12 studies (influence on the undeclared economy, %)	Average values of empirical results of 22 studies (influence on the undeclared economy, %)
Increase of the tax and social security contribution burdens	35–38	45–52
Quality of state institutions	10–12	12–17
Transfers	5–7	7–9
Specific labour market regulations	7–9	7–9
Public sector services	5–7	7–9
Tax morality	22–25	–
Influence of all factors	84–98	78–96

Source: *Schneider (2012)*

The weighting given to these barriers to formalisation varies markedly cross-nationally, not least according to the nature of the undeclared economy in different countries. One of the few sources of cross-national variations in the barriers to formalisation is the annual World Bank Doing Business survey which indicates how easy or difficult it is for a local entrepreneur to open and run a small-to-medium-sized business when complying with relevant regulations. It measures and tracks changes in regulations affecting 10 areas in the life cycle of a business: starting a business; dealing with construction permits; getting electricity; registering property; getting credit; protecting investors; paying taxes; trading across borders; enforcing contracts; and resolving insolvency. Quantitative indicators for each of these 10 areas can be compared across 183 economies and over time. Table 8 shows that while the EU27 overall ranks 38th, Iceland (ranked 9th) and the former Yugoslav Republic of Macedonia (22nd) were ranked higher in terms of the ease of doing business. Montenegro (ranked 56th), Turkey (ranked 71st) and Croatia (ranked 80th) were all ranked lower. This suggests that compliance is more complex in these latter countries than it is in the EU27, and needs to be simplified.

Table 8: *Ease of doing business in the EU27 and study countries (rank out of 183)*

	EU27 average	Croatia	Former Yugoslav Republic of Macedonia	Montenegro	Turkey	Iceland
Overall	38	80	22	56	70	9
Starting a business	66	67	6	47	61	37
Dealing with construction permits	65	143	61	173	155	34
Registering property	65	102	49	108	44	11
Getting credit	47	48	24	8	78	40
Protecting investors	68	133	17	29	65	46
Paying taxes	71	32	26	108	79	35
Trading across borders	37	100	67	34	80	81
Enforcing contracts	45	48	60	133	51	3
Resolving contracts	36	94	55	52	120	11
Getting electricity	70	56	121	71	72	1

Source: *World Bank Doing Business database*

As Table 8 shows, in each of the five countries, it is particular areas of business compliance that need to be made easier and simpler. In Croatia, the areas of dealing with construction permits, protecting investors, registering property, trading across borders and resolving contracts need to be eased and simplified. In the former Yugoslav Republic of Macedonia, meanwhile, compliance needs to be facilitated in the areas of getting electricity, trading across borders, dealing with

construction permits, enforcing contracts and resolving contracts. In Montenegro, it is the realms of dealing with construction permits, enforcing contracts, registering property, paying taxes and getting electricity, whilst in Turkey, it is the spheres of dealing with construction permits, resolving permits, trading across borders, paying taxes and getting credit that easier compliance is required.

Two issues are particularly relevant to this report: starting a business and paying taxes. Table 9 reveals that the EU27 as a whole would rank 66th out of 183 countries in terms of the ease of starting a business. This means that in the former Yugoslav Republic of Macedonia (ranked 6th out of 183), Iceland (ranked 37th), Montenegro (ranked 47th), Turkey (ranked 61st) and Croatia (ranked 67th), the ease of starting a business in terms of complying with regulations is about the same or better than in the EU27. Indeed, starting a business is easier in the former Yugoslav Republic of Macedonia than it is in even the best performer in the EU27, namely Ireland (ranked 13th), and none of these EU candidate countries performs as poorly as the worst EU27 performer on the ease of starting a business, the Czech Republic (ranked 138th). Nevertheless, some of the five countries might consider simplifying compliance procedures regarding certain aspects of starting a business. For example, the costs of starting a business could be reduced; at presents this costs 11.2% of income per capita in Turkey and 8.6% of income per capita in Croatia.

Table 9: *Ease of starting a business in the EU27 and five study countries*

Country	Ease of starting a business (rank)	Number of procedures	Time (days)	Cost (% of income per capita)	Paid-in minimum capital (% of income per capita)
Croatia	67	6	7	8.6	13.8
Former Yugoslav Republic of Macedonia	6	3	3	2.4	0
Iceland	37	5	5	3.3	12.6
Montenegro	47	6	10	1.8	0
Turkey	61	6	6	11.2	8.7
EU27 average	66	6	14	5.1	15.9
Lowest EU27 performance	138 (Czech Republic)	10 (Greece)	32 (Poland)	20.1 (Greece)	52.0 (Austria)
Best EU27 performance	13 (Ireland)	2 (Slovenia)	4 (Belgium)	0 (Slovenia)	0 (Ireland)

Source: *World Bank Doing Business database, 2012*

Some of the study countries could follow the examples set by Portugal and Bulgaria. In 2012, starting a business was made easier in Portugal by allowing company founders to choose their minimum capital and make their paid-in capital contribution up to one year after the company's creation, and by eliminating the stamp tax on companies' share capital subscriptions. In 2009, business start-up was made easier in Bulgaria by the creation of a central electronic database for commercial registration. This reform consolidated and reduced the number of registration procedures and reduced other registration formalities. It is the former Yugoslav Republic of Macedonia, however, that stands out. In this country, starting a business is easier than nearly everywhere else in the world, requiring three procedures, three days and at a cost of just 2.4% of income per capita, all undertaken in a 'one-stop shop'. This, therefore, is a best practice policy measure that both the EU27 and other candidate countries might wish to replicate, if it is deemed transferable cross-nationally.

The EU27 ranks 71st out of 183 countries on the issue of ease of paying taxes, calculated on the basis of the average figure for each Member State. As Table 10 shows, this means that it is easier to pay taxes in the former Yugoslav Republic of Macedonia (ranked 6th out of 183), Iceland (ranked 35th) and Croatia (ranked 32nd) than it is in the EU27 as a composite. It is not as easy to pay taxes in these countries as it is in the best performer of the EU27, namely Ireland (ranked 5th out of 183). In Turkey (ranked 79th) and Montenegro (ranked 108th), however, it is more difficult to comply

with the regulations when paying taxes for a small-to-medium-sized business than it is in the EU27, although neither are as poor as the worst EU27 performer, namely Romania (ranked 154th out of 183 countries). To improve the ease with which small and medium-sized business can pay taxes in these countries, therefore, attention needs to be paid in the former Yugoslav Republic of Macedonia, Iceland and Montenegro to reducing the total number of taxes and contributions paid, including consumption taxes (value added tax, sales tax or goods and service tax), as well as the method and frequency of filing. In Turkey and Montenegro, the time required to comply with paying taxes could be reduced to bring it into line with the EU27 average.

Table 10: *Ease of paying taxes in the EU27 and five study countries*

Country	Rank on ease of paying taxes	Payments (per year)	Hours per year	Total tax rate (% of profit)
Croatia	32	17	196	11.5
Former Yugoslav Republic of Macedonia	36	28	119	9.7
Iceland	35	29	140	31.8
Montenegro	108	42	372	7.1
Turkey	79	15	223	17.9
EU27 average	71	17	208	43.4
Lowest EU27 performance	154 (Romania)	113 (Romania)	557 (Czech Republic)	68.5 (Italy)
Best EU27 performance	5 (Ireland)	4 (Sweden)	59 (Luxembourg)	20.8 (Luxembourg)

Source: *World Bank Doing Business database, 2012*

One way forward is to follow recent measures taken by EU Member States. For example, in 2012, Romania made paying taxes easier for companies by introducing an electronic payment system and a unified return for social security contributions. It also abolished the annual minimum tax. In 2011, the Netherlands reduced the frequency of filing and paying value added taxes from a monthly to a quarterly basis. It also allowed small entities to use their annual accounts as the basis for computing their corporate income tax.

# Main actors tackling undeclared work 3

## Government authorities

Dekker et al (2010) found that only 8 European countries of 31 reviewed had established one body dedicated to the fight against undeclared work. In France and Germany, a single agency existed for this task, while in Italy, Lithuania, Luxembourg, Belgium, Slovenia and the Czech Republic, a central coordinating committee was responsible for ensuring coordinated action by the multifarious departments that have a stake in tackling undeclared work.

The remaining 23 countries have, to varying degrees, a less coordinated and more fragmented approach towards tackling undeclared work. None of the five countries of this study has a single agency or a central coordinating committee responsible for ensuring coordinated action by the multitude of departments involved in the fight against undeclared work.

Many countries that do not have a single agency or central coordinating committee, however, do have a department designated with lead responsibility for tackling undeclared work. As Table 11 displays, this might be a tax office, a social security administration or a labour inspectorate. In Nordic countries, the tax offices tend to take this role, not least because much undeclared work there is conducted as self-employment, which is of less interest to labour inspectorates. In much of east-central and southern Europe, undeclared work tends to take the form of waged work, and so the labour inspectorate has greater responsibility in tackling this issue.

Table 11: *Lead authority for tackling undeclared work in 31 countries*

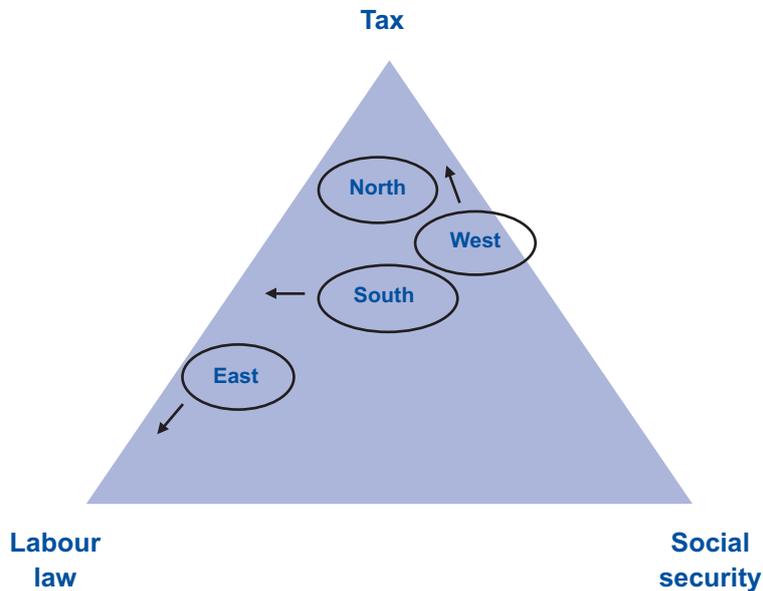
Labour authorities	Social security authorities	Tax authorities
Bulgaria, Cyprus, Czech Republic, Greece, Hungary, Italy, Latvia, Lithuania, Malta, Luxembourg, Poland, Portugal, Romania, Slovakia, Slovenia, Spain	Belgium, France, Switzerland/Liechtenstein	Austria, Denmark, Estonia, Germany, Finland, Iceland,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

Source: *Dekker et al, 2010*

Figure 3 shows where the balance lies between the various authorities in different European regions. In northern European states, it is predominantly the tax authorities who take the lead role in formulating policy on undeclared work whilst in western European states, although the tax authorities take the lead role, the social security authorities also play a role. In southern European states, the three bodies (labour inspectorates, tax offices and social security authorities) tend to contribute more equally. In east-central Europe, responsibility lies much more with the labour inspectorates and much less with the tax and social security authorities.

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

Figure 3: *Changing responsibility for undeclared work in the regions of Europe*



Three of the study countries, namely Turkey, the former Yugoslav Republic of Macedonia and Iceland, have a department with lead responsibility for coordinating the fight against undeclared work. In the former Yugoslav Republic of Macedonia, the State Labour Inspectorate (based within the Ministry of Labour and Social Policy) has been designated as the lead department. Numerous other departments are also responsible for different facets of the fight against undeclared work, including the Market Surveillance Inspectorate, Sanitary Inspectorate, Public Revenue Office, Employment Service Agency, Centres for Social Work, State Statistical Office, Central Register, as well as those responsible for customs, border police and immigration. On the whole, the level of cooperation between these agencies is weak. These departments and agencies tend not to have shared goals and work towards separate targets in relation to tackling undeclared work.

In Turkey, no single compliance unit or coordinating committee exists for tackling undeclared work, and different governmental organisations are responsible for different aspects. Nonetheless, the Revenue Administration takes lead responsibility in the fight against undeclared work. Other departments with which it cooperates in tackling undeclared work are the Ministry of Finance, Ministry of Labour and Social Security (MOLSS), Ministry of Development, Under-secretariat of Treasury, Under-secretariat of Customs, Social Security Agency (SGK), Energy Market Regulation Agency (EPDK), Tobacco Products and Liquors Market Regulation Agency (TAPDK), and Banking Regulation and Supervision Agency (BRSA). Again, however, the level of cooperation is relatively weak, in the sense that these departments largely operate in ‘silos’ with separate goals and targets, and shared goals or targets across agencies are the exception rather than the rule.

In Iceland, no one agency or coordinating committee exists with sole responsibility for tackling undeclared work, and neither is there an official lead department. Up to now the Internal Revenue Directorate has tended to take lead responsibility, although the Directorate of Labour also plays a prominent role. This is similar to other Nordic countries, where it tends to be the tax office that takes lead responsibility. Whilst the Internal Revenue Directorate is responsible for tax evasion in general and tackling the tax gap which results from the persistence of undeclared work, the Directorate of Labour, which is responsible to the Minister of Welfare, deals with contraventions of labour law, such as when people

are claiming benefits and not declaring income from unregistered employment. Again, strategies and targets tend to be department-based, and the pursuit of shared strategies and targets across departments is weak.

In the remaining two countries, namely Croatia and Montenegro, no single compliance unit or coordinating committee is responsible for tackling undeclared work, and neither is there a department that takes lead responsibility.

In Croatia, no department takes the lead. Instead, the fight against undeclared work is fragmented, with each government organisation responsible for different aspects of it, including the Ministry of Finance, the Ministry of Labour and Pension System, the State Labour Inspectorate, Tax Administration, Croatian Employment Services, the Ministry of Tourism, the Ministry of Agriculture and Customs Administration. Each ministry has its own separate strategies, operations and targets. Coordinated shared strategies, joined-up operations and common targets across departments are rare.

In Montenegro, again, no department has lead responsibility. Each government organisation is responsible for different aspects, even if much of the work tends to take place in the labour inspectorate. The labour relations department of the Ministry of Health, Labour and Social Welfare deals with the preparation, monitoring and improvement of labour legislation. The implementation of these laws is mainly undertaken by the labour inspectorate and the safety at work inspectorate. Furthermore, the employment agencies, the National Pension Fund, the Health Care Fund and other bodies such as the Revenue Agency are also involved. On the whole, however, each department has its own strategies, pursues its own operations and has its own targets in relation to undeclared work. Shared strategies, joined-up operations and shared targets are the exception rather than the rule.

### Role of social partners

The involvement of social partners in relation to tackling undeclared work also varies, although there is some tripartite social dialogue in all five countries. Again, some of the countries have a more established institutional structure for such dialogue than others, and there are also marked variations in the level of involvement of social partners.

In Croatia, the involvement of social partners occurs through the Economic and Social Council, established in 1994 to enable tripartite social dialogue between the government, employers and trade unions. To improve the level of dialogue, the Office for Social Partnership was established in 2001. Despite these formal institutional arrangements, the culture of social dialogue can be perceived as relatively weak, exemplified by the trade unions withdrawing from the Economic and Social Council in 2010 for six months in protest at the weak dialogue.

In Montenegro, similarly, a formal institutional framework exists in the form of the Social Council to involve social partners, including the Confederation of Trade Unions (CITUM) and the Association of Employers of Montenegro. An action plan for the suppression of undeclared work (developed with ILO assistance) has been adopted by the Social Council, which has a focus on awareness-raising and information campaigns.

In the former Yugoslav Republic of Macedonia, Turkey and Iceland, in contrast, no formal council exists to facilitate such dialogue in relation to undeclared work. However, social partners participate in policymaking through involvement with campaigns and initiatives. In the former Yugoslav Republic of Macedonia, such tripartite social dialogue between the government, employers and trade unions in the fight against undeclared work largely occurs through the Ministry of Labour and Social Policy. Some 35 trade unions and 6 employers' associations are involved. Here, however, the voices of social partners are perhaps not as strong as in many other European countries. The trade unions, once the major player and partner in the tripartite social dialogue, have lost much of their influence. This situation has not been helped by the fragmentation of the trade unions, their unstable finances, and lack of management capacity and active membership.

In Turkey, although no formal organisational structure exists through which social dialogue takes place, the involvement of social partners occurs through particular initiatives, such as the 'Combat against Informal Employment' (KADIM) project. This involvement could be stronger and more developed. At present the focus appears to be upon improving coordinated action across government departments; rather less emphasis has been placed so far on involving social partners.

In Iceland, although no formal organisational framework exists for the involvement of social partners in the fight against undeclared work, the involvement of the Icelandic Confederation of Labour and the Confederation of Icelandic Employers tends to occur in the form of cooperation on specific policy measures such as the introduction of ID cards and awareness-raising campaigns such as the 'fair play' campaign.

# Policy approaches towards undeclared work 4

## Typology of policy approaches

Based on the understanding that the non-compliant are ‘rational economic actors’ who will evade tax as long as the pay-off from evasion is greater than the expected cost of being caught and punished (Allingham and Sandmo, 1972), the conventional policy approach has been to deter engagement by changing the cost–benefit ratio confronting those engaged or thinking about participating in undeclared work (for example, Bardach and Kagan, 1982; Dodd and Hutter, 2000; Grabiner, 2000; Grabosky, 1995; Gramsick and Bursik, 1990; Hasseldine and Li, 1999; Job and Hinaker, 2003; Lewis, 1982; Milliron and Toy, 1988; Richardson and Sawyer, 2001; Sandford, 1999). This has been achieved by concentrating on the cost side of the equation and increasing the actual and perceived risks and costs associated with participation by, firstly, raising the perceived or actual likelihood of detection (not least by improving the coordination of strategy, operations and data sharing), and secondly, raising the penalties and sanctions for those caught. This constitutes a ‘repressive’ or ‘negative reinforcement’ approach that seeks to elicit a change in behaviour using a ‘stick’ to punish those engaged in non-compliant behaviour so that they will change their actions.

In recent decades, it has been increasingly recognised that it is also possible to alter the cost–benefit ratio by changing the benefits side of the equation, through improving the ease and benefits of, and incentives for, working on a declared basis. This can take two forms. Firstly, preventative measures can be adopted to make it easier for businesses to be compliant from the outset. Such measures could include simplifying regulatory compliance; introducing new categories of legitimate work; the provision of business support and advice; direct and indirect tax incentives; and the development of initiatives to smooth the transition to self-employment. Secondly, incentives can be used to help those already participating in undeclared work to transfer into the declared realm. These curative measures could include offering amnesties on either a societal or individual level to those who put their affairs in order; offering business advisory and support services to those seeking to formalise their endeavours; and providing a range of targeted direct or indirect tax incentives encouraging customers to use declared rather than undeclared work.

More recently, the ‘hard’ compliance policy approach that seeks to change the cost–benefit ratio confronting suppliers and purchasers of undeclared work has started to be questioned. What has emerged is a view that this should be coupled with a ‘soft’ commitment policy approach that seeks to engender a culture of commitment to tax morality as a way forward. Measures include tax education and awareness-raising exercises about the benefits of declared work, and the pursuit of perceived tax fairness, procedural justice and redistributive justice.

## Policy approaches in the EEA, Switzerland and the five study countries

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

*Member states should develop and implement broad actions and measures ... which combine simplification of the business environment, removing disincentives and providing appropriate incentives in the tax and benefits system, improved law enforcement and the application of sanctions (European Commission 2003b: 9).*

Further stimulation to move in this direction was provided by the European Commission (2007a) in its second communication on undeclared work, which explicitly called for Member States to transform undeclared work into declared work. As Williams and Renooy (Eurofound, 2009) note, this second communication on undeclared work also calls for greater attention to be paid to commitment measures that foster an allegiance to tax morality.

To evaluate the degree to which a shift away from a deterrence approach has occurred in the EEA and Switzerland, an online survey was conducted in 2010 of 104 senior stakeholders from government departments, trade unions and employer organisations in these 31 European countries; this was followed up by 24 in-depth interviews.

As Table 12 displays, 57% of stakeholders in the EEA and Switzerland stated that repressive measures are accorded the most importance in their country when tackling undeclared work and just 43% deemed measures that transform undeclared work into declared employment as being accorded the most importance, with 19% citing preventative measures, 14% curative measures and just 10% citing commitment measures. Indeed, examining what type of policy measure is accorded the least importance, some 84% cite those that seek to transform undeclared work into declared employment; only 16% cite repressive measures. The clear conclusion is that despite the call by the European Commission to transform undeclared work into declared employment, most countries remain entrenched in a deterrence approach that seeks to stamp out undeclared work.

Table 12: *Stakeholders' perception of importance of different policy measures in the EEA, Switzerland and five study countries*

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

Note: % for five candidate countries is provided in brackets.

Source: Dekker *et al*, 2010

This trend is also found among the five countries; interviews with government officials and social partners confirmed that deterrence remains the dominant policy approach. As Table 12 shows, the vast majority cited repressive measures as the most important tool that they use for tackling undeclared work. Little evidence exists to suggest that more enabling measures are considered important when combating undeclared work.

That is not to say that enabling measures are not being developed and used. As Table 13 shows, a wide range of measures are being introduced across not only the EEA and Switzerland but also the five study countries. All 31 countries seek to improve detection and 93% use penalties or sanctions. However, countries have also started to employ policy measures to transfer undeclared work into the declared realm that change the 'benefits' side of the equation by making it easier and more beneficial to operate in the declared economy, as called for by the European Commission. In total, 90% have adopted one or more preventative policy measures, although the range of measures used is relatively narrow beyond simplifying compliance. In addition, 64% use one or more curative measures, although again the range used is narrow beyond the use of targeted direct tax incentives (for example, income tax relief or reduction, or the use of subsidy schemes). Moreover, there has been recognition of the need to shift from purely the 'hard' policy approach, which changes the cost-benefit ratio confronting suppliers and purchasers, towards a 'soft' approach that seeks to move away from compliance and towards engendering a commitment to tax morality, with 69% of the 31 countries adopting some commitment measure.

Table 13: Policy measures used in the five study countries and 31 other European countries to tackle undeclared work

Policy measure	Croatia	Iceland	Former Yugoslav Republic of Macedonia	Montenegro	Turkey	% of 31 other European countries using measure
<b>Repression</b>						
<i>Penalties</i>						93
Administrative sanctions for purchasers/companies	✓	✓	✓	✓	✓	87
Administrative sanctions for suppliers/employees	✓	✓			✓	83
Penal sanctions for purchasers/companies	✓	✓	✓	✓	✓	74
Penal sanctions for suppliers/employees	✓	✓			✓	52
<i>Measures to improve detection</i>						100
Data matching and sharing	✓	✓	✓	✓	✓	83
Workplace inspections	✓	✓	✓	✓	✓	100
Registration of workers prior to starting work or on first day of work	✓		✓	✓		74
Coordinating strategy across government	✓			✓		57
Certification of business, certifying payments of social contribution and taxes	✓	✓		✓	✓	65
Use of peer-to-peer surveillance (e.g. telephone hotlines)	✓	✓		✓	✓	39
Coordination of operations across government		✓		✓	✓	61
Coordination of data sharing across government		✓		✓	✓	65
Mandatory ID in the workplace	✓	✓			✓	65
<b>Enabling compliance</b>						
<i>Preventative measures</i>						90
Reduce regulations	✓		✓	✓		48
Simplify compliance procedures	✓	✓	✓	✓	✓	87
Technological innovations (e.g. certified cash registers)	✓			✓		43
New categories of work (e.g. for mini-jobs)	✓					35
Direct tax incentives (e.g. exemptions, deductions)	✓	✓			✓	61
Social security incentives	✓	✓			✓	35
Ease transition from unemployment into self-employment	✓		✓	✓		65
Ease transition from employment into self-employment	✓			✓		44
Changing minimum wage upwards	✓	✓	✓	✓	✓	48
Changing minimum wage downwards						9
Training and support to business start-ups	✓	✓	✓	✓	✓	61
Micro-finance to business start-ups	✓	✓	✓	✓	✓	52
Advice on how to formalise	✓	✓		✓	✓	61
Connecting pension schemes to formal labour	✓		✓	✓		61
Introducing supply chain responsibility		✓			✓	17
Restricting free movement of (foreign) workers	✓					43

## Tackling undeclared work in Croatia and four EU candidate countries

Policy measure	Croatia	Iceland	Former Yugoslav Republic of Macedonia	Montenegro	Turkey	% of 31 other European countries using measure
<b>Enabling compliance</b>						
<i>Curative measures</i>		✓			✓	64
<i>Stimulate purchasers to buy declared goods and services</i>						
• service vouchers	✓	✓	✓		✓	26
• targeted direct tax incentives	✓	✓	✓		✓	61
• targeted indirect taxes		✓		✓	✓	17
<i>Stimulate suppliers to formalise their operations</i>						
• society-wide amnesties						9
• individual-level amnesties for voluntary disclosure	✓		✓			17
• formalisation advice to business						30
• formalisation support services to businesses						30
• targeted VAT reductions						17
• free record-keeping software to businesses						13
• fact sheets on record-keeping						22
• free advice/training on record-keeping						22
• gradual formalisation schemes						13
<i>Fostering commitment to declared work</i>						
Campaigns to inform undeclared workers of risks and costs of working undeclared	✓	✓		✓	✓	61
Campaigns to inform undeclared workers of benefits of formalising their work	✓	✓		✓	✓	57
Campaigns to inform users of undeclared work of the risks and costs	✓	✓			✓	61
Campaigns to inform users of undeclared work of the benefits of declared work		✓	✓	✓	✓	52
Use of normative appeals to people to declare their activities						52
Measures to change perceived fairness of the system				✓		26
Measures to improve procedural justice of the system (i.e. degree to which people believe government has treated them in a respectful, impartial and responsible manner)	✓					17
Measures to improve tax, social security and labour law knowledge	✓	✓			✓	65
Adoption of commitment rather than compliance approach (e.g. 'responsive regulation')						30
Campaigns to encourage a culture of commitment to declaration	✓			✓		39

Sources: Dekker et al, (2010) and interviews.

Regional variations occur in the adoption and use of different policy measures. Nordic and western Member States are more likely than southern and east-central European Member States to use enabling measures, especially the ‘soft’ commitment measures. When these latter Member States do adopt enabling measures, they tend to be confined to prevention.

An increase in the use of enabling measures to complement repressive measures can also be found among the countries studied, again mostly in the form of prevention. Curative measures are less common than in the EU27, and ‘soft’ measures to foster commitment to tax morality are relatively new. The five countries have pursued measures to stimulate purchasers of undeclared work to buy declared goods and services, such as through the use of service vouchers, and targeted direct and indirect tax incentives. However, the use of curative measures that seek to enable suppliers of undeclared work to legitimise their operations is notable by their near total absence. Few have used curative measures, such as society-wide amnesties, voluntary disclosure, targeted VAT deductions, fact sheets or advice on record-keeping, gradual formalisation schemes, or formalisation support services to undeclared enterprises. By contrast, each of these measures are present in an average 25% of the Member States. This clearly signals a notable gap in the range of policy measures being employed in the five countries.

The five countries have begun to use ‘soft’ policy measures that seek to engender a culture of commitment to tax morality. Indeed, approximately the same proportion of the five countries has adopted commitment measures as that found in the EU27. However, it is important to be aware, as indicated in Table 12, that no country has shifted from a compliance to a commitment approach when tackling undeclared work. This is in contrast to the EU27 where some 30% of Member States assert that they have done so, albeit mostly western and northern ones. Among the five countries, Iceland, like its Nordic neighbours, has made the greatest progress here, not least through its awareness-raising campaigns.

Clearly, similarities can be identified in relation to policy development in the EEA countries, Switzerland and the study countries. However, marked differences occur between the study countries. In Iceland, greater importance is attached to enabling measures when tackling undeclared work, similar to the Nordic states, than in the four south-eastern European countries. They, like the southern EU27 Member States, have also adopted an enabling approach, with a focus on prevention. However, in these countries, perhaps less importance is attached to these measures than in Iceland.

Even within Croatia, the former Yugoslav Republic of Macedonia, Turkey and Montenegro differences exist. In the former Yugoslav Republic of Macedonia, enabling measures are starting to be used, albeit with a focus on prevention. There, initiatives that aim to simplify the process of starting a business are perhaps best practice measures whose transferability to other EU27 nations could be fruitfully explored. Despite this, many areas for improvement remain, including giving greater prominence to ‘hard’ enabling measures to help suppliers transform their undeclared work into the declared economy and introducing a wider array of ‘soft’ measures that foster commitment to tax morality.

In Croatia, it is also the case that although enabling measures are starting to be used, there is a need to pay greater attention to measures that seek to transform undeclared work into declared work. This applies particularly to the adoption of ‘hard’ supply-side curative measures, but also to a lesser extent to ‘soft’ commitment measures to improve citizens’ tax morality, such as by changing the perceived fairness of the tax system, distributive and procedural justice, and knowledge of the tax system, in order to engender a culture of commitment to compliance.

In Montenegro, the institutions and structures being employed to tackle undeclared work are at an early stage of their development. In the context of a rapidly expanding number of formal companies, developing an appropriate and adequately robust institutional framework has been difficult. Although deterrence measures have been created, as have

a range of mostly preventative curative measures, the institutional framework in Montenegro is at an early stage of its development; further development is necessary before it can become more effective in tackling undeclared work. Montenegro needs to develop a greater deterrence capability; introduce a wider range of enabling policy measures, especially to transform undeclared work into declared work; pursue ‘soft’ measures to engender a commitment to tax morality; and better coordinate the fight against undeclared work, either by establishing a single agency responsible, a coordinating committee or a lead government department.

Turkey has shifted away from purely repressive policy measures and has introduced a wider range of enabling policy measures than other EU candidate countries. It now needs to foreground these measures more than has perhaps been the case so far. Areas for improvement in the way in which it organises the fight against undeclared work include pursuing a greater range of ‘hard’ supply-side curative measures; more fully developing ‘soft’ commitment measures to improve citizens’ tax morality; and better coordinating the fight against undeclared work across government, where many institutions appear to be involved.

### Relationship between undeclared economies and welfare regimes

Policy measures aimed directly at transforming undeclared work into declared work are not all that is required to tackle the undeclared economy. As will now be shown, there is evidence that broader work and welfare regimes influence the size of the undeclared economy in a country. Until now, in simple terms, two contrasting perspectives have prevailed on this issue about the type of work and welfare regime that produces economies in which undeclared work is rife. The neo-liberal viewpoint is that undeclared economies are the direct result of high taxes, over-regulation and state interference in the free market, and solutions include tax reductions, de-regulation and minimal state intervention. The social democratic viewpoint is that undeclared economies are the product of under-regulation and that the remedy is intervention in the economy and higher levels of social protection.

In order to determine which theory reflects the reality in the European context, the size of each country’s undeclared economy needs to be analysed in relation to its welfare regime. Five indicators that enable a distinction to be drawn between more interventionist ‘welfare capitalist’ regimes and less interventionist ‘neo-liberal’ regimes will be analysed. They are the level of implicit tax rates on labour income (Eurostat, 2007, 2011); state expenditure on interventions in the labour market as a proportion of GDP (Eurostat, 2011); the level of state social protection expenditure (excluding old age benefits) as a proportion of GDP (European Commission, 2011); the effectiveness of state redistribution via social transfers (European Commission, 2011); and the level of intra-national equality in the society, as measured by the Gini coefficient (European Commission, 2011). For fuller details of the datasets and methodology used, see Williams (2012a, 2012b) and Vorley and Williams (2012).

Starting with the relationship between the size of undeclared economies and tax levels, the neo-liberal perspective assumes that undeclared work rises when tax rates are higher and that the solution is to decrease taxes in order to reduce the size of the undeclared economy. To evaluate this, the relationship between variations in the size of the undeclared economy and variations in implicit tax rates on employed labour across the EU27 (Eurostat, 2011) are analysed. This is a summary measure of the average effective tax burden on the income of employed labour in that it calculates the sum of all direct and indirect taxes and employees’ and employers’ social contributions levied on employed labour income divided by the total compensation of employees working. Direct taxes are the revenue from personal income tax that can be allocated to labour income, while indirect taxes on labour income are those such as payroll taxes paid by the employer. Employers’ contributions to social security (including imputed social contributions), as well as to private pensions and related schemes, are also included. The compensation of employees is the total remuneration, in cash or in kind, payable by an employer to an employee in return for work done.

Analysing tax rates, and as Table 14 demonstrates, no significant correlation exists between the implicit tax rates on labour (the average effective tax burden on labour income) and the size of undeclared economies in the EU27. Using Spearman's rank correlation coefficient ( $r_s$ ) due to the non-parametric nature of the data, no statistically significant correlation is found between the size of the undeclared economy across the EU27 and the implicit tax rates on labour ( $r_s=-0.266$ ). Indeed, merely 10.2% of the variance in the size of the undeclared economy is correlated with the variance in implicit tax rates ( $R^2=0.102$ ). Hence, Member States with higher average tax burdens on labour income do not have larger undeclared economies, refuting the neo-liberal view that undeclared work is a direct result of high taxes and that the solution is to therefore pursue tax reductions. Neo-liberal work and welfare regimes with low average effective tax burdens do not have smaller undeclared economies.

Table 14: *Relationship between size of undeclared economy and work and welfare regimes (bivariate regression)*

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

\* significant within a 0.01 confidence interval

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

Is it the case that the greater the level of state intervention in the labour market, the greater the size of the undeclared economy? Alternatively, is it the case that the greater the state intervention in the labour market, the smaller the undeclared economy? To evaluate this, the varying levels of public intervention in the labour market aimed at correcting disequilibria are analysed across the EU27. Here, public interventions include measures taken by national government which involve expenditure, either in the form of actual disbursements or of foregone revenue (reductions in taxes, social contributions or other charges normally payable). These are explicitly targeted at groups of people with difficulties in the labour market, including the unemployed, people in employment but at risk of involuntary job loss, and inactive persons who are currently not part of the labour force but who would like to enter the labour market and are disadvantaged in some way (Eurostat, 2011). As Table 14 displays, the finding is not that the undeclared economy grows as the level of state expenditure in labour market interventions increases. Rather, the greater the amount spent on public interventions in the labour market, the smaller the undeclared economy will be. This correlation is statistically significant ( $r_s=-0.599$ ). Indeed, 23.5% of the variance in the size of the undeclared economy is correlated with the variance in the level of expenditure on public interventions in the labour market ( $R^2=0.235$ ). Again, no evidence is present to support the neo-liberal argument that public 'interference' in the labour market results in the growth of the undeclared economy. There is a statistically significant correlation between the size of the undeclared economy and the type of work regime (as measured by taxation levels and level of labour market intervention), and it is one in which greater intervention in the labour market leads to a reduction in the size of the undeclared economy.

This is also the case when the size of the undeclared economy is compared across welfare regimes. Examining the relationship between variations in the scale undeclared economies and variations in the proportion of GDP spent on social protection benefits, excluding old age benefits (European Commission, 2011, Table 3), Table 14 identifies a statistically significant correlation ( $r_s=-0.700$ ). In total, 46.7% of the variance in the size of the undeclared economy is correlated with the variance in the proportion of GDP spent on social protection, excluding old age benefits ( $R^2=0.467$ ). Member States that spend a higher proportion of GDP on social protection have smaller undeclared economies, as suggested by the social democratic argument, and not larger ones, as hypothesised by neo-liberals.

The strong correlation between the size of undeclared economies and the nature of welfare regimes is further reinforced when the impacts of redistribution via social transfers are evaluated. Defining poverty as the proportion of people with an income below 60% of the national median income, and analysing the reduction in percentage points of poverty before and after social transfers (European Commission, 2011, Table 3), Table 14 shows that Member States where social transfers have a greater impact on reducing poverty have smaller undeclared realms. This is again statistically significant ( $r_s=-0.642^*$ ), with 45.7% of the variance in the size of the undeclared economy correlated with the variance in the impacts of redistribution via social transfers ( $R^2=0.457$ ).

The outcome is that more equal societies (as measured by the Gini coefficient) have smaller undeclared economies than more unequal societies and this is statistically significant ( $r_s=0.448^*$ ), with 22.3% of the variance in the size of the undeclared economy correlated with the level of inequality in societies, as measured by the Gini coefficient ( $R^2=0.2268$ ). It appears, therefore, that in welfare regimes where higher levels of social protection and redistribution via social transfers lead to the creation of more equal societies, the amount of undeclared work is lower than that which occurs in less equal societies. In short, larger undeclared economies seems to be a result of under-regulation, not over-regulation.

Although these correlations do not suggest a cause-effect relationship, they do hint that some relationship exists between the type of austerity measures pursued and the size and growth of undeclared economies. What might be useful now is to evaluate longitudinally, within each country, whether this strong correlation occurs between expenditure on labour market intervention and welfare provision, and the size of undeclared economies. If a strong correlation is identified, this will provide further tentative evidence that the size of undeclared economies relates to broader economic and social policies.

# Conclusions 5

The aim of this report was to provide a systematic overview of the extent and nature of undeclared work, and how it is being tackled, in Croatia, Iceland, the former Yugoslav Republic of Macedonia, Montenegro and Turkey. The objectives have been to analyse the magnitude and character of undeclared work in these countries, to show how the fight against undeclared work is organised and to outline the policy approaches and measures being adopted.

Whatever measurement method is used, the common finding is that the size of the undeclared economy in Iceland is below the EU27 average, whilst Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Turkey have undeclared economies larger than the EU27 average. The nature of undeclared work also varies across different regions of the EU27. So far as can be determined, these five countries generally mirror the broad regional variations in undeclared work regarding the sectors in which it is concentrated, the types of work conducted, who conducts such work and their motives for doing so. Iceland mirrors the Nordic countries and the remaining four mirror the south-eastern European Member States. However, this requires further investigation. One way forward is for these five countries to implement the Eurobarometer survey, or for them to be included in any potential second wave Eurobarometer survey.

A previous study of 31 European countries (Dekker et al, 2010) revealed that eight countries (26%) have either a single agency responsible for the fight against undeclared work or a central coordinating committee responsible for coordinating action by the multifarious departments involved. None of the five countries in this study has a single agency or central coordinating committee. Instead, and to varying degrees, a more fragmented approach exists towards tackling undeclared work. In three countries, a department has been designated with lead responsibility for coordinating the fight against undeclared work, namely the Revenue Administration in Turkey, the Labour Inspectorate in the former Yugoslav Republic of Macedonia and the Internal Revenue Directorate in Iceland. In Iceland, the level of responsibility taken by the Internal Revenue Directorate in this field has been increasing. In Croatia and Montenegro, responsibility is more fragmented, with no lead department and each department pursuing its own targets.

The level of involvement of social partners in tackling undeclared work also varies between the five countries, although some tripartite social dialogue is taking place in all of them. In Croatia, the Economic and Social Council has been in place since 1994 and the Office for Social Partnership since 2001. However, trade unions withdrew from the Economic and Social Council in 2010 for six months in protest at the weak dialogue. In Montenegro, the Social Council is in place to involve social partners. In the former Yugoslav Republic of Macedonia, Turkey and Iceland, however, no formal council exists to facilitate such dialogue in relation to undeclared work, although social partners participate in policymaking through their involvement in campaigns and initiatives.

In the EU27, tackling undeclared work has been traditionally dominated by a repressive approach which seeks to stamp it out. However, there has been a call for the EU27 to pursue more enabling measures that pursue positive interventions to prevent people entering the undeclared economy and to help those already working undeclared to legitimise their operations. The EU27 as a whole continues to emphasise repressive measures, and enabling policy measures are generally believed to be less important when tackling undeclared work. However, regional variations exist in the extent to which enabling measures are being incorporated. This is also the case in the countries studied here. In Iceland, greater emphasis is placed on enabling measures than is the case in the other countries. This is similar to the Nordic countries. The four south-eastern countries, like southern EU27 Member States, have been generally slower to attach importance to enabling measures, although even here variations exist, with the former Yugoslav Republic of Macedonia pursuing effective preventative measures to a greater extent than Croatia, Montenegro and Turkey. Curative measures are less common in the candidate countries than in the EU27, and ‘soft’ measures to foster commitment to tax morality are relatively new.

Policy measures aimed directly at transforming undeclared work into declared work are not the only issue that needs to be addressed more fully in Croatia and the four EU candidate countries (and EU27) if the undeclared economy is to be tackled effectively. Much broader structural changes are also required. Work and welfare regimes that pursue tax reductions, de-regulation and minimal state intervention do not lead to smaller undeclared economies. Rather, larger undeclared economies are shown to be correlated with under-regulation. Countries with a greater level of labour market intervention, social protection and redistribution, as well as greater equality, are correlated with smaller undeclared economies. The five countries therefore need to give more prominence to a fuller range of ‘hard’ incentive measures to prevent and address undeclared work, and ‘soft’ measures that foster commitment to tax morality. Work and welfare regimes are strongly correlated with the size and growth of undeclared economies. Indeed, this perhaps tentatively explains why in Iceland the size of the undeclared economy is below the EU27 average, whilst in Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Turkey, the undeclared economy is larger than the EU27 average.

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