



## **Employment and Social Affairs Platform**

# **Diagnostic Report on Undeclared Work in Montenegro**

**Draft**

**Report prepared by Milorad Katnic and Colin C Williams**

**September 2018**



## **Contents**

<b>EXECUTIVE SUMMARY .....</b>	<b>4</b>
<b>1. INTRODUCTION: BACKGROUND CONTEXT .....</b>	<b>7</b>
<b>2. THE UNDECLARED ECONOMY: AN ANALYTICAL AND POLICY FRAMEWORK.....</b>	<b>7</b>
2.1 ANALYTICAL FRAMEWORK .....	7
2.2 POLICY APPROACHES TOWARDS THE INFORMAL ECONOMY.....	10
<b>3. EXTENT AND NATURE OF THE UNDECLARED ECONOMY IN MONTENEGRO.....</b>	<b>15</b>
3.1 MAGNITUDE OF THE UNDECLARED ECONOMY.....	15
3.2 CHARACTERISTICS OF THE UNDECLARED WORK IN MONTENEGRO.....	21
<b>4. BARRIERS TO FORMALISATION IN MONTENEGRO: DRIVERS OF THE UNDECLARED ECONOMY .....</b>	<b>27</b>
<b>5. ORGANISATION OF THE FIGHT AGAINST UNDECLARED WORK IN MONTENEGRO: INSTITUTIONAL FRAMEWORK .....</b>	<b>33</b>
5.1 RESPONSIBILITIES OF GOVERNMENT MINISTRIES .....	33
5.2. THE ROLE OF SOCIAL PARTNERS .....	38
5.3. TOWARDS A JOINED-UP STRATEGIC APPROACH .....	39
<b>6. CURRENT POLICY APPROACH AND MEASURES: AN EVALUATION .....</b>	<b>40</b>
6.1. DIRECT CONTROLS: DETERRENCE MEASURES .....	40
6.1.1. Penalties and sanctions.....	42
6.1.2. Detection measures.....	43
6.2. DIRECT CONTROLS: SUPPLY-SIDE INCENTIVES .....	45
6.3. DIRECT CONTROLS: DEMAND-SIDE INCENTIVES .....	46
6.4. INDIRECT CONTROLS .....	48
6.4.1. Altering informal institutions: Awareness raising campaigns.....	48
6.4.2. Reforming formal institutions .....	50
<b>7. REFERENCES.....</b>	<b>55</b>
<b>8. ANNEX: KEY STAKEHOLDERS CONSULTED .....</b>	<b>58</b>

## Abbreviations

ALMP – Active labour market measures

CDID - Centre for Development of Industrial Democracy

EEPS - economic entities in the private sector

EPCG – Electricity Company Montenegro

EPL – Employment protection by legislation

EU – European Union

GDP – Gross domestic product

ILO – International Labour Organisation

ISSP – Institute for Strategic Studies and Projections

MIMIC - Multiple Indicators Multiple Causes Method

NHDR – National Human Development Report

OECD – Organisation for Economic Cooperation and Development

SSCG - Association of Unions Montenegro

UNDP – United Nations Development Program

UPCG – Association of Employers of Montenegro

USSCG - Association of Free Unions of Montenegro

VAT – Value-added tax

## Executive Summary

Undeclared work is a widespread phenomenon, which is present not only in the underdeveloped economies, with inefficient institutions and a lack of trust in the government, but also more developed economies. Globally, undeclared work is rather a rule than an exemption, with over 60% of the total number of employed persons in the world having their main job in this sphere (OECD, 2009). The undeclared economy is deeply rooted into Montenegrin society and economy. Besides undeclared work, the Montenegrin labour market is marked by negative demographic trends, low activity, high unemployment, and the insufficient creation of new and high-quality employment. Different methodological approaches used for the estimation of the magnitude of undeclared work indicate that the share of employees partially or fully engaged in undeclared work, in the last ten years, is more or less stable at roughly one third of the total number of employees (UNDP, 2016).

There is no official data on the undeclared economy. The first surveys on the share of the undeclared economy in Montenegro conducted in the beginning of 21<sup>st</sup> century assessed that the undeclared economy as share in GDP ranged from 35-60%. For example, the Centre for Development of Industrial Democracy in 2000 conducted a survey among employees in the private sector, concluding that 38.6% of employees in trade, catering and construction were in unregistered employment.

Institute for Strategic Studies and Prognoses identified three key types of work in the undeclared economy in Montenegro (ISSP, 2007):

- work in unregistered companies or unregistered self-employed individuals;
- work for registered companies without registration for social security;
- persons for whose employees register and pay taxes and contributions only on part of their salary (known as ‘under-declared employment’).

The results indicated that 22.6% of all employees in Montenegro were unregistered employees. In addition, 17.5% of all formal employees received underreported salaries from their employers in order to avoid paying taxes and contribution on the whole amount of an employee’s salary. Regarding who was engaged in unregistered employment, 40% of unregistered employees were women, and the largest share (32.7%) aged from 20 to 29.

The report *Combating undeclared economy in Montenegro* of a group of authors (under the auspices of the European Foundation for the Improvement of Living and Working Conditions), analysed the scope and character of undeclared work in Montenegro as well as measures aimed at reducing undeclared work, and found that the level of undeclared economy in 2012 is significantly higher than in the EU27.<sup>1</sup>

---

<sup>1</sup> Williams, C.C. and Barić, M. (2012), *Combating undeclared economy in Montenegro*, EFILWC, Dublin.



In 2014, IPSOS<sup>2</sup> conducted a survey of the general population about their working conditions, for the Ministry of Labour and Social Welfare under the auspices of the UNDP. Undeclared work in this survey included: (a) employers, self-employed persons and persons employed for a salary in unregistered companies; (b) employees that work in registered companies without any contract and employees with a contract but with partly paid contributions. The key findings of the 2014 survey indicate that the share of unregistered employees was 22.3% of all employment, while in addition to this 10.3% of employees received underreported salaries.

Despite differences in the levels, the findings of the surveys on undeclared work in Montenegro do not differ significantly from those for other European countries in terms of who is more likely to engage in such work. Data from the survey 2013 Eurobarometer survey indicated that engagement in undeclared work is higher among men than among women, while there are no significant differences between urban and rural areas. In addition to this, the probability of engagement in undeclared work is higher for young people, less educated individuals, elderly and single or divorced persons. The rate of undeclared work in Montenegro is the highest among young people (34% for the age group 15-24) and the oldest (73% for persons of 65+). Additionally, if we observe only formally employed persons with partly paid taxes and contributions (i.e., those paid ‘envelope wages’), we can see that the highest share of these employees (19%) is in the group of young persons, (i.e. employees of the age group 15-24). This situation is similar to the situation in the neighbouring Serbia (Koettl, 2013) and EU countries (Williams and Horodnic, 2015).

Turning to explanations, a persistently high share of undeclared work suggests weaknesses in the regulatory framework, business environment as well as inefficiency in institutions. The consequences of a high share of undeclared work, besides missing revenues today, also means higher costs of social security in the future. Therefore, transiting from the undeclared to declared economy requires a high level of political support, determination and also very energetic reforms.

As key barriers to formalisation, preventing the transition from the undeclared to the declared economy, businesses identifying the following obstacles (NHDR, 2016):

- Numerous and high para-fiscal burdens,
- Economic situation – poor business results,
- High taxes and contributions,
- High severance payments in case of dismissal,
- Generosity of the welfare system, which incentivises unregistered employees to remain unregistered while enjoying the benefits of welfare.

In addition to this, those engaged in undeclared economy consider that rules are not equally applied to all, and that the inspections are inefficient. A low level of trust in general in the society and low level of trust in institutions, contributes to the persistence of undeclared

---

<sup>2</sup> IPSOS (2014), *Informal Employment and Grey Economy in Montenegro 2014*



work. According to the INFORM project 2017,<sup>3</sup> the level of trust in Western Balkan countries is generally low. On the scale from 1 to 10 (1- no trust, 10-complete trust), the trust in institutions score on average is 4.3 while trust among citizens scored on average 3.4. In the case of Montenegro, trust in institutions scored 4.9 while general trust in society received a 3.5 score.

Since 2012, the Ministry of Finance has taken a leading role in the fight against the undeclared economy. The set of measures for combating the undeclared economy has been defined in the action plan for every year, including the measures necessary for strengthening institutional capacities and human resources of the state administration bodies responsible for control and collection of revenues. The capacities of the inspection services have increased slightly over past 4 years both in terms of allocated budget as well as in term of staff numbers, however it seems that the general cost of running institutions are high and that resources could be used more efficiently in general and especially when comes to the fight against the undeclared economy.

In the last three years, Labour Inspection has detected over 7,000 cases of unreported workers, 3,085 in 2015, 1,977 in 2016 and 2,065 unreported workers in 2017. Measures usually taken by inspection are issuing orders to formalise detected unreported work, issuing monetary penalties and as a final measure prohibition of work until all work is registered.

Having in mind the structure, causes and consequences of the undeclared economy, the comprehensive plan to combat the undeclared economy should include reforms of the education, health and social care system. The scope and complexity of the taxation system should be reconsidered and well as regulatory framework on the labour market. The size and composition of public sector, and its inefficiencies should be reconsidered. The trust in society in general and trust in institutions, as well as efficiency of inspections should be part of the strategy for combating the undeclared economy.

---

<sup>3</sup> This project has received funding from the European Union's Horizon 2020 research and innovation programme under grant agreement No 693537.



## 1. INTRODUCTION

The Montenegrin labour market is characterized by low activity of the working age population, relatively high unemployment, particularly among the young, wide spread undeclared work and the lack of a sufficient number of new and quality jobs. Volume of undeclared work in Montenegro is significant, amounting to one third of total employment. The key purpose of this policy paper is to provide insight into the scope of the undeclared economy in Montenegro, to describe the policy measures implemented in order to tackle undeclared economy and their effectiveness. This involved both desk-based research and interviews with institutions involved in tackling the undeclared economy.

Second chapter sets analytical framework for analysis, summarising key academic research in the area of undeclared work as well as policy interventions. Third chapter gives insight into nature and magnitude of undeclared work in Montenegro. Fourth chapter is dedicated to identification of barriers to formalisation, while fifth chapter gives overview of the policy interventions against undeclared work in Montenegro. Final sixth chapter provides information on the used policy measures in Montenegro as well as evaluation of their efficiency.

## 2. THE UNDECLARED ECONOMY: AN ANALYTICAL AND POLICY FRAMEWORK<sup>4</sup>

### 2.1 Analytical framework

Work in the undeclared economy is, by definition, not declared to the authorities. This makes it difficult to obtain reliable estimates of its magnitude and characteristics, with various methods used to estimate its size and characteristics. Evaluating the different measurement methods available, the European Commission (2007a: 4) state, the undeclared economy:

‘can be measured both directly and indirectly. Indirect methods are based on the comparison of macroeconomic aggregates (such as national accounts, electricity consumption, cash transactions). Indirect (especially monetary) methods often over-estimate the level of [undeclared work] ... and say little about its socio-economic characteristics. Direct methods, on the contrary, are based on statistical surveys and have advantages in terms of comparability and detail, but tend to under-report the extent of ... [undeclared] work.’

---

<sup>4</sup> This chapter is transposed from two reports at the request of the Project coordinator - Williams, C., Nazarov, I. (2018) - Diagnostic Report on supporting the transition from the informal to formal economy in Azerbaijan; and Williams, C., Demetriades, S., Patra, E. (2016) - Diagnostic Report on undeclared work in Greece.



The resultant consensus has been to use indirect methods to measure the size of the undeclared economy and direct methods to identify its characteristics in terms of who engages in it, what they do and why, to inform policy development (Eurofound, 2013; Williams and Schneider, 2016). This approach will be adopted in this report.

Identifying the drivers of the undeclared economy is important because these need to be tackled to transform undeclared work into declared work. Recently, significant advances have been made in understanding the determinants of the undeclared economy by adopting an institutional perspective which transcends the previous competing debates about the varying causes of the undeclared economy (Godfrey, 2015; Webb et al, 2009, 2013; Williams and Franic, 2016; Williams and Horodnic, 2015a,b,c; Williams et al, 2015a). Institutions, or governance mechanisms, which prescribe, monitor and enforce the ‘rules of the game’ regarding what is socially acceptable, exist in every society (Baumol and Blinder, 2008; North, 1990; Scott, 1995). In all societies, these institutions are of two types: formal institutions that prescribe ‘state morality’ about what is socially acceptable (i.e., laws and regulations), and informal institutions, which prescribe ‘citizen morality’ (i.e., socially shared rules, usually unwritten) (Helmke and Levitsky, 2004).

The undeclared economy, from this institutional perspective, is explained as arising when the failings of formal institutions lead to state morality being different to citizen morality. As Webb and Ireland (2015) outline, these formal institutional failings are of four types:

- (i) Formal institutional voids, such as no social protection or a welfare ‘safety net’ which forces citizens into the undeclared economy to survive;
- (ii) Formal institutional inefficiencies, or resource misallocations by formal institutions, such as when formal institutions seek to protect or maximize economic rents for elites, or when state capture occurs by such elites, resulting in the majority not receiving a fair share in return for their contributions, or suffering from overly burdensome taxes, registration and licensing regulations and costs;
- (iii) Formal institutional uncertainty, such as when there is fear regarding the future of specific formal institutions, or when technology and socio-cultural change outpaces the ability of formal institutions to accommodate new domains of activity (e.g., ‘the sharing economy’), and/or
- (iv) Formal institutional weaknesses and instability, manifested in their lack of capacity and capability to enforce legislation (Webb *et al.*, 2009) and/or there are continuous changes in the formal ‘rules of the game’ about what is acceptable, which leads citizens and businesses to reject the continuously changing formal rules of the game in favour of their own more stable unwritten socially shared rules.

The undeclared economy arises, therefore, due to these failings of formal institutions producing a situation in which the formal ‘rules of the game’ (state morality) differ to what citizens view as socially acceptable (citizen morality). Indeed, the greater is the non-alignment of state morality and citizen morality, the greater is the prevalence of the undeclared economy.



Which specific formal institutional failings, therefore, result in the non-alignment of citizen morality with state morality, and thus the prevalence of the undeclared economy? Until now, there have been three competing theories which each identify different formal institutional failings as the cause of more extensive undeclared economies. Firstly, *modernization theory* has argued that the undeclared economy is rife in societies which are under-developed economically (i.e., with lower levels of GDP per capita) and where the formal institutions of governance are not modernised, displayed by the existence for example of higher levels of perceived public sector corruption and lower qualities of governance. Secondly, ‘*state over-interference*’ theory has argued that the undeclared economy is a resistance practice voluntarily pursued and a rational economic response to high tax rates and too much state interference such as over-burdensome rules and regulations (e.g., Becker, 2004; De Soto, 1989, 2001; London and Hart, 2004; Nwabuzor, 2005; Sauvy, 1984; Small Business Council, 2004). Third and finally, ‘*state under-intervention*’ theory views the undeclared economy as a direct by-product of too little, rather than too much, state intervention in work and welfare arrangements. In this approach, the undeclared economy is viewed as an inherent and integral component of contemporary capitalism and a key facet of the sub-contracting, downsizing and outsourcing arrangements that are emerging in advanced capitalism and enable enterprises to achieve profit through flexible production and cost reduction (Meagher, 2010; Taiwo, 2013). Consequently, the undeclared economy is depicted as unregulated, insecure and low paid employment conducted out of necessity by marginalized populations excluded from the formal economy and conducted as a last resort when no other options are available to them (Ahmad, 2008; Castells and Portes, 1989). As such, the undeclared economy is seen to result from a lack of social protection for workers and the remedy is greater state intervention in work and welfare provision to protect workers from poverty (Davis, 2006; Gallin, 2001; Slavnic, 2010).

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

- increasing GDP per capita;
- improving the quality of governance and reducing corruption;
- increasing expenditure on labour market interventions to help the most vulnerable groups;
- increasing social expenditure, and



- developing more effective social transfer systems to reduce the level of inequality and severe material deprivation, which includes improving the efficiency of collection.

Indeed, unless these formal institutional failings are tackled that result in an asymmetry between state morality and citizen morality, the undeclared economy will persist.

Some available research in the case of Montenegro, and also the trends in undeclared economy prevalence, shows that tax burden has direct impact of the on declared and undeclared work (Krsmanović, 2006, Katnic, 2016). Regulation also has a significant impact on employment and undeclared work (Katnic, 2017). Research under auspices of Association of Employers of Montenegro (UPCG, 2014) under ILO support identified regulatory framework and tax burden as some of the key factors for undeclared work. Participants in the Montenegrin labor market, both employers and employees, find regulation in the labor market is one of the factors that are decisive for participation in undeclared work by employed persons (UPCG, 2014). Theoretical and empirical findings (Heckman, Pages, 2004, Lemos 2007, Djankov, 2002) suggest that regulation in the labor market has an influence on the scale of undeclared economy through high costs of job certainty (costs of dismissals), level of the minimum wage, regulation of wage, etc. This is also true in case of Montenegro (Katnic 2016, Koettl, Gotcheva, Rutkowski, 2013)

## 2.2 Policy approaches towards the undeclared economy

It is now widely accepted across the developed, transition and developing world, that the aim of governments is not to eradicate the undeclared economy, but to support the transition of work from the undeclared to the formal economy (Dekker *et al.*, 2010; Eurofound, 2013; European Commission, 2007a; ILO, 2015b; Small Business Council, 2004; Williams, 2014; Williams and Nadin, 2012a,b, 2013, 2014).

Figure 1 displays the full range of tools available for transforming undeclared work into declared work. On the one hand, there are direct tools. These transform undeclared into declared work by ensuring that benefits of operating in the declared economy outweigh the costs of working in the undeclared economy. This is accomplished either by using deterrence measures to increase the costs of non-compliance ('sticks') and/or by making the conduct of declared work more beneficial and easier ('carrots'). On the other hand, there are indirect tools. These shift away from using 'sticks' and 'carrots', and instead focus on dealing with the formal institutional failings to repair the social contract between the state and its citizens to foster a high trust high commitment culture.

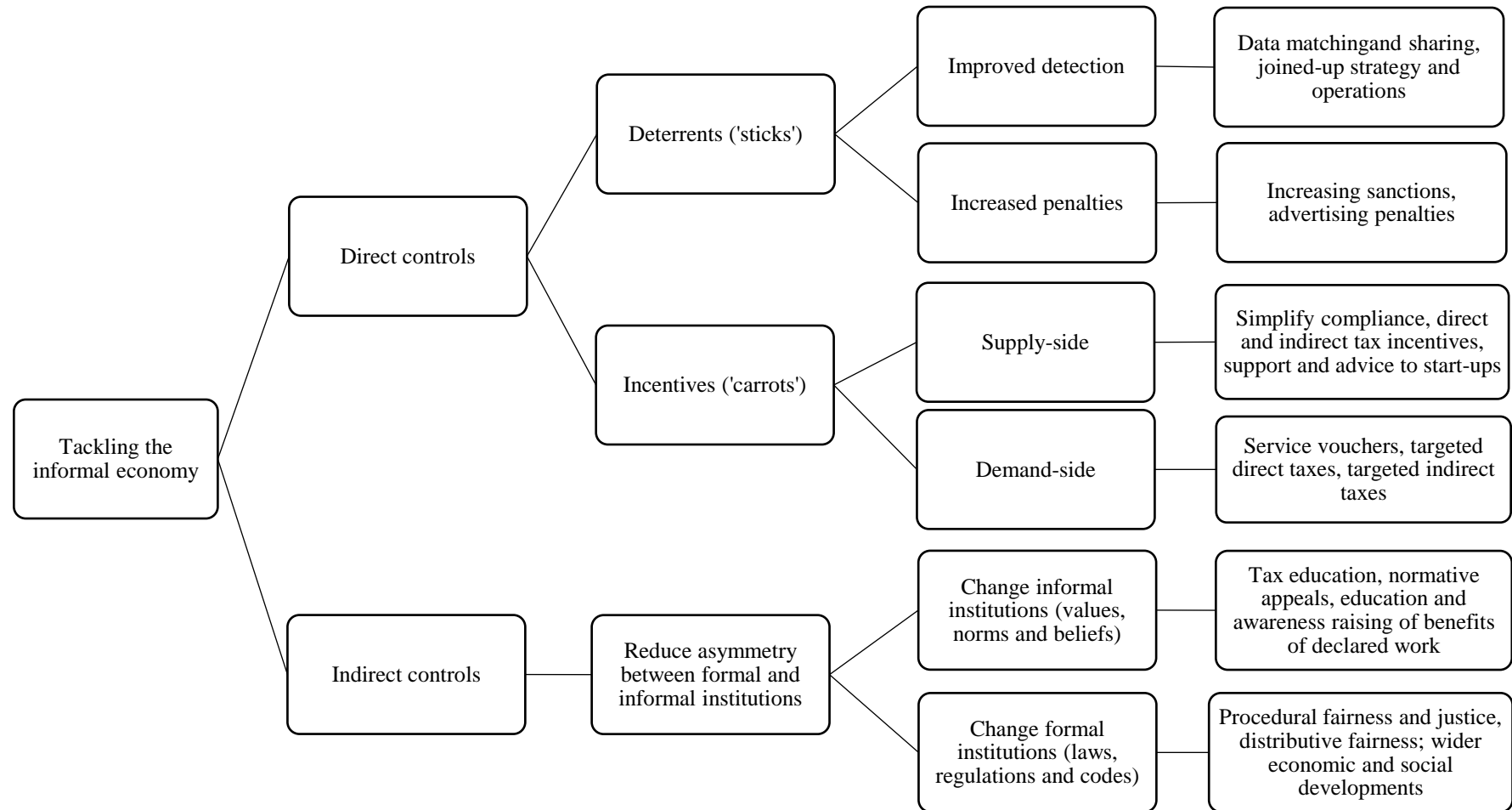
**Direct controls**, therefore, seek to reduce the costs and increase the benefits of operating in the declared economy (OECD, 2008). Viewing the non-compliant as rational economic actors who participate in the undeclared economy when the pay-off is greater than the expected cost of detection and punishment,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



- *Deterrence measures* seek to detect and punish non-compliant ('bad') behaviour (i.e., undeclared work). This is achieved by firstly, raising the perceived or actual likelihood of detection and/or secondly, increasing the penalties and sanctions for those caught. This 'negative reinforcement' approach thus seeks behaviour change by using 'sticks' to punish non-compliant ('bad') behaviour.
- *Incentive measures* seek to make it easier to undertake, and reward, compliant ('good') behaviour (i.e., declared work). To achieve this, one can use either:
  - Preventative measures to stop people moving into the undeclared economy in the first place (e.g., by simplifying compliance, using direct and indirect tax incentives to make it beneficial to operate formally, and providing support and advice about how to start-up legitimately); or



**Figure 1. Policy approaches and measures for tackling the undeclared economy**





- Curative measures to incentivise workers and businesses to make the transition to the declared economy. These can be either (a) supply-side incentives targeting businesses and workers in the undeclared economy or (b) demand-side incentives targeting their customers with rewards for using declared goods and services.

The problem with using these direct tools is that those operating in the undeclared economy are not always rational economic actors purely calculating the costs and benefits. They can be also social actors who engage in the undeclared economy because there is lack of alignment between their own morality and the laws and regulations, such as due to a lack of trust in the state and what it is seeking to achieve.

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

- *Change the informal institutions* - to change the norms, values and beliefs of citizens regarding the acceptability of the undeclared economy, so that these are in symmetry with the laws and regulations, one can use awareness raising campaigns and educational initiatives about the costs of undeclared work and benefits of formal work.
- *Change the formal institutions* – this is particularly important in societies in which there is a lack of trust in government, such as due to perceptions of public sector corruption or in societies where citizens do not believe that they receive back from government what they expect. This can involve either:
  - Changes in the internal *processes* of the formal institutions to improve the perception amongst citizens that there is procedural and distributive fairness and justice, and/or
  - Change in the *products* of formal institutions by pursuing wider economic and social developments (e.g., increased social expenditure levels, more effective social transfers).

The emerging evidence-base is that the 'best practice' when tackling the undeclared economy is to **combine direct and indirect tools** (Williams, 2014a; Williams and Renooy, 2013). For example, governments may pursue greater social expenditure to provide a welfare 'safety net' and culture changes in government departments towards a more customer-oriented approach, and introduce publicity campaigns to elicit greater commitment to compliance, but may also simplify regulatory compliance and introduce incentives (e.g., amnesties, tax deductions) to



enable undeclared labour to move into the declared economy. At the same time, and in relation to those failing to comply, they may also pursue improvements in the probability of detection and tougher sanctions for those subsequently caught.

The debate therefore is not over whether either indirect tools or direct tools should be used. The evidence is that both are needed to effectively tackle the undeclared economy. Rather, the debate is over how to combine and sequence these direct and indirect tools. Two contrasting approaches are available:

- *Responsive regulation* - this envisages a regulatory pyramid, sequenced from the least intrusive indirect controls at the bottom and used first, to the most intrusive direct controls at the top. The idea is that an authority does not need in most cases to pursue the coercion option at the top of the pyramid to win compliance. Instead, it can start with the commitment measures at the bottom of the pyramid and if these fail to elicit behaviour change with some groups, then the level of intrusiveness escalates up the pyramid until it reaches the intervention that elicits the desired response. The outcome is recognition of a continuum of attitudes towards compliance and different policy responses that can be temporally sequenced starting with commitment measures, then incentives and only after these fail are sanctions used (Braithwaite, 2002, 2009). The Australian government for example has adopted this ‘responsive regulation’ approach. In the first instance, indirect controls facilitate voluntary self-regulated compliance, followed by persuasion and only then punitive measures to tackle non-compliance (Braithwaite, 2009; Job et al., 2007).
- *Slippery slope framework* - this argues that citizens abide by the law either because they fear detection and fines due to the power of authorities (**enforced compliance**) or because they feel a commitment to be honest because they have trust in the authorities (**voluntary cooperation**). When there is effective enforced compliance as well as high voluntary cooperation (i.e., both power and trust), undeclared work is absent. When there is ineffective enforced compliance and little voluntary cooperation, undeclared work is extensive (Alm and Torgler, 2011; Alm et al., 2012; Kastlunger et al., 2013; Khurana and Diwan, 2014; Kirchler et al., 2008; Kogler et al., 2015; Muehlbacher et al., 2011a,b; Prinz et al., 2013).

This recognition that both effective enforced compliance and high levels of voluntary cooperation are essential for tackling the undeclared economy is now being seriously considered by authorities in various countries (OECD, 2013).

Indeed, the European Commission’s European Platform Tackling Undeclared Work has referred to this slippery slope framework as a ‘**full policy operationalisation model**’. This is seen as a model for implementing the holistic approach that combines the range of policy approaches and measures available (and uses all measures concurrently). This approach asserts that the most effective approach is to concurrently implement direct measures (e.g., workplace inspections) to enhance the power of authorities as well as indirect measures (e.g., awareness raising) to enhance trust in authorities (Williams, 2016). This approach is based on evidence that a high trust high power approach is the most effective in tackling undeclared

work. Indeed, it is this analytical framework and policy approach that is the basis for this report.

### 3. EXTENT AND NATURE OF THE UNDECLARED ECONOMY IN MONTENEGRO

#### 3.1 Magnitude of the undeclared economy

The undeclared economy in Montenegro became part of statistical and scientific research for the first time at the end of 20<sup>th</sup> and the beginning of 21<sup>st</sup> century. The estimated level of the undeclared economy in Montenegro during the 1990s and in the beginning of the 2000s ranged between 35% and 60% of the GDP (UNDP, 2016).

Research of the Centre for Development of Industrial Democracy (CDID) in 2000 indicated that 38.6% of employees in the sectors of hospitality, trade and construction were engaged undeclared work. Among those engaged in undeclared work, almost one third were in this arrangement for more than two years, while more women were engaged undeclared work than men, while the young and elderly were also more likely to be participating in undeclared work than other age groups.

Estimates of the Institute for Strategic Studies and Projections have shown that in 2002, the share of the undeclared economy amounted to 30% of the GDP<sup>5</sup>, while a UNDP assessment for 2002 estimated that the real unemployment rate was lower than the official one, that 25.5% of active population had undeclared incomes, and that 18% of them did more than one job.<sup>6</sup>

A policy paper “Undeclared Economy and Unprotected Work in Montenegro”, published by the Centre for Development of Industrial Democracy from Podgorica for the Confederation of Independent Trade Unions of Montenegro, showed that the causes of the undeclared economy have included: a high tax rate, excessive regulation by the state and underdeveloped institutions. In addition to these, some specific causes have also been identified, like the slow pace of the transition process, international sanctions in the 1990s, and differences in the systems that existed in Montenegro and in Serbia that at that time were in one state. Key conclusions of study are as follows:

- Out of the workers who were using their forced leaves, about 40-50% (i.e. circa 6,000) worked in the grey zone of the undeclared economy;
- Out of the total number of unemployed persons, 30-40% (i.e. about 30,000) did not declare their employment;
- Out of the total number of retired persons, 10-12% (i.e., circa 8,700) worked in the grey zone of the undeclared economy;

---

5 For details see the publication Montenegrin Economic Trends and Survey of Households at [www.isspm.org](http://www.isspm.org)

6 INCI (International Nomenclature of Cosmetic Ingredients)





- Out of the total number of refugees and displaced persons capable to work, 30-35% (about 10,000) worked in the grey zone of the undeclared economy;
- That 5,000-10,000 persons from abroad were hired undeclared to do certain jobs, primarily seasonal work.

These data show that in the observed period, about 50,000 to 65,000 workers were employed in some form of undeclared work in either declared or undeclared businesses. Observed by gender, a slightly higher number of men were employed undeclared (50.7%), while observed by the age structure, the largest number of undeclared employed persons were the young, i.e. persons under 25 (36.5%) and elderly - over 55 (44.4%). If we take into account the qualification structure of employees, then according to the research, undeclared work was the most frequent among persons who have only a primary education level (47%), and secondary school level (42.8%), while among the employed persons with higher education, 11.5% worked undeclared. Observed through the perspective of occupations, the occupations where undeclared work was most common include construction workers, waiters and shop assistants. The occupation with the least frequent engagement in undeclared employment were administrative workers. Observed by sectors, the strongest presence of the undeclared economy was recorded in hospitality industry (31.6%), construction (38.5%), trade (25.7%), and transportation (17.6%).

A slight decline of the share of undeclared economy in the total value of economy was recorded in 2005. On the basis of the surveys in 2005 (Omnibus survey, December 2005, ISSP), the share of undeclared economy in GDP was estimated at 25%, or about €400 million. The results indicated that the less developed regions in Montenegro had a higher undeclared economy rate, in that the undeclared economy was recorded in the most developed Southern region to be 30.6% of GDP, 23.8% in Central region and 45.6% in the least developed Northern region of Montenegro. The key sectors where activities of undeclared economy were recorded included trade (38.1%), agriculture (18.2%), the hospitality industry (19.1%), construction industry (10.8%), and transportation (9.6%). The share of the undeclared economy during the season was higher for the workers with low qualifications. The forms in which the undeclared economy was manifested in the trade sector included: illegal import of goods, trade in goods without proof that customs duties were paid or without declaration of origin, payment of the tax only for certain group of products, etc. The undeclared economy in the construction sector referred to usurping of the construction land, to the difference between declared surface and surface actually used, construction without permit, etc. Agriculture was labelled as the sector with the highest exposure to the undeclared work due to undeclared production for subsistence of the farmers and sale of products out of the market. Domestic crafts and services are also the activities closely connected to the undeclared economy since the sale of products and services is done outside of the tax system. The undeclared economy in tourism is manifested in the undeclared accommodation rented to tourists in private accommodation facilities, as well as in the failure to issue receipts to the tourists, or failure to register employees, etc.

The Labour Force Survey undertaken by the Institute for Strategic Studies and Projections for the Employment Office in 2007 covered 1,550 households, i.e. 4,711 persons older than 15 in



all Montenegrin municipalities. The survey findings indicated to three forms of undeclared work that exist in Montenegrin labour market:

- employment in the undeclared economy (which implies employment in unregistered companies, or activities of self-employed persons that do not register their activities at all),
- undeclared employment in the formal sector (which implies employment of persons in registered companies but without registration for social insurance); and
- employment in the formal sector with "partial registration" (which refers to the persons whose employers or they themselves pay taxes and contribution only on certain part of their income from employment, usually the amount set as the minimum in the labour legislation).

The results show that 22.6% of employees or close to 50,000 individuals were hired in the undeclared economy (they either worked in unregistered companies or as unregistered workers in registered companies), while out of the total number of employees, 17.5% (or 31,000) had only part of their salaries declared. This means that almost 50,000 persons out of 220,000 employed persons were not fully registered in either the declared or undeclared economy. At the same time, 13.2% of owners and co-owners of businesses operated in undeclared economy.

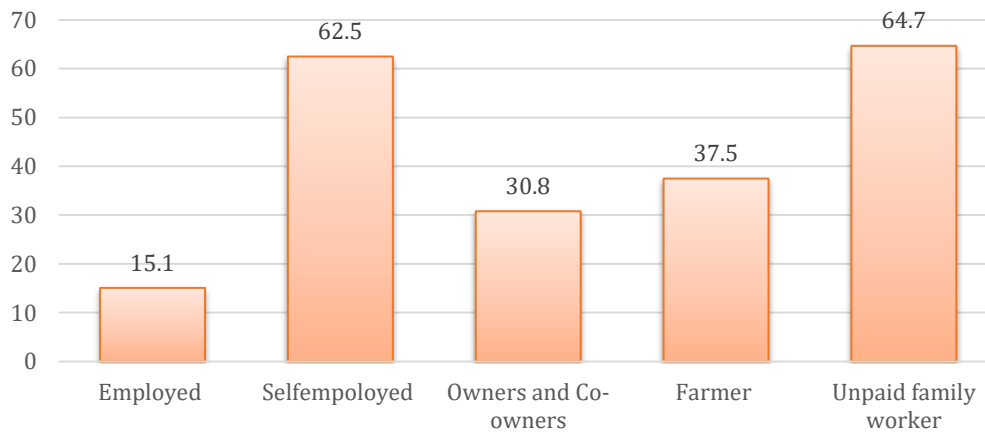
Figure 1. Structure of employed persons by their position or engagement in undeclared and registered economy



**Source:** Institute for Strategic Studies and Projections, Employment Office of Montenegro (2007), *Labour Force and Employment in Montenegro*

Survey data indicated that the majority of undeclared workers are employees (48.9%) or persons hired by employer, which runs, registered or unregistered business. Self-employed persons made 15.8% of total undeclared workers, unpaid family workers - 22.6% while farmers and businesses owners made 12.7% out of total number of undeclared workers. .

Figure 2. Share of employees with partly declared salary in the total number of registered employed persons



**Source:** Institute for Strategic Studies and Projections, Employment Office of Montenegro (2007), *Labour Force and Employment in Montenegro*

Compared with previous research, the 2007 survey showed that among undeclared workers, 40% were women, while the largest number of persons engaged in the undeclared economy was in the age group 20 to 29 (32.7%). This indicates to the fact that young person's entering the labour market has the strongest propensity to undeclared employment. Hence, they do not enjoy appropriate protection. Share of other age groups in undeclared economy is as follows age group of 30 to 34 -11.8%, 35 to 39 - 11.6% and 50 to 54 - 11.9%. Larger share of undeclared employees in 2007 had the four-year education level acquired in the vocational secondary schools (45% of all persons engaged in the undeclared economy).

The structure of employees in the undeclared economy by sectors was as follows: the largest share was recorded in hotels and restaurants (19.1%), agriculture (18.0%) and wholesale and retail (15.7%), while the lowest share was recorded in renting of property (0.2%), electricity supply, water supply and gas supply (0.7%), health sector (0.7%) and financial mediation (0.9%).

The study *Strengthening of Social Dialogue in Montenegro - Reducing Undeclared Labour and Grey Economy through Social Partnership* conducted in 2009 estimated that undeclared work made 15-20% of the total employment in Montenegro.<sup>7</sup> The regional study by the International Labour Organization from 2011 showed that 77% of all undeclared employed persons in Montenegro work in the declared economy while 23% work in the undeclared economy.<sup>8</sup> As for the status of employment, 15.8% of all undeclared workers in Montenegro are self-employed, while the bulk of undeclared work takes place in the declared sector. Just like some other research, this one confirmed that there are more men than women in undeclared work.

<sup>7</sup> Implementation of this study was financed by the International Labour Organization (ILO)

<sup>8</sup> ILO - A comparative Overview of Informal Employment in Albania, Bosnia and Herzegovina, Moldova and Montenegro



According to the ILO report *Global Employment Trends in 2013*, Montenegro recorded certain progress in some of the labour market indicators. However, the increase in undeclared employment still exists. The research, namely, showed that Montenegro had recorded an increase in undeclared employed persons from 17% to 19% between 2000-2010.

Under the auspices of the European Foundation for the Improvement of Living and Working Conditions, a group of authors analysed the spread and character of undeclared labour in Montenegro and measures aimed at reducing the undeclared economy. The analysis was done on the basis of comparison with EU27.<sup>9</sup> The report on Montenegro is a part of the research study on undeclared labour in five countries, out of which at the moment of the study four were EU candidate countries (Iceland, Montenegro, Macedonia and Turkey), while Croatia was to accede EU (in July of the year of the research). On the basis of earlier research about the scale of the undeclared economy in Montenegro, the study found that the level of undeclared economy is significantly higher than in the EU27.

The study of the European Movement in Montenegro "*Social and Economic Position of Women in Montenegro*" (2011) made the conclusion that women in Montenegrin society are faced with a large number of problems in numerous domains of private and public life, including the labour market, because employment in the female population is characterized by more frequent acceptance of jobs that are poorly paid, temporary, or with worse working conditions.

The report *Informal Economy in Montenegro - Creating the Environment for Sustainable Development of Companies in Montenegro* is one of the recent reports that provide an overview of the history of the problem, the forms of undeclared economy (work in the grey zone and undeclared business operations), as well as various causes of undeclared economy in Montenegro. The document was prepared by the Union of Employers of Montenegro in late 2014. The causes that were recognized as the most significant ones for the development and spread of undeclared economy in Montenegro and for hindering its formalization include:

- Insufficient level of the rule of law, reflected in the inefficient public administration, selective and random implementation of legislation and inconsistent interpretation of legislation by various instances of administrative services;
- Inadequate regulatory framework that primarily refers to high transaction costs, the burdening legislation, complicated, expensive and inadequate registration procedures;
- Inflexible labour legislation, particularly in terms of legal limitation to the duration of the contracts of employment for a fixed term;
- High burden of taxes and contributions on salaries;
- High and numerous duties on the local self-government level; and lack of available funds.<sup>10</sup>

---

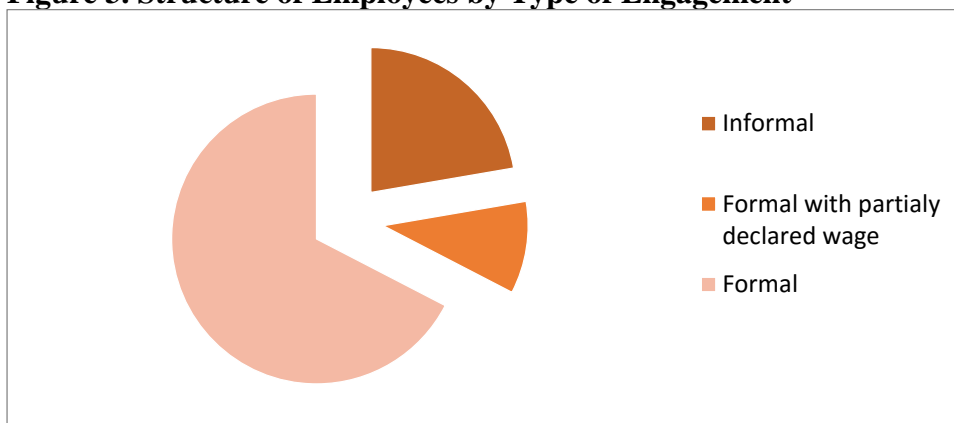
9 Williams, Barić (2012), *Combating undeclared economy in Montenegro*, Williams, Barić (2012), *Tackling Undeclared Work in Montenegro*, EFILWC

10 Union of Employers of Montenegro, (2011), *The report Informal Economy in Montenegro - Creating the Environment for Sustainable Development of Companies in Montenegro*, pp. 12-16.

The survey of the general population about the working conditions, conducted by IPSOS for the Ministry of Labour and Social Welfare (IPSOS, 2014), under the auspices of UNDP, defined undeclared work as follows: (a) employers, self-employed persons and persons employed for salary in unregistered companies; (b) employees that work in the registered companies without any contract and employees with contract but with partly paid contributions. According to the data, 29.2% of the working age population (15+) worked in the declared economy, while about two times less persons worked in the undeclared economy, i.e. 14.2%.<sup>11</sup>

According to the Survey, in 2014 Montenegro had 70,418 undeclared employed persons and employed persons with partly declared earnings. This was 32.7% of the total number of employed persons. Out of this number, 46,452 employed persons or 22.3% of all employees in Montenegro were undeclared and they were earning incomes that were not formally recorded, i.e. they were receiving salaries in cash without any payment of the appropriate taxes and contributions. The remaining 10.3% of the total number of employees, or 23,966 employees, had partly registered salaries, i.e. taxes and contributions were paid only on a part of their salaries (usually on the minimum wage for certain education level), while they received the rest in cash without payment of taxes and contributions.

**Figure 3. Structure of Employees by Type of Engagement**



**Source:** IPSOS (2014), *Informal Employment and Grey Economy in Montenegro 2014*

In addition to undeclared employment and salaries generated in the undeclared sector, the companies also have revenues that are not declared.<sup>12</sup> IPSOS also estimated having in mind undeclared surpluses that the total undeclared economy in Montenegro is 24.5% of GDP.

<sup>11</sup> The Survey was conducted in November 2014 in the sample of 1,038 households and 409 companies and entrepreneurs.

<sup>12</sup> IPSOS (2014), *Informal Employment and Grey Economy in Montenegro*

The average share of undeclared economy in GDP in European Union in 2012 amounted to 18.4% of GDP, where the lowest share of the undeclared economy was in Austria (7.6%) and the highest in Bulgaria (31.9%).

**Table 1. Undeclared Economy in the European Union (2012)**

<b>Austria</b>	7.6	Spain	19.2
<b>Luxembourg</b>	8.2	Portugal	19.4
<b>The Netherlands</b>	9.5	Italy	21.6
<b>UK</b>	10.1	Hungary	22.5
<b>France</b>	10.8	Slovenia	23.6
<b>Ireland</b>	12.7	Greece	24.0
<b>Germany</b>	13.3	Poland	24.4
<b>Finland</b>	13.3	Malta	25.3
<b>Denmark</b>	13.4	Cyprus	25.6
<b>Sweden</b>	14.3	Latvia	26.1
<b>Slovakia</b>	15.5	Estonia	28.2
<b>Czech Republic</b>	16.0	Lithuania	28.5
<b>Belgium</b>	16.8	Romania	29.1
<b>EU 27</b>	<b>18.4</b>	<b>Bulgaria</b>	<b>31.9</b>

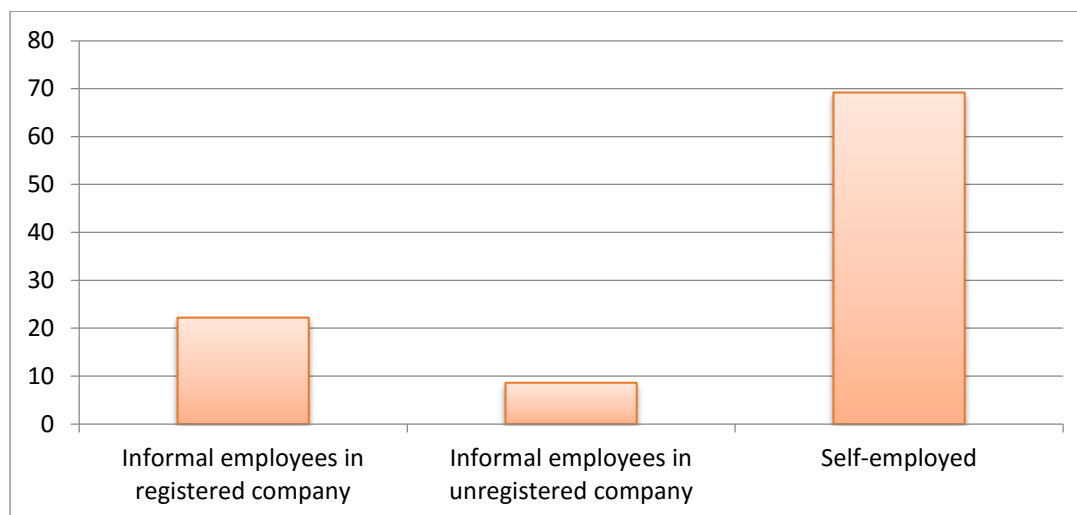
**Source:** Tackling Undeclared Work in European Union Member Countries and Norway, 2013

Updated data on the number of undeclared employed persons in the European countries are not available since they are not a part of official statistics. The Institute for the Study of Labour from Germany made an assessment for 2009 on the basis of Labour Force Survey (Table 2.1.2).

### 3.2 Characteristics of undeclared work in Montenegro

The structure of undeclared work in Montenegro, according to available surveys, has changed slightly. As opposed to earlier surveys (CDID, 2000), newer surveys (ISSP 2007, IPSOS 2014) indicate that the male population is dominant among undeclared workers. Findings of the surveys about the employed persons engaged in the undeclared sector in Montenegro do not differ significantly from those for other European countries. Analysis of the data from the survey Eurobarometer from 2013 shows that engagement in undeclared work is higher among men than among women, while the percentage of engagement in undeclared work among the citizens of urban areas is not much different from that in the rural zones. The probability of engagement in the undeclared economy is higher for young people, less educated individuals, elderly and single or divorced persons, as well as for those that have more than one child and struggle to pay bills every month.

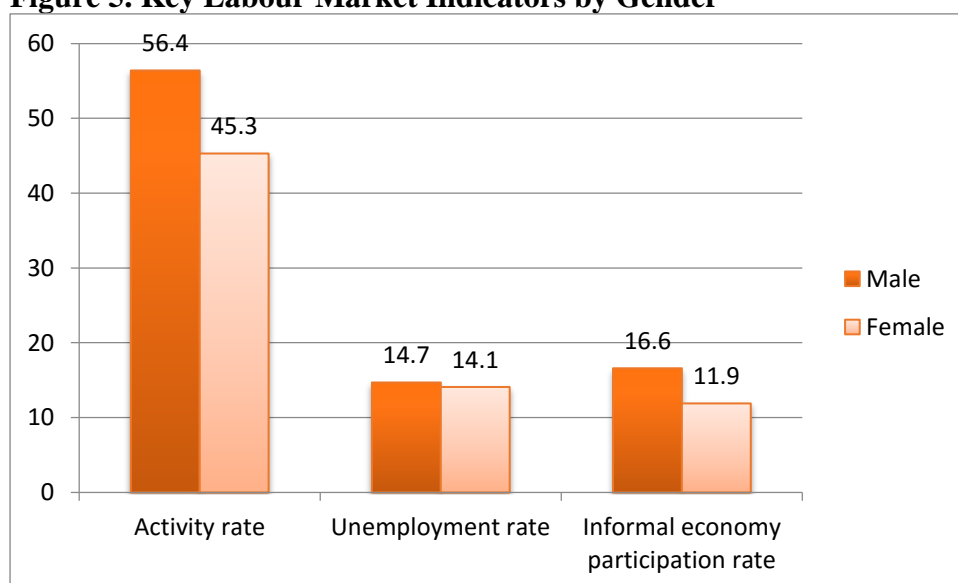
**Figure 4. Characteristics of Undeclared Workers**



**Source:** IPSOS (2014), *Informal Employment and Grey Economy in Montenegro 2014*

In the structure of undeclared employed persons the share of self-employed is on the level of 70%, which possibly indicates the reasons for their engagement in the undeclared economy. On one side, a high share of self-employed persons in the group of undeclared employed persons shows that individuals do themselves opt to be engaged in the undeclared economy. This situation can also be an indicator of the lack of work places in economy and of the fact that legislation regulating the business field is rigid, and that the tax burden on the labour costs is high. In addition to this, having that survey showed that there is a large share of welfare beneficiaries engaged in undeclared work, that they are registered for welfare benefits and in the same time are self-employed.

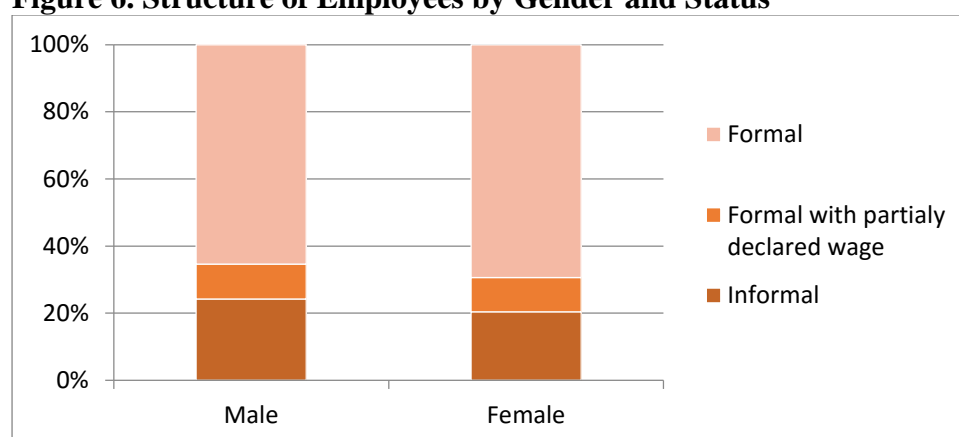
**Figure 5. Key Labour Market Indicators by Gender**



**Source:** IPSOS (2014), *Informal Employment and Grey Economy in Montenegro 2014*

The survey has shown that women are less engaged in undeclared activities than men.<sup>13</sup> Also, the activity rate of women is lower than the activity rate of men, and the same goes for the unemployment rate. Out of the total number of employed women, every fifth woman is engaged within the undeclared sector, while for men, every fourth man is participating in undeclared work. Close to 70% of women are formally employed while about 65% of men are formally employed.

**Figure 6. Structure of Employees by Gender and Status**



**Source:** IPSOS (2014), *Informal Employment and Grey Economy in Montenegro 2014*

Although the highest share among undeclared employed persons are those aged between 35 and 64 (59.9%), the rate of undeclared employment is the highest among young people (34% for the age group 15-24) and the oldest (73% for persons of 65+). Additionally, if we observe only formally employed persons with partly paid taxes and contributions, we can see that the highest share of these employees (19%) is in the group of young persons, i.e. employees of the age group 15-24. This situation is similar to the situation in the neighbouring Serbia (Koettl, 2013) and EU countries (Williams and Horodnic, 2015).

**Table 2. Structure of Employees by Engagement in the Undeclared Economy (% of the total number of employees of certain age group)**

Age	Formally employed persons	Formally employed persons with only part of taxes and contributions paid	Informally employed	Total
<b>15-24</b>	48%	19%	34%	100%
<b>25-30</b>	72%	12%	17%	100%
<b>31-45</b>	71%	11%	17%	100%
<b>46-64</b>	67%	8%	25%	100%
<b>65+</b>	24%	2%	73%	100%
<b>Total</b>	67.3%	10.4%	22.3%	100%

<sup>13</sup>IPSOS (2014) - *Informal Employment and Grey Economy in Montenegro*



**Source:** IPSOS (2014), *Informal Employment and Grey Economy in Montenegro 2014*

In spite of the fact that persons who retired due to old age have the right to work without the obligation to suspend their right to a pension, which is not the case with the users of a family pension (except for pupils/students that receive family pension), there is still a large number of retired persons that are active in the undeclared economy.<sup>14</sup> The tax wedge on the average wage of an employee is 40.1% whilst the tax wedge for an employed pensioner is 32.2%, which is high. A relatively high tax wedge and no sanctions for undeclared engagement means that it pays for pensioners to work undeclared.

**Table 3. Employed Persons by Status and Education Level**

Education degree	Formally employed persons	Formally employed persons with only part of taxes and contributions paid	Informally employed persons	Total
<b>Without primary school</b>	23.1%	6.0%	70.9%	100.0%
<b>Primary school</b>	43.3%	6.4%	50.4%	100.0%
<b>Secondary school</b>	66.0%	11.2%	22.8%	100.0%
<b>High school</b>	76.7%	15.4%	7.9%	100.0%
<b>University</b>	86.2%	8.6%	5.2%	100.0%

**Source:** IPSOS (2014), *Informal Employment and Grey Economy in Montenegro 2014*

The level of education is an important factor that determines person's status in the labour market. In the group of employed persons without primary school education, 70.9% are engaged in the undeclared sector. The higher education level, the larger percentage of formally employed persons, i.e. the lower the percentage of undeclared employed persons.

The data are not so linear for formally employed persons that receive a part of their salary without payment of taxes and contributions to the state. The largest percentage in this group are persons with upper-secondary and higher school education, 11.2% and 15.4% respectively. The percentage declines for persons with a university degree.

Approximately two thirds (63-66%) of undeclared workers do their activities outside of any company, i.e. in family farms, at home, in the form of "door-to-door" sale, in the vehicle, in the street, in the open market or in some other non-typical place, while this percentage is much lower for formally employed persons (12.8%). Undeclared employment is a characteristic of micro companies (less than 10 employees) since 80.8% of undeclared workers are in such companies.

---

<sup>14</sup> Amendments to the Law on Pension and Disability Insurance from 2010 define that students and pupils who use family pension have the right to be formally employed and to continue receiving family pension by the end of their schooling.





Observed by activities, the largest share of undeclared work was recorded in agriculture and in the households as employers - 87.1% and 90.9% work undeclared in each of these sectors respectively. A high share of undeclared employed persons in the total number of employed persons is recorded in the construction industry (36.3%) and services (34.9%). The largest volume of evasion, i.e. paying taxes and contributions on a part of salaries only, was recorded in arts, recreation, and entertainment (32.6%), processing industry (26.5%) and expert, research, innovations and technical activities (28.5%).

Since unregistered self-employed persons make almost 70% of the total number of undeclared employed persons, their age structure has a slightly different picture than the total population of undeclared employed persons. In this population, the dominant share is that of the employed persons that belong to the age group 46-64. Given their age structure, there is a high probability that these employed persons are at the same time users of the benefits for unemployment and other rights. Hence, it is not profitable for them to formalize their status.

Analysis of the structure of self-employed persons by education shows that 37% are persons without any education and with primary school education, while 6% are the persons with university education.

According to the results of the survey on the conditions of business operations of enterprises and entrepreneurs in Montenegro in 2014, 38.4% of businesses in Montenegro had some undeclared activities.<sup>15</sup> Roughly one third of businesses had undeclared employed persons (34.2%), while 17.4% of the VAT tax payers made more than 10% of payments in cash.<sup>16</sup> This survey showed that legal entities are more inclined to get involved in the undeclared economy than registered entrepreneurs (38.7% to 36.8%). Enterprises established in 2009 and later are more inclined to do undeclared activities than enterprises established before 2009 (42.4% to 34.7% respectively). These findings indicate that the enterprises established after 2009 faced more difficult conditions of business operations after the outbreak of the global crisis, and partly also indicate that, as they grow and develop, companies increasingly operate within the declared economy. The cause of this difference may partly lie in the fact that in the large system and enterprises established several decades ago (EPCG, Telekom, commercial banks, etc.) are/were state owned and most employees are formally employed.

Table 4- Percentage of economic entities in the private sector (EEPS) that are engaged in the undeclared economy by their characteristics

	% EEPS engaged in undeclared economy	% EEPS with informally employed persons	% VAT payers with more	% EEPS that have both forms of undeclared work

<sup>15</sup> IPSOS (2014), *Informal Employment and Grey Economy in Montenegro*

<sup>16</sup> The research was conducted in such a way that the representatives of the business sector in Montenegro (economic entities and entrepreneurs) were answering indirect questions with the view to providing estimates of grey economy in other companies.

			than 10% cash payments	
Total	38.4	34.2	17.4	13.3
Type of economic entity				
Company	38.7	34.1	19.3	14.7
Entrepreneur	36.8	35.0	7.0	5.2
Number of employees				
Micro (0-9)	38.5	33.8	14.9	10.2
Small (10-49)	42.1	39.8	27.5	25.3
Medium and large (50*)	11.1	6.3	7.9	3.2
Activity				
Other services	45.8	43.4	19.0	16.7
Tourism	31.4	31.4	13.3	13.3
Agriculture	51.1	44.7	17.0	10.6
Construction industry	38.5	35.9	27.8	25.1
Trade	36.8	31.4	14.9	9.4
Industry	26.9	16.5	17.4	7.0
Region				
Northern	26.6	26.6	8.1	8.1
Central	42.5	36.2	19.0	12.7
Southern	38.5	35.1	19.3	15.8

**Source:** IPSOS (2014), *Informal Employment and Informal Economy in Montenegro 2014*

Undeclared activity is more present in the group of small enterprises with 10-49 employed persons (42.1%) and this group of companies hires the largest share of undeclared employed persons (39.8%) and makes the highest percentage of undeclared turnover (27.5%). Among micro enterprises with 0-9 employees there is a slightly lower rate of undeclared activities (38.5%), while it is the lowest among medium size and large enterprises with 50 + employees (11.1%).

The largest percentage of businesses that are engaged in the undeclared economy are in agriculture (51.1%), sector of other services (45.8%) and the construction industry (38.5%). The largest percentage of businesses, VAT payers, that have undeclared incomes operate in the construction industry (27.8%). More than one third of businesses in the construction industry (35.9%) have undeclared employees. The largest percentage of businesses entities that hire workers without contract or with contract but without declaring the entire salary operate in the field of construction (34.3% and 21.8% respectively).

Observed by the regions, businesses with the headquarters in the central region are most inclined to do undeclared activities, and those in the North are the least inclined to operate in such a way (42.5% to 26.6%). A similar distribution can also be seen in individual forms of undeclared economy, indicating a change in the structure of undeclared work compared with previous research, where the highest rate of undeclared work was recorded in the Northern region and lowest in the Southern region (ISSP, 2007).

#### 4. BARRIERS TO FORMALISATION IN MONTENEGRO: DRIVERS OF THE UNDECLARED ECONOMY

Empirical studies since 1990s (for example Schneider, 2015) have identified the key determinants of the undeclared economy that can be put into four broad groups:

- Costs of formality - taxes and other burdens,
- Quality of regulations and business environment,
- Informal institutions - tax morale, and
- Efficiency of the public sector in provision of services - justification for taxation and sanctions.

Table 5. The key determinants of the undeclared economy<sup>17</sup>

Cause	Theoretical explanation	References
<b>Taxes and tax burden of labour</b>	Total tax burden influences the choice of work/leisure and can stimulate the labour supply in the undeclared sector. The higher the difference between the total labour costs in the declared economy and earnings after the taxes and contributions are paid, the higher is the incentive to reduce the tax burden and to work in the undeclared economy.	Thomas (1992), Johnson, Kaufmann i Zoido-Lobaton (1998), Giles (1999), Tanzi (1999), Schneider (2003,2005) i dr.
<b>Quality of institutions</b>	Quality of institutions influences informality - particularly the (in)efficient and discretionary application of tax legislation. It has stronger impact than the level of burden. Certain level of taxes that is later spent on the productive public services characterise efficient policies. Undeclared sector is developed as a consequence of failures of the institutions in the promotion of the efficient market economy.	Johnson and others (1998), Friedman, Johnson, Kaufmann and Zoido-Lobaton (2000), Buehn and Schneider (2012) etc.
<b>Regulations</b>	Regulations like legislation in the labour market or trade barriers constitute an important factor that reduces the freedom of choice for individuals in the declared economy. Regulations lead to significant increase of labour costs in the declared economy and create the incentive to work in the undeclared economy.	Johnson Kaufmann and Shleifer (1997), Johnson, Kaufmann and Zoido-Lobaton (2000), Schneider (2011).
<b>Public sector services</b>	Increase in the undeclared economy can be driven by lower tax revenues that in their turn then influence the quantity and quality of the offered goods and services in the public sector and this can lead to the increase of taxes for individuals and firms, in spite of deterioration	Johnson, Kaufmann and Zoido-Lobaton (1998) Feld and Schneider (2010).

<sup>17</sup> Schneider, K. (2015) - Outside the State – the Shadow Economy and Shadow Economy Labour Force.

	in the quality of public goods. The consequence is even stronger incentive to take part in the undeclared economy. Countries with higher tax revenues that are achieved with lower tax rates with less regulations, better rule of law and lower corruption level have a lower level of undeclared economy.	
<b>Tax Morale</b>	Efficiency of the public sector has an indirect effect on the scale of undeclared economy because it influences the tax morale. Taxpayers are more inclined to pay taxes honestly if they get valuable public services in return. However, taxpayers comply more in case that this principle does not operate if the application of legislation is fair. Better tax morale and social norms can lead to the reduction in the probability that individuals will work in grey economy.	Feld and Frey (2007), Kirchler (2007), Torgler and Schneider (2009), Feld and Larsen (2005, 2009).
<b>Intimidation</b>	In spite of the strong emphasis on intimidation in public policies aimed at the reduction of undeclared work, a very small number of empirical researches dealt with this issue. Certain number of empirical studies has shown that punishments do not have any negative effect on the undeclared economy, while the subjective assessment risk of registering irregularities does have an impact. Granger causality test shows that the scale of undeclared economy has an impact on the intimidation policy, i.e. the higher share of undeclared economy is the more is the government policy based on promoting penal policies, while the policy of intimidation itself does not have an impact on the reduction of undeclared economy.	Andreoni, Erard and Feinstein (1998), Pedersen (2003), Feld and Larsen (2005, 2009), Feld and Schneider (2010)

Source: Schneider, K. (2015) - *Outside the State – the Shadow Economy and Shadow Economy Labour Force*.

The active population in Montenegro as key motives for participation in undeclared economy identifies the following: low standard of living, i.e. poverty, economic crises and: unemployment, state policy and work of the state bodies, high taxes and contributions (IPSOS, 2014). When assessing the factors that drive the employers not to declare their employees, members of the working population say that the key factors are poor business results that make it impossible for them to operate fully in the declared economy (39%) and high taxes and contributions (34%). Employers share the same view on the motives for undeclared engagement - poor business results (46%) and high taxes and contributions (36%).

Undeclared employees consider the business environment unfavourable, particularly for small companies, and that stricter penalties would only lead to closing of those companies that would not be able to operate in full compliance with the law and that too high penalties

would have negative consequences both for the employers and for the undeclared employed persons.

Businesses consider that the key reasons for the undeclared economy are as follows (UNDP, 2016):

- numerous and high para-fiscal burdens (82% of the employers )
- poor business results (81% of the employers)
- high taxes and contributions (75% of the employers)
- high severance pays that have to be paid to the employees in case of dismissal (66% of the employers)
- long period that the state has for VAT refund (64% of the employers)
- possibility for the employees to use social support and other benefits intended for unemployed persons (64% of employers)
- short period that the law allowed for fixed-term employment - 2 years (58% of the employers)

Over 50% of employers consider that benefits from undeclared employment are higher than the threatened penalties. Observing listed reasons for undeclared work, it is clear that the burden of declared work is too high, but also employers perceive that there is a low probability that they would be punished anyway. On the other side, employers expressed their willingness to formalize work and employees if the tax rates and contributions were lower and if they could be ensured that legislation would be applied equally to everyone.

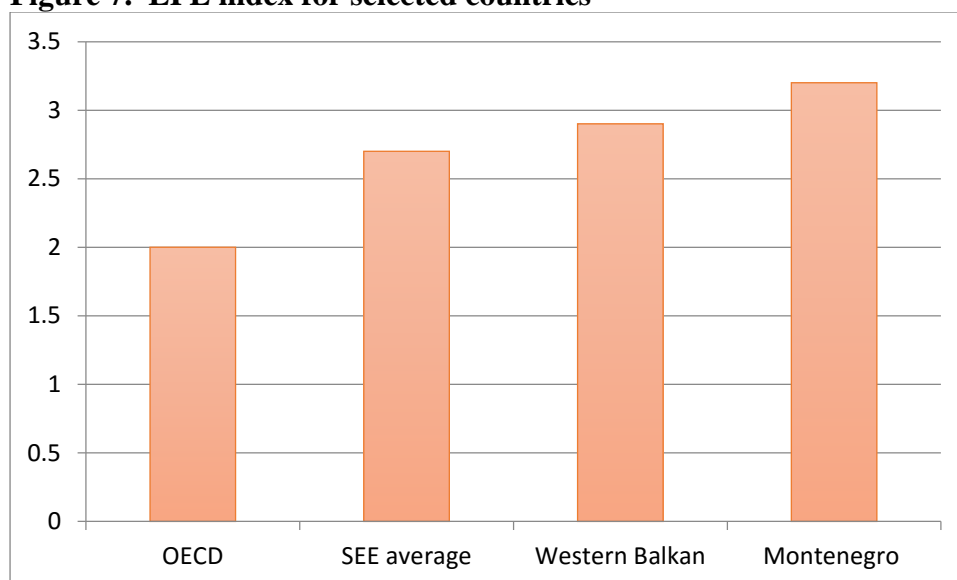
Correlation shows the direction of the changes in the employment in the declared sector under the influence of the change in the tax burden (Katnic, 2016). Correlation between the tax burden and the total number of formally employed persons in Montenegro is negative and statistically significant, indicating that every increase in the tax burden influences negatively employment in the declared sector. The negative correlation between employment in the formal sector and tax burden indicates to the fact that the reduction of tax burden increases employment in the declared sector.

In addition to the direct impact of the level of tax rates on declared and undeclared employment, regulation also has a significant impact on employment. Rigid regulation on the labour market is identified as one of the factors that are decisive for undeclared engagement of employed persons. The situation on the labour market of Montenegro confirms the relevant theoretical and empirical findings (Heckman, Pages, 2004, Lemos 2007, Djankov, 2002) that regulation in the labour market has an influence on the scale of undeclared work through high costs of job certainty (costs of dismissals), level of the minimum wage, regulation of wage, etc.

The level of employment protection in Montenegro is relatively high in comparison to the countries of EU and OECD members, since it amounts to 3.2 (in the range from 0 to 6, where 0 is flexible regulation and 6 is the rigid one). Additionally, the Severance Pay Generosity Index (Dolanc, 2012) shows that among the countries of South-East Europe, Montenegro has

the most generous severance pay system.<sup>18</sup> This generous severance pay system influences the reductions in dismissals on one side, and the smaller volume of generating new jobs or opening of the jobs in the undeclared sector. Additionally, the generous severance pay system reduces the intensity of flows in the labour market and discourages the employers in introducing new technologies. It also decreases productivity and economic growth (Holzman, Vodopivec, 2012).

**Figure 7. EPL index for selected countries<sup>19</sup>**



Source: wiiw (2009)

Results of the protection of employment in the labour market (OECD, 2004) are primarily the lack of mobility in the labour market, lower activity rate, higher volume of long-term unemployment and the low rate of compliance and high share of undeclared economy in the labour market. All the listed consequences of rigid employment are present in Montenegro.

Institutional theory defines institutions as cognitive, normative and regulatory structures that provide stability and meaning to the social conduct (Scott, 2005). Formal institutions are codified in laws and rules, while informal institutions represent the norms, convictions and values cherished by individuals and reflect individual attitudes about what is right and not subject to legal sanctions. Informal institutions can be complementary to the formal institutions and they can also be in a mismatch with formal institutions. If there is a synergy between formal and informal institutions, the undeclared economy will be much lower and citizens will comply with the legislation. Reasons for non-compliance with the legislation can be found in the fact that formal rules are too complicated so that citizens unintentionally do not comply with them.

<sup>18</sup> The Severance Pay Generosity Index is measured on the basis of the amount of severance pay after one year of work, 5 years of work and 10 years of work. The value of the index is the number of weekly wages per year of work that employed person is entitled to in case of termination of labour contract.

<sup>19</sup> Wiiw (2009) – Study on Adjustment Capacity of Western Balkan Countries to External Shocks





Tax morale or attitude of citizens towards payment of taxes shows how citizens see tax evasion as an acceptable or unacceptable practice. The tax morale index ranges between 1 and 10, where 1 means that tax evasion is absolutely unacceptable, while 10 means that tax evasion is absolutely justified. The value of the tax morale index for the EU Member States was calculated on the basis of the Eurobarometer survey from 2013 - citizens allocated numbers from 0 to 10 to the question of whether it was acceptable to cheat when paying taxes and whether there was any justification in individual cases.

The average value of the tax morale index for EU-28 is 2.29, which means that citizens of the European Union consider evasion of taxes to be socially unacceptable behaviour. On the basis of the data on the participation in the undeclared economy and the value of this index it was established that there is a statistically significant link between the percentage of the participation in the undeclared economy and tax morale (Williams and Horodnic, 2015).

The Tax Morale Index for Montenegro (Katnic, 2016) shows that 80% of the Montenegrin consider tax evasion as unacceptable and therefore the value of the index for Montenegro is 2.73. However, in spite of the fact that failure to pay taxes and contributions is socially unacceptable, it still is a very significant practice of employers and self-employed persons.

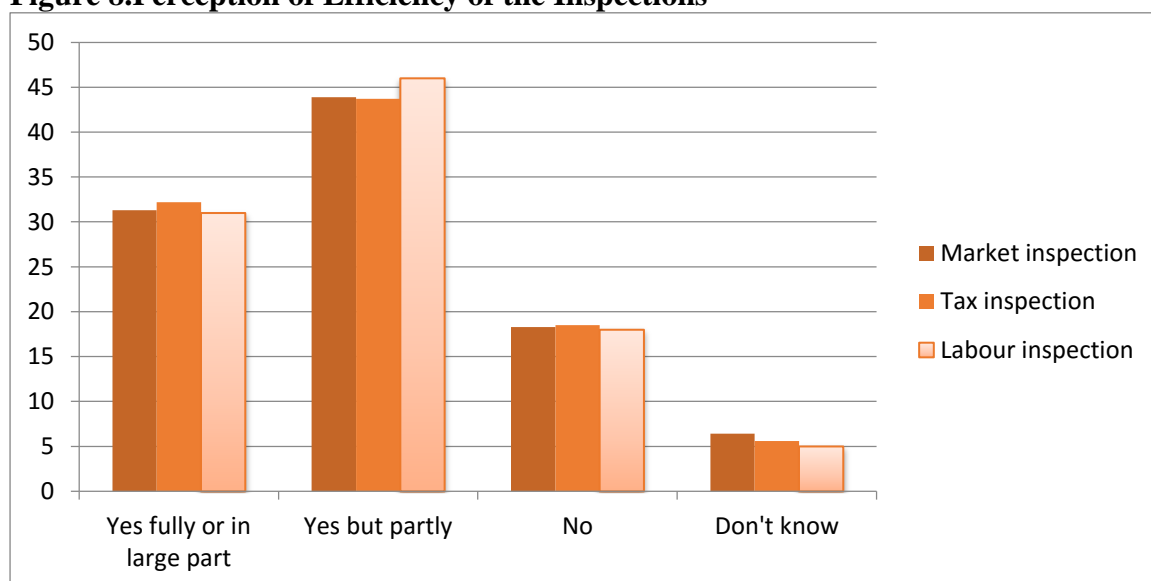
The scale of the undeclared economy also depends on the efficiency of institutions as well as on the belief of the citizens that in the application of the law they will be treated equally. Efficiency of the institutions also depends on how much the formal institutions correspond to the attitudes of the population. The research has shown that 58.5% of the population of working age think that companies that employing persons undeclared will be detected. The same respondents also think that the probability that such companies will be punished is 87.6%, while they think that the probability that they will actually pay the penalty is 88.7% (IPSOS, 2014).

The IPSOS survey showed that only one third of citizens of working age consider that inspections are capable to fully or partly detect undeclared work. About 46% of the respondents believe in the efficiency of the labour inspection bodies, while the remaining 33% do not think that the labour inspection bodies are successful in detecting undeclared labour.

Labour inspection visited two thirds of the respondent companies in 2014, imposed sanctions on 20% of them, most frequently to the companies with undeclared employed persons. In half of the cases the employers were of the opinion that the penalties are appropriate; approximately one quarter thought that the penalties were mild, and approximately one fifth that the penalties were too high. About 15% of employers say that they managed to avoid paying the penalty imposed by the inspection.

Particular attention should be dedicated to the practice and conduct of the inspection, in terms of their approach to the objects of inspection and (not) imposing penalties. An increasing number of employees complain against different interpretation of legislation by the inspection, depending on individual inspectors and against a large degree of the discretion on the side of the inspectors.

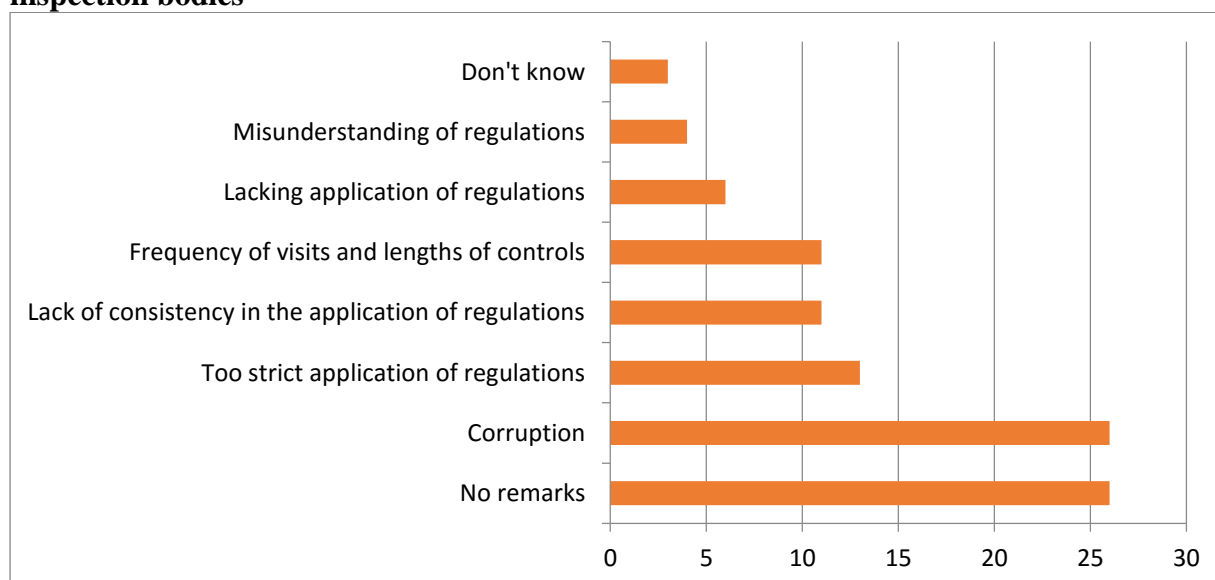
**Figure 8. Perception of Efficiency of the Inspections**



**Source:** IPSOS (2014), *(Informal Employment and Grey Economy in Montenegro)*

The working population has a similar perception of the efficiency of the tax and market inspection in detecting undeclared work as they have of the labour inspection. However, given the mostly positive perception regarding the efficiency in detecting undeclared work, only 26% of employers do not have any remarks about the work of the inspectors.

**Figure 9. Complaints of the employers in the private sector against the work of the inspection bodies**



**Source:** IPSOS (2014), *(Informal Employment and Grey Economy in Montenegro)*

The perception of a quarter of employers is that the inspectors are susceptible to corruption. 24% of employers complain that the inspections implement the legislation strictly (13%) and inconsistently (11%), while 11% of employers think that the inspectors spend unjustifiably



long time in their controls. The problem for 6% of employers is that legislation is not applied, while 4% of the employers think that the inspectors do not know the laws.

The above results indicate to the perception of the population that the inspections (labour, tax and market inspections) have the capacity to detect undeclared employment and undeclared activities, however the expectations from the successful controls are significantly lower. Also, when the work of inspection in Montenegro and their plans of work and reports are analysed, the impression is that the emphasis is on the strategy of "intimidation" and punishment, as well as that insufficient attention is dedicated to education of the incumbent entities. Education of the incumbent entities becomes particularly important in the environment of intensive regulatory activity, as it is the case with Montenegro and in the time of amendments to legislation with a view to ensuring harmonization with the European legislation.

## **5. ORGANISATION OF THE FIGHT AGAINST UNDECLARED WORK IN MONTENEGRO: INSTITUTIONAL FRAMEWORK**

### **5.1 Responsibilities of government ministries**

First national policies dealing with the issue of undeclared work, including the fight against undeclared employment, were designed in the Economic Reform Agenda 2002-2005. Later, the fight against undeclared economy was in the National Strategy of Employment and Development of Human Resources 2007-2011 as well as in action plans following the strategy. The institutional framework in combating undeclared economy included the following bodies:

- Ministry of Labour and Social Welfare
- Ministry of Finance
- Employment Office
- Labour Inspection later Inspection Administration
- Tax Administration
- Ministry of Interior

The measures of combating undeclared economy were related to the reduction in the costs of doing business, reduction in the administrative and tax burden and the strengthening of the control by the state aimed at eliminating undeclared employment. Implementation of these measures included the weakening of the motivation to employ workers undeclared and reducing the tax burden on salaries of employees in order to encourage employment. The reduction of the tax burden on salaries created an incentive for reductions in undeclared work and for improvement of the business environment. However, all these measures mainly contributed to creation of new jobs in the declared economy, while the number of undeclared employees more or less remained constant over time. By 2011, the impact of policies on combating the undeclared economy i.e. securing transit from undeclared to declared work was mostly weak because the process of implementation was limited. This conclusion is also supported by the ILO report from 2011, which identified these problems as:



- Insufficient authorities and poor financial position of the inspection services, as well as the lack of human capacities for adequate work;
- Insufficient role of all social partners in the process of developing policies and still inefficient work of the social councils;
- The system of education not aligned with the needs of the labour market;
- Out-dated and inefficient legislation;
- Responsibility and leadership not properly defined, etc.

Having in mind the identified weaknesses, starting from 2012, the Ministry of Finance took a leading role in the fight against the undeclared economy. In addition to this, having in mind the complexity of the undeclared work problem, as well as the lack of clarity in the work of inspections supervising the market of goods and services, the Government of Montenegro decided to merge all inspection functions into single inspection authority. Inspections have been merged into a single Inspection Authority since 2012; however, tax inspection and customs inspection remained within Tax and Customs Administration respectfully. Assuming the leading role in combating undeclared economy, the Ministry of Finance has established a work team, led by the Minister of Finance, composed of all relevant institutions including the Ministry of Labour and Social Welfare, Inspection Authority, Tax Authority, Customs Administration, and Police Authority. Later revision in the membership of the work team included associations of employers, representatives of trade unions, and Parliament. The work team/ committee for combating undeclared economy in 2017 reduced membership to solely government representatives. The committee is chaired by the vice-president of the Government for economic policy, while members are representatives of Ministry of Finance, tax, customs, police and inspection authorities.

The set of measures for combating the undeclared economy has been defined in the action plan for every year, including the measures necessary for strengthening institutional capacities and human resources of the state administration bodies responsible for control and collection of revenues. Within the Administration for Inspection Affairs, the Labour Inspectorate has been conducting direct inspection control of all employed persons, i.e. inspection control of the implementation of laws, secondary legislation and other regulations in the field of labour, employment, and safety and health at work. Labour Inspectorate undertook preventive measures and repressive measures against the undeclared economy.

The action plan for combating the undeclared economy for 2013 (and every plan after that) envisaged a very ambitious slogan “zero tolerance of undeclared work” and includes a range of measures primarily aimed at enhancing penalties, increases in excise taxes, tighter and more frequent controls, change in regulatory framework and improvement of IT systems. Government reports indicated that fiscal discipline improved, having in mind an increase in revenues.<sup>20</sup> However, since VAT and personal income tax have increased, it is very difficult to actually assess the impact of the measures.<sup>21</sup> The action plans for 2014, 2015 and 2017

---

<sup>20</sup> In 2013 the budget revenues increased by 117.5 million euro or 10.4% in comparison to the level from 2012.

<sup>21</sup> VAT rate increased from 17% to 19% and personal income tax rate from 9% flat rate changed into progressive taxation with rates 9% and 15% for income that is above average wage in Montenegro.

focused on legislative and operational activities, strengthening of institutions (IT capacities and human resources), as well as education and cooperation.

On the other hand, when it comes to key institutions and improvement of their capacities, which was envisaged in the Action plans, with the leading role of Ministry of Finance, some of the key measures aimed at combating the undeclared economy are implemented by the Inspection Authority, and two authorities that are organisational units of the Ministry of Finance - Tax Authority and Customs Authority.

The capacities of the inspection services have increased slightly over past 4 years both in terms of allocated budget as well as in term of staff numbers. The number of labour inspectors has increased by 12.9% while the number of inspectors engaged directly on activities for combating undeclared work has increased by 20% in the past four years.

**Table 6. Capacities of Inspection Administration**

	2015	2016	2017	<u>2018<sup>22</sup></u>
<b>Total number of employees</b>	310	310	233	264
<b>Inspectors</b>	262	257	184	202
<b>Labour inspectors</b>	34	34	33	38
<b>Inspectors engaged on the activities that relate to detection of undeclared employment</b>	25	26	25	30
<b>Other staff</b>	48	53	49	62

Source: Tackling Undeclared Work Survey 2018

Also the budget allocations for the Inspection Administration is 15.5% higher in 2017 compared with 2015, while the share of expenditures oriented on control activities remained more or less constant amounting to roughly three quarters of overall expenditures.

**Table 7. Budget of the Inspection Administration, in mln €**

	2015	2016	2017
<b>Overall budget</b>	4.78	5.32	5.52
<b>Wage expenditures</b>	3.67	4.26	4.35

<sup>22</sup> Difference in total number of employees in Inspection Administration in 2017 and 2018 is result of organizational change and transfer of some inspections to line ministries.

Wages expenditures - inspectors	3.10	3.53	3.44
Wages expenditures - others	0.00	0.00	0.00
<b>Equipment</b>	0.07	0.11	0.21
Maintenance of equipment	0.05	0.08	0.08
Purchase of equipment	0.02	0.02	0.12
<b>Control related expenditures</b>	0.26	0.24	0.37
Expenditures for automobiles			0.09
Fuel expenditures	0.23	0.22	0.25
<b>Other expenditures</b>	0.10	0.07	0.17
Software expenditures	0.08	0.05	0.05
<b>Expenditures related to fight against undeclared economy as % of total</b>	<b>73.3%</b>	<b>74.0%</b>	<b>73.7%</b>

Source: Tackling Undeclared Work Survey 2018

In the case of Customs Administration inspection, capacities have increased by 20.9%, i.e. number of custom inspector increases by this percentage, while total number of employees remained more or less constant. Inspectors make approximately one fifth of the total number of employees in Customs administration. Employees in Customs Administration are not directly linked to detection of undeclared work. Their scope of work and area of inspection is more related to detection of undeclared economy in general and trade of excise goods.

**Table 8. Capacities of Customs Administration**

	2015	2016	2017	<u>2018</u>
<b>Total number of employees</b>	501	499	504	506
<b>Inspectors</b>	105	112	110	127
<b>Other staff</b>	396	387	394	379

Source: Tackling Undeclared Work Survey 2018

Budget allocations in the period 2015-2017 have remained more or less the same while inspection related expenditures averaged 8% in the past three years.

**Table 9. Budget of the Customs Administration, in € mln**

	2015	2016	2017
--	------	------	------

<b>Overall budget</b>	6.51	6.95	6.54
<b>Wage expenditures</b>	5.23	5.68	5.45
Wages expenditures - inspectors	0.10	0.11	0.11
Wages expenditures - others	5.13	5.57	5.34
<b>Equipment</b>	0.17	0.19	0.17
Maintenance of equipment	0.12	0.13	0.11
Purchase of equipment	0.05	0.05	0.05
<b>Control related expenditures</b>	0.02	0.02	0.02
Expenditures for automobiles	0.01	0.01	0.01
Fuel expenditures	0.01	0.01	0.01
<b>Other expenditures</b>	0.26	0.26	0.19
Software expenditures	0.26	0.26	0.19
<b>Expenditures related to fight against undeclared economy as % of total</b>	8.5%	8.3%	7.5%

Source: Tackling Undeclared Work Survey 2018

In the case of the Tax Administration, inspectors make roughly 27% out of total number of employees while number of inspectors increased by 7.3% in 2018 compared with 2015.

**Table 10. Capacities of Tax Administration**

	2015	2016	2017	2018
<b>Total number of employees</b>	536	568	558	612
<b>Inspectors</b>	150	155	155	161
<b>Other staff</b>	386	413	403	451

Source: Tackling Undeclared Work Survey 2018

The budget allocation of the Tax Administration follows a similar trend to the Customs Administration. However expenditures aimed at the fight against the undeclared economy made one quarter in 2015 and 2016 while increased to over 28% in 2017.

**Table 11. Budget of the Tax Administration, in € mln**

	2015	2016	2017
<b>Overall budget</b>	8.15	8.56	8.19
<b>Wage expenditures</b>	7.39	7.75	8.11

Wages expenditures - inspectors	1.62	1.66	1.76
Wages expenditures - others	5.77	6.09	6.34
<b>Equipment</b>	0.07	0.06	0.18
Maintenance of equipment	0.00	0.00	0.00
Purchase of equipment	0.07	0.06	0.18
<b>Control related expenditures</b>	0.07	0.07	0.08
Expenditures for automobiles	0.01	0.02	0.02
Fuel expenditures	0.06	0.05	0.06
<b>Other expenditures</b>	0.21	0.27	0.31
Software expenditures	0.21	0.27	0.31
<b>Expenditures related to fight against undeclared economy as % of total</b>	24.3%	24.1%	28.6%

Source: Tackling Undeclared Work Survey 2018

The capacities of inspection authorities as well as the allocated budget indicate that inspections have increased in capacities in terms of number of inspectors and in budget, or at least do not decrease. However, observing the share of total expenditures dedicated to combating the undeclared economy, especially tax and customs administration, it seems that the general cost of running institutions are high and that resources could be used more efficiently in general and especially when comes to the fight against the undeclared economy.

## 5.2. The role of social partners

Cooperation of social partners, employers' associations and trade unions in Montenegro is organised under umbrella of the Social Council of Montenegro. The Social Council is established as a tripartite body, made up of 11 representatives of the government, representatives of trade unions and of employers. According to the mandate of Social Council – establishment and development of social dialogue, status of employees and employers, support to peaceful resolution of disputes, and other issues that are related to socio-economic position of employees and employers – the Social Council has a mandate to discuss all relevant questions that relate to undeclared economy.

There are two national level trade union associations, both members of Social Council – Association of Unions Montenegro (SSCG), which gathers 23 branch level unions, and Association of Free Unions of Montenegro (USSCG), gathering 13 branch trade unions. Association of Employers of Montenegro (UPCG) is representative of employers. UPCG is representative employers association active since 2005.

There is additional organisation Chamber of Commerce, not a social partner, however very actively involved and contributing to policy making, including undeclared employment policies.

Association of Employers, Association of Unions Montenegro and Association of Free Unions of Montenegro and Inspection Authority have signed Cooperation Protocol on March 1<sup>st</sup> 2017. This protocol is aimed at improving cooperation among signatories in the area of protection of the labour market participants.

Both Chamber of Commerce and Association of Employers actively participate in law making process in Montenegro, in some cases as members of working teams and in some cases through ex-post assessments of government policies. When comes to labour market activities and fight against undeclared employment UPCG and Chamber of Commerce on the new Labour Law and Law on Foreigners as key activities that are relevant for combating informal employment in Montenegro. Both associations including trade unions were included in the work of the Government Committee on undeclared economy.

### 5.3. Towards a joined-up strategic approach

Since 2002 strategic documents in Montenegro recognize the issue of undeclared work and determine measures aimed at its reduction. Since 2012 these activities are formalised in the Action plan for combating the undeclared economy, where all activities are listed with the key institutions responsible. Action plans do not have goals or clearly set numerical targets, except the general statement – reduction of undeclared economy.

Survey - Tackling Undeclared Work Survey 2018, conducted among state bodies in charged for undeclared economy fight, and interviews with the representatives of these institutions indicated that there is no clear view on the goals. The question was:

*“How are the national targets for tackling undeclared work in your Member State best described?”*

- a. Common: There is one set of national targets for tackling undeclared work that is common across the whole of government*
- b. Shared: Some government departments/agencies have shared targets*
- c. Separate: Each government department/agency has its own targets.”*

Some respondents declared that the goals are common; some consider that goals are shared while some consider that each body has its own targets. However, observing government strategic documents and action plans, it is clear that there is no clearly set target for combating the undeclared economy. The documents and strategies mainly list activities aimed at combating undeclared employment. One of the reasons for not having clearly set goals and indicators to monitor performance is the lack of a consistent source of data on the undeclared economy. Official statistical agencies do not publish data on the undeclared economy so it is very difficult to set targets, especially numerical targets and to later monitor success of the implemented measures.



Joint strategic approach, having that there is a political will and cooperation might be implemented. However, there is a need to have a consistent source of data for setting numeric goals and monitoring success.

## 6. CURRENT POLICY APPROACH AND MEASURES: AN EVALUATION

The assessment of the current policy approach assessment is based on a review of government strategies, action plans and reports as well as on a survey among institutions involved in tackling the undeclared economy, namely the Tackling Undeclared Work Survey 2018, conducted in June 2018.

### 6.1. Direct controls: deterrence measures

Enhancement and increased frequency of controls is one of the constant activities in action plans aimed at combating the undeclared economy. Labour Inspection, as part of the Inspection Administration, is charged to control the application of the Labour Law and other relevant legislation. In the period from 2015 to 2017, labour inspection has conducted on average 10,000 controls per annum. The number of controls is highest in the activities that are marked in the surveys as most prone to undeclared work and that are influenced by the tourist season. Three sectors that are believed to traditionally have the largest percentages of undeclared work and at the same time are under a strong impact of seasonal work, especially the tourist season, are hotels and restaurants, the construction sector and trade.

**Table 12. Number of inspections conducted by the Labour Inspection**

Number of inspections	2015	2016	2017
<b>Overall number of inspections</b>	<b>10806</b>	<b>10063</b>	<b>9130</b>
Production and crafts	942	787	2.403
Hotels and restaurants	3.502	3.263	2.152
Trade	3.241	2.544	1.834
Construction	1.377	1.454	1.086
Manufacturing	430	461	307
Arts, entertainment and recreation			253
Education, information and communications	302	371	227
Health and social protection	251	240	144
Transport and storage	162	254	106



Financial activities and insurance			85
Financial, technical and support services	211	233	71
Administrative and supporting service activities			62
Science and technic activities			45
Electricity	18	108	36
Agriculture, fisheries and forestry	13	49	26
Mining			10
Other	357	299	283

Source: Tackling Undeclared Work Survey 2018

The regional distribution of controls also indicates that the highest frequency of controls is present during the summer season in the Southern region. There is a special regime for work of all inspection services during the tourist season, including police, tax and customs, since the probability for undeclared activity is highest during this season. Engagement of undeclared employees' (both residents and foreigners) during the summer season on the coast in hotels and restaurants and trade is a problem as well as engagement of both residents and foreigners on the jobs in the construction sector. Besides unregistered employment, the undeclared economy is manifested through non reporting or underreporting of turnover, failing to issue fiscal receipts to customers and smuggling excise goods.

**Table 13. Number of inspections by Labour Inspection by regions**

	2015	2016	2017
Overall number of controls	10.806	10.063	9.130
<b>Northern region</b>		2.434	2.123
<b>Central region</b>		2.926	2.762
<b>Southern region</b>		4.703	4.245

Source: Tackling Undeclared Work Survey 2018

Labour Inspection has detected 3085 cases of unreported workers in 2015, while the number has decreased by roughly one third in 2016 and 2017, where there was 1977 and 2065 registered cases of undeclared workers. Labour Inspection states that number of unregistered workers detected during controls or changes in the number is not good indication of trends in the undeclared work, given that labour inspectors can detect only those individuals that are present on the spot during control. This is especially having in mind limited capacities of inspection and number of employers/legal persons in Montenegro (over 30,000 companies).

**Table 14. Number of cases of unreported work by Labour Inspection by regions**

	2015	2016	2017
<b>Number of unreported workers</b>	3.085	1.977	2.065

Source: Tackling Undeclared Work Survey 2018

Tax Administration does not generate reports dedicated to undeclared workers having that unreported workers are discovered during usual full or partial tax controls. However, in 2015, the Tax Administration has conducted 4080 controls, in 2016 3837 controls and 3807 full or partial tax controls in 2017. These controls included control of accuracy in reporting, calculation and payment of taxes and contribution on wages. Tax authorities detected unreported work of foreigners holding work permits issued by Employment Agency of Montenegro. In 2015, following order by tax authorities, 708 foreign workers is registered for payment of taxes and contribution, 1678 in 2016 and 1959 in 2017.

### 6.1.1. Penalties and sanctions

The institutional approach to combating undeclared work in Montenegro is rather based on intimidation and penalty policy, as well as on the additional regulation aimed at combating the undeclared economy. One of the basic goals, in addition to the goal of reducing undeclared employment, was to increase budget revenues. Action plans for combating undeclared employment in the period from 2013 to date are more focused on stricter penalties, increased frequency of controls, imposing fines and sanctions, followed by changes in regulatory framework enabling such policies. Repressive policy aimed at formalization, without adjustments in the formal institutions and gradual formalization, would mean the increase in poverty, since incomes from undeclared activities have a significant impact on poverty reduction (Katnic, 2016).

**Table 15. Policy measures used in Montenegro**

	Policy measures used		Policy measures used in Montenegro						
	Yes	No	Inspection Administration	Labour Inspection	Police	Tax Administration	Customs Administration	Other	Social partners
<b>Use of penalties and fines for companies</b>	x		x	x		x	x		
<b>Use of penalties and fines for purchasers</b>		x							
<b>Use of 'blacklists'</b>	x					x			

Source: Tackling Undeclared Work Survey 2018

Observing policy measures used in Montenegro, all inspection services use a system of fines and penalties for companies. Police administration actions, which are engaged in the cases of work of non-residents, relate to cancelling residence permits. The Tax Authority in addition to penalties and fines publishes both Black and White List of taxpayers.

Table 16. Imposed sanctions and fines by Labour Inspection

Sanctions	2015	2016	2017
Order to correct irregularity	1897	1257	1193
Order to remove irregularity	72	47	37
Temporary prohibition of work	3	3	2
Monetary fines (number of cases)	2590	2033	2272
Amount of fines	942.660,00 €	950.150,00 €	1.115.200,00€
Initiation of misdemeanour procedure	16	7	3

Source: Tackling Undeclared Work Survey 2018

The penalty policy has a certain sequencing of actions. First comes the order to correct an irregularity, for example in the case when unregistered work is detected inspection issues an order to register employees. If the company does not obey, the following action is an order to remove the irregularity. If employer fails to remove the irregularity, then inspection issues a prohibition of work for a certain period until the order of inspection is obeyed.

### 6.1.2. Detection measures

Formal nomination of the Committee for combating undeclared economy assumed coordinated approach to combat the undeclared economy in general and as well undeclared employment of domestic and foreign labour.

Table 17. Policy measures used in Montenegro for detection

	Policy measures used	The department primarily responsible for each policy measure

	Yes	No	Inspection Administration	Labour Inspection	Police	Tax Administration	Customs Administration	Other	Social partners
Data matching and sharing	x				x	x	x	x	
Workplace inspections	x		x	x		x			
Registration of workers prior to starting work or on first day/week of work	x					x			
Coordination of strategy on undeclared work across government departments	x		x	x	x	x	x	x	
Coordination of operations across government departments (e.g., joint operations/workplace inspections)	x		x	x	x				
Data mining		x							
Use of peer-to-peer surveillance (e.g. telephone hotlines to inform about abuses/cases)	x		x	x		x			
Certification of business, certifying payments of social contributions and taxes		x							
Use of mandatory ID in the workplace	x		x	x					
Supply chain responsibility		x							

Source: Tackling Undeclared Work Survey 2018

One of the most coordinated approaches to tackling the undeclared economy is in relation to reducing the unregistered work of foreigners. Every year a large number of employees is engaged during the summer and construction season, a number that equals almost to one quarter of Montenegrin labour force. The majority of these employees are foreign workers. State bodies involved in process of issuing residence and work permits share data among each other (Police Authority and Employment Agency of Montenegro) and sends data to the Tax Authority for validation of registration for tax purposes. When it comes to work of domestic labour during season, the Employment Agency of Montenegro has a set of incentives for hiring and registering domestic workers. Each of the inspection services has a special hotline for reporting irregularities as well as getting various information on application of regulations. Also, during the tourist season and construction season, inspections are sometimes organised as joint inspection of several inspectors covering tax, labour and health and safety regulations. Moreover, in some activities such as in hospitality and the trade sectors, workers are required to have ID's. However, despite all these activities, having in mind that inspection can control only those that are present on the spot, inspections

face serious limitations in the detection of undeclared work. Also, modernisation of inspection work, use of modern technologies and more active data sharing and data mining could contribute to better efficiency.

## 6.2. Direct controls: supply-side incentives

Although the scale of the undeclared economy is significant, Montenegro does not have any system of incentives that would be focused on the formalization of economic activities. However, there are a number of other measures in the field of employment policy and tax policy that can be at the same time seen as measures for formalization.

**Table 18. Policy incentives used in Montenegro**

	Policy measures used		The department primarily responsible for each policy measure						
	Yes	No	Inspection Administration	Labour Inspection	Police	Tax Administration	Customs Administration	Other	Social partners
Service vouchers		<b>x</b>							
Targeted direct tax incentives (e.g., income tax reduction/subsidy)		<b>x</b>							
Targeted indirect taxes (e.g., VAT reductions)		<b>x</b>							
Initiatives for customers to request receipts (e.g., Lottery for receipts)		<b>x</b>							

Source: Tackling Undeclared Work Survey 2018

Higher spending on active labour market policies (ALMPs) should support formalization on the side of the supply and on the side of the demand of labour. On the side of supply, the active policies increase the flows from unemployment into formal employment (Hazans, 2011). Empirical findings about the effects of the active measures to employability produce various results and primarily depend on the design of the active measures (Card et al, 2009).

In Montenegro, the overall spending on ALMPs was about 0.5% of the GDP before 2011, when as a part of the measures of the fiscal savings, this spending was cut in half and in 2012 and 2013 the spending on active policies fell to 0.1% of GDP. However, in 2013, the programme for professional training of persons with a university degree started, with roughly 4,000 participants per year and an annual cost close to €10 million. The spending on active



measures in the labour market, thanks to this program, reached the level of 0.5% GDP again. This level of spending on active measures is high if we compare it to that of other countries in the region, although it is slightly lower than the EU average. However, the structure of spending by type of programme and characteristics of participants changed significantly, since persons with university degree make 80% of the total number of beneficiaries of active measures.

### 6.3. Direct controls: Demand-side incentives

Tax subsidies for employers represent a tax credit for employees that employ for the first time employees from certain groups. Subsidies assume exemption from paying income tax and employers' share of contributions for compulsory social insurance. Employer can use this subsidy if he or she employs person registered in the Employment Office as unemployed, if such person is older than 40, member of RAE population<sup>23</sup>, employed for more than 5 years, finished a traineeship period and is to be employed for an unlimited term, as seasonal worker, is the beneficiary of the allowance for unemployed persons with over 25 years of service and in other cases.

Through a special programme the Government subsidizes contributions for social insurance for registered farmers. Registered farmers are obliged to pay contributions for social insurance on the fixed basis of 20% of the average salary, while the remaining contributions of 40% of the average salary, which is currently the amount of the minimum wage, are subsidized by the state.

The Law on Social and Child Care (2013) envisages stronger cooperation between the Employment Office and social welfare centres with the view to activating beneficiaries of the material allowance for families<sup>24</sup>. These beneficiaries who are able to work have to be registered in the Employment Office and accept offer of a job, training, retraining and additional training if they do not want to lose the right to material allowance for families for at least a year

**Table 19. Policy incentives used in Montenegro**

	Policy measures used		The department primarily responsible for each policy measure						
	Yes	No	Inspection Administration	Labour Inspection	Police	Tax Administration	Customs Administration	Other	Social partners

<sup>23</sup> Romani, Ashkali and Egyptians

<sup>24</sup> Social assistance benefit

Simplify procedures for complying to existing regulations (e.g., easier registration procedures; simplify forms; reduce duplication)	x					x			
Society-wide amnesties		x							
Individual-level amnesties for voluntarily disclosing undeclared activity		x							
'Formalisation' advice to start-ups	x							x	
'Formalisation' support services to existing businesses		x							
Direct tax incentives (e.g., exemptions, deductions)		x							
Targeted VAT reductions		x							
Provide free record-keeping software to businesses		x							
Provide fact sheets on record-keeping requirements		x							
Provide free advice/training on record-keeping		x							
Gradual formalisation schemes		x							
Initiatives to ease transition from unemployment into self-employment	x								
Initiatives to ease transition from employment into self-employment		x							
Providing businesses with access to free marketing (e.g., at trade fairs)		x							

Source: Tackling Undeclared Work Survey 2018

Undeclared work gives significant incomes to individuals and job opportunities in the situation where supply of vacant jobs in the formal sector is limited. Disposable salaries in the undeclared sector are just slightly lower than the salaries in the formal sector (UNDP, 2016), thus, under assumption of constant cost for employers, the formalization would reduce disposable salaries to individuals by approximately 40% (tax wedge on labour cost).

Self-employed persons make roughly 50% of undeclared employees. They have an average income that is close to statutory minimum wage. Formalization of these jobs would mean that individuals would be deprived of at least 50% of their total income and they would get prospects of a pension instead. Since individuals, particularly younger people, value more the



present than the future, voluntary formalization is not much probable for this group of undeclared employed persons.

The key costs of the companies for the formalization process include the increase in expenditures for paying taxes and other fees and compensations, as well as the increase in the administrative costs, since formal economic entities are obliged to keep accountancy records and to prepare various types of reports for institutions. In addition to these costs, the direct costs of compliance with rigid regulations would also be increased - applying minimum wage, severance pay in case of termination of employment contracts, compensations for vacations, sick leaves, additional payments for night work, overtime and work on holidays. These are lower or non-existent in undeclared work (Arandarenko, Simović, 2015). For individuals, the costs of formalization primarily include the reduction of available income and limitations in terms of engagement in additional activities, since they would have to request a formal approval by the employer.

## 6.4. Indirect controls

### 6.4.1. Altering informal institutions: Awareness raising campaigns

In addition to the activities aimed at improving the legislative framework and capacity of institutions in combating undeclared work, in the recent period significant activities have been undertaken with a view to raising awareness and improving knowledge of citizens about the undeclared economy.

**Table 20. Policy measures used in Montenegro – awareness raising**

	Policy measures used		The department primarily responsible for each policy measure						
	Yes	No	Inspection Administration	Labour Inspection	Police	Tax Administration	Customs Administration	Other	Social partners
Campaigns to inform suppliers of undeclared work of the risks and costs of working undeclared	x		x			x		x	
Campaigns to inform suppliers of undeclared work of the benefits of formalising their work (e.g., informing them		x							

where their taxes are spent)									
Campaigns to inform users of undeclared work of the problems of purchasing goods and services from the undeclared economy	x					x			
Campaigns to inform users of undeclared work of the benefits of declared work (e.g., informing citizens of the public goods and services they receive with the taxes collected)								x	
Normative appeals to businesses to operate on a declared basis	x								
Measures to improve the degree to which customers of enforcement agencies believe they have been treated in a respectful, impartial and responsible manner		x							
Measures to improve tax/social contributions/labour law knowledge		x							

Source: Tackling Undeclared Work Survey 2018

During 2011, the Ministry of Finance launched the campaign "VAT is your money". It was aimed at reducing the undeclared economy in the field of issuing fiscal receipts through intensified inspection control and support of the public to the campaign. In 2011, visible results were recorded in terms of the increase of revenues from VAT and increase in the number of taxpayers and VAT payers.

In 2013, the Government of Montenegro started implementing the project "Including citizens in combating grey economy" which was implemented in cooperation with the Faculty of Electrical Engineering from Podgorica, UNDP and with the support of the British Embassy in Podgorica. This project ensured easy engagement of citizens in combating the undeclared economy through the mobile application "Be Responsible" that was used by more than 3,500 of users. The campaign that was conducted within this project led to the increase in the awareness about the negative sides of the undeclared economy. Primarily the campaign "Be Responsible! It's up to you! Grey economy 0%" that was conducted in the period from 2013 to the end of 2014, resulted in significant engagement of citizens in combating the undeclared economy. In this period the citizens, namely, lodged about 5,000 reports indicating undeclared employment, failure to issue fiscal receipts and other irregularities in the market.



As the result, on the basis of the imposed penalties, about €550,000 was collected. In addition to this, the campaign also promoted the call centre of the Administration for Inspection Affairs and Tax Administration. The goal was to facilitate and simplify the information and involvement of citizens and to promote work of the relevant inspection services.

Along with this campaign, the Ministry of Finance started the campaign "Speak up! - Reveal Grey Economy!" („Na sva zvana siva zona -ukaži na sivu ekonomiju!“) in order to achieve an active role of citizens in the process of combating the undeclared economy, primarily through indicating failure to issue fiscal receipts, avoiding paying excise duties, illegal employment, illegal construction and other irregularities. The campaign facilitated communication between citizens and relevant services by providing a telephone hotline in the Tax Administration and Administration which was free of charge to call.

#### 6.4.2. Reforming formal institutions

In spite of significant improvements in the regulatory framework in Montenegro since 2000, it is still inflexible. It is characterized by large administrative barriers, some of them being a consequence of unselective transposition of the EU legislation that is not adjusted to the local economic circumstances. Some regulatory policies are absolutely contrary to the incentives for formal employment.

The structure of undeclared workers (mostly older persons) shows that by providing privileges to certain groups (early pensions, disability pensions, social transfers etc.), the system creates motivation and an environment for a high percentage of undeclared workers.

Members of the working population and employers have contradictory opinions about Montenegrin labour legislation. According to the Survey results, the working population in Montenegro dominantly thinks that the rights of workers are endangered, and 79% of the working population thinks that the Labour Law protects the interests of the employers more than the interest of the workers, while 13% is of the opinion that the Labour Law is more on the side of the workers. Opinions of the representative of companies are different - the group of those who think that the Law protects the rights of the workers more is approximately the same in size as the group of those who think that the Law is more on the side of the employers (43%).

Unions of employers in Montenegro agree that labour legislation is focused on the protection of employed persons in their workplaces and that it does not promote flexibility, new forms of labour and mobility, as the key elements for enhancing skills and competencies of employed persons (i.e. human capital). They see labour legislation and related regulations in the field of labour relations as a "significant obstacle to achieving maximum effects of capital investments and creative work of employed persons." The need to improve labour regulations in Montenegro is also recognized in the reports of the relevant international organizations. The document "Preparation for Prosperity" (World Bank, 2013) notes that the ability of the economy to respond flexibly to changes is extremely important for economic results and that flexibility is higher if employed persons are not "entrapped" in narrow specializations and if they are prepared for mobility and acquisition of new skills. In one of the conclusions, it is



noted that the Government should continue improving its regulation of the labour market in order to avoid disincentives to the generation of new jobs. The Montenegro 2018 Report of EU Commission states that Montenegro needs to “improve labour market flexibility to boost participation rates and reduce informality”.<sup>25</sup>

Countries with higher tax revenues that are achieved with lower tax rates with less regulations, better rule of law and lower corruption level have a lower level of undeclared economy. Efficiency of the public sector has an indirect effect on the scale of the undeclared economy because it influences the tax morale. Taxpayers are more inclined to pay taxes honestly if they get valuable public services in return.

A significant source of growth of the burden of legislation, and in such a way also an encouragement for doing business in an undeclared zone, is the uncritical and non-selective "copying" of international practice with a view to achieving faster integration in international organizations and initiatives.

It is important to continue the process of reform of public administration and the process of regulatory reform that will not necessarily mean less employees in the public sector and smaller volume of regulations, but that will lead to the professional, non-discretionary and efficient work of employees with the regulations that are understandable and applicable. There is something that seems to be even more important than the initiative to abolish unnecessary laws and that is to prevent the adoption of new, illegible and inapplicable laws that are in collision with the existing ones.

Since 2004, tax policy reforms, primarily the reform of taxation of income and profit, have had a positive impact on the tax morale and scale of the undeclared economy. Available data show that the scale of undeclared employment in absolute figures is rather constant, while there is a significant growth of declared employment.<sup>26</sup> The consequences of the decrease in the total tax burden on the labour costs<sup>27</sup> are manifested in the increase of the tax discipline and growth in the collection of the income tax. Reduction in the effective tax rate in the period from 2004 to 2008 by approximately 10 percentage points resulted in the growth of income from the income tax of almost 100%. In addition to the effective income tax rate, in the period since 2004 the total tax burden on the labour costs has been reduced also through the reduction of the rates for contribution for compulsory social insurance (from the total of 24% to 20.5% for pension insurance and from the total of 14% to 12.3% for health insurance, whereby a half of the costs were paid by the employer and half by the employee).<sup>28</sup>

---

<sup>25</sup> <https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/20180417-montenegro-report.pdf>

<sup>26</sup> In the period since 2002 the effective tax rate has been reduced by 10 pp (or approximately by one fifth), while formal employment increased by approximately one quarter (23.7%)

<sup>27</sup> Tax burden of the labour costs is an indicator of the ratio between the costs for net salaries and compulsory taxes and contributions. Tax burden shows how much of 1 euro spent on the labour costs goes to the employed persons, and how much is paid in form of taxes and contributions.

<sup>28</sup> In 2010 the structure of burden changed. The contributions that are to be paid by the employee increased, while those to be paid by the employer declined. This change led to the situation that majority of the employers kept the net earnings on the constant level and increased the gross salaries,

In spite of the reductions of the tax burden on labour costs effected in the last decade, the tax burden in Montenegro is still 3 percentage points higher than the average in the European Union (36.7%) and it is 4 percentage points higher than in the countries that are members of the Eurozone (35.5%). The average tax burden of the labour costs in Montenegro is by 5 pp higher than the average for the OECD Member States (34.8%) that are the most developed economies in the world. This difference is even more significant if we compare the reliefs and exemptions that are applied in the tax regulations of developed countries and those applied in Montenegro.

In addition to the amount of the tax burden, the administrative burden-cost of paying taxes is also a particularly important part of the tax system from the perspective of formalization. Relevant studies show that in Montenegro it is very complicated to pay taxes, particularly if you are an individual or a self-employed person. One of the sub-indicators of the Ease of Doing Business Index is paying taxes index.<sup>29</sup> If we observe only the total tax rate as a percentage of profit, then Montenegro is ranked 23rd out of 198 countries. However, if we include the indicators of the number of payments, procedures and the time required for calculating, reporting and paying taxes, Montenegro is in 98<sup>th</sup> place out of 189 countries. An average, small enterprise spends 320 hours a year to comply with the tax legislation.

#### 6.4.2.1. Modernising governance

Strengthening of the efficiency of institutions and strengthening of the trust in the institutions means the reduction of differences between formal and informal institutions. The practice recorded globally is that the enforced compliance with the legislation using strict rules, definition of procedures, centralized control and supervision, based on a "cops and thieves" approach, results in low trust and is not always effective at reducing non-compliance (Williams and Horodnic, 2015).<sup>30</sup> Given the limited reach of such policy, reflected in the maintenance and negligible reduction in the scale of undeclared work in the economies worldwide, the recommendation is that the approach of the state has to change significantly and that the approach where the culture of trust is cherished, as well as high dedication and alignment with the beliefs of the individuals has to be taken.

Since the scale of the undeclared economy can be reduced only through the reduction of asymmetry between formal and informal institutions, changes have to be made within both the formal and informal institutions. Changes in the informal institutions i.e. in the attitudes and perception of citizens about the benefits and threats of undeclared work can be achieved through the following:

- Increase in the awareness about the consequences of the lack of formal working history, benefits and lack of formal/undeclared work;

---

which in turn led to the increase of the overall tax burden on the labour costs, since the gross salaries constitute the basis for calculation of the employer's part of the contribution.

<sup>29</sup> Doing Business index

<sup>30</sup> William, C., Horodonic, I.(2015) „Marginalisation and participation in the informal economy in Central and Eastern European nations, Post-Communist Economies , str. 153-169



- Tax education with a view to harmonizing the value with the formal rules and promotion of self-regulation;
- Improvement of the policy with a view to ensuring better planning, execution of the budget and measuring of the achieved results, as well as through the increase in transparency of public spending and visualisation of the budget.

Population will not improve tax morale if the trust in the institutions is low and if the belief in the existence of corruption in the public sector is widespread. Modernization of the government and governance, promotion of responsibility for the results as well as the change of governance style are required both in terms of managing public finances and in terms of ensuring public services, particularly those that are financed directly from taxation of labour (health insurance, insurance from unemployment).

It is important that citizens perceive the system as just and therefore the following is required (Williams and Horodonic, 2015):

- Improving procedural justice - tax authorities should treat citizens and businesses with respect, impartially and responsibly focus on the service-oriented approach;
- Ensuring procedural regularity - individuals have to be convinced that the part of the tax they pay is fair in comparison to what others pay;
- Establishing redistributive justice, in such a way that citizens are convinced that for the taxes that they pay they get the appropriate quality of service from the public sector.

In addition to the above listed changes that are related to how citizens perceive whether paying or not paying taxes and contributions is justified, and the changes in the improvement of the manner and style of managing institutions, changes are required in the formal rules as well. As theoretical and empirical findings have shown, the legal framework in the labour market is too rigid for the economy like Montenegro. In addition to this, the scope of the tax burden is too high in comparison to the more developed countries that have much higher spending on social care. The tax burden is perceived among owners and directors of companies as one of the most serious problems and motives for undeclared labour. They usually do not perceive labour legislation as such a serious problem because they mostly do not comply with it, since the perception is that the inspections are insufficiently efficient in the detection of undeclared work.

Based on the principle "less is more", the framework of the rights from the Labour Law should be harmonized in such a way as to promote the key rights of the employed persons and to move the focus from the certainty of job to the certainty of employment, i.e. to increase flexibility in the labour market and mobility between jobs and employers. Higher mobility between jobs means the enhancing of human capital through the enhancing of skills and competences of employed persons. Attachment to one job mostly means stagnation and inability to adapt to changing circumstances, which happened to a large number of employed persons in Montenegro when the transition process started. In the pre-transition period, which is not a feature of transition economies only, the probability that the employees will earn their



pension in the company where they started working was high. Today, such a practice is inconceivable.

#### 6.4.2.2. Changing the structural conditions

Given the profile of the undeclared sector in Montenegro, particularly the fact that the dominant part of the undeclared sector is made up of self-employed persons, it is clear that the overall business environment has certain deficiencies and contradictory features. Formalization, dominantly focused on repression, would lead to the reduction of undeclared work, but it would also lead to the reduction of total work and economic activity and to the increased poverty.<sup>31</sup> This kind of policy would be particularly dangerous in the countries where the working engagement of the population is on the low level, as it is the case with Montenegro.<sup>32</sup> That is why in formulating the adequate policy for the reduction of the scale of undeclared work the decision makers should carefully design measures that will ensure less painful transfer from undeclared to declared work.

Broadly speaking, the most desirable option is to generate new jobs and to make them as high quality as possible. However, high quality jobs do not depend on the good will of any person, not even of decision makers or economic entities.<sup>33</sup> High quality jobs require conducive, competitive, stable and predictable institutional system and time. If we waited only for the high quality new jobs and if we insisted on formalization through repression, a large number of undeclared workers would only become inactive. That would contribute neither to the reduction of poverty, nor to the budget revenues, nor to the human development.

Therefore, the formalization policy has to be focused on the long-term measures that are related to:

- Improvement of the business environment and improvement of the quality of services of the public sector, to generate new and higher quality jobs;

---

<sup>31</sup> Although the engagement in the informal economy is not a desirable way to be engaged as an individual, the share in the informal activities decreases inactivity and unemployment among active working population. This fact is particularly important since around 70% of undeclared employed persons in Montenegro are undeclared self-employed persons, which indicates to the development of small entrepreneurship within the informal sector.

<sup>32</sup> From the perspective of formalization, particular attention should be given to the hypothetical case that there is no income from informal employment, since the poverty risk rates would be much higher. If individuals lost their incomes from unregistered work, the poverty risk rate would be 30.3% instead of 19.3% (increase by 57%), while additional loss of income for employed persons that have only part of the taxes and contributions paid would increase the poverty risk rate to 33.6%. Taking away the incomes from informal employment would produce much more negative effect on the growth of the poverty risk rate than if social transfers were taken away.

<sup>33</sup> Concept and definition of labour undergo dynamic changes. In the future the traditional work tied for the office or production plant will decrease. Technology enabled us to work anywhere and made monitoring and recording work and collecting taxes and other liabilities more difficult. That is why the traditional employment strategies and approaches to the employment policies do not produce results any more.





- The change of the "wrong" incentives in the system, so that those that work undeclared can feel the benefits of formalization;
- The more efficient work of inspection bodies;
- The promotion of equal rules for all to strengthen trust.

Starting from the above, but primarily from the reasons and motives for undeclared work in Montenegro, we can define several (general) and specific recommendations the implementation of which would lead to formalization of work, and to overcoming of exclusion and marginalization. Having in mind structure, causes and consequences of the undeclared economy the comprehensive plan to combat undeclared economy should include reforms of education, health and social care system. In addition to this, the scope and complexity of taxation system should be reconsidered and well as regulatory framework on the labour market. Moreover, the size and composition of public sector, and its inefficiencies, should be tackled, having in mind that large financing needs of the public sector limit the prospect for quality jobs in the private sector through a high tax wedge. And last but not the least, measures that need to improve trust in society and trust in institutions, efficiency of inspections should be part of strategy for combating the undeclared economy.

## 7. REFERENCES

2002 ILC Declaration on the informal economy.

Čok, M. Sambt, J. (2011), Montenegro: Projection of Categories Related to the Pension System, University of Ljubljana.

Dell'Anno, R. ( 2009) -„Institutions and Human development in Latin American Informal Economy“

Dolenc, P. (2012) - Severance pay schemes in SEE countries, CEF

Elgin,C., Oztunah,O. (2012)<sup>1</sup>“ Institutions, Informal Economy and Economic Development“, Bogazici University, Istanbul, Turkey

Employment Policy (Supplementary Provisions) Recommendation, 1984 (No. 169).

Frey (1989) – How Large (or Small) Should the Underground Economy be? Cambridge University Press

Friedman, Johnson, Kaufmann, Zoido-Lobaton 1999 Dodging the Grabbing Hand: Determinants of unofficial activity in 69 Countries, World Bank

IMF – Shadow Economy Around the World –Size, Causes, and Consequences

IPSOS (2014) - Informal Employment and Grey Economy in Montenegro



ISSP/ZZZCG (2007), Labour Force and Unemployment in Montenegro, July 2007 (<http://www.zzzcg.org/shared/dokumenti/Izvjestaji/Radna%20snaga%20i%20zaposlenost%20Final%20-%20RATKO%20BAKRA%C2%AC.pdf>)

Johnson, Kaufmann, Shleifer (1997) – The Unofficial Economy in Transition

Katnic, M. (2016) – National Human Development Report – Informal Work - from Challenge to Solution, United Nation Development Program, Podgorica

Katnic, M. (2017) – Administrative Costs of Tax and Labour Regulation in Montenegro, United Nation Development Program, Podgorica

Katnic, M. (2017) – Minimum Wage in Montenegro, United Nation Development Program, Podgorica

Katnic, M. (2017) – Tax Wedge on Labour, United Nation Development Program, Podgorica

Krsmanović, A. (2006) - Determinants of unemployment in Montenegro, with special emphasis on the tax wedge, Labor Market (Trziste rada), Employment Agency of Montenegro, Podgorica

Koettl, J., Gotcheva, B, Rutkowski, J. (2013) – Removing Disincentives to Work in Montenegro, World Bank, working paper

Loyaza, N. (1996) – The economics of the Informal Sector: a Simple Model and Some Empirical Evidence from Latin America

Mahbub ul Haq (1934-1998) – founder of the Human Development Report.

Neck, Hofreither, Schneider (1989) –The Consequences of Progressive Income Taxation for the Shadow Economy: Some Theoretical Considerations

OECD (2009) - „Is Informal Normal? – Towards more and Better Jobs in Development Countries

OECD (2009) - „Is Informal Normal? – Towards more and Better Jobs in Developing Countries p.11

Schneider, F. Buehn, A. Montenegro, C. (2010), New estimates for the Shadow Economy all over the World, International Economic Journal

Schneider, K. (2015) - Outside the State – the Shadow Economy and Shadow Economy Labor Force.



Suharto, E (2002) - Human development and the urban informal sector in Bandung, Indonesia: the poverty issue, New Zealand Journal of Asian Studies 4, str. 115-133

Unija poslodavaca Crne Gore (2014) - Neformalna ekonomija u Crnoj Gori - stvaranje ambijenta za održivi razvoj preduzeća -

<http://www.poslodavci.org/biblioteka/publikacije/neformalna-ekonomija-u-crnoj-gori-stvaranje-ambijenta-za-odrzivi-razvoj-preduzeca-u-crnoj-gori>

Unija poslodavaca Crne Gore (2014) - Regulatory Framework in Montenegro – Creation of Ambient for Sustainable Development of Companies in Montenegro -

<http://www.poslodavci.org/biblioteka/publikacije/regulatorni-okvir-u-crnoj-gori-stvaranje-ambijenta-za-odrzivi-razvoj-preduzeca-u-crnoj-gori>

Wiiw (2009) – Study on Adjustment Capacity of Western Balkan Countries to External Shocks

William, C., Horodonic, I., Windebank, J.(2015)– „Explaining participation in the informal economy: An institutional incongruence perspective“ International Sociology str. 296

Williams, C., Demetriades, S., Patra, E. (2016) - Diagnostic Report on undeclared work in Greece.

Williams, C., Horodnic, I.(2015) „Marginalisation and participation in the informal economy in Central and Eastern European nations, Post-Communist Economies , str.153-169

Williams, C., Nazarov, I. (2018) - Diagnostic Report on supporting the transition from the informal to formal economy in Azerbaijan



## **ANNEX I: KEY STAKEHOLDERS CONSULTED**

Ministry of Finance

Customs Administration

Tax Administration

Ministry of Labor and Social Welfare

Public Employment Service

Directorate for Inspection Affairs

Chamber of Commerce

Union of employers

Union of Independent Trade Unions

ISSP