



Employment and Social Affairs Platform

**DIAGNOSTIC REPORT ON
UNDECLARED WORK IN SERBIA**

Draft

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Abbreviations

ALMP – Active labour market policies
BEP – Business Enabling Project
CATUS – Confederation of Autonomous Trade Unions of Serbia
EEA – European Economic Area
ESAP – Employment and Social Affairs Platform
EU – European Union
EURES – European Employment Services
GDP – Gross domestic product
HTC – Household Tax Compliance
ILO – International Labour Organization
IMF – International Monetary Fund
KPI – Key Performance Indicators
LFS – Labour Force Survey
LI – Labour Inspectorate
MIMIC – Multiple Indicators Multiple Causes Method
NALED – National Alliance for Local Economic Development
NHDR – National Human Development Report
OECD – Organisation for Economic Cooperation and Development
PES – Public Employment Services
PPS – Public Policy Secretariat
RCC - Regional Cooperation Council
SAE – Serbian Association of Employers
SELDI – Southeast Europe Leadership for Development and Integrity
SORS – Statistical office of the Republic of Serbia
TA – Tax Administration
UNDP – United Nations Development Program
USAID – United States Agency for International Development
VAT – Value-added tax
VDP – voluntary disclosure policies
WB – World Bank
WCSUW – Working Committee for Suppression of the Undeclared Work



Executive Summary

This report evaluates the extent, nature and drivers of the undeclared economy in Serbia and is followed by a report that will provide recommendations regarding how this sphere can be tackled.

Extent and nature of the undeclared economy in Serbia

The undeclared economy in Serbia has been estimated using direct and indirect methods. The MIMIC method has the broadest coverage, since it covers all institutional sectors and all forms of the shadow economy. The most recent MIMIC method estimates the size of the shadow economy in Serbia as approximately 27.9% during 2013, while according to the adjusted MIMIC size of undeclared economy in Serbia was 18.1% of GDP in 2013. According to the new survey method - the "shadow economy index", which is based on data on undeclared employee salaries and undeclared corporate profits, the volume is 14.9% of GDP. However, this estimate represents the lower margin of the undeclared economy, since the survey covered only registered enterprises and entrepreneurs.

Recent empirical research shows that since 2012, the share of businesses engaged in the undeclared activities has significantly decreased from 28.4% in 2012 to 16.9% in 2017, and that there is approximately an additional 17% of unregistered businesses. Thus almost 1/3 of registered businesses in Serbia are involved in undeclared activities. There is a somewhat higher percentage of business entities that engage workers without contract - undeclared work, in relation to those who pay their employees a part of their earnings in cash – under-declared work while in almost every other company that has informal employees both forms of undeclared economy activities are present. Newly established enterprises and entrepreneurs are slightly more involved in undeclared economy activities than the older ones, while the largest share of businesses engaged in the undeclared economy activities are in agricultural sector (20.8%) and catering (19.6%).

Since 2015, the official informal employment rate (including those employed in agriculture) has slightly increased from 19.5% in 2015 to 20.7% in 2017. In Serbia, undeclared work typically takes the form of informal wage employment and informal self-employment. Recent studies show that more than a third of those in undeclared employment in Serbia, do not possess labour contracts. Results also show that almost on third of all employees working in the undeclared economy pay social and health security on the minimum wage and save on their actual salary difference.

Undeclared work is undertaken by all social groups and in almost all industries. However, they were the most prevalent in the construction, agriculture (seasonal jobs), catering, trade and craft sectors, as well as in textile and food processing industries. When it comes to different types of undeclared work inspections reveal that the most common recorded violations were employment of unskilled and semi-skilled workers that are above 40 years of age or that are receiving social assistance, without a contract - a necessity-driven 'lower tier'. This is followed by non-declaring to pension or health insurance authorities and hiring



seasonal workers for seasonal jobs in agriculture on an undeclared basis. Undeclared activities are also quite common in several professional groups in a voluntary-oriented ‘upper tier’. It would thus be a mistake to adopt a laissez-faire approach towards the undeclared economy based on the belief that it is solely a survival strategy for populations excluded from the declared economy. What interventions are required, therefore, to tackle the undeclared economy?

Drivers of the undeclared economy in Serbia

In the past few years, significant advances have been made in understanding the determinants of undeclared work by a new institutional approach. To explain undeclared work, this asserts that every society possesses institutions which prescribe, monitor and enforce the ‘rules of the game’ regarding what is socially acceptable. In all societies, these institutions are of two types: formal institutions that prescribe ‘state morality’ about what is socially acceptable (i.e., laws and regulations), and informal institutions which prescribe ‘citizen morality’ (i.e., socially shared rules, usually unwritten). The social acceptability of engaging in undeclared work in Serbia, however, is not even across all population groups. In Serbia attitude towards undeclared economy represents a key determinant of both participation and a percentage of activity in undeclared economy. Business that justify undeclared work are 50% more likely to be involved in shadow economy.

Undeclared work, from the institutional perspective, is explained as arising when the failings of formal institutions lead to state morality being different to citizen morality. These formal institutional failings are of four types: (i) formal institutional voids, such as a weak welfare ‘safety net’ which forces citizens into undeclared work to survive; (ii) formal institutional inefficiencies, or resource misallocations by formal institutions; (iii) formal institutional uncertainty, and/or (iv) formal institutional weaknesses and instability. These failings result in citizens viewing as socially acceptable what is deemed illegal by the state. Undeclared work arises, therefore, due to the failings of formal institutions which leads citizen morality to not be aligned with state morality.

Analysing the evidence on which formal institutional failings are significantly associated with the growth of undeclared work, the last few years have seen multiple studies which reveal that undeclared work is more extensive in those nations when there is: lower GDP per capita; higher public sector corruption and lower quality governance; lower expenditure on labour market interventions to help the most vulnerable groups; lower social expenditure, and social transfer systems that are ineffective in reducing the level of inequality and severe material deprivation.

To tackle the undeclared economy in Serbia, therefore, there will be a need to address the following formal institutional failings:

- Increase in the quality of public governance and public goods and further reducing public sector corruption would significantly encourage;
- Pursuing more efficient expenditure on labour market interventions to help the most vulnerable groups, which has witnessed reductions in recent years;
- Reducing distortions introduced by taxes and tax compliance costs;



- Encourage taxpayers to regard evasion as immoral;
- Developing more effective and targeted social transfer systems that reduce the widening levels of income inequality.

Unless these failings of formal institutions are addressed, then the asymmetry between state and civic morality will persist, and consequently so too will the prevalence of undeclared work. How, therefore, can these failings and imperfections in formal institutions that lead to an extensive undeclared economy be addressed?

Organisation of the fight against undeclared work: institutional framework

In 2015, Serbia established a Central Coordination Body for Directing Activities for Reducing the Shadow Economy responsible for ensuring coordinated action by the multifarious public administration bodies involved in tackling undeclared economy. This central body is responsible for developing the integrated holistic strategy towards the undeclared economy, and also houses an information unit to coordinate data mining and sharing on this issue. The Overall Objective of the National Program for Countering the Shadow Economy is to reduce the shadow economy share in the GDP of the Republic of Serbia. Besides, there are four specific objectives – 1) improved monitoring of shadow economy flows; 2) improved functioning of the fiscal system; 3) reduction of administrative and parafiscal burdens on businesses and citizens; and 4) raising awareness among citizens and businesses on the significance of reducing the shadow economy and motivation for compliance with regulations. The involvement of social partners in relation to tackling undeclared economy is improving, with increasing involvement in decision making process.

Current policy approach and measures: an evaluation

Serbia uses a broad range of measures to tackle the undeclared economy. An Action Plan has been developed by the Central body and is currently being implemented. To that end, a comprehensive approach - 18 measures and 107 activities are proposed to tackle the undeclared economy. However, an enforced compliance approach, rather than a voluntary cooperation approach, is still more dominant, and the policy measures mainly focus upon deterring engagement in undeclared work by increasing the penalties and risks of detection. However, some of these policies may lead not to transformation of undeclared to declared work, but to eradication of the undeclared economy. Eradication of the undeclared economy is also perhaps not desirable. If the eradication of the undeclared economy is pursued, then not only may it prove to be a rather costly option for governments to completely eradicate such endeavour, but in doing so, governments will destroy precisely the entrepreneurial endeavour they are seeking to nurture and develop.

What is encouraging is that increasing emphasis in Serbia is given to on the one hand, improving the benefits of and incentives for declared work, and on the other hand, more indirect tools to deal with the formal institutional failings so as to reduce the asymmetry between state morality and civic morality, such as awareness raising campaigns and dealing with the imperfections and failings of formal institutions (e.g. by facilitating procedural and



redistributive justice and fairness, and pursuing wider economic and social policies). Serbia has transferred a number of good practice measures in terms of both the shift from the use of solely deterrence measures to the broader use of incentives.



1. Introduction: Background Context

The Employment and Social Affairs Platform (ESAP) is a regional project financed by the European Commission and jointly implemented by RCC and ILO in Albania, Bosnia and Herzegovina, Kosovo*¹, Montenegro, Serbia and The Former Yugoslav Republic of Macedonia. The project, which began its implementation in 2016 and lasts for 3 years, aims to strengthen regional cooperation and institutional capacities of national administrations, employers' and workers' organisations, enabling them to develop and effectively implement labour market and social policy reforms in their EU enlargement process.

The four specific objectives of RCC-implemented action of the Employment and Social Affairs Platform project are directed towards:

1. Enhancing regional cooperation and establishing of a structured regional Employment and Social Affairs Platform;
2. Supporting the processes for preparation, monitoring and follow up of the integrated Economic Reform Programmes (employment and social component) and monitoring of the current Employment and Social Reform Programmes;
3. Enhancing the capacities of the relevant administrations for improved policy outcomes and policy reviews related to the prioritised employment, human capital and social policies;
4. Strengthening the capacities and the existing PES Network with a view to facilitating the SEE 2020 labour mobility objective and preparations for future participation in the European Employment Services (EURES).

The purpose of this assignment in the field of undeclared work is to provide evaluation of existing policy approaches to undeclared work and institutional set-ups in Serbia using holistic approach. The aim of this report is to explain the scale and nature of undeclared work in Serbia investigate the main determinants of the undeclared economy, to describe and assess the direct and indirect policy approaches, analyse the organisation of the fight against undeclared work with regard to direct and indirect policy approaches and identify barriers to formalisation and needs in the area of undeclared work.

To achieve this, the report reviews and provides an in-depth assessment of direct and indirect policy approaches and related institutional set-ups and identify needs and barriers to formalisation.

This particular objective aims to answer the following key questions:

- What is the extent and nature of undeclared work in Serbia?
- What are direct and indirect policy approaches to tackling undeclared work in Serbia?



- What are the institutional set-ups for tackling undeclared work using direct and indirect policy approaches?
- What are the barriers preventing the adoption of a wider range of direct and indirect policies?
- What are the identified needs which will further foster more effective formalisation of undeclared work using direct and indirect policy approaches?

In a context marked by a significant level of undeclared work (including a widespread practice of under-declared work), tackling the undeclared economy is increasingly seen as a major economic and social challenge in Serbia. The current business climate in Serbia is characterized by relatively high under-reporting rates, as well as a relatively high share of undeclared work. This, along with high unemployment, has undermined the collection of tax revenue and social security contributions. Apart from significant negative impacts on the economy and social institutions, undeclared work implies risks for the individual workers, including lack of social security, protection of rights and possibilities for career advancement.

Tackling the undeclared economy remains a significant challenge despite the efforts made in recent years, including imposing stricter sanctions, reducing non-wage costs and reducing bureaucratic obligations and the administrative burden. On the one hand, therefore, this report provides support to the Serbian Government and social partners in tackling undeclared work by identifying the causes, circumstances and forms of undeclared work in Serbia. This has been achieved through a multi-stakeholder diagnostic of the situation involving the meetings listed in Annex A, along with a desk-based review of the current situation. The information generated will be used to assess a comprehensive policy action plan, with a view to enabling the transformation of undeclared work into declared work. While the current program set out to facilitate the transition from undeclared to declared work in Serbia provides an integrated regulatory and policy framework based on a combination of deterrence, preventive and curative policies, and is based on good practice being developed elsewhere in the European Union, the recommendation will seek to assess current action plan, recommend additional activities as well as some pilot activities to enable the resultant integrated policy framework to be implemented and its impact assessed in terms of declared work.

Although there is no official universal definition of ‘undeclared work’, it is widely accepted across the European Union that this covers *‘productive activities that are lawful as regards their nature, but are not declared to the public authorities, taking into account the differences in their regulatory systems between Member States’* (European Commission, 2007a: 2).

Despite some 45 different adjectives and 10 nouns currently used to denote this activity (e.g., ‘informal’, ‘shadow’, ‘black’ and ‘underground’ sector/economy/work), we use the undeclared economy throughout this report. Indeed, the definition used aligns closely with the definition of the ‘shadow economy’ adopted by Schneider and Enste (2000, 79), which views it as including all legal production and provision of goods and services that are deliberately concealed from public authorities for the following four reasons: (i) to avoid payment of income, value added or other taxes; (ii) to avoid payment of social security contributions; (iii) to avoid having to meet certain legal standards, such as minimum wages, maximum hours, safety standards, etc.; and (iv) to avoid compliance with certain

administrative procedures, such as completing statistical questionnaires or other administrative forms. Although such a definition intimates that undeclared work might be a voluntary decision not to comply with legal obligations, to assume this would be to ignore how economic units and individuals may not be able to abide by the law, for instance, due to inappropriate legislation or lack of awareness. This has been taken on board in this report and its action plan.

2. Undeclared Work: An Analytical and Policy Framework

2.1 Analytical framework

Undeclared work by definition is 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:

‘Undeclared work 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.’

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 will be the approach adopted in this report.

To identify the drivers of the undeclared economy is important because it is these that need to be tackled to reduce the undeclared economy. Recently, significant advances have been made in understanding the determinants of undeclared work by adopting an institutional perspective which transcends the previous competing debates about the varying causes of undeclared work (Godfrey, 2015; Webb et al, 2009, 2013; Williams and Franic, 2016; Williams and Horodnic, 2015a,b,c; Williams et al, 2015a). Institutions, or governance mechanisms, which prescribe, monitor and enforce the ‘rules of the game’ regarding what is socially acceptable, are seen to 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).

Undeclared work, from this institutional perspective, is explained as arising when the failings of formal institutions lead to state morality being different to citizen morality. 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 undeclared work 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 to reject the continuously changing formal rules of the game in favour of their own more stable unwritten socially shared rules.

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



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

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

Indeed, unless these formal institutional failings are tackled that result in an asymmetry between state morality and citizen morality, undeclared work will persist. For example, Williams and Horodnic (2016) examine the formal institutional failings that are associated with higher level of under-declared work (i.e., the illegal employer practice of under-reporting employees' salaries) in the EU-28 using data from the 2013 Eurobarometer survey of 11,025 employees. Rather than an individual criminal act that increasing the risk of detection can tackle, they reveal that this is a symptom of systemic problems. They show that under-declared work is concentrated in countries with:

- lower levels of economic development and less modernised state bureaucracies;
- greater income inequality;
- higher rates of severe material deprivation;
- less effective redistribution via social transfers, and
- lower levels of labour market interventions to protect vulnerable groups in the labour market.

They also importantly reveal no significant association between increasing the perceived risk of detection and the likelihood of participating in under-declared work, when other variables are held constant. Under-declared work is nevertheless significantly associated with the non-alignment of state morality and citizen morality. To reduce under-declared work, therefore, the conventional approach of improving detection seems ineffective. Instead, if under-declared work is to be resolved, policy measures are required that tackle the formal institutional failings that lead to an asymmetry between the formal 'rules of the game' and citizen morality.



2.2 Policy approaches towards undeclared work

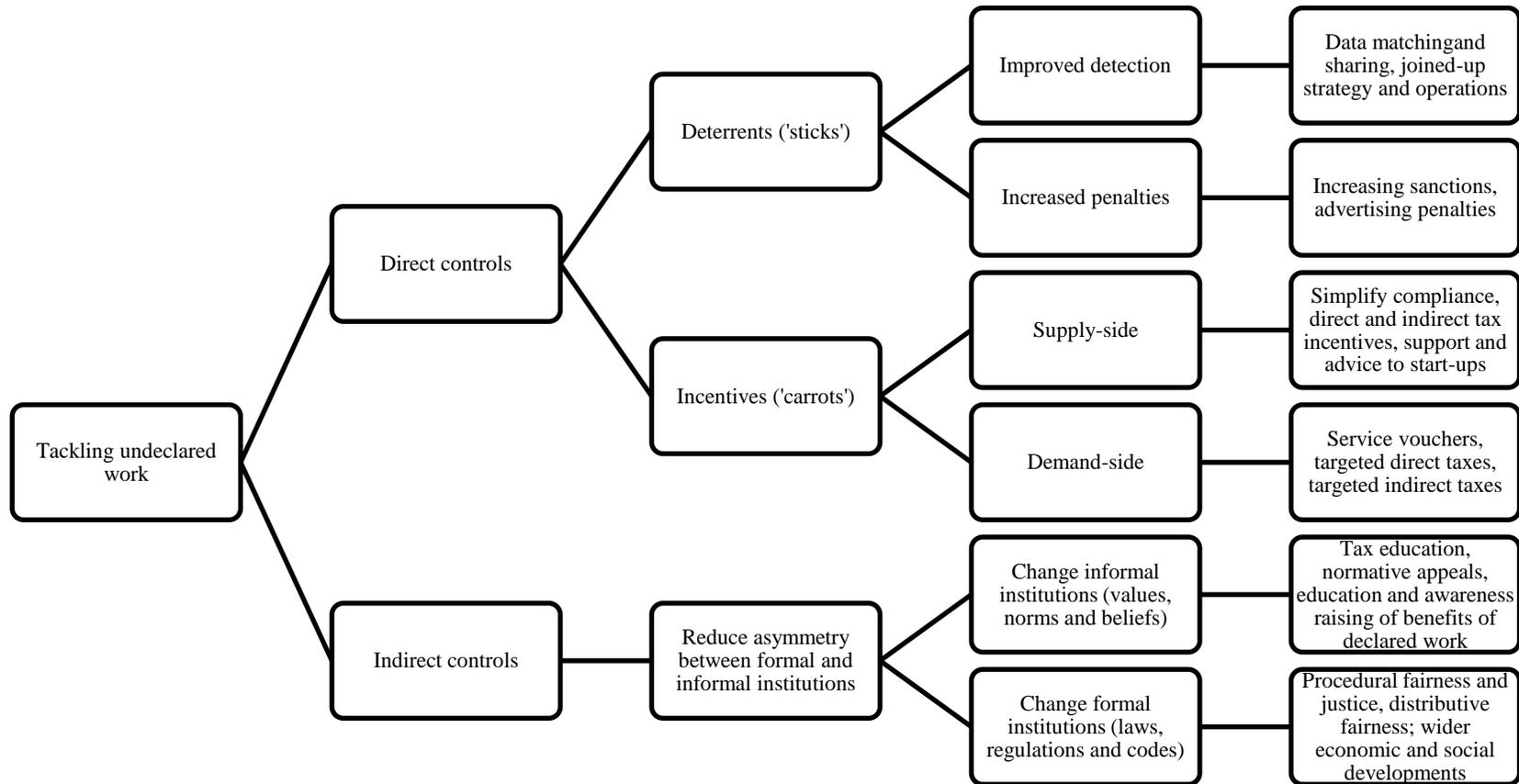
It is now widely accepted across the developed, transition and developing world, that the aim of governments is not to eradicate the undeclared economy, but to move undeclared work into the declared economy (Dekker *et al.*, 2010; Eurofound, 2013; European Commission, 2007a; ILO, 2015b; Small Business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

Figure 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 so as to repair the social contract between the state and its citizens in order to foster a high trust high commitment culture.



This project is funded by the EU

Figure 1 Policy approaches and measures for tackling undeclared work





Direct controls, therefore, seek to reduce the costs and increase the benefits of operating on a declared basis (OECD, 2008). Viewing the non-compliant as rational economic actors who engage in undeclared work 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 on a declared basis, and providing support and advice about how to start-up legitimately); or
 - Curative measures to incentivise workers and businesses to make the transition to the declared realm. These can be either (a) supply-side incentives targeting businesses and workers in the undeclared economy or (b) demand-side incentives targeting their customers with rewards for using declared goods and services.

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

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

- *Change the informal institutions* - to change the norms, values and beliefs of citizens regarding the acceptability of undeclared work, so that these are in symmetry with the laws and regulations, one can use awareness raising campaigns and educational initiatives about the costs of undeclared work and benefits of declared work.
- *Change the formal institutions* – this is particularly important in societies in which there is a lack of trust in government, such as due to public sector corruption (European



Commission, 2014) or in societies where citizens do not believe that they receive back from government what they expect. This can involve either:

- Changes in the internal *processes* of the formal institutions to improve the perception amongst citizens that there is procedural and distributive fairness and justice, and/or
- Change in the *products* of formal institutions by pursuing wider economic and social developments (e.g., increased social expenditure levels, more effective social transfers).

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

- *Responsive regulation* - this envisages a regulatory pyramid, sequenced from the least intrusive indirect controls at the bottom and used first, to the most intrusive direct controls at the top. The idea is that an authority does not need in most cases to pursue the coercion option at the top of the pyramid to win compliance. Instead, it can start with the commitment measures at the bottom of the pyramid and if these fails 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 fails 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 voluntary cooperation are essential for tackling undeclared work is now being seriously considered by authorities in various countries (OECD, 2013). Indeed, it is this analytical framework and policy approach that is the basis for this report. With this analytical framework and policy approach in hand, attention now turns to an analysis of Serbia and what needs to be done.

3. Extent and Nature of Undeclared Work in Serbia

3.1 Magnitude of the undeclared economy

As stated in the previous section, several methods have been developed to measure the phenomenon of undeclared work in order to improve the understanding of its dimensions and causes. These methods can be roughly divided into two groups: indirect and direct methods of measurement. Indirect methods are mainly aimed at measuring or estimating the size of undeclared work. The undeclared economy in Serbia has been estimated using following direct and indirect methods:

- a) the MIMIC method, a modelling-based indirect approach;²
- b) the Household Tax Compliance (HTC) method, based on 2010 data for Serbia, which is an indirect method as it is based on macroeconomic data;
- c) Survey based methods - the Survey on Conditions for Doing Business/ the Shadow Economy index.

Different methods provide different estimates of the size of the undeclared economy in Serbia. The methods differ in the coverage of the undeclared economy, both in terms of the institutional sectors, forms of undeclared economy and the methodology used. Hence, it needs to be explicitly stated that the various estimates reported here are not firm figures, but a range of estimates derived using various measurement methods commonly used by academics and policy-makers to develop approximations of the relative size of the undeclared economy.

3.1.1 Indirect Methods

² The MIMIC (multiple indicators, multiple causes) represents a statistical technique consisting of observed and unobserved variables that have specification of causal relationships among the unobserved variables. It is assumed that the shadow economy remains an unobserved phenomenon (latent variable) which can be estimated using quantitatively measurable causes of illicit employment, e.g. tax burden and regulation intensity, and indicators reflecting illicit activities, e.g. currency demand, official GDP and official working time.



The MIMIC method has the broadest coverage, since it covers all institutional sectors and all forms of the shadow economy. The most recent MIMIC method estimates the size of the shadow economy in Serbia as approximately 27.9% during 2013 (Hassan and Schneider, 2016). Schneider et al. (2014) also provide MIMIC estimation of the shadow economies of 11 Central and Eastern Europe Countries, 2001–2010. They report that the shadow economy in Serbia contracted from 33.2 percent of GDP in 2001 to 30.1 percent in 2010. However, these estimates, although using the same methodology differ from the more recent figures due to method’s sensitivity.³

Hassan and Schneider (2016) also provide **adjusted MIMIC estimation** for 157 countries including Serbia, adjusting for several factors (Table 1).⁴ Due to adjustments they obtained a corrected shadow economy estimate which is roughly two thirds of the unadjusted size of the shadow economy. If we apply adjustment to the most recent data for Serbia, size of undeclared economy in Serbia is 18.1% of GDP in 2013.

Unfortunately, there are no more recent data on undeclared economy in Serbia obtained using the MIMIC approach (Medina and Schneider, 2018). While the newest MIMIC regression includes more than 150 countries, Serbia was among countries that were dropped as the time series were not long enough.

Table 1 Size of undeclared economy in Serbia, % of official GDP MIMC Method

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Average
Hassan and Schneider (2016)																
MIMIC estimate*	34.3	33.0	35.6	39.2	41.5	39.1	36.5	32.2	28.5	29.4	31.6	37.4	34.7	32.4	27.9	34.2
MIMIC estimate with self-employment*	34.3	33.9	37.1	41.5	44.3	41.7	38.4	33.4	30.6	31.7	34.6	39.5	37.2	34.3	29.8	36.2
Adjusted MIMIC estimate*																22.3
Adjusted MIMIC estimate with self-employment*																23.5
Schneider et al. (2014)																
MIMIC estimate		33.2	32.7	32.1	32.0	31.6	31.2	30.7	30.1	30.6	30.1					31.4

Source: Hassan and Schneider (2016) and Schneider et al. (2014)

The HTC method estimates only those forms of the shadow economy that can be identified and estimated on the basis of household income and consumption data. The HTC method (Schneider et al. 2014) estimated the extent of the shadow economy in Serbia at 23.6 percent

³ The issue with MIMIC approach is that for transition countries is that assumptions about the size and stability of parameters in estimating equations are often violated due to the unstable economic conditions that prevail in such countries

⁴ As stated in Medina and Schneider (2018), one big problem with macro approaches is that they use causal factors like tax burden, unemployment, self-employment and regulation, which are also responsible for people undertaking do-it-yourself activities or asking friends and neighbors to do things. “Hence, do-it-yourself activities, neighbors’ or friends help and legally bought material for shadow economy activities are included in these macro approaches. This means that in these macro approaches a “total” shadow economy is estimated which includes do-it-yourself activities, neighbours’ help, legally bought material and smuggling.” (Medina and Schneider, 2018, p.17)



in 2012. The figure obtained using the HTC method is lower than that derived from the MIMIC model since data on household income and consumption cannot cover aspects of the enterprise sector (such as corporate income and property tax, charges, fees, etc.).

SORS adjusts GDP estimates to account for the non-observable economy. Yet, despite the importance of the estimate and its impact on all public policies, this information is not widely available on the web site of SORS. According to SELDI report (2016) the estimated percentage of non-observable economy increased from 9.1% in 2009 to 14.4% in 2014. However, the structure of the non-observed economy is not available.

3.1.2 Direct Methods

Most recently, Krstić and Radulović (2018) used a survey of company managers to measure the size of the undeclared economy.⁵ Following Putninš and Sauka (2015) they combine misreported business income and wages as percentage of GDP and provide detailed information on the structure of the undeclared economy in the business sector. The approach assumes that company managers are the most likely to know how much business income and wages go unreported due to their unique position in dealing both of these types of income. Previously, a rather similar approach was used to obtain macro-level estimate of Serbia's undeclared economy (Schneider et al. 2015). Using the data derived from the enterprises and entrepreneurs survey, two most significant forms of the undeclared economy (i.e., unreported employee wages and unreported sales) were estimated. Krstić and Radulović (2018) provide comparable estimates using both approaches. Regarding registered businesses, the undeclared economy was reduced from 21.2% in 2012 to 15.4% of GDP in 2017.

According to the new survey method - the "undeclared economy index", which is based on data on undeclared employee salaries and undeclared corporate profits, the volume of 14.9% of GDP is very similar to the one obtained by the first survey. We should emphasise that this estimate represents the lower margin of the undeclared economy, since the survey covered only registered enterprises and entrepreneurs. Turning to whether the undeclared economy is growing or declining over time using the survey method, Table 2 reveals that between 2012 and 2017, there was significant decline in the size of the undeclared economy.

⁵ The survey was conducted in September and October 2017. The sample included 1,049 economic entities, i.e. 540 companies and 509 entrepreneurs. Most respondents were owners or managers of business entities. Data is collected by face-to-face method. The survey was conducted on a stratified sample of business entities. The sampling is based on the list of all active economic entities (enterprises and entrepreneurs) registered with the Business Registers Agency. The data are representative at the national level and according to the mentioned strata (region, activity and size of the enterprise). The realized sample included 461 business entities that participated in the same survey conducted in 2012, which allows monitoring of their status change in the period of 5 years (2012-2017).

Table 2 Survey Methods Size of undeclared economy in Serbia, % of official GDP

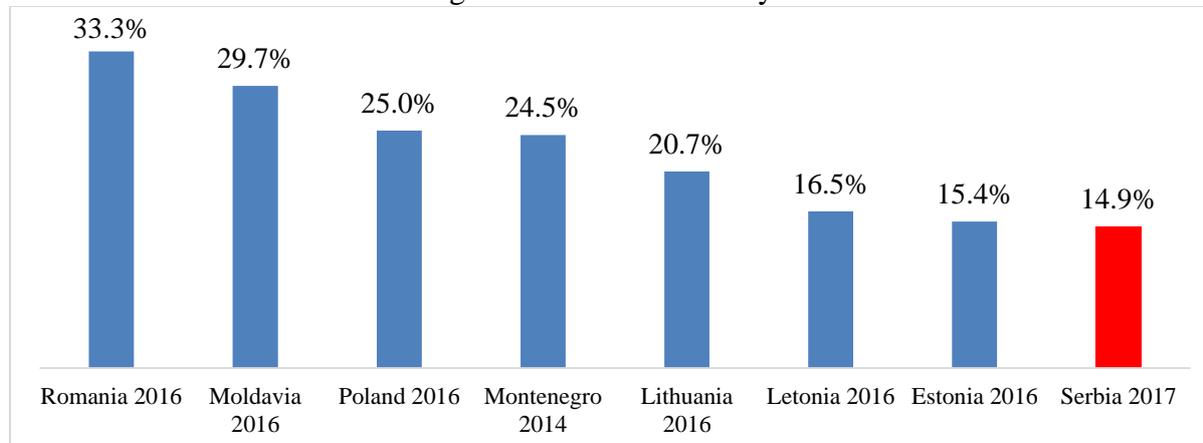
Method	Year	Estimate
Schneider et al. (2014)		
Survey Method	2012	21.2
Krstić and Radulović (2018)		
Survey Method	2017	15.4
Shadow Economy Index	2017	14.9

Source: Schneider et al. (2014), Krstić and Radulović (2018) Anкета o uslovima poslovanja privrednih subjekata (preduzeća i preduzetnika) u Srbiji 2017. Ipsos i NALED.

Compared to other countries where an innovative survey method has been applied, the undeclared economy in Serbia is rather low. However, the participation of unregistered companies, which is not covered by this assessment, is significantly higher in Serbia compared to the Baltic countries - according to the assessment of businesses 17.2% of businesses in their activity are not registered.

Regarding the structure of the undeclared economy in Serbia, informal employment, or partial or complete payment of wages in cash, accounts for a much larger part of the undeclared economy than the undeclared business surplus (profit). **About 62% of the undeclared economy is related to unreported salaries of employees.**

Figure 2 Shadow Economy Index



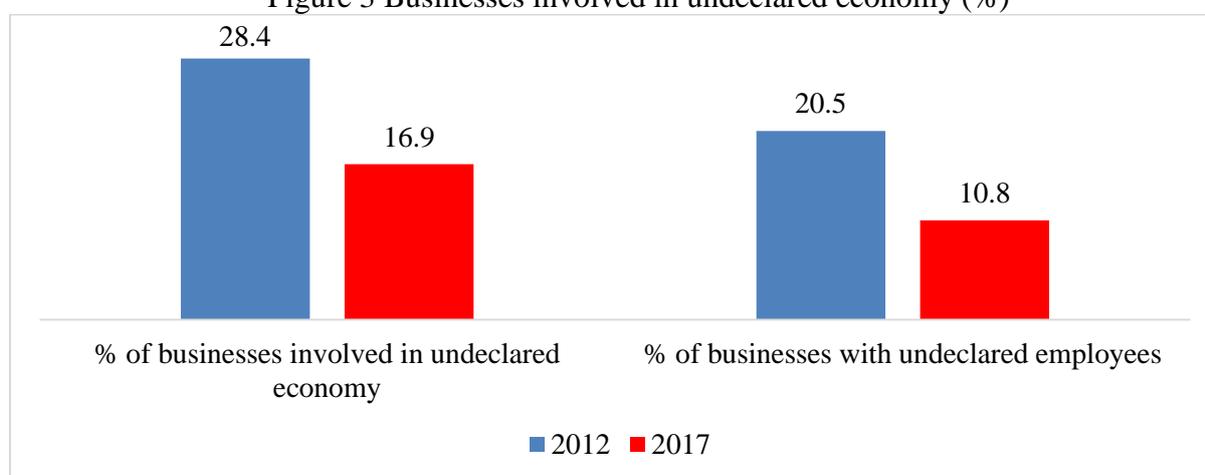
Sources: For Romania and Moldova Putniš, Sauka and Davidescu (2018); For Poland Lechman and Nikulin (2018), For Serbia Krstić and Radulović (2018), For Montenegro Krstić and Barry (2017)

Since 2012, the share of businesses engaged in the undeclared activities has significantly decreased from 28.4% in 2012 to 16.9% in 2017.⁶ Krstić and Radulović (2018) report that 16.9% of registered businesses in Serbia were engaged in undeclared activities in 2017.

⁶ A slightly higher percentage is obtained if payments that are not recorded in business books are used instead of cash payments of VAT payers: 23%. This is expected due to the wider coverage of companies and entrepreneurs that make cash payments in relation to those that are in the VAT system.

Approximately one tenth of business entities (10.8%) had informal employees, while 6.9% conducted cash payments cash, even though they were VAT payers. Finally, payments in cash that were not recorded in the books were present in 11.1% of business entities. Share of companies that have undeclared employees, as well as the share of VAT payers who make cash payments is reduced by approximately 10 percentage points. Despite a significant reduction, we should emphasise that these figures represent the lower margin of the undeclared activities. Finally, survey shows that businesses estimate that there are additional 17.2% unregistered companies. Consequently, almost 1/3 of businesses in Serbia are involved in the undeclared activities.

Figure 3 Businesses involved in undeclared economy (%)



Source: Business Environment Survey 2017, Ipsos/ NALED.

Krstić and Radulović (2018), report that every tenth business admitted that it has informal employment. However only a small number of respondents have provided an answer to this question. Table 3 shows related data based on perception of businesses on the involvement of other businesses (in the same sector) in undeclared activities. The data again show a very significant reduction in all forms of undeclared economy compared to 2012. The decrease was more pronounced in case of the share of informal employment (of both types). The reduction of the undeclared economy in this five-year period has contributed to macroeconomic stability, improvement of the business environment, recovery of the labour market, as well as more efficient collection of tax revenues.

Table 3 Perception of Businesses on the participation of other businesses in undeclared economy

	2012.	2017.
% of businesses with undeclared employees	23,9	5,3
% of businesses who pay their employees using envelope wages	24,7	7,5
% turnover outside of VAT	21,6%	15,8

Source: Business Environment Survey 2017, Ipsos/ NALED.

3.2 Nature of the undeclared economy

Varieties of undeclared work

The undeclared economy includes both wholly undeclared work and under-declared work.

- *Undeclared work* refers to work entirely undeclared to the state for taxation, social insurance and/or labour law purposes. This includes unregistered employees without a contract who work for a business, for a household, as family members, private tutors, or as farm workers. These workers might be secondary or multiple job holders who have social security coverage in their main job but do not contribute in their second job, or they may be pensioners, students, or others not in additional forms of declared employment. Besides undeclared wage work, there is also undeclared own-account work conducted on a self-employed basis where all or some of their transactions are not declared. Many of these self-employed in Serbia may well be ‘bogus self-employed’.
- *Under-declared work* refers to the illegal employer practice of salary under-reporting, including the practice of declared employers paying declared employees two salaries: (a) an official salary declared for tax, social security and labour law purposes, and (b) an additional undeclared remuneration received ‘under the table’ or by ‘envelope’.

To further understand the sectors in which the undeclared economy is concentrated and who participates in such work, firstly, the demand for undeclared goods and services is analysed, secondly, the supply of undeclared work and third and finally, the nature of under-declared work in the form of ‘envelope’ wages in terms of who receives such additional undeclared wages and the determinants of its prevalence.

Labour Inspectorate data

One of the major problems when analysing the nature of the undeclared economy in Serbia is that there are few sources of data. Indeed, a useful starting point when discussing the nature of undeclared work in terms of the sector, business and spatial variations, are the results of surveillance activities of Labour Inspectorate. According to the Labour Inspectorate (2018), although **violations in employment relations were present in almost all industries, they were the most prevalent in the construction, agriculture (seasonal jobs), catering, trade and craft sectors, as well as in textile and food processing industries. Unregistered activities are also quite common in several professions.**

When it comes to different types of undeclared work, the 2017 Annual report of the Labour Inspectorate reveals that the **most common recorded violations were employment of unskilled and semi-skilled workers that are above 40 years of age or that are receiving social assistance, without a contract.** This is followed by non-declaring to pension or health

insurance authorities and hiring seasonal workers for seasonal jobs in agriculture on undeclared basis.

Table 4 Labour Inspectorate Oversight - Surveillance Activities and Results

Year	Total number of surveillances	Scope of the oversight (number of workers)	Number of undeclared employees	Number of newly registered employees (after surveillance)
2015.	61.776	696.822	16.408	12.250
2016.	53.069	533.119	19.472	17.589
2017.	53.424	510.725	22.411	21.171

Source: Labour Inspectorate Annual Reports (2015-2017)

NALED Business Survey Data Study

NALED (2018) reports that observed by the type of undeclared activities, **there is a somewhat higher percentage of business entities that engage workers without contract - undeclared work, in relation to those who pay their employees a part of their earnings in cash – underdeclared work** (9.1% to 7.6 respectively), while in almost every other company that has informal employees both forms of undeclared economy activities are present. Table 5 shows the share of business entities in the undeclared economy in the total number of business entities by their basic characteristics.

Newly established enterprises and entrepreneurs are slightly more involved in undeclared economy activities than the older ones (17.2% to 16.8% respectively). However, the difference between them has significantly decreased in relation to 2012, which can be explained, inter alia, by significantly improved business climate and reduced unfair competition of the informal sector. In turn, these developments probably had more effect on young firms that are usually more prone to undeclared activities to increase competitiveness and deal with barriers to entry.

The relatively high level of self-employment and large share of micro- and small enterprises in Serbia is frequently seen as the catalyst for the prevalence of the undeclared economy. However, as stated in Krstić and Radulović (2015), **the typical link between the undeclared economy and the size of the business, whereby businesses with fewer workers are more likely to engage in the undeclared economy** (Rice 1992; Hanlon et al. 2007; Tedds 2010; Williams 2006), **is not as pronounced in Serbia.** Companies that were more engaged in undeclared economy were relatively larger enterprises (those with 20 or more employees) – every fifth business with 20 or more employees has undeclared employment (19.8%). On the other hand, micro businesses with up to 4 employees were more prone to VAT tax evasion activities (17%).

Table 5 Share of businesses involved in undeclared economy and undeclared employment

	% businesses involved in undeclared economy		% businesses with undeclared employment	
	2017	2012	2017	2012
Total	16.9	28.4	10.8	20.5
Type				



Company	18,2	23,0	12,3	14,5
Sole proprietor (entrepreneur)	16,4	30,7	10,2	23,0
Age				
Newly established (up to 2 years)	17,2	32,1	14,3	32,1
Other	16,8	27,9	10,5	19,6
Number of employees				
Up to 4	15,9	27,7	10,5	20,2
5-19	17,7	32,8	7,5	23,6
20 and more	24,2		19,8	
Sector				
Agriculture	20,8	33,8	18,5	20,0
Industry	18,2	27,5	9,5	20,2
Construction	17,3	42,9	11,3	32,7
Trade	17,0	24,9	7,4	15,0
Transport	18,0	32,7	12,9	23,8
Catering	19,6	33,1	15,1	22,4
Other Services	14,7	25,0	11,8	21,4
Region				
Belgrade	19,2	24,7	10,4	16,2
Vojvodina	14,8	25,6	10,3	19,8
Central and Western Serbia	17,3		10,9	
South and Eastern Serbia	15,2		12,0	

Source: Krstić and Radulović (2018)

Krstić and Radulović (2015) report that the largest share of businesses engaged in the undeclared economy activities are in agricultural sector (20.8%) and catering (19.6%). These results are similar to results from 2012. However, compared to 2012 construction industry, in 2017 was only slightly above the average (17.3%). Potential explanations for the reduction of undeclared activities in construction sector are the major reform in the area of building permits issuance, the reform of the inspection surveillance system, and especially the activities of the labour inspection. Agriculture has the highest percentage of economic entities with informal employees (18.5%), while the percentage of VAT payers who make payments are significantly lower than the average (8.2%). In fact, agriculture has the largest percentage of business entities that are hiring workers without contract, or with a contract, but with underreporting (16.3% and 14% respectively). Agriculture also has the highest percentage of economic entities, which simultaneously has both forms of undeclared activities (11.7%). In the catering industry, 15.1% of business entities have informal employees, and 15.7% of the VAT payers are partially hiding their turnover.

According to Krstić and Radulović (2018) there are somewhat significant regional differences of businesses involved in undeclared work in Serbia. **For instance, businesses from Belgrade and surrounding area are more likely to carry out undeclared activities in comparison with their counterparts from other regions.**

Labour Force Survey Data

Informal employment in Serbia is measured relatively comprehensively. The Labour Force Survey (LFS) is the source of data on the labour supplied to firms by households or individuals conducted on a regular basis by national statistical office. The LFS provides informal employment rate i.e. the share of persons working without formal contract in the total number of employed. This category includes the employed in unregistered companies, the employed in registered companies but without formal contract and without paying social and pension contributions, as well as unpaid family workers. However, the validity of the LFS data was extensively debated (Arandarenko, et al 2017, Petrović, et al 2017, Kovačević, et al 2017).

In Serbia the decreasing trend in unemployment rate (which began in 2013) has continued in 2017. The unemployment rate was 13.5%, which relative to 2016, represents a 1.8 drop in percentage points (p. p.). The employment growth and decrease in unemployment during 2017 were accompanied by a slight decrease in inactivity. The inactivity rate was 46.0% and less than the previous (2016) year by 0.7 p.p. Approximately, **a third of the new jobs created recently have been in the undeclared economy (app. 82.000)**, suggesting a strong pro-cyclical relationship between growth and informal employment (World Bank, 2017).

According to the LFS, during 2017 there has been an increase in the number of formally employed persons by 95 200 (or 4.5%) and a decrease in the number of informally employed persons by 20 000 (3.3%). The informal employment rate has decreased by 1.3 p. p. and amounts to 20.7%, respectively the number of informally employed persons amounts to 579 200. However, **since 2015 the informal employment rate (including employed in agriculture) slightly increased from 19.5% in 2015 to 20.7% in 2017**. If a stricter definition of formal/informal employment is applied, which means that persons who do not exercise the right to health and pension insurance are informally employed, the number would be added another 192 300 persons, so that the number of informally employed would amount 771,500 and the informal employment rate 27.6%.

In Serbia undeclared work typically takes the form of informal wage employment and informal self-employment. Unpaid (contributing) family workers are quite widespread in agricultural households. More detailed information from the Serbian LFS shows that there is significant change in the structure of informally employed by status. In 2015, most (42 percent) of the informally employed were unpaid family workers, about one third were self-employed without employees, and about one quarter were employees. In 2017, almost half of informally employed were self-employed without employees and only 28% unpaid family workers. In 2017, the majority (27.2 percent) of informal workers lived in Šumadija and Western Serbia, followed by South-Eastern Serbia (24.7 percent), Vojvodina (17 percent), while only about 8 percent resided in Belgrade.

Table 6 summarises the main labour market indicators, including the informal employment rate, for the period 2015-2017. Young people, women and the older age group are most affected by informal employment.

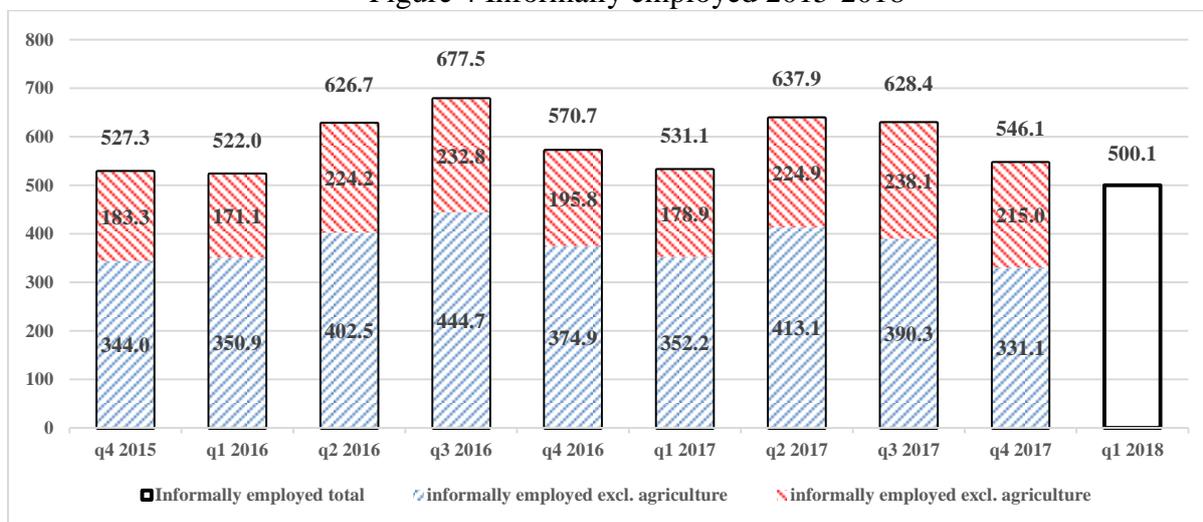
Table 6 Main Labour Indicators

	2015	2016	2017
Rate of Activity aged 15 and over	51.6%	53.3%	54%
Employment rate	42.5%	45.2%	46.7%
Unemployment rate	17.7%	15.3%	13.5%
Employed - aged 15 and over (in thous.)	2558.4	2719.4	2794.7
Formally employed (in thous.)	2060.5	2120.2	2215.4
Informally employed (in thous.)	497.9	599.2	579.2
Informally employed without agriculture (in thous.)		312.2	347.6
Informally employed by status (in thous.)			
Self- employed with employees	2.7	2.5	1.6
Self- employed w/o employees	162.5	245.9	279.4
Employees	125.3	132.9	136.5
Contributing family workers	207.4	217.9	161.6
Informally employed by age (in thous.)			
15-24	48.4	55.3	46.3
25-54	286.9	333	219.7
55-64	105.8	128.7	126
65 and over	56.7	82.1	87.3
Informally employed by sex (in thous.)			
Male		321.1	306.6
Female		278.1	272.6
Informal employment rate Male		21.00%	19.60%
Informal employment rate Female		23.40%	22.20%
Informally employed by region			
Belgrade		74.7	80.9
Vojvodina		133.7	132.2
Šumadija and Western Serbia		234	219.3
Eastern and Southern Serbia		156.8	146.8
Informally employed by sector (in thous.)			
Agriculture		287	231.6
Industry		34.6	31.8
Construction		43.8	42.2
Services		233.9	273.7
Informal employment rate excluding employed in agriculture		11.48%	12.43%
Informal employment rate including employed in agriculture	19.46%	22.03%	20.72%

Source: SORS, Labour Force Surveys (2015-2017)

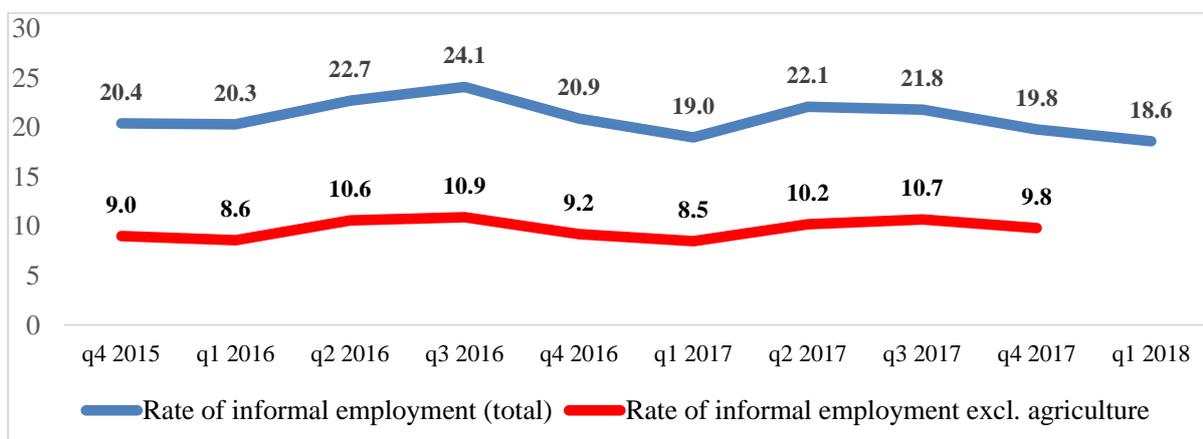
Estimates based on the quarterly Labour Force Survey of the Statistical Office of the Republic of Serbia (SORS) show that informal employment has been first increasing since 2015, and then decreasing to only 18.6% (500 thousands informally employed) in the first quarter of 2018.

Figure 4 Informally employed 2015-2018



Source: SORS Labour Force Surveys

Figure 5 Rate of informal employment 2015-2018



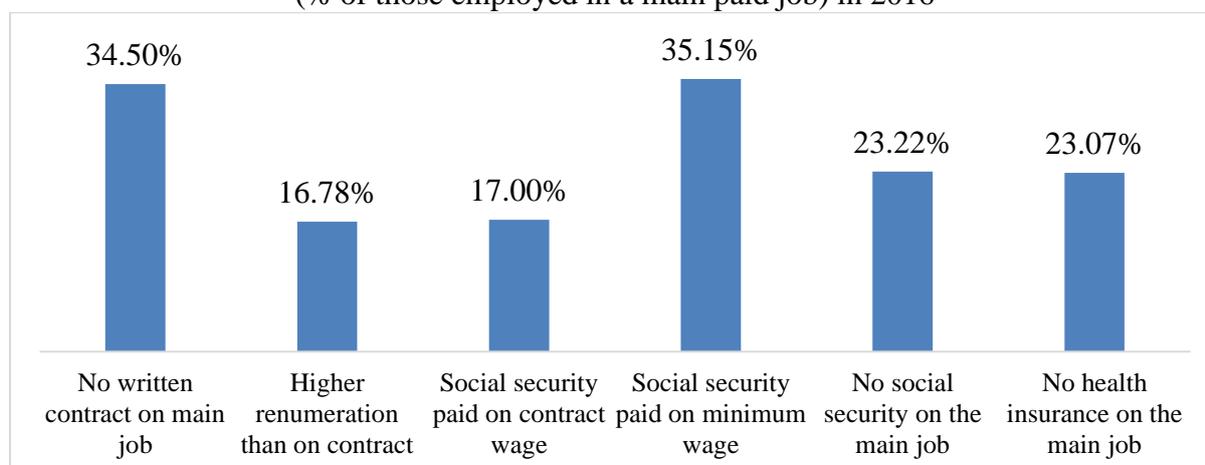
Source: SORS Labour Force Surveys

SELDI conducted national representative survey on a sample of 1,061 Serbian citizens using as a benchmark ILO data for the undeclared economy. SELDI assessed the employment in the undeclared economy (as a percentage of total non-agricultural employment) i.e. all jobs in unregistered and/or small-scale private, unincorporated enterprises that produce goods or services meant for sale or barter. For the purpose of this survey, self-employed street vendors, taxi drivers and home-based workers are all considered enterprises, regardless of the size of their operation. However, agricultural and related activities, households producing goods exclusively for their own use (e.g. subsistence farming, domestic housework, care work, and employment of paid domestic workers), and volunteer services rendered to the community



are excluded. According to this definition, **Serbia had undeclared employment of between 5.3% (the lowest in 2013 since 2010) and 6.6% (the highest in 2014 since 2010).**⁷ Figure shows that more than a third of those in undeclared employment in Serbia, do not possess labour contracts. Results also show that **almost on third of all employees working in the undeclared economy pay social and health security on the minimum wage and save on their actual salary difference.**

Figure 6 Serbia - Prevalence of different types of hidden employment
(% of those employed in a main paid job) in 2016

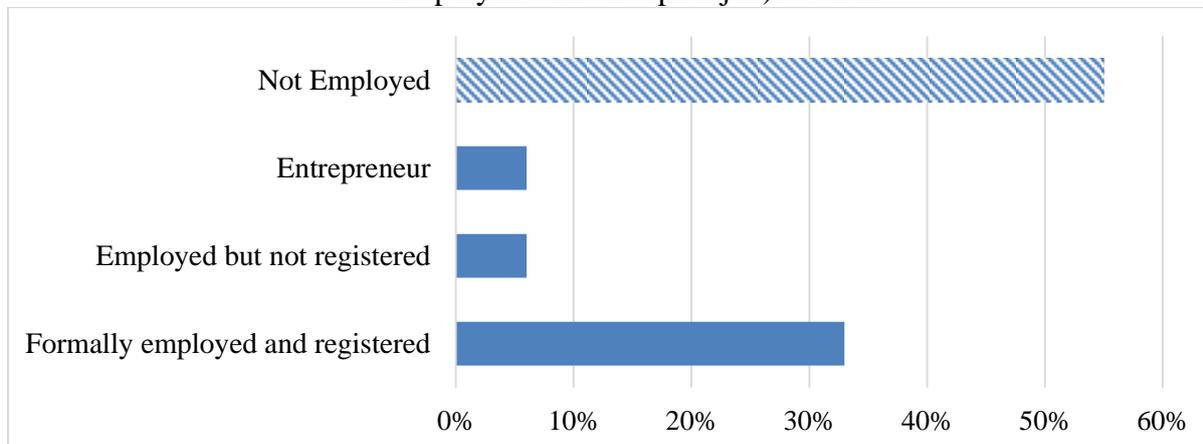


Source: SELDI Hidden Economy Survey (2016).

The other relevant survey of the character of undeclared work is a survey of persons (consumers) conducted by NALED. This interviewed 1,000 respondents face-to-face using a multi-stage random (probability) sampling methodology, which ensured that on the issues of gender, age, region and locality size, the sample was proportionate to, and representative of, the Serbian population. This survey examines several issues related to undeclared and under-declared work in Serbia. Of the citizens who are employed, two thirds receive compensation on their bank accounts, however, more than a quarter of them receive earnings / remuneration in cash, or partially in hands.

⁷ SELDI has used a broader definition of the hidden economy to be measured. A person is counted as being engaged in the hidden economy if they participate in at least one of six hiding practices: 1) No written contract with the employer at the main job; 2) Actual remuneration received in the previous month was higher than the one written in the contract with the main employer, based on a verbal agreement; 3) No social security is paid on the main job 4) The base for the social security paid is the minimum wage, even if the actual salary is higher; 5) The base for the social security paid is the amount written in the contract and not the actual received, which is higher; 6) There is no health insurance on the main job. However, the definition does not include cases of social and health security avoidance, for example, through cash advances on a monthly basis and a longer contract in order to keep below the minimum amount of income on which security is due. Neither does it include other legal ways of reducing tax payments in relation to labour provided. See SELDI (2016) p. 21-22

Figure 7 Serbia - Prevalence of different types of hidden employment (% of those employed in a main paid job) in 2016

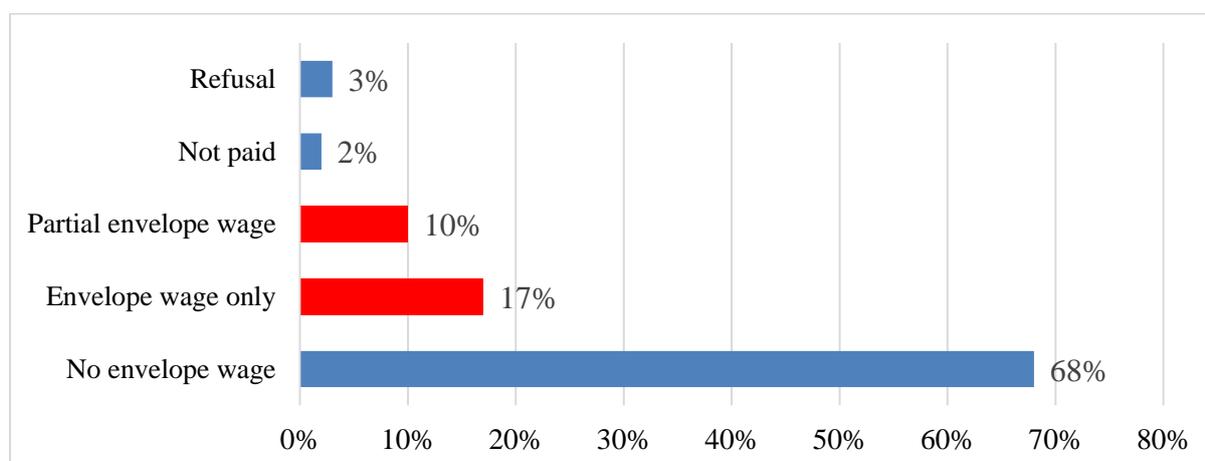


Source NALED Survey of Citizens (2017)

As explained by Williams (2009c), the remuneration in envelope wages is quite prevalent practice in transitional countries. Serbia is no exception as significant part of undeclared activities is related to under-declared employment which is where a formal employer under-reports a formal employees' salary, such as by paying them two salaries, a declared official salary and as undeclared ('envelope') wage, in order to avoid the full tax and social contributions due.

According to the 2017 NALED Survey 27% of both formally and informally employed (13% of totally employed in the sample) that were interviewed asserted that their employer paid them either a declared wage plus an additional undeclared (envelope) wage or total wage was paid as envelope wage. However, we should emphasise that some forms of work undertaken was not captured (e.g. paid favours conducted for close social relations, such as kin, friends, acquaintances and neighbours). Although this illegal employer practice prevails across all socio-demographic and socio-economic groups, it is nevertheless more common in some than others. Citizens with lower than average tax morale are again more likely to receive envelope wages, as are women, younger people and those aged 55 plus, single people, those living in larger households, in urban areas and facing difficulties in paying their bills. On the whole, therefore, it is marginalized groups who are more likely to have this illegal wage practice imposed on them by employers.

Figure 8 Envelope wages - the share of employees whose wages are paid in cash



Source NALED Survey of Citizens (2017)

4. Barriers to Formalisation – Drivers of the Undeclared Economy in Serbia

As the analytical framework in section 2.1 highlighted, undeclared work arises when the failings and imperfections of formal institutions result in an asymmetry between state morality (the laws and regulations) and citizen morality (citizens' norms, values and beliefs regarding the acceptability of these laws and regulations).⁸ People are willing to pay taxes also because they value public goods that their taxes finance. Randelović (2017) assessing implications of tax moral in Serbia states that increase in the quality of public governance and public goods, such as efficiency of administration, rule of law, protection of property rights and other public goods, would significantly encourage tax compliance.

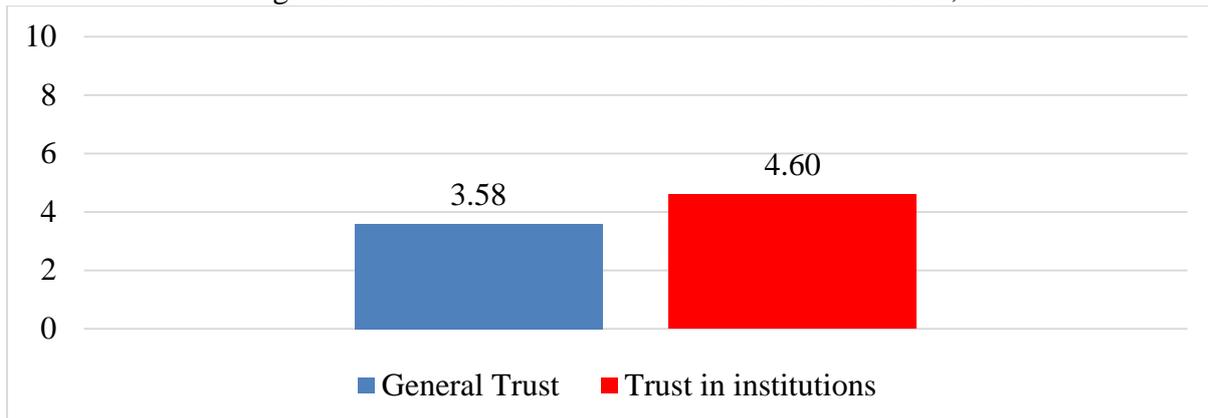
In Figure 9, an indication is provided of the degree to which state morality and citizen morality does not appear to be aligned in Serbia by examining the proportion of people who have trust in others and trust in the state institutions. To the extent that these attitudes are reflected in the compliance behaviour of Serbian citizens, low expectations of what others are doing and the erosion of trust and in the authorities will reduce voluntary compliance. Hence, a part of non-compliance is due to the low levels of trust in terms of both horizontal relations

⁸ This is also the first cause emphasized in the National Program for Countering the Shadow Economy (National Program). Namely, National Program names several causes of shadow economy: 1) Low level of tax culture among citizens and businesses, usually caused by distrust in state institutions, non-transparent budget spending, lack of awareness and corruption; 2)-complicated regulatory framework susceptible to frequent changes, inconsistent regulation use, inadequate knowledge of regulations and poor public administration capacities for enforcing regulations;-3) relatively high tax and para-fiscal burdens with added administrative barriers and high administrative costs for businesses and citizens; 4) relatively high rates of corruption and state tolerance for the informal sector (inspection, customs, judicial system, police);-5) high level of unemployment and poverty.



(i.e., generalized trust) and vertical relations (i.e., lack of citizen trust in the state). This in turn fuels the prevalence of undeclared work and the fiscal authorities being unable to meet its tax receipt goals, the labour inspectorate witnessing labour law violations and the social insurance bodies witnessing social insurance non-payment.

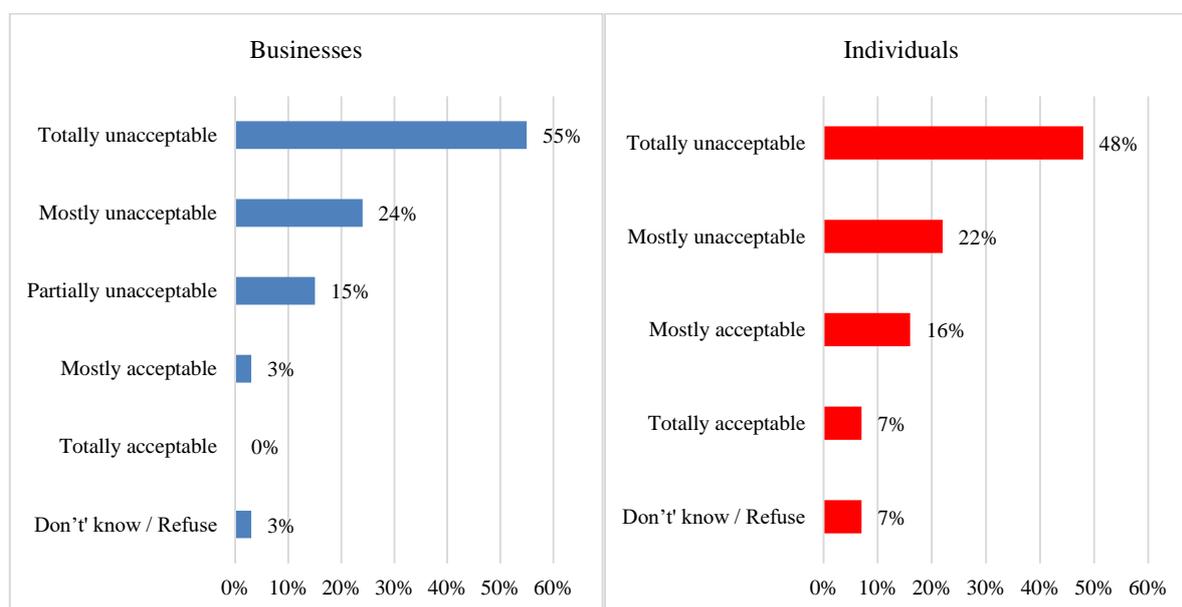
Figure 9 Generalized and institutional trust in Serbia, 2017



Source : INFORM, 2017

Figure 10 provides a more direct measurement by examining the acceptability of undeclared work (i.e., ‘shadow economy’). The perceived social acceptability is higher for individuals than for businesses. About 23% of surveyed individuals perceive shadow economy as totally or mostly unacceptable. The Serbian businesses are less tolerant of other businesses and individuals participating in informal economy. As many as 80% of surveyed business entities consider that such behaviour is unjustified or mostly unjustified. Only 14% of them have a neutral attitude towards this issue, and only 3% think it is justified. This is a significant improvement compared to 2012, when 72% considered that such activities were not or were mostly unwarranted, while 8% considered it to be largely or completely justified.

Figure 10a and 10b Social Acceptability of undeclared work



Source: NALED Business Survey 2017 and NALED Citizens Survey 2017

The implication, therefore, is that the Serbian authorities will find greater support among the firms, than by individuals. **The social acceptability of engaging in undeclared work, however, is not even across all population groups.** Generally, survey shows that individuals with lower education and those that live in urban areas (Belgrade) are less supportive. This is rather expected as the social acceptability of undeclared work is most often greater among those with fewer years in education. Other groups that have higher tolerance towards undeclared work are usually men, younger age groups, single people and single person households, people defining themselves as working class, as well as those who seldom have difficulties paying the household bills, the self-employed and living in urban areas.

To determine whether there is an association between attitudes (i.e., the acceptability of undeclared work) and participation in undeclared work (on both the demand- and supply-side), when other characteristics are taken into account and held constant, the results of a both a probit and a linear regression analysis (Krstić and Radulović, 2018) show that **attitude is a key determinant of both participation and a percentage of activity in the undeclared economy.** Business that justify undeclared work are 50% more likely to be involved in the undeclared economy. This reveals that businesses that are engaged in the undeclared economy have a significantly higher tolerance (or lower tax morality). While the situation is probably similar for the household sector, currently, there is a lack of thorough assessment of socio-economic and spatial variables and the acceptability of undeclared work.

Which specific formal institutional failings, in consequence, result in this non-alignment of citizen morality with state morality (i.e., low tax morality), and thus the prevalence of undeclared work? As section 2.1 revealed, a wealth of cross-national studies shows that the failings and imperfections in the formal institutions that result in an asymmetry between state morality and citizen morality, and thus the prevalence of undeclared work, are:

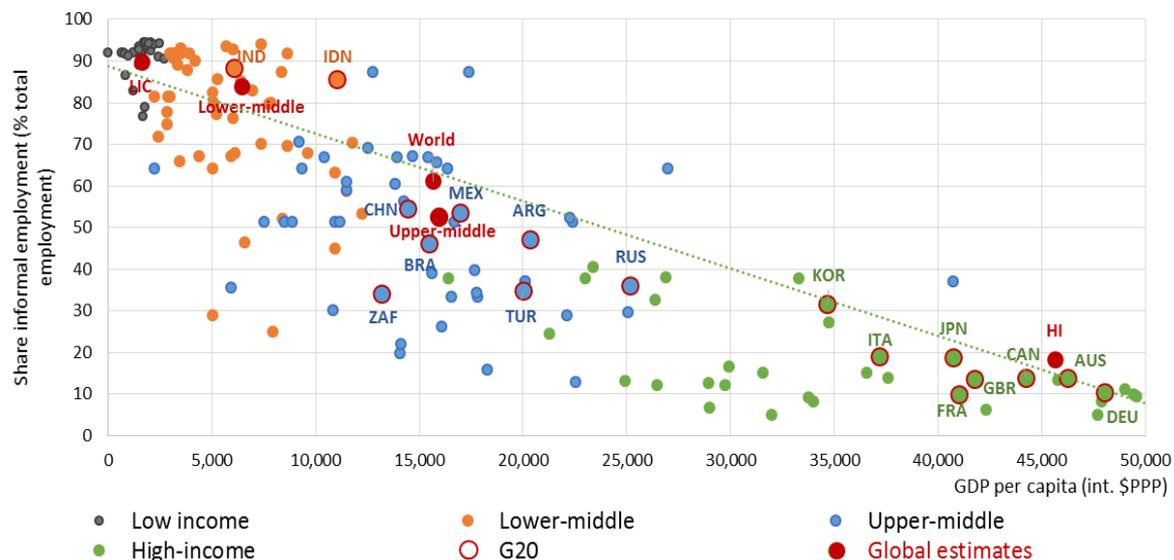
- lower GDP per capita;



- higher corruption and lower quality of governance;
- lower expenditure on labour market interventions to help the most vulnerable groups;
- lower levels of social expenditure, and
- social transfer systems that are less effective at reducing the level of inequality and severe material deprivation, which includes improving the efficiency of collection.

Growth is a very important driver of formalization. Indeed, sustained economic growth results in more predictable labour markets, thus favouring an increase in long-term contracts. In this context, formalization becomes more feasible. Nevertheless, growth will not by itself solve the challenge of mass informal employment, as comparative data shows that countries with similar level of economic development (measured by GDP per capita) are presenting very different levels of informality. The problem of informality is grounded in the inability of growth patterns to create sufficient formal jobs to absorb all those who want to work (either new entrants or those trapped in the informal economy). Structural transformation leading to reducing informal non-wage earners and increasing formal wage earners, and to up-scaling economic units and increasing their productivity, are crucial conditions for transition from the informal to the formal economy.

Figure 11 Share of informal employment in total employment and GDP per capita (latest available year)



Note: The coefficient of determination $R^2=0.57$ worldwide.

Source: ILO harmonized data on the share of informal employment in total employment and World Development Indicators 2017 for GDP per capita.

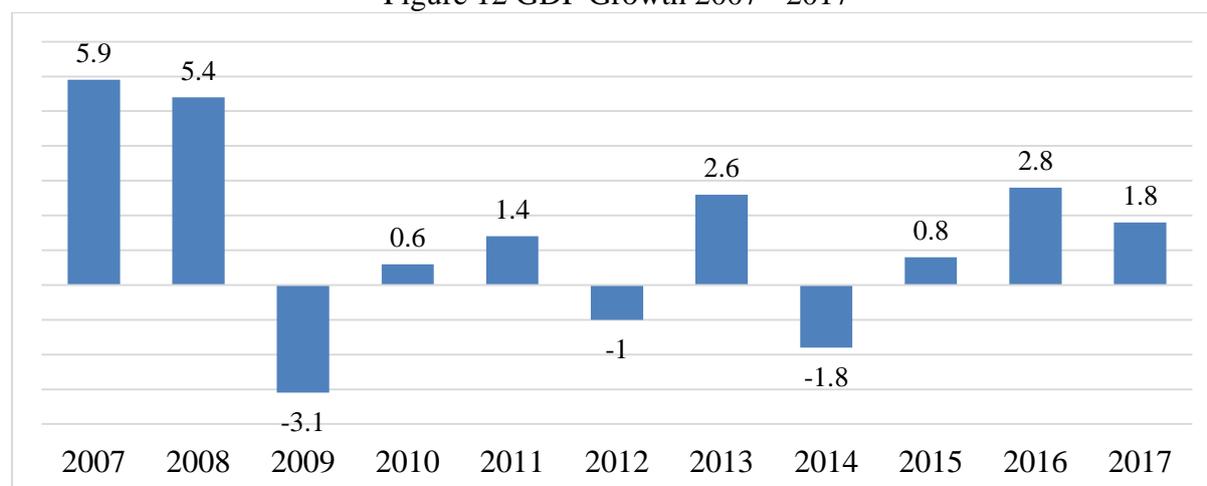
Here, therefore, we evaluate the direction of change in each of these in Serbia in order to evaluate where macro-level intervention is required in order to stem the growth of the Serbian undeclared economy.

The financial crisis exposed the structural weaknesses in Serbia's economic growth model and prompted the need for fiscal consolidation and an acceleration of the unfinished transition to a market economy (World Bank, 2014). Serbia's rapid growth in 2001–08 was

driven mainly by domestic consumption and led to significant internal and external imbalances that proved to be unsustainable. The Government’s economic reform program focuses on ensuring economic and financial stability, halting further debt accumulation, and creating an environment for economic recovery and growth to foster employment and raise living standards. These goals will be achieved primarily through fiscal consolidation measures and an acceleration of structural reforms to remove existing bottlenecks to economic growth, including reform of state-owned enterprises (SOEs), creating the foundation for faster growth and private sector–led job creation over the medium term.

Figures 12 and 13 examine the trends in GDP growth and GDP per capita, which has been widely identified as strongly correlated with the size of the undeclared economy; the lower the GDP per capita, the larger the undeclared economy (ILO, 2013; Williams 2014 a,b,c,d, 2015a,b, 2016; Williams and Horodnic, 2016). The positive recovery trends of economic activity, which had emerged in 2015, were intensified throughout 2016 and 2017 through the continued reduction of internal and external imbalances. The reforms carried out in the areas of construction and labour legislation, with strong fiscal adjustments, had a favourable impact on the investment climate.

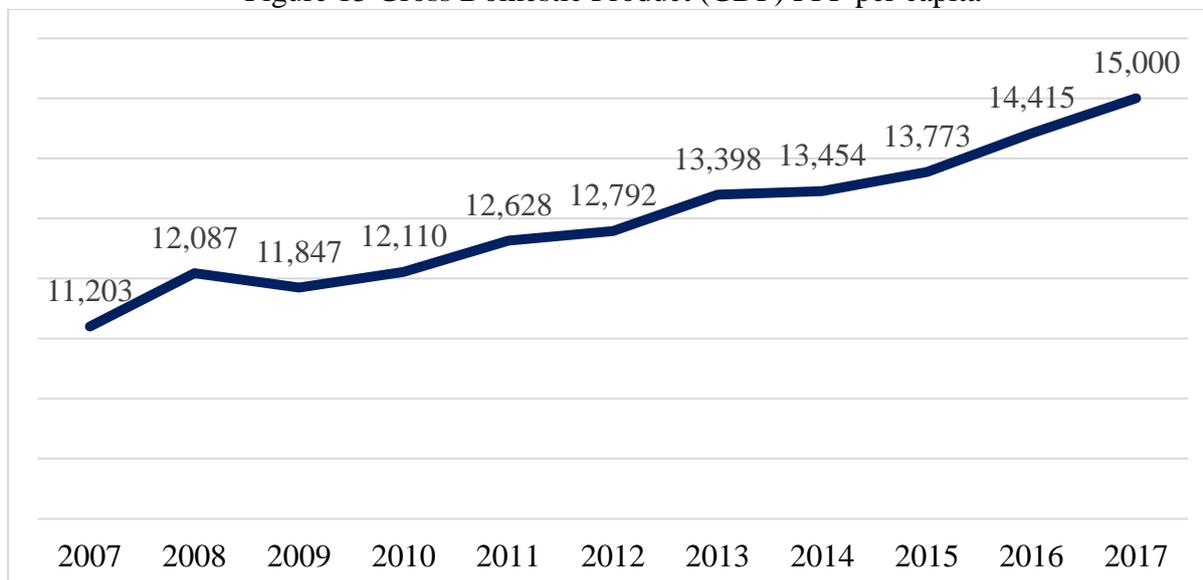
Figure 12 GDP Growth 2007 - 2017



Source : IMF Data Mapper

The other measure of GDP per capital examines **GDP per capita based on purchasing power parity (PPP)**. As Figure 7 reveals, GDP is gross domestic product converted to international dollars using purchasing power parity rates. This reveals that GDP per capita based on purchasing power parity (PPP) has improved in Serbia indicating expected decline in the prevalence of the informal economy, which is reinforced by the estimates presented in the previous section, which show a decline in the size of the informal economy.

Figure 13 Gross Domestic Product (GDP) PPP per capita



Source : IMF Data Mapper

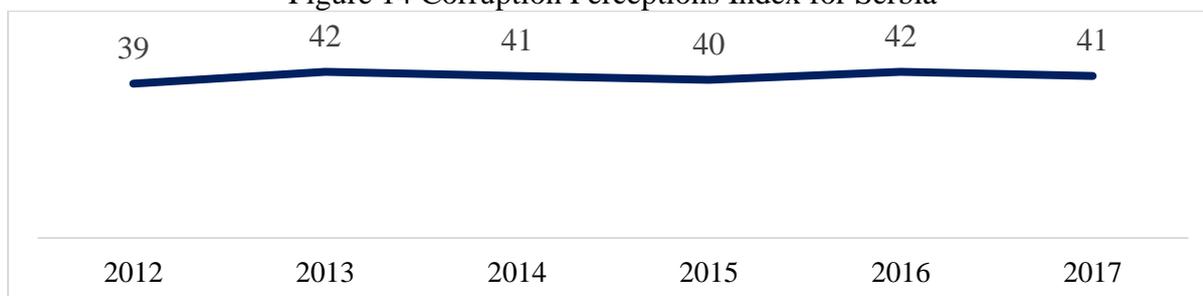
Given that this is a crucial systemic determinant of the level of undeclared work, the strong suggestion is that continuing increase in GDP per capita in Serbia will be associated with decrease in the prevalence of undeclared work.

However, lower GDP per capita is not the only formal institutional failing which results in a higher level of informality. A second important determinant is the **perceived level of corruption and quality of governance**. It is also the case that cross-national studies reveal that the greater the level of public sector corruption and the lower the quality of governance, the more extensive is the undeclared economy (see section 2.1). Improving the quality of governance and reducing corruption are key means of reducing the undeclared economy. One reason this is the case is because many exits the declared economy due to the level of public sector corruption, since it increases the cost of doing business and operating undeclared is a means of escaping from having to make such bribe payments.

Despite Serbia remaining in a relatively low position at 77th out of 180 countries globally, there does appear to have been very modest progress made since 2012. As Figure 5 displays, on a scale where 0 equals highly corrupt to 100 equals very clean, the rating of Serbia in Transparency International's Corruption Perceptions Index (CPI) has very modestly improved from 39 in 2012 to 41 in 2017. As such, **further reductions in public sector corruption and the quality of governance are required if the prevalence of undeclared work is to be tackled.**



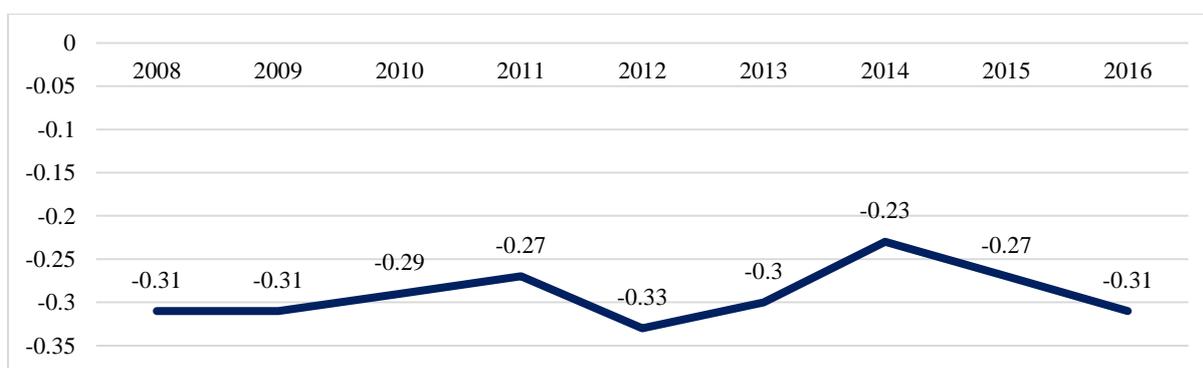
Figure 14 Corruption Perceptions Index for Serbia



Source : Corruption Perception Index (Transparency International)

A further indicator of corruption is the perception of the control of corruption. This captures the perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. The estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5. As Figure 15 reveals, the control of corruption remains pretty much stagnant. If the control of corruption continues to improve, then the prevalence of the informal economy will reduce.

Figure 15 Control of Corruption: Estimate



Source: World Bank database

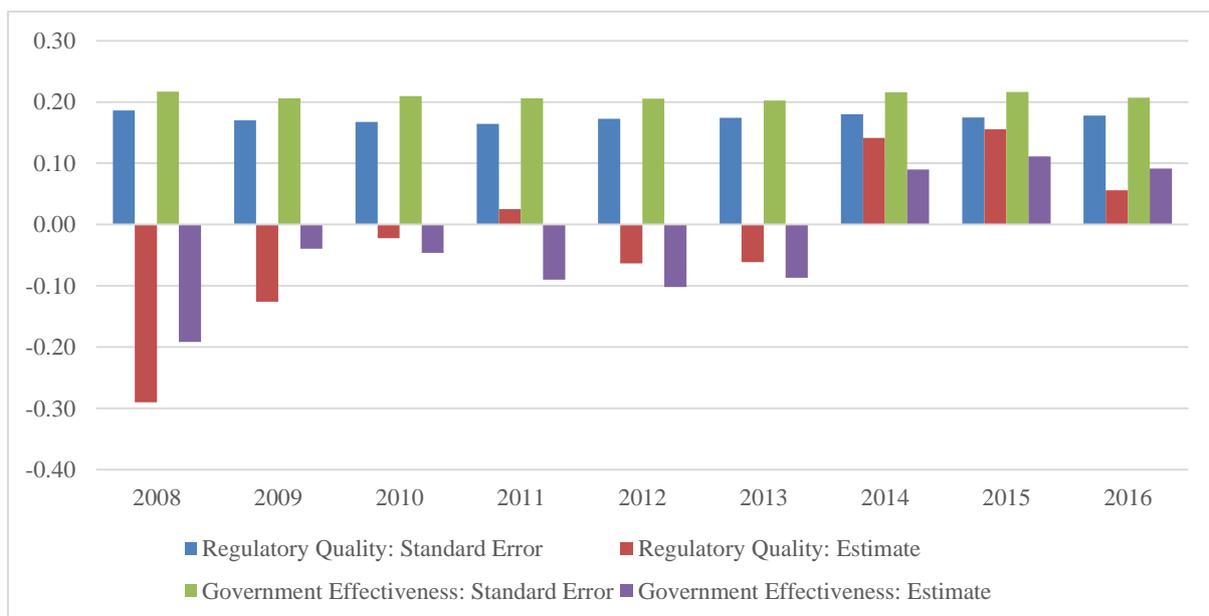
Business survey show some decline of corrupt practices. According to the USAID BEP Surveys, respondents continued to report less effects of corruption on their business in 2017, with 12% stating that it affects them a lot and 34% saying it affects them sometimes; this



compares to 17% reporting in 2014 that it affects them a lot, and 42% saying it affects them sometimes. Other indicators of corrupt practices also continued to decline.⁹

Closely related to the perceptions of corruption is the quality of governance, and this is also an important determinant of the size of the informal economy in a country. Figure 16 provides two measures: 1) **regulatory quality** which captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development and 2) **government effectiveness, i.e. perceptions of the quality of public services**, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation. These estimates give the country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

Figure 16 Regulatory Quality and Government Effectiveness



Source: World Bank, Worldwide Governance Indicators

⁹ For example, perceptions of corruption and ill intent among inspectors have improved. Relative to 2016, there has been a major decline in the number of businesses who see inspectors as corrupt: 15 percent of those polled now believe bribing inspectors is the only way to avoid a fine, as compared to 24 percent who felt the same in 2016. Similarly, 28 percent of all firms now feel inspectors have orders to issue unwarranted fines, in contrast to 2016, when 38 percent shared this view. This matches the fall in the average fine from 2,128 euros in 2016 to 898 euros in 2017 (BEP Survey 2017)

Doing Business data indicate that the overall business environment has improved appreciably relative to 2008. According to the estimations of the World Bank Serbia was ranked in the 86th place in 2008 in the list of countries for doing business and in 2015 it has progressed its place to 43rd.

These findings are supported by business surveys. USAID BEP business survey (2017) also indicates that the overall business environment has improved, and that progress has been made since 2014 in most areas measured. However, 12 percent of businesses polled believe that corruption affects their business, while 34 percent claim that corrupt practices “sometimes” affect the way they operate. Thus, policies aiming at the reduction of the undeclared economy in Serbia should focus on the fight against corruption and on the improvement of the quality of governance, mainly by reducing the unnecessary state interventions, by abolishing the clientelist relations of politicians with the electorate and by combating the persistent institutional weaknesses that provide fertile ground for rent seeking behaviour. In this context, ... the effective reduction of the shadow economy in the long-run is mainly a social issue, namely an issue of social development.’

Most stakeholders argue that the high labour tax burden is to blame for the level of undeclared work in Serbia. BEP business survey (2017) among Serbian enterprises reveals that wage taxes and contributions were perceived as the most damaging macroeconomic indicator with 67 percent of businesses reporting this view. First, it is often argued that “*the tax burden on labour income in Serbia is relatively high – at about 40 percent, it is close to the EU average level but notably higher compared with the OECD average or some other Western Balkan peers.*” (IMF, 2017, p.10). Second, it is also argued that high labour taxes burden and its regressivity are some of the main drivers of large informal employment and high labour taxes evasion in Serbia (Arandarenko and Vukojević, 2008; Krstić and Sanfey, 2013).

One of the key characteristics of labour taxation in Serbia is that the progressivity is rather low. In other words, marginal tax rates on labour income are high and relatively flat for incomes up to five times average level and drop sharply afterwards due to maximum SSC thresholds. Based on the IMF calculations, above five times average level of income, labour taxation becomes regressive as the effective tax burden falls with income. Hence, **the high tax wedge can have significant implications for activity, employment, and informality, particularly at low levels of income.** Current tax burden may discourage individuals to take up formal employment by raising the cost of labour to the employers and reducing the take-home pay for workers. The IMF (2017) has suggested careful approach to designing the tax wedge on labour income by revisiting the SSC and PIT schedules. This could stimulate both demand and supply of labour but may also have significant implications given the link between contributions and entitlements, and tax sharing arrangements between levels of government.

Using microsimulation model, Randelović (2015) shows that tax reform, which would imply introduction of progressive taxation of labour income, may yield adverse effects on the tax evasion. Namely, reforms that would introduce more progressive taxation of labour income in Serbia could lift some of the tax burden for low income earners, but



simultaneously would make some of them ineligible to benefits, which may drive them to work (at least partly) in informal sector. Randelović (2015, p. 87) suggests, redistribution of tax burden (from low to high income earners) as an approach that could contribute to fight against tax evasion, if such reform is accompanied with the reform of benefits system. Under such reform eligibility criteria (for benefits) would be attached to gross, rather than net income, although it might make means- or income tested benefits less targeted.

Krstić (2016) states that high labour taxes for low-wage earners in Serbia were due to the minimum social security contributions that employers and employees are obliged to pay. The minimum base for the calculation of social security contributions equalled 35% of the average gross wage. If the monthly gross wage of an employee is below 35% of the average gross wage, social security contributions are still calculated on this threshold. It is not adjusted for hours actually worked, so the same threshold was applied to part-time and fulltime workers. This has created incentives for low-wage earners to work informally or become inactive and receive benefits such as unemployment benefits, monetary social assistance, and/or child allowance – which may increase inequality.

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

The situation is more complex. On the one hand, in societies where citizen morality and state morality are aligned, tax rates can be high since citizens realise that taxes are the price they pay for a civilised society. Tax rates, therefore, are not, or at least not the key problem in Serbia. It is the lack of trust in the state and belief that they receive appropriate public goods and services for the taxes they pay. There was recognition for example that citizen morality and state morality are not aligned, not least due to a lack of trust in the state apparatus, and that this results in it being difficult for citizens to accept high tax rates due to the inadequate public goods and welfare services received in return. The focus needs to be on: (1) improving the ability to sustain higher tax rates by aligning state morality and citizen morality, not least by improving perceptions of distributive fairness (i.e., that people receive a fair and equitable return in terms of public goods and services for the taxes they pay), and (2) significantly improving tax collection.

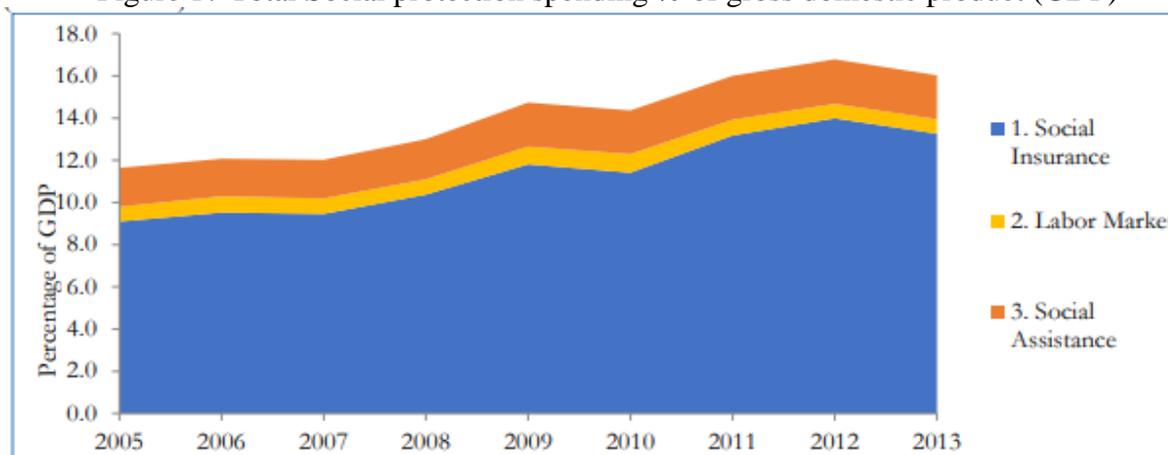
Labour Market Interventions and Social Protection

There is also no evidence that reducing state intervention in the labour market reduces the size of the undeclared economy. Undeclared work is lower in countries where a larger proportion of GDP is spent by governments on interventions in the labour market targeted at groups with difficulties, such as the unemployed, people in jobs but at risk of involuntary job



loss, and inactive persons currently not part of the labour force but who would like a job and are disadvantaged in some manner (Eurofound, 2013; Vanderseyen et al, 2013; Williams, 2014a,b,c,d, 2015a,b, 2016; Williams and Horodnic, 2016). It has also been widely shown that the greater the level of expenditure on social protection as a proportion of GDP, the less prevalent is undeclared work (Eurofound, 2013; Vanderseyen et al, 2013; Williams, 2014a,b,c,d, 2015a,b, 2016). As Figure 17 reveals, in 2013 public spending on social assistance programs in Serbia represented 2.0% of GDP.

Figure 17 Total Social protection spending % of gross domestic product (GDP)

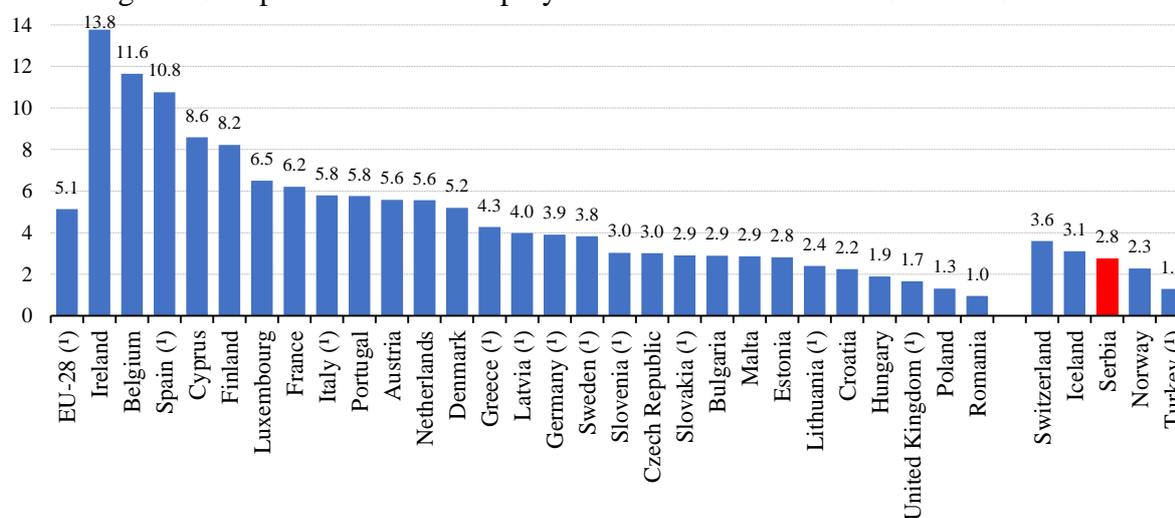


Source: Europe and Central Asia Social Protection Expenditure and Evaluation Database, World Bank.

Note: Spending on war veterans benefits was not available after 2011, and for subsequent years projections are based on past growth rates.

Unemployment benefits are one component of such expenditure, representing 0.6 percent of GDP in 2015. Figure 18 shows relative position of Serbia compared to EU members.

Figure 18 Expenditure on unemployment related benefits in 2014 as a % of GDP



(*) provisional



Source: Eurostat (online data code: spr_exp_sum)

Expenditure on unemployment benefits as a percentage of GDP and as a share of total social protection expenditure has decreased.

Table 7 Unemployment benefits as a % of GDP

2008	2009	2010	2011	2012	2013	2014	2015
1.0	1.0	1.0	0.8	0.8	0.7	0.6	0.6

Source: Eurostat

In Serbia the number of unemployment benefit recipients is not large owing to the prevalence of the long-term unemployed and the considerable proportion of first-time job-seekers, and the expenditures on active labour market policies are low, especially in Serbia (0.015% of the GDP in 2014) (Matković, 2017, p. 39). Hence, only a small portion of those registered as unemployed receive unemployment benefit. This, therefore, does not provide the unemployed with a ‘safety net’ so that they do not have to turn to the undeclared economy as a means of survival.¹⁰ Putting in place a stronger ‘safety net’, therefore, and targeting social expenditure at groups likely to enter the undeclared economy, will be required to reduce the ready-supply of labour for the undeclared economy.

Studies also reveal a strong positive relationship between the level of equality in societies and the prevalence of undeclared work; the greater the income inequality, the more prevalent is the undeclared economy (Williams, 2014 a,b,c,d, 2015a,b, 2016; Williams and Martinez-Perez, 2014; Williams and Horodnic, 2016). **Krstić (2016) shows that income inequality, measured by the Gini coefficient, has significantly increased in Serbia over the period of economic crisis, reaching 38.7 in 2013¹¹.** Similarly, Arandarenko et al. (2017) show that the value of the Gini coefficient spanning 38.0 to 38.6 for the period 2013-2016 indicates a relatively stable but very high-income inequality compared to EU members (Figure 20).

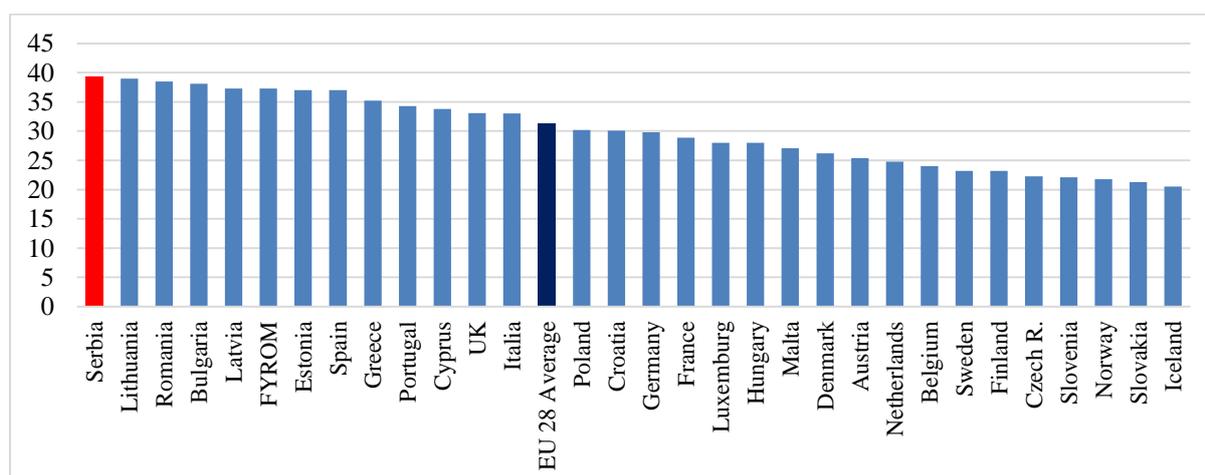
¹⁰ Benefit equals 50% of the insured's average earnings in the last six months is paid The minimum benefit is 80% of the national monthly minimum net wage and the maximum benefit is 160% of the national monthly minimum net wage. The benefit is paid monthly; a lump sum is paid if the funds will be used as start-up capital for a new business. The duration of unemployment benefit depends on the length of the coverage period or the insured's age: the benefit is paid for up to three months with one to five years of coverage; up to six months with six to 15 years; up to nine months with 16 to 25 years; up to 12 months with more than 25 years; or up to 24 months if the insured will be of pensionable age within the next two years.

¹¹ Krstić (2016) shows that the Survey of Income and Living Conditions -SILC data reveals much higher income inequality in Serbia, using both inequality measures, than observed in the previous period of 2006-2010 based on the Household Budget Survey - HBS data. Krstić (2016) also presents another inequality measure which does not capture inequality across the whole income distribution like the Gini coefficient, - the quintile ratio. The quintile ratio also significantly increased in 2012-2013, from 8.6 to 9.8. This means that the equalised income of 20% of the population was almost 10 times higher than that of the poorest 20% in 2013.



These findings suggest that rising inequality contributed to the size of the undeclared economy.

Figure 19 Gini Coefficients EEA and Serbia



Source: Arandarenko et al. (2017). Note: Gini coefficient for equivalent disposable income. Source: SILC 2015, Eurostat. For Macedonia Gini coefficient is for year 2014

Both Krstić (2016) and Arandarenko et al. (2017) suggest that causes of such a high inequality are **the high rate of low work intensity of household members and the high proportion of people working in non-standard forms of employment** (i.e. part-time, temporary, and self-employment arrangements) mostly in the informal sector.¹² Similarly, the high rate of very low work intensity of household members in Serbia was due to the high inactivity of the working-age population (15-65 years old), as well as to the fact that a low percentage of such persons live with other adults who work.

Finally, the low coverage of social transfers, particularly monetary social assistance and child benefits, and the very low level of progressivity of the Serbian personal tax system explain the relatively modest – by international standards – redistributive role of direct taxes and social transfers. Hence, as Krstić (2016) shows higher levels of income inequality and greater levels of undeclared work in Serbia go hand-in-hand.

In sum, to tackle the undeclared economy in Serbia, it is not simply a case of pursuing enforced compliance/direct controls (using deterrents and incentives) and voluntary cooperation/indirect controls (using awareness raising campaigns about the unacceptability of undeclared work and reforms to the processes of formal institutions). Although these are

necessary, they are insufficient. There is also a need to change the macro-level economic and social conditions which result in the prevalence of the undeclared economy. These include:

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

There was widespread recognition for example that formal institutional failures lead to a lack of alignment of state morality with citizen morality, not least due to a lack of belief and trust in the state apparatus, and that this results in it being difficult for citizens to accept high tax rates due to the inadequate public goods and welfare services received in return.

Box 1. Views of Serbian stakeholders on determinants of undeclared and under-declared work.

It is important to highlight that many stakeholders identified some or all of these drivers during interviews with them. Serbian stakeholders highlighted a number of (both structural and non-structural) determinants of the undeclared and under-declared work, including:

- high unemployment rates, especially among young people;
- high levels of parafiscal charges
- low level of tax morality and tolerance
- unequal treatment
- high tax rates and non-labour costs - social security contributions for both employers and employees;
- the lack of trust in state mechanisms and the mindset developed because of these factors.
- Insufficient capacities of inspections
- Inadequate penalties,

Given this identification of the drivers of the undeclared economy, attention now turns to the organisation of the fight against undeclared work in Serbia and an evaluation of the policy approach and measures being pursued.

5. Organisation of the Fight Against Undeclared Work: Institutional Framework

How, therefore, is the fight against undeclared work organised? And are there ways in which the institutional framework can be improved? Table 8 provides a conceptual framework for evaluating the current organisational approach of the Serbian government.



At the top of this spectrum are fully joined-up forms of government where one agency/department is responsible for the whole undeclared economy. Moving down the spectrum, there are then a range of cross-government departmental co-operations ranging from initiatives where the co-operating government departments have common shared targets to achieve at the level of strategy, operations or data matching (and which relate to the whole undeclared economy or specific sectors, occupations and so forth). Following this, there are then cross-government departmental co-operations where the departments involved have separate targets to achieve and which again can be applied at the level of strategy, operations or data matching. Finally, and at the bottom of the spectrum, are completely fragmented forms of government in the form of a departmental ‘silos’ approach.¹³

Table 8 A hierarchy of joined-up government

Approach	Scope	Targets	Level
Single compliance unit	Whole undeclared economy	Common	Strategy, operations and data matching
	Segment	Common	Strategy, operations &/or data matching
Cross-Departmental Cooperation	Whole/segment	Shared	Strategy
	Whole/segment	Shared	Operations
	Whole/segment	Shared	Data matching & sharing
	Whole/segment	Separate	Strategy
	Whole/segment	Separate	Operations
	Whole/segment	Separate	Data matching & sharing
Departmental ‘silos’	Segments	Separate	Strategy
			Operations
			Data matching

Source: derived from Dekker et al (2010)

5.1 Cross-departmental Cooperation

Serbia adopted cross-departmental cooperation and has a rather cohesive and coordinated institutional infrastructure for tackling undeclared economy. Coordination of undeclared work was first initiated in 2014 In 2015 the Government adopted a strategic framework for reducing the undeclared economy in the Republic of Serbia – National

¹³ This table only considers joined-up government, not joined-up ‘governance’, which includes tripartite social dialogue.



Program for Countering the Shadow Economy.¹⁴ The Overall Objective of the National Program for Countering the Shadow Economy is to reduce the undeclared economy share in the GDP of the Republic of Serbia.¹⁵ Besides, there were four specific objectives – 1) improved monitoring of shadow economy flows; 2) improved functioning of the fiscal system; 3) reduction of administrative and parafiscal burdens on businesses and citizens; and 4) raising awareness among citizens and businesses on the significance of reducing the shadow economy and motivation for compliance with regulations. The National Program also sets principles and measures of implementing the National Program for each of abovementioned specific objectives. Activities, with deadlines, bodies and organizations responsible for activity implementation, financial requirements and indicators for monitoring the execution of measures of the National Program are set in **annual Action Plans**, enacted by the Government. **The first Action Plan for Implementing the National Program for 2016 with projections for 2017** was published together with the National Program, as its integral part.

A Central Coordination Body for Directing Activities for Reducing the Shadow Economy (Coordination Body) was established in 2015.¹⁶ This body was set up with the aim of coordinating the activities of public administration bodies and guiding activities for the preparation and implementation of the National Program for Countering the Shadow Economy. The Coordination Body has sessions several times a year and annually sets priorities. The main tasks of the Coordination Body are to analyse and highlight the prevalence of shadow economy. The Coordination Body for the control of shadow economy comprises of representatives from all institutions and organisations enforcing control of shadow economy in Serbia, including labour, tax, social security, policy and financial crime investigation.¹⁷

¹⁴ Since the unified policy of reducing the shadow economy contains elements of horizontal policy, certain areas of this program are already covered to a lesser or greater extent by other strategic documents. The program is a complement to previously adopted documents including Public Administration Reform Strategy ('Official Gazette RS', No 9/14 and 42/14 - correction), Action Plan for Implementing the Public Administration Reform Strategy for the 2015-2017 period ('Official Gazette RS', No 31/15), National Anticorruption Strategy for 2013-2018 ('Official Gazette RS', No 57/13), Action Plan for Implementing National Anticorruption Strategy for 2013-2018 ('Official Gazette RS', No 79/13), National Judicial Reform Strategy for 2013-2018 ('Official Gazette RS', No 57/13), Strategy for Supporting Small to Medium Sized Enterprises, Entrepreneurship and Competitiveness for the 2015-2020 period and Action Plan for Implementing the Strategy for Supporting Small to Medium Sized Enterprises, Entrepreneurship and Competitiveness for 2015 with Projections for 2016 ('Official Gazette RS', No 35/15) and Strategy for Investigating Financial Crimes for 2015-2016 ('Official Gazette RS', No 43/15).

¹⁵ More specifically, the National Program states that the aim is to reduce the shadow economy share in the GDP from 30,1% to 26,7% (MIMIC method) by implementing measures defined in the National Program beginning in 2015 and ending in 2020. The use of MIMIC method is rather problematic, due to volatility of results as explained in section 3.

¹⁶ See Government's Decision on Establishing the Coordination Body for Directing Activities for Reducing the Shadow Economy ('Official Gazette RS', No 140/14 and 24/15).

¹⁷ Participants in the activities of the Expert Group are: the Cabinet of the Prime Minister of Serbia, Ministry of Public Administration and Local Self-Government, Ministry of Trade, Tourism and Telecommunications, Ministry of Finance, Ministry of Economy, Ministry of Labour, Employment, Veteran and Social Issues,



Simultaneously, **the Expert Group of the Coordination Body (Expert Group)** was established with the task to prepare and submit the Draft National Program along with the Draft Action Plan for Countering the Shadow Economy to the Coordination.

In 2017 the Coordination Body adopted a **new Action plan for 2017 and 2018**. Table 9 shows the structure of the Action Plan with key goals and measures. Amended plan envisaged an increase in the number of measures and the intensifying of the activities of relevant institutions aimed at reducing the volume of illicit trade, undeclared work and tax evasion. The focus of the amended Action Plan, which **contains 18 measures and 107 activities**, is similar to the previous with several additions e.g. measures aimed at strengthening the capacity of the tax administration.

Table 9 Action plan for 2017 and 2018

Goal 1	Improved Monitoring of Shadow Economy Flows/Improved Inspection Oversight	2017
Sub goal 1.1.	Improving the Inspection Oversight System	
Measure 1.1	Improving the Capacity of Inspection for Planning, Enforcing and Reporting in Inspection Oversight	
Measure 1.2	Establishing mechanisms for securing the transparency of inspection oversight and interaction with businesses and citizens	
Measure 1.3	Improvement of the System for Prosecution of Offences and Violations Against Business Entities	
Measure 1.4	Improvement of activity coordination between customs, inspections and the police	
Measure 1.5	Creation of Uniform Sanction Policies for the Shadow Economy	
Measure 1.6	Enhancement of the Database System for Salaries and Employee Contributions	
Measure 1.7	Improved Oversight of Activities that Require a Permit	
Sub goal 1.2	Enhancing capacities of Tax administration aimed to curb shadow economy	Added
Measure 1.8	Improving Tax Administration Oversight	Added
Goal 2	Improved Functioning of the Fiscal System	
Measure 2.1	Stimulation of Regulation Compliance and Creation of Incentives for Transferring Shadow Economy Operations to Legal Flows	
Measure 2.2	Improvement of Fairness in Fiscal Policies	
Measure 2.3	Improvement of the Fiscalization System	
Goal 3	Reduction of Administrative Burdens on Businesses and Citizens	
Measure 3.1	Establishment of Public Registry of Parafiscal Charges	
Measure 3.2	Establishment of Unified Legal Framework for Regulation of Fees for Use of Public Goods	
Measure 3.3	Establishment of Public Registry of Procedures/Formalities That Businesses and Citizens	

Ministry of Justice, Ministry of Internal Affairs, Tax Administration, Customs Administration, Republican Secretariat for Public Policies, National Alliance for Local Economic Development, Fair Competition Alliance and Chamber of Commerce and Industry of Serbia.



Goal 4	Raising Awareness of Citizens and Businesses on the Significance of Countering the Shadow Economy and Motivation for Compliance with Regulations	
Measure 4.1	Raising Awareness of the Shape and Appearance of the Shadow Economy Through Informative, Educational Campaigns	
Measure 4.2	Organization of Lottery	
Measure 4.3	Activities of Tax Administration with the aim to increase Tax Morality (Culture)	Added

The Expert Group is coordinated by NALED in cooperation with the Public Policy Secretariat. The Expert Group suggest priorities to the Coordination Body.¹⁸

Box 2. Tackling Undeclared Work - Priorities for 2018

The Body has suggested following priority activities within the specific measures for the upcoming period.

- 1.2.5 Implementation of a single information system e-inspector
- 1.4.3 Establishing better coordination of the work of the inspections and prosecutors' offices in the suppression of criminal offenses in the field of the grey economy
- 3.1.2 Decrease in the number of parafiscal charges
- 1.2.7 Conducting professional training of inspectors in the field of inspection supervision in relation to sectoral regulations
- 1.2.9 Improve coordination of inspectors in accordance with their needs
- 1.4.7 Establishing coordination of the inspections and other state bodies in charge of initiating misdemeanour procedures in the field of gray economy with misdemeanour courts
- 1.2.4 Standardization of the risk assessment process in the planning and implementation of the inspection in accordance with the guidelines
- 1.2.6 Conducting professional training of inspectors for the use of IT systems and in the field of planning of inspection supervision
- 1.6.1. Analysis of penal measures conducted in sectoral regulations and sentences
- 1.1.6 Amendments to the Law on Inspection Supervision and Completion of harmonization of special laws with the Law on Inspection Supervision
- 1.2.10 Provision of necessary equipment for inspections
- 1.4.2 Equalization of the practice of prosecutor's offices in dealing with criminal offenses with elements of the undeclared economy
- 1.5.2 Improving the coordination of the work of the Customs Administration and

¹⁸ For 2018 priorities are mainly concentrated on the improvement of supervision and coordination of inspections. Priorities include implementation of the e-Inspector (IT platform), improved coordination of various inspections and public prosecutors, education of inspectors, risk assessment, etc.



inspection bodies through data exchange and harmonization of procedures for monitoring the grey economy flows

- 1.9.10 Improved oversight of persons performing unregistered activity

Based on the discussions with the representatives of the Coordination Body, the amendments to the current Action plan will also contain sector specific measures. Three sectors that will be covered are transport, agriculture and accommodation and food service activities.

Finally, as one of the bodies within the Coordination Body the **Working Committee for Suppression of the Undeclared Work (WCSUW) was formed in November 2017**. The members of WCSUW are mainly inspections (inspectorates) that are relevant for sectors where the undeclared work is most prevalent. The WCSUW adopted action plan for coordinated inspections for 2018.

5.2 Responsibilities of government ministries and inspectorates

5.2.1 Ministry of Labour, Employment, Veteran and Social Affairs/ Labour inspectorate

The Ministry of Labour, Employment, Veteran and Social Affairs takes overarching responsibility for labour law violations, and given that tackling undeclared work in Serbia is primarily perceived as concerned with the social protection of workers, this Ministry is viewed as the lead Ministry in tackling undeclared work, taking responsibility for the definition and implementation of policies on employment, working conditions and social security, coordinating the system of labour administration, including the Labour Inspectorate.

The Labour Inspectorate is an administrative body within the Ministry of Labour. LI performs inspection and related tasks in the field of labour relations and work safety. The overall goals of the Labour Inspectorate in the field of labour relations are to minimise risks employees face at work, tackle undeclared work (“rad na crno”) and combat breaches of rights arising from employment or collective agreement.¹⁹ The Labour Inspectorate is also charged with carrying out other activities related to the implementation of the Labour Law, the Health and Safety Law, and other labour legislation.

The Inspectorate employs almost 250 inspectors, mainly lawyers and engineers specialising in various fields, and operates in each of the 25 administrative districts and in Belgrade. At

¹⁹ <http://www.minrzs.gov.rs/lat/dokumenti/inspekcija-rada/nadleznost-inspektorata.html>



the end of 2017, the Labour Inspectorate had a total of 265 employees (out of 282 systematized jobs), of which 247 labour inspectors. In addition to inspectors, the Inspectorate also has 11 civil servants and 5 other administrative workers. The ILO (2006) recommends that advanced countries have at least one labour inspector per 10,000 employed persons while transition countries have one inspector per 20,000 employed persons. If we use average registered employment in 2017, we obtain **8,500 employees per inspector which means that at least with respect to human resources there is a sufficient number of labour inspectors**. However, using LFS data on employment the ratio is 10,500 which is again close to the international standard.

Table 10 Labour Inspectorate Employees

Labour Inspectorate	2015	2016	2017
Employees Total	264	262	263
Inspectors	242	240	247

Source: Labour Inspectorate

Table 11 Educational background of inspectors (2017)

Lawyers	131
Engineers	116

Source: Labour Inspectorate

The labour inspectors are civil servants selected by a state personnel selection commission. Candidates for labour inspection posts must have a university degree and since 2016 pass state examination for inspectors.

An integrated inspection oversight concept has been in place in the LI since early 2010 (Arandarenko, 2012). This means that all labour inspectors undertake comprehensive inspection actions: employment issues are not kept separate from those related to health and safety. A priority task of the Inspectorate has always been to verify whether workers have formal employment contracts. Arandarenko (2012) emphasizes that labour inspectors' main task is to oversee the implementation of statutory provisions governing "entering into labour relations": i.e., uncovering informally employed workers and formalising their status as people in informal employment are not protected by workers' rights, face greater risk of injury, are not entitled to healthcare, and are denied unemployment benefits and old age pensions due to the fact they are not registered for mandatory social security when in work. Hence, safeguarding public interest, non-declaration of employees entails tax evasion and a number of safety hazards are primary tasks of the LI.

The Inspectorate is entitled to audit businesses: where it detects breaches of law—including work without a written employment contract—it can require deficiencies to be eliminated within a short period of time. Labour inspectors are authorised to inspect a business's internal bylaws and individual contracts, as well as other documents in accordance to the Law on Inspection Oversight. They may take statements from corporate officers and other interested parties, and may also inspect offices, production plants, and other premises. The inspectors are also entitled to launch audits based on reports made by third parties - members of the



public, workers, or any other interested parties. The employer must notify the Inspectorate of the steps taken within 8 days; inspectors will then visit the employer again to verify that the issue has been resolved. When workers without employment contracts are discovered at a business the employer is given a deadline for either signing contracts with those employees or letting them go.

Since 2015 several important changes affected the work of the LI. First, before 2015, unregistered businesses, typically located in private homes and with all workers employed informally, were allowed by law to deny labour inspectors access to their premises, since the Labour Inspectorate did not have jurisdiction over them. Since the introduction of the Law on Inspection Oversight the Inspectorate can audit unregistered businesses as well.²⁰

Labour Inspectorate sets annual plans and publishes annual reports, posted on the site of Ministry of Labour, Employment, Veteran and Social Affairs.²¹ Annual Reports of Labour Inspectorate (Annual Report 2015, 2016, 2017) have stated that informal employment is most common in specific sectors trade, construction, industry, tourism and catering, crafts and home repair, and personal services. Based on Annual Reports, it seems that catering and construction record an increase in informal employment over the same periods of each year. Catering sees this trend in the summer, while in construction it is evident towards the end of the building season as employers strive to meet deadlines. Undeclared employment in the construction sector is fostered by high employee turnover, frequent shifts from one construction site to another, and brief periods of employment, as workers remain on site only until a particular job is finished. However, enhanced inspection oversight is employed in the construction sector throughout the year due to the possible health and safety risk. Inspectors have also discovered that unregistered employers in the shadow economy mainly hire young unskilled labourers, with at most secondary school diplomas; they also employ workers without permanent incomes, the unemployed over 40 years of age, beneficiaries of various types of assistance or social security. Throughout the observed period there is no change in key findings of the LI.

5.2.2 Ministry of Finance/ Tax Administration

²⁰ The Law on Inspection Oversight was enacted on April 15, 2015 and published in the Official Gazette of the Republic of Serbia No. 36/2015. The Law entered into full force on April 30, 2016. English translation of the Law on Inspections Oversight is available at

http://www.bep.rs/images/gallery/2016_10_17/Serbia%20Inspection%20Oversight%20Law%20Apr%202015%20EN.doc The Law on Inspection Oversight serves as the framework law for all inspection related procedures. The Law introduced a number of additional changes affecting 1) transparency and standardization of inspection oversight (inspection plans and control lists are published on inspectorates' websites; inspectorates must give legal entities written notice of an inspection, three working days prior to the inspection at the latest) and 2) powers of inspectorates (now these powers are much broader).

²¹ <https://www.minrzs.gov.rs/lat/pres/saopstenja/izvestaj-o-rad-u-inspektorata-za-rad-za-2017-godinu.html/>



The Ministry of Finance, meanwhile, takes responsibility for that aspect of the undeclared economy related to tax non-compliance. In recent three years, considerable progress has been made on strengthening tax compliance. As often perceived in Serbia, “an in-depth reform and development of the Tax Administration are of key importance for efficient economic environment and for the suppression of the informal sector” (Vučković et al. (2016) p. 13). In 2015, the Government of Serbia adopted the Transformation Programme of the Tax Administration followed by an Action Plan. The plan aims to implement an in-depth reform of the Tax Administration and the development of a modern institution capable of efficient detection and prosecution of tax evasion focusing on key operational shortcomings, such as the inadequate organisational structure with a large number of small and inefficient offices, weak and insufficient human resources and fragmented and obsolete information systems which do not allow for efficient resource management and risk-based tax evasion identification.

Enforcement needs to be strengthened by: improving debt collection; adhering strictly to the no amnesty commitment; introducing instalment arrangements in line with international practice; adhering to filing deadlines; improving dispute resolution and judicial process; and developing taxpayer assistance strategies to improve voluntary tax compliance.

Resources and staffing. Several reviews and studies emphasized that **Serbia has the smallest number of tax officers per capita of all the countries in the region**, their salaries are not competitive compared to the private sector (especially in the case of more experienced tax officers), while the Serbian Tax Administration is also burdened with a large number of non-tax related competencies (software legality, real estate valuation, VAT refund on baby products, etc. (Vučković et al., 2016).

The Serbian revenue administration is aging, with more than 50% of staff exceeding 50 years of age. Inadequate educational and age structures of the staff make it more difficult to increase the efficiency of tax authorities. The average age of Tax Administration staff is over 50, while the average in the comparable countries is 44. Unfavourable age and educational structures represent significant limit to the efficiency and high average age of Tax Administration staff can lead to a high natural workforce outflow in the upcoming period.

The appointment process for staff was also constrained by the overall general government hiring constraints. To allow Tax Administration to cope with these problems, in 2017, the Government allowed Tax Administration, despite the hiring constraints in the public sector, to employ new staff. Nevertheless, these issues represent a significant aggravating factor in the process of modernisation of the Tax Administration. In fact, as shown in Vučković et al. 2016, the number of Tax Administration staff is among the lowest in the group of comparable countries in the region. With over 6,200 employees, Serbian Tax Administration has fewer employees per capita than comparable countries. Serbia has one Tax Administration employee per 1,261 inhabitants which was lower by 18% compared to new EU member states.



A serious obstacle lies in the uncompetitive salaries when compared to the private sector. One of the most observed inefficiencies is the inadequate staff allocation by sectors. Namely, a small number of staff is performing basic activities such as control and revenue collection, while the majority work on support tasks such as administration, human resources, receipt and processing of tax returns, etc. Thus, the Tax Administration has at its disposal around 600 field control inspectors, which is about 10% of the total staff and well below the international recommendations that inspectors should comprise about 25% of the total staff.²²

Skills are also lacking across main functions, such as audit and debt collection. However, upgrading staff is notoriously difficult due to a low-entry level pay and a flat grade for auditors, which do not create sufficient incentives for existing and new staff to perform complex tasks. For example, in comparison with revenue administrations in other advanced countries—where the minimum remuneration of an auditor is about 134% of GDP per capita, tax auditors in Serbia are paid significantly less—at less than 50% of GDP per capita. According to available data, only 55% of the employees in Tax Administration received higher education, while the average in the comparable countries is 12 p.p. higher (Vučković, et al 2016). Particularly alarming was the situation with tax inspectors, of which there are only 500, even though international experience calls for at least 1,000 (qualified) tax inspectors for a country like Serbia.

Operational reforms. There is a need to improve detectability of tax evasion by: (i) adopting segmentation strategies that focus resources where the tax risks are the greatest (e.g., largest taxpayers, high-wealth individuals, and high income self-employed); (ii) improving the incentives and qualifications of staff in these units; (iii) increasing collection of third-party information; and (iii) using risk-based approach to audit. Tax administration recently. The Tax Administration has introduced an ambitious Transformation Program (2015-2020) aimed to create a modern TA utilizing e-based business processes, delivering taxpayer services and modern compliance risk management (Poreska uprava, 2015). This requires many fewer, but larger offices, organized differently, with more highly-skilled employees and adequate management framework to ensure proper prioritization, coordination, and consistency of approach and adoption of the new operational model which separates the administration of core and non-core tax activities and significantly consolidates the administration of core tax activities (IMF, 2016).

²² Vučković et al. (2016) state that around 300 employees were transferred from administration to work on simpler inspection tasks, such as employee registration control and issuing fiscal receipts in retail shops. While these moves resulted in a significant increase in field controls it is clear that the newly introduced tax controllers “cannot serve as an adequate or sustainable replacement for the shortage of qualified tax inspectors. Additionally, there are indications that a disproportionately large number of tax inspectors is engaged in the control of small and medium taxpayers, whereas optimal allocation would call for a greater focus on large and medium taxpayers, responsible for the dominant part of tax revenues. This is why special attention needs to be paid to the establishment of adequate capacities within the Centre for Large Taxpayers in the upcoming tax administration reform.”



5.2.3 Role of other Ministries and Inspectorates

Beyond the Ministry of Labour and Ministry of Finance a range of additional Ministries/Inspections have responsibility for tackling various aspects of the undeclared economy. However, their role is sector specific (e.g. Tourism Inspection, Social Protection Inspection, etc.).

5.3 Bodies of Social Dialogue

The Social and Economic Council of the Republic of Serbia was first established in August 2001 under the Agreement on the Establishment and Scope and Mode of Operation of the Social and Economic Council of the Republic of Serbia, concluded between the Serbian Government, Confederation of Autonomous Trade Unions of Serbia (CATUS), Trade Union Confederation “Nezavisnost” (TUC “Nezavisnost”), Association of Free and Independent Trade Unions and the Serbian Association of Employers (SAE).²³ The Council was established with the aim of engaging in and developing a social dialogue on the issues of importance for realizing economic and social freedoms and rights, improving the financial, social and economic position of employers and employees and their living and working conditions, developing the negotiation culture, encouraging a peaceful settlement of work-related disputes, developing democracy and issuing magazines, brochures and other publications within the scope of its work.

The Social and Economic Council reviews the development and promotion of collective negotiations; influence of economic policy and its implementation measures on the social development and stability, employment, wage and pricing policies, competition and productivity, privatization and other structural adjustment issues; workplace and living environment protection; education and professional training; health care and social protection and security; demographic developments and other issues in accordance with the acts of the Social and Economic Council.

The Council also reviews and provides its views on draft laws and other proposed regulations of importance for the economic and social position of employees and employers. The

²³ The Law on the Social and Economic Council of the Republic of Serbia was adopted in November 2004 (Official Gazzete of the Republic of Serbia, No. 125/04) giving the Social and Economic Council of the Republic of Serbia a legal framework for establishment and operation. The Law defines the Council as an independent body, made up of representatives of the Serbian Government, representative associations of employers and representative trade unions. The Council is made up of 18 members and in the current convocation the Government is represented by six, SAE by six, CATUS by four and TUC “Nezavisnost” by two members.



Council adopts decisions by consensus in the form: stands, opinion, initiatives, recommendations and conclusions. In accordance with its Rules of Procedure, the Council has formed four permanent working bodies: Working Body on Economic Issues, Working Body on Collective Negotiations and Peaceful Resolution of Work-Related Disputes, Working Body on Workplace Safety and Health Issues and Work Body on Legislation. In 2010 the SEC together with the trade unions published a report “Efficient Combating the Informal Economy” that was based a survey among economically active population (employed and unemployed). However, since the SEC is less active in the field, mainly due to the new organisational structure.

5.4 Conclusion

Action plans are updated every year with the participation of relevant stakeholders and individual targets. The introduction of holistic integrated strategic approach for tackling undeclared work in Serbia has achieved significant results. Action plans set strategic objectives for the various Ministries and agencies involved in the fight against undeclared work. Key performance indicators (KPIs) follow so-called SMART (Specific, Measurable, Achievable, Relevant & Time-bound) approach and tackling undeclared work can be measured.

6. Current Policy Approach and Measures: An Evaluation

To evaluate the current policy approach and measures adopted in Serbia, both desk-based research was conducted as well as meetings with a wide array of stakeholders in May and June 2017 in Serbia (see Appendix A for a list of the organisations to whom questionnaire was sent and/or with whom meetings were held). Table 10 summarises the current policy measures used in Serbia and compares this with the range of policy measures pursued in European Economic Area (EEA) as reported by Dekker et al (2010).

While the table reveals that Serbia is still mainly focused upon using deterrence measures to stamp out undeclared work it is also introducing an increasing number of incentive measures that are changing the ‘benefits’ side of the equation by adopting measures to make it easier and more beneficial to operate in the declared economy. Hence, **Serbia is slowly shifting from predominantly the ‘direct controls’ (enforced compliance) approach towards an ‘indirect controls’ (voluntary cooperation) approach that seeks to engender a commitment to operating on a declared basis.**

Table 12 Policy measures used in Serbia and 31 EEA countries to tackle undeclared work

Policy	Use in Serbia	% of EEA nations	% EEA stakeholders stating measure is:



			Effective	Neutral	Ineffective ^e
DIRECT CONTROLS					
Deterrence					
Penalties:	Yes	93	50	45	5
Administrative sanctions for purchasers/companies	Yes	87	46	49	6
Administrative sanctions for suppliers/employees	No	83	41	59	0
Penal sanctions for purchasers/companies	Yes	74	59	33	8
Penal sanctions for suppliers/employees	No	52	53	42	5
Measures to improve detection:	Yes	100	64	34	2
Data matching and sharing	Yes	83	72	25	2
Workplace inspections	Yes	100	75	17	8
Registration of workers prior to starting work or on first day of work	Yes	74	74	23	3
Coordinating strategy across government	Yes	57	56	44	0
Certification of business, certifying payments of social contribution and taxes	No	65	62	33	5
Use of peer-to-peer surveillance (e.g. telephone hotlines)	Yes	39	20	80	0
Coordination of operations across government	Yes	61	64	36	0
Coordination of data sharing across government	Yes	65	82	19	0
Mandatory ID in the workplace	Yes	65	70	30	0
Enabling compliance:					
Preventative measures:	Yes	90	45	43	12
Reduce regulations	Yes	48	56	38	6
Simplify compliance procedures	Yes	87	62	38	0
Technological innovations (e.g. certified cash registers)	Yes	43	73	27	0
New categories of work (e.g., for small or mini-jobs)	Yes	35	59	33	8
Direct tax incentives (e.g., exemptions, deductions)	Yes	61	57	33	10
Social security incentives	Yes	35	62	15	23
Ease transition from unemployment into self-employment	Yes	65	29	63	8
Ease transition from employment into self-employment	No	44	15	77	8
Changing minimum wage upwards	Yes	48	24	59	18
Changing minimum wage downwards	No	9	0	50	50
Training & support to business start-ups	Yes	61	50	46	4
Micro-finance to business start-ups	Yes	52	48	52	0
Advice on how to formalise	Yes	61	33	67	0
Connecting pension schemes to formal labour	Yes	61	47	41	12
Introducing supply chain responsibility	No	17	78	0	22
Restricting free movement of (foreign) workers	Yes*	43	29	53	18
Curative measures:	Yes	64	61	35	4
Stimulate purchasers to buy declared:					
Service vouchers	No	26	58	42	0
Targeted direct tax incentives	Yes	61	65	29	6
Targeted indirect taxes	No	17	63	25	13
Stimulate suppliers to formalise:					
Society-wide amnesties	Yes	9	10	0	0
Individual-level amnesties for voluntary disclosure	Yes	17	75	25	0
Formalisation advice to business	Yes	30	44	56	0
Formalisation support services to businesses	Yes	30	57	29	14
Targeted VAT reductions	No	17	43	43	14
Free record-keeping software to businesses	No	13	50	50	0
Fact sheets on record-keeping	No	22	57	43	0



Free advice/training on record-keeping	No	22	57	43	0
Gradual formalisation schemes	No	13	67	33	0
INDIRECT CONTROLS:		69	44	52	4
Change values, norms & beliefs					
Campaigns to inform undeclared workers of risks and costs of working undeclared	Yes	61	64	36	0
Campaigns to inform undeclared workers of benefits of formalising their work	Yes	57	43	47	10
Campaigns to inform users of undeclared work of the risks and costs	Yes	61	50	40	10
Campaigns to inform users of undeclared work of the benefits of declared work	Yes	52	35	59	6
Use of normative appeals to people to declare their activities	Yes	52	33	67	0
Measures to improve tax/social security/labour law knowledge	Yes	65	50	50	0
Campaigns to encourage a culture of commitment to declaration	Yes	39	29	64	7
Reform formal institutions					
Measures to change perceived fairness of the system	No	26	25	75	0
Measures to improve procedural justice of the system (i.e., degree to which people believe government has treated them in a respectful, impartial and responsible manner)	No	17	60	40	0
Adoption of commitment rather than compliance approach (e.g., 'responsive regulation')	Yes	30	50	40	10

6.1 Direct controls: deterrence measures

Citizens abide by the law either:

- (1) because individuals are motivated to comply with laws due to a fear of consequences for doing otherwise i.e. they fear detection and fines due to the power of authorities (enforced compliance) – deterrence-based theories; or
- (2) because they feel a commitment to be honest and have trust in the authorities (voluntary cooperation).

In Serbia, emphasis is slowly shifting from pursuing enforced compliance to voluntary cooperation. Recently, enforced compliance has been largely sought not by providing incentives to operate in the declared economy but by increasing the perceived and/or actual costs of working in the undeclared economy. This has been achieved firstly, by raising the penalties and sanctions for engaging in undeclared work and secondly, increasing the perceived and/or actual risk of detection.

6.1.1 Penalties and sanctions

A reform of the tax penalty system in Serbia was introduced in 2014. Since 2014 all penalties for breach of tax legislation were stipulated in the Law on Tax Procedure and Tax Administration (LTPTA). Until 2014, penalties for breach of tax legislation in Serbia were regulated by means of numerous sectoral laws (e.g. the Law on VAT, the Law on Personal Income Tax, the Law on Corporate Income Tax, etc.), as well as by the framework Law on Tax Procedure and Tax Administration, with penalty-related provisions of the sectoral laws often not being aligned with provisions of the framework law (Randelović, 2016, p.119). All penalty provisions were moved from the specific tax laws to the framework law. Generally, penalty-related provisions of the framework law were (1) extended, (2) shifted towards ad valorem penalties, and (3) increased.

Besides LTPTA, in November 2016, the Serbian Parliament adopted amendments to the Criminal Code stipulating changes to criminal offence of tax avoidance. Most importantly, the Code has increased the threshold for criminal prosecution of tax avoidance. Previously, this threshold was very low (RSD 150,000 or less than EUR 1,500) requiring criminal investigations of minor cases of failure to pay tax, which were often the result of a mere mistake, rather than an actual intent to avoid tax. Such provision had negative effect requiring already scarce resources of both the Tax Police and the Office of the Public Prosecutor (who has a legal obligation to investigate all cases which may fall under legal definition of tax avoidance) to be devoted to minor cases instead of concentrating on high-profile cases of tax avoidance. The law increased the threshold for criminal prosecution from



RSD 150,000 to RSD 500,000 (app. EUR 4,000). It remains to be seen whether such still a relatively low threshold will bring improvement in the prosecution of tax avoidance.

New amendments to the LTPTA were adopted in April 2018 introducing even harsher penalties for specific tax offences.²⁴ In case a major breach of tax laws is determined in the tax audit, authorities can now prohibit the taxpayer from conducting business activities for up to 15 days in case that irregularities were determined by the inspection for the first time, up to 90 days for the second time and up to the one year for the third time. This is significantly harsher than the maximal 60-day period which was previously prescribed by the law. Another major change is that the TA cannot submit a request for the initiation of misdemeanour proceedings when it has already notified the Tax Police on its suspicions that the taxpayer has committed a criminal tax offence, thus preventing the simultaneous existence of criminal and misdemeanour proceedings. For severe breach of tax legislation (such as introduction of sophisticated tax evasion schemes, resulting in evasion of large amounts of taxes) the maximum sentence stipulated by the Serbian tax law is 10 years.

Randelović (2016) provides the comparative analysis of the tax penalty schemes in Serbia and several European countries. He finds that tax penalty scheme in Serbia is to a large extent harmonized with the practice in other countries and that tax penalties structure and levels being close to the average (Randelović, 2016, p.119) and argues that **larger shadow economy and tax evasion in Serbia, when compared to other countries, are not caused by low statutory penalty rates**. However, many tax audit cases end up in court, resulting in downwards revision of the initial assessment and fine imposed by the Tax Administration. Randelović (2016) believes that this is due to two reasons. First, in some cases the Tax Administration inappropriately assessed the case. Second, in other cases it may also be due to general practice of Serbia's judiciary system, that courts tend to assess the sentence close to the lower bound.

Similarly, the actual penalties and sanctions for informal employment have seen steady increases during last several years.²⁵ According to Article 273 of the Labour Law fines from RSD 800 000 to RSD 2 million are envisaged (about €5,000 to €17,000 at the current exchange rate) for businesses employing workers without appropriate contracts, not paying social security contributions, not paying wages, paying wages below the statutory minimum, or paying wages partly 'cash in hand'. Fines for entrepreneurs are also high and amount RSD 300,000 to RSD 500,000 i.e. less than a half the amount applicable to businesses.

In addition to a stricter penal policy, it seems that labour inspectors are more proactive in bringing and arguing cases in misdemeanour court. In 2017, the total amount of fines

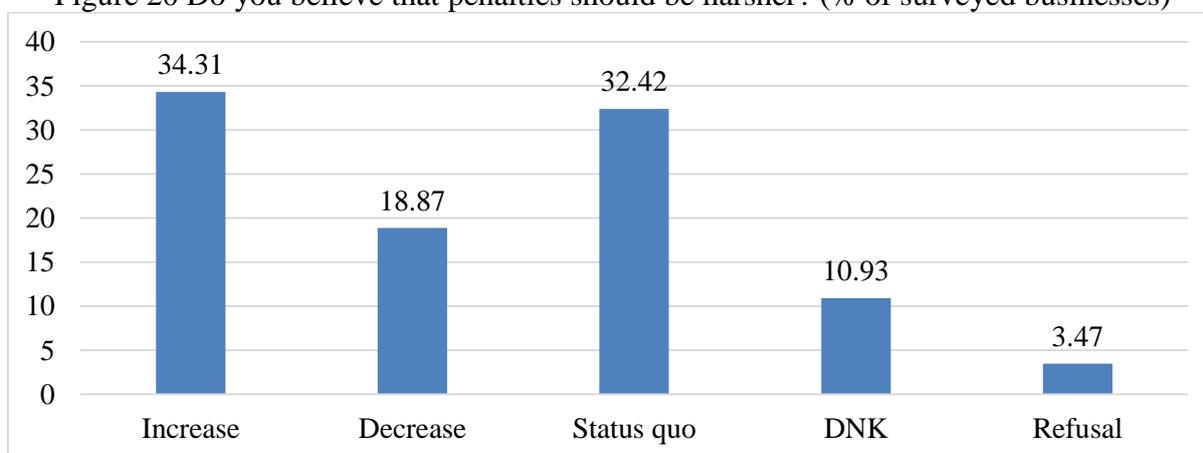
²⁴ Official Gazette of the Republic of Serbia. No. 30/2018

²⁵ Prior to amendments of the Labour Law, penalties of RSD 1,000,000 (9,000 Euros at the relevant exchange rate) were stipulated for businesses employing workers without a proper contract, not paying social insurance, unpaid wages, wages below the legal minimum and 'envelope' wages.

imposed according to the decisions of misdemeanor judges was RSD 153 million. LI filed 1,337 requests for initiation of misdemeanor proceedings (the average amount of the sentence imposed was RSD 114,470 (app. EUR 1.000). However, still a significant number of procedures were suspended or interrupted.

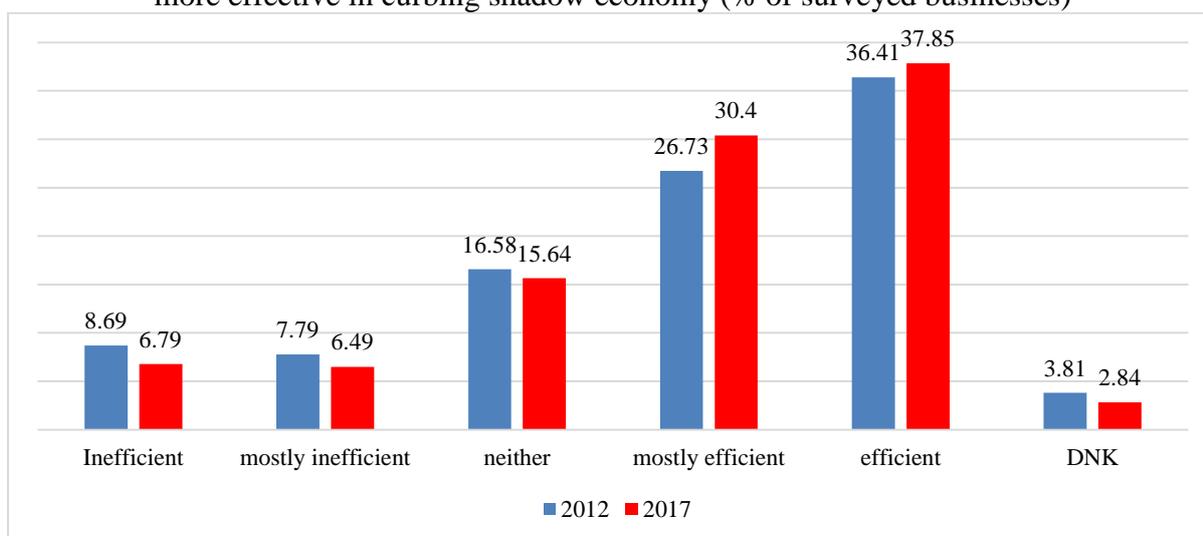
Interestingly, both businesses and regulators believe that penalties should be harsher or at least at the same level. More than one third of businesses believe that penalties should be harsher, and this view is shared by several stakeholders who provided response to the questionnaire.

Figure 20 Do you believe that penalties should be harsher? (% of surveyed businesses)



Source: Business Environment Survey 2017, Ipsos/NALED.

Figure 21 Efficiency of harsher penalties – Do you believe that harsher penalties would be more effective in curbing shadow economy (% of surveyed businesses)



Source: Business Environment Survey 2017, Ipsos/NALED.



This view is similar to the one in other European countries where 50 per cent of stakeholders interviewed in 2010 view this measure as effective and 45 per cent as a neutral and only 5 per cent as ineffective (Dekker et al., 2010). Indeed, this conservative view of the effectiveness of penalties and sanctions is correct. The attitude to the scope and significance of sanctions as a very important for incentives, because if the perception of the severity of the sanctions is low, businesses have a greater incentive to engage in the shadow economy, or to carry out tax evasion and continue with undeclared work. However, recent research found no association between the perceived penalties and the likelihood of participating in the informal economy (Williams and Horodnic, 2017). Furthermore, while most stakeholders perceive that increasing penalties will have significant impact on undeclared work, such approach may have unintended consequences as well. For example, raising further penalties may provide incentives for the purchasers of shadow work to resort to do-it-yourself activities or simply not consume the services (Mogensen, 1985). **Overall, therefore, further altering the sanctions and penalties should not be the focus of attention of a national action plan for supporting the formalisation of the informal economy.** The perceived risk of detection, however, is significantly correlated with the likelihood of participation.

Two-thirds of all business entities surveyed thought that there was a 50 % or less chance of an entity or person operating in the shadow economy being penalised after getting caught, while 17 % thought that one in every ten managers would face sanctions. The total probability of anyone who gets caught facing any sanctions is even lower, since as many as two-thirds (67 %) of the businesspeople surveyed thought that the fine imposed would be paid in fewer than 50 % of all cases, while 17 % felt that only one in every ten fines would be paid. Thus, the likelihood that those who get caught actually are fined and pay that fine is believed to be very low. There are various ways in which business entities avoid paying their dues. **According to the results of the survey the most common means of avoiding payment of a fine is corruption (40 %), followed by shifting the company's business to a newly established entity (17 %), or simply waiting for charges to lapse due to the operation of the statute of limitations (18 %).**

Serbia established Central Register of Temporary Restrictions of Rights of Entities in 2016. The Central Register was established pursuant to the Law on the Central Register of Temporary Restrictions of Rights of Entities Registered with the Serbian Business Registers Agency (RS Official Gazette No 12/2015 – hereinafter: Law). It is a centralized repository of systematically collected data on business entities and their owners, directors, members of supervisory boards and other bodies that have had criminal, civil or administrative sanctions imposed against them. The aim is to improve transparency of doing business in Serbia and increase security of business transactions among all market players.

The grounds for temporary restriction entail the following measures: (1) injunctions, restrictions or precautionary measures with respect to carrying on registered business activities or operations; (2) injunctions preventing the disposal of money; (3) injunctions restricting responsible executives in a legal person or sole traders from practicing their duties or professions; (4) injunctions or restrictions with respect to the disposal of shares or other restrictions pursuant to regulations governing the legal status of companies; (5) measures foreseen by regulations governing tax proceedings and tax administration; (6) **measures**

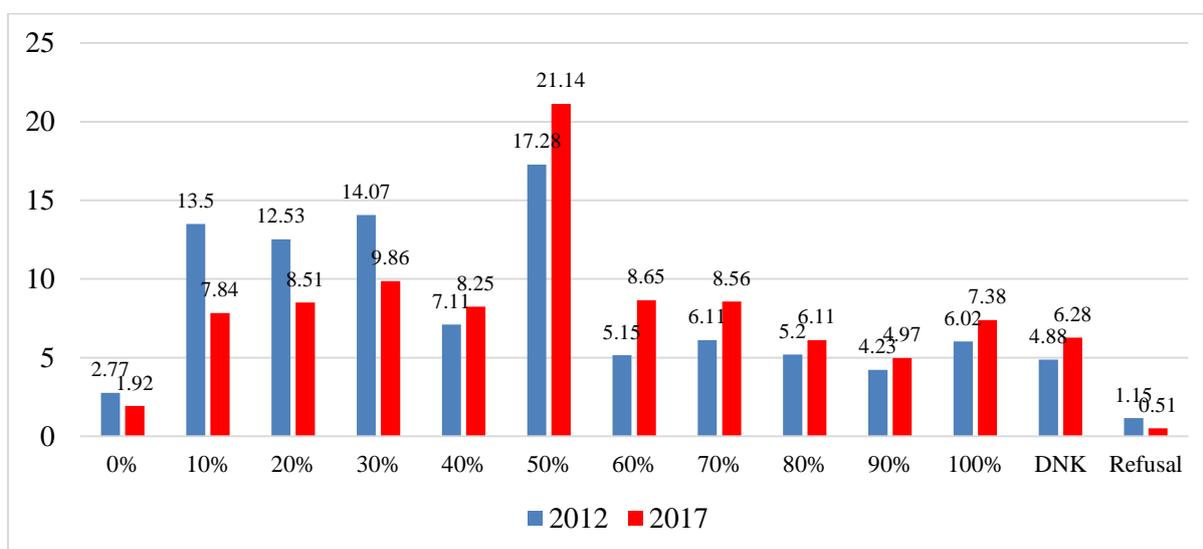


imposed in a procedure instigated by the bodies of inspection control, (7) measures revoking authorizations, licenses, permits, approvals, concessions, subsidies, incentives or other entitlements provided for by special laws; (8) other measures in accordance with the law. Identification data on a legal entity with temporarily restricted rights are available on the SBRA's website, while data on individuals who have had injunctions and security measures imposed against them in court proceedings are not in the public domain and may only be obtained in line with regulations governing criminal records. Data registration authorities and data reporting authorities All state authorities that have a role in the system of registration of persons with temporarily restricted rights are divided into two basic categories: a data reporting authority is responsible for delivering data or documents on an entity with temporarily restricted rights, stipulated by this law, to the SBRA, in electronic format, using electronic services, or the purpose of registering these in the Central Register; a data registration authority is responsible for entering the data on a person with temporarily restricted rights, stipulated by this law, into the Central Register through the Unique interoperability platform (UIP). However, currently registry contains 308 injections.

6.1.2 Detection measures

In both literature and empirical studies, sanction probability plays a very significant role in explaining the causes of undeclared work (Krstić and Radulović, 2015). Before assessing the measures used to improve detection, it is useful to evaluate the perceived risk of detection in Serbia. Both 2012 and 2017 survey elicit businesses' perceptions of the probability of being caught for various forms of shadow activity and the severity of penalties if caught. As Figure reveals, in 2012 the majority (50 per cent) of the businesses surveyed believed that the risk of detection was small (less than 50 percent risk of detection) and only 27 per cent perceive the risk of detection as high (higher than 50%), with 27 per cent viewing the risk as 50:50. A further 9 per cent asserted that they do not know the risk of detection and 2 per cent refused to answer. Figure shows relatively significant shift in the perceived risk of detection as now 36% perceive the risk as high (above 50%) and only 36% (compared to 50%) as low or relatively low.

Figure 22 Assessment of perceived risk of detection in 2012 and 2017



Source: Business Environment Survey 2017, Ipsos/NALED.

Furthermore, business entities' expectations of receiving fines for operating in the shadow economy in 2012 were even lower. The 2017 survey results show that businesses believed it was more likely for the company manager or entrepreneur to be penalised if caught operating informally. A similar increase was also recorded for the other two perceived probabilities - the likelihood of punishment and the likelihood of paying a penalty. In 2017 a considerably smaller number of business entities (53%) believe that businesses continue to engage in informal business if caught.²⁶

Based on these results It might be assumed, therefore, that in Serbia in last five years policy measures have been implemented that lead businesses to believe that the risk of detection is higher. Indeed, in last three years, the majority of measures in Serbia pursued to tackle undeclared work have been focused on improving the perceived and actual risk of detection.

Workplace inspection

One of the most prominent and common measures used to increase the risk of detection is the workplace inspection (Williams, 2014, p.95). To improve the effectiveness of workplace

²⁶ Interestingly, empirical results do not show that the probability of detection is statistically significant determinant of business being engaged in undeclared economy. Similarly, a variable describing the attitude of the respondents regarding the severity or mildness of the existing sentences is not statistically significant. However, it is hard to interpret these results. Namely, it is possible that companies that state that the penalties are mild do not operate in the grey economy but expect additional protection against unfair competition through major sanctions. On the other hand, an opposite interpretation is possible, according to which the economic entities who participate in the grey economy have stated that the sentences are mild, which is certainly a motive for carrying out activities in the grey economy.

inspections as a tool for increasing the perceived or actual risk of detection, Serbia introduced a range of policies. Based on 2015-2017 data, instead of simply increasing the number of inspections conducted through, Labour Inspectorate seek to increase detection through various initiatives that seek to improve the probability of detection, such as by targeting ‘suspect’ sectors, etc.

Table 13 Labour Inspectorate - Total number of Inspections by type

	2015	2016	2017
Total number of inspections	61776	53,069	53,424
Registered subjects	-	52256	52,655
Unregistered subjects	-	813	759
Employment issues related oversight	32,692	-	28,087
Complete oversight	1,615	-	1,082
Partial oversight	20,817	-	19,799
Third party initiated	8,680	-	5,564
Control	1,580	-	1,642
Integrated oversight	12,444	-	10,466
Regular and enhanced oversight	-	-	9,140
Control oversight	-	-	1,326
Health and Safety	16,640	14,156	14,012
Regular	11,342	-	9,941
Control	2,980	-	2,405
Third party initiated	1,370	-	837
Other	948	-	919

Source: Labour Inspectorate Annual Reports

In 2017, the labour inspectors detected a total of 22,411 undeclared workers during oversight of both registered and unregistered businesses (21,228 persons at work "in black" with registered and 1183 persons with unregistered entities). This is approximately 15% increase compared to 2016, when 19,472 undeclared workers were found, which is again 37% more than 2015. In addition, Labour inspectorate issued 769 decisions on banning the activity of unregistered entities until they are registered in accordance with the law.

Table 14 Labour Inspectorate – Scope of the oversight 2013-2017

	2013	2014	2015	2016	2017
Total number of employees in subjects of oversight	503,613	626,984	696,882	533,119	510,725
Total number of employees in working place	-	-	128,133	-	240,648
Total number of undeclared employees	5,744	5,831	16,408	19,472	22,411



Share of undeclared employees to total employees	1.14%	0.93%	2.35%	3.65%	4.39%
Undeclared employees					
Registered businesses	-	-	-	-	21,228
Unregistered businesses	-	-	-	-	1,183
Signed contracts with previously undeclared employees	4,314	4,250	12,250	17,589	21,171

Source: Labour Inspectorate Annual Reports

Registration of workers prior to starting work

In December 2017 the latest changes and amendments to the Labour Law entered into force. Most of the amendments reflect the effort of authorities to eliminate “unregistered employment”, i.e. employment without a written employment agreement and without registering the employees for social security in line with mandatory legal requirements. One of the changes pertains to **the requirement for the employers to register all employees with the Central Registry of Social Security (“CRSS”) before the employee’s first day of employment.** This change is introduced primarily in order to combat undeclared employment. In practice, it rather common for businesses who have unregistered employees, and which were subject to labour inspection oversight to present to the inspector employment agreements allegedly concluded on the very day of the inspection, or citing ‘trial employment periods’, claiming they need to assess the performance of prospective employees before entering into employment contracts and registering workers for social insurance (Arandarenko, 2012). They also attempt to justify shadow employment by claiming employees are reluctant to enter into formal contracts and wish to receive higher wages resulting from employers not paying taxes. The previous version of this provision of the Labour Law allowed for a period of 3 days following the conclusion of the Employment Agreement for the employer to register employees with the CRSS. Failure to register employees with the CRSS within the provided deadline is now treated as a misdemeanour, and punishable by a fine of up to EUR 12.500.

Coordination across government

Besides Strategy that was discussed in the previous section, the major step in the improvement of coordination across government was the adoption of the Law on Inspection Oversight. This law has significantly improved inspections’ coordination and strengthened their preventive and advisory role, risk-based assessment and risk management. An important novelty of this law is the comprehensive inspection control over the unregistered entities, entities operating without a license, a permit and other form of public approval, and those who employ informally. All inspections, within their remits, are in charge for inspection control over these entities, under this Law. The Law on Inspection Oversight has introduced harmonization and coordination of inspections, establishing the Coordination Commission for Inspection Oversight at the national level and the Coordinating Bodies for Inspection Oversight at the local level. Within this commission, sectoral working groups are organized, in which activities are coordinated through the public-private dialogue. The Coordination Commission approves the inspections’ plans and conducts various tasks aimed at improving



the effectiveness of inspection oversight, training of inspectors, strengthening inspection capacities, cooperation with other administrative bodies, local self-government and judicial authorities.

Mandatory ID in the workplace

The improved detection in Serbia is enabled through mandatory record keeping in the workplace. Namely, pursuant to the provisions of Article 35 of the Labour Law it is stipulated that the employer is obliged to work contract or other contract in accordance with the Law or their copy, “*in the headquarters or other business premises of the employer or elsewhere, depending on where the employed or employed person is working*”. Similar requirements existed before, but provisions stipulating location of documentation were introduced only in 2014. According to stakeholders, prior to these changes, this abuse has been rarely sanctioned in practice by the LI. Furthermore, a failure to comply with these legal provisions envisages relatively high fines that were increased in 2017 (a fine of RSD 100,000 – 300,000 for legal entities or RSD 50,000 – 150,000 for entrepreneurs is imposed for this specific misdemeanour).

Use of peer-to-peer surveillance (e.g. telephone hotlines)

In March 2018, as part of the project “Say NO to undeclared employment”²⁷, carried out by the Ministry of Labour a free phone line for reporting illegal employment has been opened. Citizens can dial 0800 300 307 for free and anonymously report if they have been hired without an employment contract, and both businesses and employees can report any other kind of unlawful practice related to the Labour Law. Besides the phone line, the citizens and businesses can use of web application. Reporting may be anonymous, and the report (claim) is forwarded to the nearest competent labour inspection. Based on the report, inspection performs oversight and in case of detection of any illegal status, act in accordance with the law and initiate measures. According to the MOL a significant number of reports on the “undeclared work” were submitted since the beginning of the campaign. Moreover, most of the claim/reports are grounded. Besides this aspect of educating the citizens on their rights, the Project is focussed on the Labour Inspectorate capacity building. Training events will be held for additional education of labour inspectors in all the 27 administrative districts in the Republic of Serbia.

Data matching and sharing and Coordination of data sharing across government

Despite the development of databases across the bodies responsible for business registration tax, social security and labour law compliance at the moment there is a lack of a fully coordinated approach to data sharing. To resolve data sharing issues, in November 2016

²⁷ For more details see section discussing the use of campaigns.



Serbia launched development of the e-Inspector, a unified information platform that will instead of having each inspection own information system create the one-comprehensive system for all inspections. The establishment of a unified inspection information system - e-Inspector will contain modules and algorithms, planning and conducting inspection oversight and registers and data records including Business Registration Agency, Real Estate Cadastre, Tax Administration and other relevant registers and data records needed for risk assessment. In addition, it will serve as a tool for, filing reporting and risk assessment.²⁸ The preparation of this software is on-going. The plan is that the first set of inspections will start to use e-Inspector by the end of 2018. The first four inspections (including LI) are currently being connected to the information system of e-Inspector. The plan is to have all 42 inspection services connected by mid-2019, which will enable full transparency of the activities of inspection services.

There are still several unresolved issues related to allocation of responsibilities with respect to maintenance, general reporting, etc. of the e-inspector system. At the moment, it is envisaged that Inspection Coordination Unit will take care about activities related to the development of the e-inspector. While each inspection will be able to do data mining, with respect to undeclared work, the other option is to have one specialist unit that gathers information and conducts data mining investigations into undeclared work. This unit would produce reports on the undeclared economy and investigate using data mining specific organizations and persons suspected of engaging in undeclared work at the request of other organizations, such as the labour inspectorate, tax administration, etc. (see Box 3).

²⁸ Detailed description of the e-inspector framework is available at <http://www.ite.gov.rs/doc/tenderi/O5-2016/KD%20%20za%20uslugu%20Uspostav.%20jedinstvenog%20inf.pdf>

Box 3 Joining-up data mining

Initiative: Grey Economy Information Unit (*Harmaan talouden selvitysyksikkö*), Finland

Aim: To join-up the previously fragmented function of data-mining.

Description: In Finland, data mining is the responsibility of the Grey Economy Information Unit (*Harmaan talouden selvitysyksikkö*). Established on 1 January 2011, this specialist unit within the tax administration (in the Ministry of Finance) gathers information and conducts investigations into undeclared work. This unit produces reports on the undeclared economy and investigates specific organizations and persons suspected of engaging in undeclared work at the request of other organizations, such as the police, customs bureau and Finnish Centre for Pensions as well as authorities dealing with work safety, debt recovery and bankruptcies. The unit has the power to obtain information from the authority that requests the compliance report. A compliance investigation can also be a general phenomenon report. The unit does not charge for the preparation of compliance reports and is entitled to obtain the necessary information free of charge. A compliance report can be used only for the requested purpose, although it can be used as basis for another report requested by the same authority on the same subject. The Grey Economy Information Unit is authorised to keep a database within the meaning of the Data Protection Directive (95/46/EC, 1995), containing information necessary for the preparation of reports. The data controller is the tax administration.

Evaluation: Its budget in 2011, the unit's first year, was €1.6 million and €1.9 million in 2012. Some 20 persons are employed. After a year and a half of operation, the unit completed over 40 information gathering and dissemination tasks. It also produced approximately 11,000 compliance reports to other authorities (this mandate started in July 2011). During 2011, 732 tax audits were conducted on information provided, resulting in €42 million of undeclared wages and €65 million in undeclared sales being recovered (Virtanen, 2013).

However, even prior to the adoption of the Law on Inspection Oversight several inspectorates-initiated activities in the field of data matching and sharing. In 2014, the LI concluded a Cooperation Agreement with the Central Registry of the Unified Compulsory Social Security (CROSO). By this agreement, the Central Registry and the labour inspectorate regulated mutual cooperation in relation to the exchange, use and protection of data registered and recorded in a single database of the Central Registry. In this way it is possible for labour inspectors to check in the process of checking whether the submission of a unique application for mandatory social insurance by employers was filed in the Central Registry. In addition, the LI intensified joint oversight with other relevant inspections Market and Tax inspection.

Targeting of workplace inspections

Since the adoption of the Law on Inspection oversight, a new approach to inspection oversight is based on a planned risk assessment, a system that identifies possible damage to environment, health, safety, market functioning, infringement of rights and endangering goods, and the likelihood that certain activities or behaviour of an entity will lead to such damage. The risk assessment and development of inspection oversight plans based on the estimated risk are introduced by the Law on Inspection Oversight, in accordance with the



modern standards as mandatory for all inspections. Risk assessment determines priorities for supervising. Within the inspection oversight, risk assessment is carried out through the inspection check-lists. In the event that there is some failure in the company's operations, the inspector, in proportion to the violation of regulations and the degree of risk, requires the implementation of appropriate measures. Check-lists forms are publicly available, thus enabling the businesses to obtain appropriate information about their obligations and to perform self-assessment, leading to more compliance. All 40 national inspectorates compiled check-lists from their remit - a total of 804 check-lists are published, which are available through the Coordination Commission's web-site www.inspektor.gov.rs.²⁹

Similarly, annual plans of all 40 national inspectorates are provided on the same web-site. Plans differ depending on the area, but generally they set some key performance indicators, though this is not always the case. In case of the LI, the plan states that each inspector should perform at least 170 oversights (including comprehensive – regular or irregular oversight, partial oversight, and control oversight). These oversights should be distributed according to the size of subjects of the inspection.³⁰ Further improvements in workplace inspections could be achieved. It is not only the resources of the LI that hinder the effectiveness of workplace inspections but also the quality of the information systems for data mining to identify targets for inspections. Currently a several initiatives with respect to the tools, procedures and coordination with other relevant authorities to prevent, identify and remedy suspected cases of labour law violation are in the preparatory or advanced stage

So far better targeting lead to significant reduction of administrative burden. According to the BEP survey management spends less time management in dealing with inspections (from 70 hours in 2011 to 20 hours in 2017). Better targeting and other reforms lead to significant increase in public trust in inspections reflected in BEP annual business surveys across several categories (positive perception, inspector training, professionalism – app. 75% of positive perception).

Several initiatives are undergoing. Currently, inspections are developing Rules of Procedures for Risk Assessment. Approximately, half of Inspections have prepared these Rules. Ministry of Public Administration and Local Self-Government (MPA) is preparing a functional analysis that should help inspection to improve targeting and enable personnel in inspections to perform expert and analytical inspection tasks in a high-quality way. The analysis will assess current capacities and develop a plan on how to improve inspection human resources and equipment, as well as proposals for inspectorates' institutional

²⁹ For example LI has 6 check-lists that are available at <http://inspektor.gov.rs/kontrolne-liste.php?id=58>

³⁰ Annual Plan is available at <http://inspektor.gov.rs/planovi/56/Plan%20inspekcijskog%20nadzora%20za%202018%20-%20Inspektorat%20za%20rad.doc>

restructuring and possible mergers. It is expected that this analysis will be drafted by October 2018.

So far, Law on Inspection Oversight was followed by adoption of inspection by-laws, guides, methodologies and templates, facilitating the implementation. The next step in this reform is to harmonize the Law on Inspection Oversight as a framework law with the sectoral inspection legislation. **Through the process of harmonization of sectoral inspection legislation with the Law on Inspection Oversight, 150 laws were analysed, and all laws will be harmonized with the framework law.** This should further improve the implementation of the comprehensive inspections reform.

Other incentives for compliance

A greater focus upon the advisory and preventative role rather than the enforcement role would therefore be a useful development. In practice, inspections often neglect advisory role. The preventive and advisory role of the inspections, under the Law on Inspection Oversight, includes transparency of inspection documents and information, providing expert support to the businesses through official advisory visits, and harmonization of inspection actions and practice. As a result of the reform, several positive developments are reflected in business surveys across several categories (positive perception, inspector training, professionalism – app. 75% of positive perception). The results of inspection reform so far include significant decrease in business costs measured as time management spends in dealing with inspections (from 70 hours in 2011 to 20 hours in 2017), and significant increase in public trust in inspections.

Still, in Serbia, as a country characterized by SMEs and micro enterprises, a better balance between reactive and proactive visits could be a positive development., the number of labour inspection visits per inspector could be much higher with better planning and with a more adequate composition of the inspection teams, taking into account the economic sectors and local realities. General perception of stakeholders is that there is an under-emphasis put on the educational or promotional function of labour inspectorates to increase awareness among businesses and workers about the rules on undeclared work and how such situations can be avoided or regularized. Instead, they are largely viewed as enforcers handing out fines and penalties. The overall balance between preventive and enforcing services is not systematic or based on strategic objectives, even though such a balance is important for promoting a culture of compliance. Currently, it does not appear that notifications and/or warnings (e.g. improvement or compliance orders) are used to their full potential or in a more regular way.

Another method to improve the effectiveness of inspections is to use **notification letters** so as to encourage voluntary compliance (without the need for a workplace inspection, or that they may be audited in future after submitting their tax return). While at present, neither labour nor tax inspectorates use such an approach, they both expressed interest to apply this a potentially cost-effective way in which to achieve greater self-compliance. These may also contain normative information on why it is important to be compliant and not to use undeclared work. It is expected that some of these activities supported by donors will be initiated in 2019.



Supply chain responsibility

Increasing the potential of detection does not always have to lie with state authorities. Social partners can also play a central role. Some 17% of European countries have introduced **supply chain responsibility** in an attempt to tackle the undeclared economy. In those countries which have done so, 78% of stakeholders view this as an effective policy instrument and the remaining 22% as ineffective. To see how this operates in practice, a case study is provided of the implementation of supply chain responsibility in Finland (see Box 4). Such voluntary initiative may have a considerable support within the context of corporate social responsibility agendas.

Box 4 Introducing supply chain responsibility

Initiative: Contractor's Obligations and Liability Act, Finland

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

Description: The 2006 Contractor's Obligations and Liability When Work Is Contracted Out Act requires that the party responsible for a construction project obtains necessary guarantees that subcontractors fulfil their various obligations. The law has been in effect since 2007, but obligations in construction sector expanded in 2012. The 2006 legislation originally exempted established subcontracting relationships from a background check, but this hampered the enforcement of the legislation. These have now been included, as has accident insurance been included on the list of items that now needs checking. The objective of the original legislation as well as the 2012 amendments has been to combat the undeclared economy and promote fair competition between companies, particularly in the construction sector. Long subcontracting chains lead to situations where work is carried out without withholding employee taxes, making VAT payments, making pension payments, or observing conditions laid out in collective bargaining agreements. The legislation placed the responsibility on the users (which tend to be larger businesses) of subcontractors and temporary work agencies that these subcontractors and employment agencies meet their obligations. Contracting parties are required to ask for and obtain documents that verify certain registrations and payment of taxes as well as a reference to applicable collective bargaining agreements or corresponding conditions. Depending on the results of the background check, contracting may be subject to a penalty. The contracting party must inform its employee representatives of subcontracting or the use of employment agency workers. The act is limited to work taking place on the premises or site of the contracting party by employees of a subcontractor or an employment agency.

Evaluation: An early evaluation of the measure found that the law and its contents were known, although this questionnaire-based evaluation also revealed some companies were unaware of them (predominantly small companies). There was more uncertainty of the law's applicability in different sectors and situations, but most respondents regarded it as useful in raising the issue of employer obligations in contracting decisions so as to avoid undeclared work occurring. One problem identified by the respondents of the early evaluation was the additional work required by contracting companies. So too was getting the required information on foreign companies identified as a problem, the penalties were viewed as too low for some situations and the omission of accident insurance from the documents to be requested was considered a problem. This feedback was taken into account in the 2012 amendments. This set the penalties higher at between €16 000 and €50 000 depending on the size of the contract, included accident insurance on the list of documents to be collected, and dropped



existing business relationships from exemption because of the prior difficulties of verifying this. In 2010, there were 872 investigations by the authorities (50% in the construction sector). In total, 2541 contracts were examined, and half found to contain violations. By March 2011, penalties totalling €302 500 had been imposed based on the 2010 investigations (Alvesalo and Hakamo, 2009; Työ-ja elinkeinoministeriö, 2011).



6.2 Direct Controls: supply-side incentives

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

Box 5 Business certification schemes

Initiative: Certification scheme for cleaning companies, Norway

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

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

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

Simplify Compliance

Serbia has made much progress in closing the gap with best practices in business regulation. Most recently, the main factors effecting these achievements are reforms carried out fields starting a business, registering a property, paying taxes and dealing with construction permits **The World Bank Doing Business Reports between 2016 and 2018 summarise the major initiatives already undertaken in Serbia to simplify compliance (see Box 6).**

Box 6 Doing Business

Doing Business 2018

- Starting a Business: Serbia made starting a business easier by reducing the signature certification



fee and increasing the efficiency of the registry, reducing the time for business registration.

- Registering Property: Serbia improved the reliability of its land administration system by implementing a geographic information system.
- Enforcing Contracts: Serbia made enforcing contracts easier by adopting a new enforcement law that broadens and clarifies the responsibilities of enforcement agents as well as the powers of the courts during the enforcement process.

Doing Business 2017

- Starting a Business: Serbia simplified the process of starting a business by reducing the time to register a company.
- Dealing with Construction Permits: Serbia made dealing with construction permits faster by implementing an online system and streamlining the process of obtaining technical conditions for the building permit.
- Registering Property: Serbia simplified property transfer process by introducing effective time limits.

Doing Business 2016

- Dealing with Construction Permits: Serbia made dealing with construction permits less costly by eliminating the land development tax for warehouses. On the other hand, it also introduced a mandatory inspection of foundation works.

Paying Taxes: Serbia made paying taxes easier for companies by introducing an electronic system for filing and paying VAT and social security contributions as well as by abolishing the urban land usage fee. On the other hand, Serbia increased the property tax and environmental tax rates.

With respect to paying taxes in 2014 and 2015, Serbia simplified its payroll and social security returns, and introduced e-filing for payroll taxes and social security contributions, VAT and corporate income tax. This was significant improvement reducing the number of payments indicator from 67 in 2013 to 33 in 2015 and the time to comply from 279 hours to 226 hours over the same period. An additional boost was given by abolishing land usage charges which positively impacted the number of payments as well as the overall tax burden. Following these changes Serbia performs well in Paying Taxes, especially compared to its peers in Central and Eastern Europe. On average, compliance with tax obligations takes 19% less time than 3 years ago (PriceWaterhouseCoopers, 2017, p 58-59). In addition, several other initiatives and projects aimed at simplifying local taxes and charges and quasifiscal fees are ongoing, as well as projects around simplifying and streamlining both tax procedures and tax reporting. Yet more could be done to further simplify compliance and align regulatory processes with best practices.

In 2018, several simplification measures should provide additional incentives for formalisation. First, the electronic registration of entrepreneurs is enabled at the Serbian Business Registers Agency (SBRA) as of January 2018. Now the entrepreneurs can register without going to the counter of the SBRA but doing it completely online and besides that, for less amount of money and for much shorter time. Second, the requirements to use company seal in specific business transaction was abolished. Third, electronic invoices are valid without seals and signatures - there is no longer any obligation to issue printed invoices, nor to post by mail. Fourth, the Law on Administrative Fees has been amended to allow free

access to user related data in official database in case user filed a request electronically. **Currently, Public Policy Secretariat is implementing the e-Paper project with the aim of listing and digitising all administrative procedures and other conditions for doing business.** Simplifying regulatory compliance however, need not solely concern relatively minor administrative changes such as simplifying the number of procedures and forms.

Reverse VAT charge mechanism

The reverse VAT charge mechanism in the construction industry is often used as an anti-evasion measure whereby the buyer, not seller, must file and pay the VAT (See Box 7).³¹ The Law on Value Added Tax was amended in 2012 introducing the application of the reverse-charge mechanism into Serbian legislation in the construction industry. Subsequent changes of the Law in 2015 expanded the scope of the reverse-charge mechanism in the construction industry to remove legal uncertainties. However, as stated in Milošević and Kovačević (2016) the abovementioned changes have further complicated the situation, significantly increased legal uncertainty and additionally burdened VAT-payers (as well as the Ministry of Finance itself, which drafted the new provision) due to the fact that there is a need to interpret, on a daily basis essentially, who is liable to compute VAT for a vast variety of supplies that might be deemed as supplies from the construction industry. Furthermore, Milošević and Kovačević (2016) argue that the (official) reasons for introducing the reverse-charge mechanism are not entirely in line with the reasons for which this mechanism is used within the EU. According to authors, **the revised provision of Article 10 (2) (3) of the VAT Law represents an acceptable solution for achieving the resistance of the VAT system in terms of tax evasion, however changes should be considered regarding the application of the said mechanism.**

Box 7 Reverse VAT charges

Initiative: Reverse charges in the construction industry, Sweden

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

Description: To tackle VAT fraud and undeclared work in the construction industry, the Swedish government introduced a law on reverse charges for VAT effective from 1 July 2007. A reverse charge means that the buyer, not the seller, must file and pay the VAT. A company selling construction services more than on a temporary basis must pay VAT for its sub-contractors. If the purchaser is not a construction company, the vendor shall add VAT to the invoice. If the purchaser is

³¹ The reverse-charge mechanism in the construction industry was implemented in the Directive 77/388/EEC15 by means of the Directive 2006/69/EC16 at the initiative of the European Commission in 2005. From the explanation of the document by means of which the modification of the communitarian legislation was proposed, it may be concluded that the motives for such intervention were primarily anti-evasive. Detailed discussion of the application of reverse charge mechanism and ambiguities is provided in Milošević and Kovačević (2016).



a construction company, the vendor shall not add VAT to the invoice. Instead, the purchaser will be responsible for reporting the output VAT. Reverse VAT liability does not apply to sales which consist solely of materials.

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

Initiative: Reverse VAT in the construction industry, Finland

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

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

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

New categories of declared work

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

Box 8 New forms of declared work

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

Aim: To bring small mini-jobs into the declared economy that would otherwise be conducted on an undeclared basis

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

Evaluation: According to data from the Hungarian National Tax and Customs Administration, between April and May 2010, 505,621 simplified employment cases were registered at the tax authority, of which 417 937 entries were for ad hoc/casual employment, 15,877 for seasonal agricultural employment, 6393 tourism employment, 761 at non-profit organizations, and 10,326 in plant cultivation. Of these jobs, 499,987 lasted less than five days and 2,169 longer than five days. By July 2011, there were 512,000 temporary or seasonal jobs registered as simplified employment from 370,000 employers. Between 1 August 2010 and 31 December 2011, around 12.5 million working days were registered across these 17 months and HUF 8 billion (€28 million) flowed into the state's treasury (Rindt and Krén, 2013).

Generally speaking Serbian Labour Law distinguishes employees and contract workers. Employees may be engaged under an open-ended contract of employment, or a fixed-term contract of employment (for a maximum of 24 months and longer in exceptional cases prescribed by the provisions of the Labour Act). Apart from employment, work may also be performed on a contract basis under: (i) a temporary or seasonal work contract; (ii) a service contract; (iii) an agency contract; (iv) a vocational training or advanced training contract; and (v) a supplementary work contract. Thus, recent changes of the Labour law introduced some of new categories of declared work.

However, the Labor Law does not contain provisions regulating the leasing of employees. This institute is applied in practice by the competent authorities tolerate it. Currently, there are many temporary employment agencies in Serbia which provide rental services to employees. It is estimated that almost 100 temporary employment agencies are allowed to provide rental services of employees, and more than 10,000 of employees are engaged in this way. Many employers, in practice, opt to hire workers through leasing, in order to circumvent the provisions of the Labor Law, in particular those relating to the termination of the employment contract. Rented employees practically conclude an employment contract with the temporary employment agency, while they work in the premises of another employer who rent them from the Agency. The temporary employment agency, as a formal employer, has a full employment responsibility for the hired employee, including liability in relation to termination of employment contracts (except for obligations related to safety and health at work for which the employer hires employees). Given the generally high percentage of employees' success in the labour disputes in front of the Serbian courts, to avoid these and

other risks employees opt for such solution. Currently, the MOL is preparing the draft version of the regulation that will resolve these issues.

Social security and direct tax incentives

Another supply-side incentive is to use **social security and direct tax incentives** to prevent citizens and businesses entering the undeclared economy. This measure was first introduced in 2014. In December 2017, the parliament adopted amendments to the Law on Personal Income. New provisions extend the current tax relief period that refers to employment of new individuals to December 31st, 2019. The existing **tax relief for the employer relates to the right to a refund of paid salary tax in the percentage from 65% to 75%**.

The amendment also introduces the new type of tax relief for youth's employment when starting their own business through tax exemption (as well as mandatory social security exemption) to income during the first years of establishing business. It is envisaged that the right to exemption from paying personal income tax on salary can be achieved for up to nine newly employed persons, in the tax period in which the employer is established/registered and in the following tax period. The envisaged tax relief will be applied as of 1 **October 2018**. This incentive can be used by newly established companies or entrepreneurs for up to 9 employees who have completed a high school or college in the last year for a maximum of one year or are longer than six months on the records of the National Employment Service. The condition for using the measure is that the annual salary of each employee in the tax exemption regime must not exceed the amount of triple average annual earnings in Serbia. The use of tax exemption can only be used once and throughout the period beneficiaries are entitled to health insurance and other rights arising from employment, except for pension and disability insurance, which if they wish to pay them in accordance with the applicable regulations. This is also one of the measures proposed in the action plan. The initiative was proposal by NALED based on the Analysis of tax and non-tax exemption of beginners in business conducted in 2017. The analysis showed that the estimated savings by new entrepreneurs will be up to RSD 250,000 per year.

However, there are other potential incentive-based measures that may be applied in Serbia. One interesting case is presented in Box 9 as Romania introduced incentives to workers to operate in declared economy in construction sector.

Box 9 Social security incentives

Initiative: Builders Social House, Romania

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

Description: In Romania, 'The Construction Sector Social Agreement for 2007-2009' (*Acordul Social Sectorial Pentru Construcții 2007-2009*) estimates that some one-third of the active workforce operates in the undeclared economy and highlights the importance of tackling this sphere. The Builders Social House (*Casa Socială a Constructorilor, CSC*) is one prominent initiative used to enable this work to take place in the declared rather than undeclared economy. The CSC was established in 1998 as a privately-run welfare organization, to which the representative trade unions

and employer organizations in the construction and building materials sector contribute in equal measure. It provides welfare payments during the cold season (1 November - 31 March), when the construction sector slumbers, to workers in registered declared employment and in doing so, provides an incentive for workers to be in the declared economy rather than working in the undeclared economy in the construction and building materials sector. CSC members are construction companies and manufacturers of building materials. Entitlement to welfare payments during these winter months is only available to declared employees, that is, those with employment contracts recorded with the local labour inspectorates, and whose social security contributions due by both the employer and employee have been paid. Corporate contributors pay 1.5% of their turnover into the CSC scheme, and employees contribute 1% of their gross base salary.

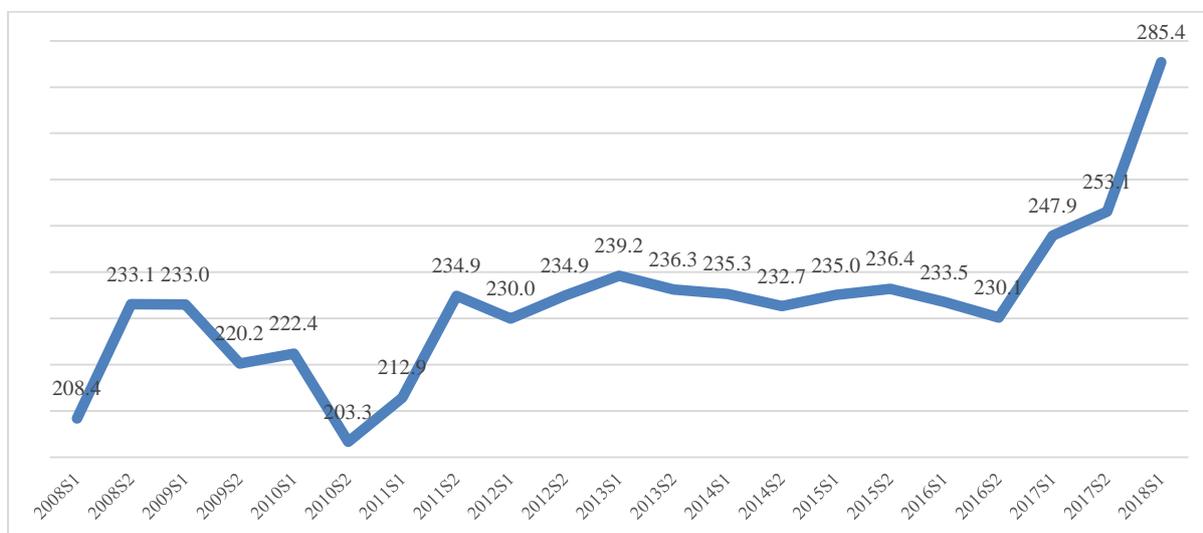
Evaluation: In 2008, CSC had 573-member organizations accounting for 40% of all declared employment in the construction and building materials industries. During the 2007-8 winter period, 102,387 declared workers benefited from this scheme as recipients of welfare payments (Eurofound, 2013). This is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

In Serbia, self-employment support entails the provision of professional assistance, entrepreneurship training and self-employment subsidy. Financial self-employment support in 2017 is awarded in the form of subsidy, disbursed as a lump sum of RSD 180,000 per beneficiary.

Changing minimum wage

The amount of the minimum wage is one of the key parameters that define how many workers will be ‘squeezed out’ of the formal sector (Arsić, et al 2015). The higher the minimum wage the higher the likelihood of greater worker pressure on the informal sector. The minimum wage can artificially constrain demand for labour and provide disincentive for businesses to hire some workers due to their low marginal productivity. Low productivity workers will either remain unemployed or will move to sectors without a minimum wage. If a uniform minimum wage applies across the entire formal sector, as is the case in Serbia, then the informal sector is the only way out for workers whose marginal productivity is lower than the minimum wage.

Figure 23 Minimum wage dynamics (2008 – 2018 measured at the beginning of the half-year) (EUR)



Source: Eurostat

After increase in 2008, between 2009 and 2018, the minimum wage in Serbia fluctuated in a relatively stable interval of between 42 and 47 percent of the average wage. In 2017, for example, the ratio of the minimum to the average wage was at 46.2 %, ³² while in April 2018 minimum wage was RSD 32.131,24, while average wage was RSD 67.901 (the ratio of the minimum to the average wage was at 47.3%). This may be considered relatively high by international comparison and can provide an incentive to informal employment. Setting a high minimum wage brought about a reduction in demand for low-skilled labour and led to an increase in the level of noncompliance among businesses. As a result, there was a decline in formal, and an increase in hidden employment and envelope wages. For example, according to the SELDI (2016) survey in Serbia there was a significant number of employees (22 %) who receive higher salaries than the minimum wage, but who report the minimum wage as their income level for social and healthcare security payments.

Figure shows an increase for 2018. Namely, last year, the Socio-Economic Council agreed to increase the minimum wage by 10 percent (to RSD 143, corresponding to about €1.20 per hour) in 2018. ³³ To avoid impacting competitiveness or low-skilled employment, the government envisaged raising the personal income tax threshold (to RSD 15,000 per month) to offset costs on employers and provide some reduction in the labour tax wedge for low-income workers.

³² As mean wages are affected by extreme values, median wages provide a better point of reference, especially in countries that have high wage inequality. However, such statistics is not available.

³³ "Official Gazette of the Republic of Serbia" No.88/2017 17.



Table 15 Minimum wages and average annual rate of change 2008-2018

Minimum wages (EUR per month)		Average annual rate of change, January 2008 to January 2018
January 2008	January 2018	
208	285	3.2%

Source: Eurostat

Table 16 Monthly minimum wage as a proportion of the mean value of average monthly earnings

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Industry, construction and services (except activities of households as employers and extra-territorial organisations and bodies)	35.7	46.4	44.9	44.1	45.8	44.4	43.7	46.3	44.6	46.3	:
Business economy	36.0	49.5	46.6	45.2	46.6	45.0	44.0	44.8	42.7	44.2	:

Source: Eurostat

Micro-finance to business start-ups

According to the recent EIB Report (EIB, 2016), the virtual absence of a microfinance sector has left the supply of microloans low, and as the few equity funds active in the country target either technology start-ups or larger consumer-oriented businesses, microenterprises and non-technology start-ups are essentially left without a source of funding. Consequently, bank loans remain the most dominant source of lending for SMEs. While the share of loans to SMEs has been disproportionately affected by the downturn from 2011 to 2013, in 2014-2016 period there was a positive growth rate in SME loans and an increase in SME loan share in all business loans.

In Serbia, the MSME sector constitutes 99.8% of all enterprises (app. 325.000 enterprises), generates about two-thirds of total employment, contributes to app. 60% of value-added of the Serbian economy and creates app. 45% of total exports, thus being a key to fostering competitiveness and employment. However, the sector also faces specific challenges, such as difficult access to finance and heavy regulatory burdens. Serbian government has recognized the importance of micro and small enterprises and introduced policy measures to create favourable conditions to foster enterprise creation and growth and to address difficult access to finance, heavy regulatory burden and other market failures affecting the MSME sector. Despite a proactive and comprehensive approach to MSME policy access to finance remains a key obstacle to the development of the MSME sector.

Over the last years MSMEs credit conditions have improved. Maturity structure MSMEs loans has improved, due to a decrease in the NBS key policy rate and a lower rate in the euro money market. Collateral was required from 41% of SMEs applying for bank financing in 2016, albeit a decline from 49% in 2015. Loans linked to foreign currency remain predominant way of lending (65,6% of total lending in 2016). While interest rates for these loans are significantly lower compared to 2012, they are still averaging app. 5.0%. MSMEs



interest rates are higher compared to rates charged to large enterprises, although the interest rate spread has narrowed to 189 basis points in 2016. According to the OECD Scoreboard (OECD, 2018), during 2016 only 16.5% of SMEs requested bank financing and rejection rate in Serbia is high compared to other countries (28.1%).

In 2015 the Government of Serbia adopted SMEs, Entrepreneurship and Competitiveness Strategy for 2015-2020 setting the medium-term framework for MSME development policy. One of key pillars of the strategy is the improvement of access to sources of financing. The aim is to make loans to MSMEs accessible under improved conditions as well as to provide training in the field of financial management. In addition, the government is offering several MSME support programs through development finance institutions, however their effectiveness is limited. The current framework of development finance institutions includes the Development Fund (DF) and the Serbian Export Credit and Insurance Agency (AOFI) that provide loans, guarantees, export credit insurance, factoring, and export financing to enterprises. Lack of proper oversight and governance, poor credit policies and decisions as well as limited accountability of the institutions have resulted in a significant waste of public resources. **The government has therefore established a working group to identify options for providing development finance in Serbia in a more comprehensive manner.** The goal is to identify the role and functions of development finance that would be suitable for the Serbian market and to propose what kind of changes are needed to align the current framework with the EU and be able to maximize the potential of development finance without putting too much burden on the budget itself.

Society-wide amnesties

Most of the studies on the effectiveness of this policy measure have focused upon tax amnesties. Baer and LeBorgne (2008: 5) define a tax amnesty as ‘a limited-time offer by the government to a specified group of taxpayers to pay a defined amount, in exchange for forgiveness of a tax liability (including interest and penalties) relating to a previous tax period(s), as well as freedom from legal prosecution’. An amnesty therefore enables the non-compliant not to incur sanctions that the failure to pay on a timely basis would ordinarily incur.

Tax administrations need to strike a balance between revenue collection and fairness in how revenue is collected. With an amnesty, revenue is collected that might not otherwise be forthcoming, but there are fairness concerns which may impact on the efficiency of revenue collection in the future. Amnesties are often seen by honest taxpayers as a special deal for evaders and as violating principles of fairness. Indeed, Luitel and Sobel (2007) find that the repeated offering of amnesties reduces state revenue collection. However, Alm et al. (1990) find that if an amnesty is a ‘one-time event’ and coupled with new enforcement measures, the negative effects on future revenue collection can be offset. **Overall however, and as Mikesell and Ross (2012) reveal, the evidence is that amnesties do not increase long-run revenues. Rather, amnesties decrease long-run revenue.** Indeed, in Serbia expectations of future tax amnesties may also be undermining efforts both to collect arrears and to enforce current tax obligations (World Bank, 2015, p. 15) and have negative impact on the overall tax

moral, thus contributing to noncompliance (Randelović, 2015). Despite this, Serbian tax administration used amnesties because they wanted to achieve short-term windfalls.³⁴

Individual-level amnesties for voluntary disclosure

Serbian tax legal framework allows taxpayers to come forward and correct a mistake, inaccurate or incomplete information or to disclose information they have not reported during previous dealings with the Tax Authorities without penalty or prosecution. Although not officially recognized as voluntary disclosure policies (VDP) by the Serbian authorities and legislation, article 182 of the Law on Tax Procedure and Tax Administration allows taxpayers under specific conditions to make disclosure of a mistake or other tax information which have not been reported to the Tax Authorities in prior periods but may affect the tax position of the taxpayer. However, the law does not allow taxpayer to submit amended tax returns during a tax audit or after the tax administration renders a tax resolution, and since 2018 the taxpayers will now be unable to submit an amended tax return once the Tax Police starts an investigation. Several stakeholders stated that these recent changes are ambiguous as the police is not obliged to inform taxpayers on pending criminal investigations.

Formalisation advice to businesses and formalisation support to businesses

A further supply-side incentive to encourage declared work is the provision of **support and advice on formalisation** both by government and by social partners. The preventive and advisory role of the inspections, under the Law on Inspections oversight includes providing expert support to the businesses through official advisory visits. As stated in the previous section, this activity seems to be underutilized in practice.

In Serbia, several institutions provide formalisation advice and formalisation support. The National Employment Service provides informative and advisory services through their business centres network. In 2017, 18,296 persons used these services. In addition, NES also provides mentoring and specialized trainings for newly established businesses. In 2017, 433 businesses used mentoring programme. This programme is focused on providing

³⁴ Some types of amnesty are more lucrative in terms of short-term revenue than others. As Mikesell and Ross (2012) reveal, the features influencing the level of return are: the length of the amnesty period; the quarter in which the amnesty is held; the time since the last amnesty, and whether there are accompanying measures. Keeping an amnesty open less than 60 days, holding it in the third quarter of the year, and not operating a voluntary disclosure scheme result in higher revenue rates. However, revenue declines with each successive amnesty and increase with the amount of time since the last amnesty. Indeed, amnesties, if used, must be coupled with increased sanctions to ensure that future compliance is not affected. Amnesties have largely been used by tax administrations.



assistance to business entities established by beneficiaries of subsidies for self-employment, to be able to maintain and improve business activities during the first years of operation. Development Agency through its network of accredited regional development agencies provides a standardized set of services consisting of: information, training, advisory services, mentoring and promotions. For potential and existing micro, small and medium enterprises and entrepreneurs, cooperatives and clusters of services from this program are free.

These initiatives could be extended and could also focus more upon providing formalisation advice to current businesses that operate on a partially undeclared basis about how they can put their affairs in order. A broader initiative might also include the use of ‘role models’ organised by for Development Agency.

The use of non-governmental bodies to provide this advice is important so that there is greater willingness and less fear from businesses of approaching them for such advice. At present, one notable initiative in this regard is the NALED initiative that uses a helpline and 15-20 advisors to provide advice to enterprises on tax, social security and labour law.

6.3 Direct Controls: demand-side incentives

Besides providing supply-side incentives to operate in the declared economy, recent years have witnessed the expansion of demand-side incentives to encourage the purchase of declared goods and services. One option is to give straightforward income tax relief, claimed on tax returns, to customers using declared labour to do specific tasks (e.g., roof maintenance, outside painting, domestic cleaning) commonly conducted in the undeclared economy, so that the wage costs of employing workers on a declared basis become equivalent or better than the wage costs of employing somebody on an undeclared basis (see Box 10).

*Box 10 Tackling the demand-side: the use of tax deductions***Initiative: Tax deductions for household work, Sweden**

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

Description: Since 8 December 2008, Swedish citizens have been able to apply for a tax deduction amounting to 50% of the labour cost for the renovation, conversion and extension of homes (ROT), and also for household services (RUT), including cleaning, laundry, basic gardening and babysitting. The maximum annual tax deduction that can be applied for is SEK 50 000 (€6000) for each individual. In the government bill from 2007 where the RUT deduction was proposed, the measure was estimated to cost SEK 1.3 billion per year (€155 million). The ROT-deduction was in the spring budget bill in 2009 and was calculated to cost SEK 13.5 billion per year (€416 million) (Swedish Tax Agency, 2011). As of 1 July 2009, companies performing household services charge the customer the costs of materials and half the labour costs, including VAT. The company performing the work then requests the outstanding sum from the Swedish Tax Agency. As a result, the customers only pay half of the labour cost at the point of purchase of the service.

Evaluation: Comparing data from 2005 and 2011, the Swedish Tax Agency (2011) display that undeclared work has decreased by about 10% within the categories of jobs covered by the ROT and RUT-deduction. In the autumn of 2011, the Swedish Federation of Business Owners (*Företagarna*) conducted a survey of 2447 construction companies. The results show that nearly 90% felt that the ROT-deduction had a positive impact on reducing undeclared work in the sector compared with 78% in 2009. In 2010, 1.1 million people bought household services with a tax deduction (RUT and ROT) and the Swedish Tax Agency paid out SEK 1.4 billion (€166 million) in RUT deductions and SEK 13.5 billion (€1.6 billion) in ROT-deductions. This means that around 7.6 million hours of cleaning and household (ROT) services and 53 million hours of renovation work (ROT) were performed using these schemes (Brunk, 2013c).

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

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

Description: Since 1 June 2011 until the end of 2013, it has been possible for each member of the household over 18 years of age to deduct from their taxes up to DKK 15 000 (€2000) the costs of employing craftspeople and domestic helpers under a pilot project called 'Home-Job Plan' (*Bolig-Jobplan*). The major difference compared with the Swedish scheme therefore, is that whilst Sweden has a maximum tax deduction of €6600, the cap is €2000 in Denmark. The activities covered include cleaning, indoor-outdoor maintenance of the house, gardening and babysitting. The cost to the government is estimated to be DKK 1 billion (€134 million) in 2011 and around DKK 1.75 billion (€234 million) in 2012 and 2013. The expenses and the company involved is informed digitally by the buyer of the services to the tax authorities in a special template, who then deduct 15% of the amount in the yearly tax or fiscal income. The action involved for the buyer of these services resembles an ordinary payment transfer, and the system does the rest.

Evaluation: Relative to expectations, the pilot project has so far been a success. Some 270 000 people used the deduction in 2011 and most of the work involved home improvement, maintenance and repair. They have on average reported deductions of DKK 9800 (€1315) per person. In total, the deductions reported constitute DKK 2.7 billion (€362 million). The tax value of those deductions is around DKK 900 million (€121 million) (Jørgensen, 2013).



Another option is to use **service voucher schemes**. A service voucher is a means of payment, subsidised by government, which allows a private user to pay an employee for conducting tasks. By providing service vouchers to those employing labour, which pays a portion of the fee given to the worker, the intention is to encourage them to purchase services on a formal rather than informal basis.

Service voucher schemes have various advantages, both for domestic workers and for their employers:

- The domestic workers have access to social security benefits (pensions, health insurance, accident cover etc.);
- These schemes are easy to join and use, both for the worker and for the employer;
- Administrative formalities are simplified for the employer;
- The worker is guaranteed at least the legal minimum wage;
- The worker is certain of being properly formal, as the risk of administrative errors due to the inexperience of an individual private employer is eliminated;
- In the case of a problem with the employment relationship or questions about the legislation, both the employee and the employer have somebody from whom they can seek advice; and
- The schemes enable mainly low-qualified people to find formal employment.

Williams (2018b) asserts that the lessons from an evaluation of these schemes are that countries considering the introduction of service voucher schemes to tackle the informal economy should:

- Use them to formalise the domestic services sphere (including caring services), rather than to regulate occasional work.
- Use and limit service vouchers to paying for those specific domestic service tasks where the use of the informal economy is rife.
- Use them to pay for regular as well as occasional domestic service provision.
- Limit the end-users to individuals/households.
- Service voucher schemes should in addition to allowing the direct employment of a private individual by a household, also establish authorised provider organisations which employ the service voucher workers.
- If the aim is to use service vouchers to tackle informal work in the domestic services sphere, less emphasis is required on the persons entitled to work under the voucher scheme (e.g., long-term unemployed, retired, students). This is more an issue where service voucher schemes are used as active labour market policy initiatives to re-insert specific groups into the labour market.
- Set a limit on the number of service vouchers a user can purchase, not on the level of income of a service voucher worker. If an additional sub-objective of service vouchers is to meet social needs, consideration may be given to whether some population groups should have a right to purchase a higher number of vouchers to meet their needs.



- The price of a service voucher should represent the minimum price a user pays for one hour's work.
- Conduct prior evidence-based research to decide the price of a service voucher for a user (and thus level of subsidy required), so that it is competitively priced with the alternative option of using informal work.
- Ensure that the service voucher system allows workers to gain access to key social security benefits comparable to those held by people employed, and covers unemployment benefits, pension benefits, sickness benefits, maternity leave and health benefits.
- Provide ex-ante and ex-post evaluations of the extent to which service vouchers reduce informal work in the domestic services realm (including caring services), but also evaluations of whether service vouchers are acting as a substitute for permanent formal employment contracts.

Some variant of a social voucher scheme is potentially transferable to many countries. The major barriers to their effectiveness are firstly, budget constraints and secondly, the level of development of the formal domestic service market. Some countries, that is, have little or no tradition of domestic services being conducted for payment by people outside the family, and thus in these Member States, the utility of a service voucher scheme is minimal. However, in such countries, it is also possible to widen the scope of activities covered by such a scheme to other household services where the informal economy is rife, such as home repair and maintenance work.

Box 11 Universal Service Employment Voucher in France

In 2006, France introduced the universal service employment voucher (Chèque emploi service universel or CESU), a scheme that makes it easier for private citizens to pay for services to individuals (services à la personne).

Very varied occupations fall within the scope of the 21 services to individuals covered by this scheme. Housework and domestic tasks are among them. Others include small-scale gardening and maintenance, child-minding, help with school homework, preparing meals, assisting older people or others needing personal assistance at home (except for medical services), assisting people with disabilities, caring for pets, helping with home-based administrative tasks etc.

In principle, these services are provided at the home of the individual concerned, but they may also take place outside the home, provided they are an extension of home-based services. Thus, the CESU may be used to pay for child-minding outside the home by an approved childcare assistant, a care structure (a creche, drop-in care centre or kindergarten) or out of hours care in schools.

In the second quarter of 2010, almost 1.5 million employees were working inside private individuals' homes. If child-minders who work in their own homes are included, the individual services sector employed almost 1.8 million people in the second quarter of 2010.¹

Most of the jobs paid by CESU are performed by low-qualified women.



Incentives for beginners in business

The introduction of incentives for beginners in business refers to persons who completed a high school, faculty or unemployed for more than six months on the records of the National Employment Service in the previous year. According to the amendments to the Law on Income Tax and the Law on Contributions for Compulsory Social Insurance, new entrepreneurs will be exempted from the establishment of their employees for the first two years of their establishment. This measure is applicable for start-ups that employ up to nine employees who meet the specific conditions (employees should have graduated or completed high school in the previous year, or that they have been for more than six months registered with the National Employment Service). **This measure will be applied from October 2018.** In addition, entrepreneurs will have the right to reimburse paid taxes and contributions from 65% to 75% by the end of 2019. Another useful measure that will relieve the economy is to increase the tax-free part of the workers' salaries from 11,790 to 15,000 dinars, which is estimated to save about 11,6 billion dinars to the business sector.

Establishment of mechanism for more efficient registration of seasonal workers

In May 2018, the Parliament adopted the Law on simplified seasonal employment in agriculture.³⁵ The intention of the Law is to legalise employment of seasonal workers working in agriculture on an undeclared basis. The most important novelty of the new regulation is that it provides a simplified registration procedure. Employers will engage seasonal workers as well as the length of the engagement. by registering their and the company's data on a Tax Administration's portal or by telephone, without the need to sign formal contracts. This should be done online, on the first day of engagement, and similarly, on the event of termination of the employment, employers will have to register the termination the day after it happened. Seasonal workers are limited to working up to 120 working days a year, counting from the day the employer registered the seasonal worker online, with the Tax Administration. Employers will have to inform the seasonal worker about the work to be done, the expected duration of work engagement, the work health and safety conditions, daily and weekly working hours, breaks during work and the amount of financial compensation for the work. The seasonal worker and the employer enter into a verbal employment contract with the employer obligated to issue a certificate of contractual conditions at the written request of the seasonal worker. The financial compensation for seasonal workers will be calculated and paid per hour and cannot be lower than the minimum wage e on the day of reimbursement. At the moment, the minimum hourly wage stands at 143 dinars. The wage is paid at the end of the working day, if the seasonal worker and the employer have not agreed differently.

³⁵ The draft law envisaged the introduction of a voucher system in agriculture

Incentivise electronic payments

Given that a large proportion of payments for work in the undeclared economy are in the form of cash, one way forward is to **incentivise electronic payments** and in doing so, shift away from cash payments. According to the findings of Schneider (2011), a 10 % increase in the share of electronic payments will lead to a 5 % drop in the shadow economy. We should emphasise that existing Action Plan envisages several activities in this area.

In Serbia, wages/salaries can be paid either in cash or via banking transfer. Currently they are paid mostly via banking transfers, especially medium and large enterprises. According to the World Bank data (Global Findex Database), in 2017 **83% of the wage recipients in Serbia received their wages into their accounts at financial institutions.**

Figure 24 Wages Received into a financial institution account (% wage recipient, age 15+)



Source: World Bank Global Findex Database

To transfer from cash to electronic payments, a first option is for governments to introduce a ceiling for cash transactions. In Serbia **the Law of performing of payments by legal entities, entrepreneurs and natural persons who are not engaged in a business activity** (Official Gazette of the RoS, No. 68/2015), which came into force as of 1 October 2015, stipulates that all payments made by legal entities and entrepreneurs should be cashless. According to the Law, cashless payment should be understood as either bank transfer or card payment. In order to ensure the effectiveness of the regulation, fines of RSD 10,000 to RSD 2,000,000 for violation of this law have been introduced. **Currently, Serbia does not have a ceiling for cash transactions for natural persons.** A potential regulation introducing ceiling



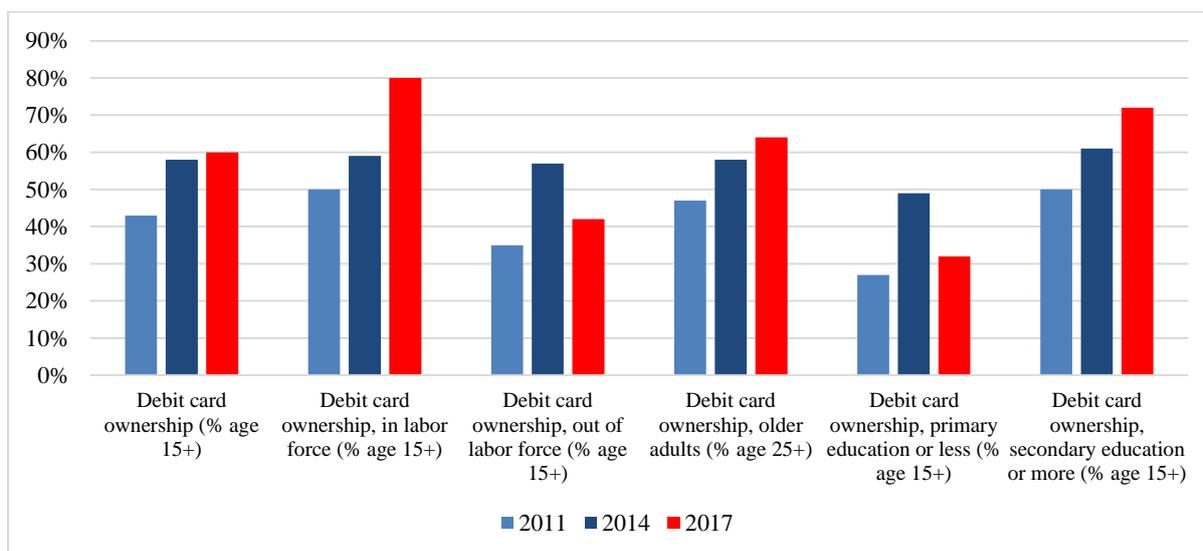
for consumer cash payments in Serbia could be introduced in the Law of performing of payments by legal entities, entrepreneurs and natural persons who are not engaged in a business activity, similarly to the currently binding obligation for payments made by legal entities (or such ceilings could be introduced for cash payments in selected sectors, especially those accounting for a large share of the shadow economy in Serbia (Ernst and Young, 2016).

A second option is to make electronic payment available across all sectors, especially those dominated by cash transactions such as bars and taxis. This has been only partially introduced in Serbia. In Serbia, Law on fiscal cash registers stipulates the installation of equipment enabling card payments only to certain businesses, in particular retail sales, as well as hotels, restaurants and catering. However, there are no sanctions for violating the requirement to possess POS terminals by the businesses that are subject to this obligation. Consequently, it is recommended that appropriate penalties be introduced in the legislation.

At the moment a number of professions are exempt from mandatory recording of turnover via fiscal cash register, in line with regulations of the Statute on Determining Professions Exempt from Registration of Turnover via Fiscal Cash Register ('Official Gazette RS', No 61/10, 101/10, 94/11, 83/12, 59/13 and 100/14) – 2015. The list of professions that are exempt is much longer compared to the countries in the region, which makes it particularly difficult to control them due to a lack of proper oversight.

A third option was recently introduced in Serbia. Namely, in May 2018 the Parliament has adopted the Law on Multilateral Interchange Fees and Special Operating Rules for Card-based Payment Transactions. The aim of the Law was to reduce the costs of payment card acceptance and increase the number of points of sale where it's possible to pay for goods and services by a payment card. The law is prescribing the maximum fee amount charged by card operators for cashless payments, modelled on European practice. According to the law, a multilateral interchange fee may not exceed 0.2% (0.3%) of the value of transaction for any debit (credit) card transaction. This represent a significant step, as in some cases these fees were as much as 2.5%.

Figure 25 Debit Card Ownership



Source: World Bank Global Findex Database

National Action Plan states other activities that should increase electronic payments including subsidizing point of sale terminals to small and micro enterprises and benefits for cashless payments vis-à-vis cash payments. Serbia should examine the effects of various measures that provide incentives for using cards at the point-of-sale, as **many day-to-day transactions, especially those worth less than RSD 1,000 remain cash-based**. Developing incentives for individuals to use cards could be a way forward. However, these tax incentives (mostly related to the reduction of the tax component of retail prices, provided that a consumer makes a card payment at the point of sale) if any should be designed very carefully through. Another option is to discourage easy access to cash. The presence of no-fee automated teller machines (ATMs) provides uninhibited access to cash and subsequent cash payment at the point-of-sale.

6.4 Indirect controls

Until now, all the measures proposed have been direct controls which seek to change the cost/benefit ratio confronting businesses and citizens when considering participation in undeclared work either by increasing the costs of undeclared work or the benefits of declared work. As shown in section 2.2 however, business and citizens are not always simply rational economic actors. They are also often social actors who do not comply because they either lack trust in the state, or do not understand or believe in what the state is seeking to achieve (i.e. they lack ‘vertical’ trust), or they believe that many others are operating undeclared so see no reason that they should operate on a declared basis (i.e., they lack ‘horizontal’ trust).

To tackle undeclared work, the root causes that lead to the values, norms and beliefs of citizens not being aligned with the laws and regulations, needs to be tackled. This is what indirect controls seek to achieve by dealing with the formal institutional imperfections and failures that lead to the decision to engage in the undeclared economy. **Serbia is paying an increasing attention to such indirect controls as a means of tackling the undeclared economy**. These measures are based on two sets of initiatives. Firstly, initiatives can be



pursued to alter the norms, values and beliefs of citizens so that they align with the laws and regulations and secondly, and in order for this to be achieved, it is also necessary to deal with the formal institutional failings and imperfections so as to foster greater self-compliance in the population.

6.4.1 Altering informal institutions: awareness raising campaigns

Many citizens do not fully understand why they pay their taxes and/or what these taxes are used for by governments; they do not fully make the connection between the public goods and services they receive (e.g., hospitals, schools, transport infrastructure) and the taxes they pay. To achieve better understanding, two broad forms of education are required. On the one hand, and **to prevent unintentional non-compliance, citizens need to be educated and informed about what the current system requires of them.** On the other hand, and more broadly, citizens need to be educated about **the benefits and value of paying tax and being compliant with labour law and social insurance regulations, by educating them about the benefits of paying taxes and social insurance contributions, and complying with labour law, in order to develop their intrinsic motivation to do so and facilitate greater self-regulation.**

In Serbia comprehensive activities begun with the proclamation of 2016 as the ‘Year of Countering the Shadow Economy’. Several activities ensured a greater visibility of the fight against the shadow economy through the campaign and information distribution (developed national campaign identity, short videos, promotional materials, billboards, videos, advertisements, brochures, posters ...). Hence at present, several initiatives in this regard have been pursued in Serbia. Portal “Uzmi račun“ (Take the receipt) contains numerous information and links to various sources.

Serbia is making intensive efforts to encourage consumers – through lotteries and information campaign to get into the habit of asking for official receipts when shopping. The receipts lottery „Uzmi račun“ measure builds on this approach by encouraging consumers to ask for receipts. There is currently limited evidence of the impact of this ongoing initiative. However, a press release by NALED that during the duration of the prize game, citizens sent 107,322,950 fiscal accounts and slip boxes, or 10,732,295 envelopes. The minimum value of sent invoices is estimated at 37.4 billion dinars, and the corresponding VAT is 3.4 billion dinars or 28.5 million euros. According to a survey conducted by Ipsos citizens for the needs of NALED in May 2018, 41% of the population (24% in person, 17% through family members) participated in the prize competition The lottery was used in 2018 as well. The total value of the prize pool for both rounds of the prize competition was 257.230.048 dinars (with VAT included). The prize pool included a total of 291 prizes, of which 11 apartments, 100 cars and 180 vouchers worth 60,000 and 120,000 dinars. Dwellings and cars were provided from the budget of the Republic of Serbia, while 180 vouchers provided NALED from the donations of the economy.

The second and perhaps more important type of education is that which seeks to educate citizens about the benefits and value of being compliant with labour, tax and social insurance



regulations. One potential and partial remedy, therefore, is to educate citizens about the activities on which their taxes are spent, and the value of pensions and abiding by labour law. If citizens are informed and knowledgeable about the current and potential public goods and services which they are receiving for their money, and the value of having a pension, they may be more willing to pay their taxes and social contributions (Bird et al., 2006; Saeed and Shah, 2011).

Next step in this direction in Serbia could be a campaign that would to provide information to tax payers regarding where their taxes are being spent and how much they are contributing to which activities of government. This set out what portion of their taxes is spent on which public goods and services. Another simple way of doing this is to display signs such as ‘your taxes are paying for this’ on public construction projects (e.g., new roads), on ambulances, in doctor’s waiting rooms, in hospitals and schools, which convey a clear message to the public that the taxes they pay are being used to provide these public goods and services.

Box 12. ‘Unpaid taxes will leave a mark’, Estonia

Aim. The aim of this information campaign was to raise awareness of how taxpayers’ money is being used by the state. The campaign explained why it is important to pay taxes and what each citizen receives in return.

Description. Following a 2009 survey which revealed that 26% of respondents did not know what kind of services they receive from the state, and 11% said that they get nothing from the state (Lillemets, 2009), in 2010 and 2011, information campaigns were instigated by the Estonian Tax and Customs Board to raise awareness among the population as to how taxpayers’ money is being used by the state (Estonian Tax and Customs Board, 2010, 2011a, b).

The information campaign, ‘Unpaid Taxes Will Leave a Mark’, was implemented in two stages. Stage 1 was conducted in nine Estonian cities during January and February 2010. The main message was: ‘Unpaid taxes will leave a mark. You like highways in order, ambulances, efficient work of rescue workers and the police. So do we.’ For instance, a message was shown on the back of buses together with a picture of rescue workers: ‘Should we take the trolley bus to an emergency call-out? This can happen if you do not pay your taxes.’ In addition, a thank you message was attached to rescue cars in Tallinn, Harju and Virumaa counties and ambulance cars in Tallinn saying that these cars had been bought with taxpayers’ money. The aim was to raise awareness of the objects that are financed from tax income and to bring forward the services that the citizens receive for their tax payments.

Stage 2 was conducted in eight cities across Estonia during October 2011. The follow-up campaign kept the same main message, ‘Unpaid taxes will leave a mark’, although the sub-messages were geared towards social and cultural issues. In addition, TV and radio commercials were added. For instance, in relation to the 100th anniversary of the Estonian film industry, a TV commercial was published stating that on account of the current tax arrears, 722 domestic films a year could be made instead of the current three films. Radio commercials concentrated on the number of computers that could be bought for children, and outdoor commercials that 295 new kindergartens could be built. The messages were thus socially relevant and related to the Estonian context – the lack of childcare opportunities and kindergarten places is an acute problem, especially in the capital, Tallinn.

Evaluation. It is difficult to measure any change in behaviour resulting from the campaign. However, the visibility of the campaign was measured as well as how people remembered the messages and their assessment of the campaign. The campaign was regarded as successful – it was relatively well



noticed and the average score was good compared to other state and educational campaigns. The follow-up campaign was also effective in reinforcing the campaign message and making people think about why we pay taxes and raised understanding that paying taxes helps the state to function and provide social guarantees to people (Estonian Tax and Customs Board, 2011b).

The visibility of both parts of the campaign was measured by JCDecaux. The first part of the campaign was best received by 31–50 year-old men, of whom 62% remembered the campaign in the capital, Tallinn, mainly based on posters on the street. In addition, men of ethnic minorities and managers and specialists remembered the campaign better than average. The second part of the campaign was noticed by 59% of respondents aged 15–74. Considering that the average share for campaigns in general is 45%, the results are relatively good. The largest share of people who noticed the campaign was among 51–59-year-olds who use the public transport system. 78% of all people who use public transport remembered the campaign. The share was also higher among ethnic minorities (62%). Compared with the first part of the campaign, the share of respondents who remembered the campaign had increased in almost all groups.

The respondents considered the main message of the campaign to be that the maintenance of the state is the responsibility of all citizens. 65% of the respondents found that the commercial was suitable for increasing awareness of unpaid taxes. The messages of the campaign were found most suitable by Estonians (79%) and the 60–74 age group (83%).

It is transferrable to other contexts. To achieve impact, a lesson is that the messages used must be context-specific and relevant to the audiences.

Source: Nurmela, K. (2013) Information campaign on tax compliance, Estonia. Available at: <https://www.eurofound.europa.eu/data/tackling-undeclared-work-in-europe/database/information-campaign-on-tax-compliance-estonia>

For a campaign to be effective however, it has to use tailored advertisements that will need to vary in form and content depending on the audience targeted. The language, media used, word style and slogans that will be effective for one population group such as younger people, will not be for another group such as the elderly. Similarly, effective media for one target group, such as newspaper adverts for older people, will not be for the internet-oriented younger generation. As shown in other realms of advertising, harnessing the power of celebrities can also be effective in influencing the target audience. If celebrities and/or opinion leaders are used by administrations, then as Lessing and Park (1978) identify, it is necessary to differentiate three types of campaign. These are firstly, information campaigns where citizens lacking knowledge refer to opinion leaders for information, such as highly respected economic experts via television commercials, talk shows and newspaper articles, secondly, utilitarian campaigns when citizens are motivated by hearing about others rewarded or punished, such as when names are published of those who pay taxes and do not and, third and finally, value-expressive campaigns when citizens are encouraged to associate themselves with positive role models, such as by publicising the tax payments of famous television and movie stars, athletes, scientists, politicians and business tycoons, holding them up as role models for the law-abiding citizen to follow.

Campaigns to inform undeclared workers

There is tentative evidence is that emphasising the benefits of working declared rather than the costs and risks of engaging in undeclared labour is more effective. As Thurman



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

In September 2017, the Ministry of Labour supported by the Norwegian government launched the project “Support to the Labour Inspectorate in Suppression of “Informal Work“. The project provides assistance to the LI through capacity building and public awareness campaign dedicated explicitly to reduction of all forms of undeclared work. **The campaign of the Ministry of Labour “Say No to Undeclared Work” emphasizes the adverse consequences of the undeclared work.** The media campaign was launched in January 2018. The campaign consists of the web portal, created on the address www.recineradunacrno.rs, where information can be found on the project, applicable labour legislation in the Republic of Serbia and the forms to be used to report on an employer who hires non-registered people. Employees can report undeclared work, check their status – whether social contributions are paid, obtain a detailed explanation about procedural steps, download forms, etc.

Publication on the internet is additionally strengthened by continuously updated pages on social networks Facebook, LinkedIn and YouTube. Apart from Internet, the campaign is conducted on TVs with national frequencies, by broadcasting video clips, distributing flyers and brochures.

6.4.2 Reforming formal institutions

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

Changing the processes of formal institutions addresses two key types of formal institutional failure. On the one hand, changing the processes of formal institutions tackles formal institutional inefficiencies, or resource misallocations by formal institutions, such as when formal institutions seek to protect or maximize economic rents for elites, or when state capture occurs by such elites, resulting in the majority not receiving a fair share in return for their contributions, or suffering from overly burdensome taxes, registration and licensing regulations and costs. On the other hand, changing the processes of formal institutions tackles formal institutional weaknesses and instability, manifested in their lack of capacity and



capability to enforce legislation and/or there are continuous changes in the formal ‘rules of the game’ about what is acceptable, which leads citizens to reject the continuously changing formal rules of the game in favour of their own more stable unwritten socially shared rules. These malfunctions lead to a non-alignment between state morality and citizen morality. To change this, processes need to be altered to ensure that there is procedural justice, procedural fairness and distributive fairness. This net result will be a shift in public institutions away from a ‘cops and robbers’ approach and towards a more customer-friendly orientation. Each is here considered in turn.

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

- (i) The consistency rule - procedures should be consistent across people and time; nobody should be favoured or disadvantaged.
- (ii) bias suppression rule - egoistic intentions and prejudice on the part of the decision-makers should be avoided;
- (iii) accuracy rule - all relevant sources of information should be exhausted, in order that decisions are based on well-founded information;
- (iv) correctability rule - the possibility of the adjustment or revision of decisions made;
- (v) representativeness rule - the opinions and interests of all parties should be considered, and
- (vi) ethicality rule - procedures should align with the prevailing moral and ethical values.

Leventhal’s rules deal primarily with the decision-making process. However, Bies and Moag (1986) argue that it is also important to consider interpersonal interactions and whether there is respectful and fair treatment (i.e., interactional fairness). Compliance is significantly higher when citizens perceive there to be interactional fairness. Being treated politely, in a dignified manner and with respect, being given a say, and having genuine respect shown for one rights and social status all improve compliance (Gangl et al., 2013; Hartner et al., 2008).

Consequently, it is necessary for the state to move towards a customer-oriented service approach that treats citizens with respect and dignity. This shift from a coercive to cooperative approach seeks to reduce the need for enforced compliance. The more regulatory interactions are grounded in trust, the greater is the likelihood of self-regulation or voluntary compliance.

Procedural fairness. People who receive procedurally fair treatment by an organization will be more likely to trust that organization and will be more inclined to accept its decisions and follow its directions (Murphy, 2005). If one citizen caught violating the law pays no fines, but others caught have to pay, s/he will view themselves as being treated unfairly. Fairness is one of the most important determinants of compliance (Hartner et al., 2011; Kirchgässner, 2010, 2011; Molero and Pujol, 2012). If citizens feel that they are not receiving fair treatment, non-compliance increases (Bird et al., 2006). Where grievance exists either in absolute terms (e.g., those who feel that taxes are too high, those who feel that public funds are wasted) or in



relative terms (e.g., the suspected level of others' tax evasion), the result is greater non-compliance. Indeed, and as shown above, citizens can justify their own non-compliance in the perceived non-compliance of others. If the undeclared economy is perceived as extensive, then this justifies citizens engaging in non-compliant behaviour themselves. This obviously has implications for administrations. If the authorities advertise that the undeclared economy is extensive, then they create the conditions for widespread grievance and for greater participation in the undeclared economy of those who might not have otherwise done so. Similarly, if an offender believes that administrations are communicating disapproval to them through disrespect or stigmatising them, such as by labelling them with negative identities (e.g., thief, tax cheat), re-offending results since the individual externalizes the blame and feels alienated (Murphy and Harris, 2007).

Distributive fairness. Whether a citizen adheres to the codified laws and regulations and does not engage in the undeclared economy is heavily determined by whether they believe that they receive the goods and services they deserve given the taxes they pay (Richardson and Sawyer, 2001). Taxes, after all, are prices for the public goods and services provided by the government. If citizens view their interests as properly represented in formal institutions and they receive what they view as appropriate public goods and services for the taxes they pay, their identification with the state increases and their willingness to contribute is greater. As the IMF (2013: 18) state, 'The distribution of the revenue burden across society, and perception that everyone is paying their fair share, plays a key role in gaining support for the fiscal adjustment mix. ...

To date in Serbia, the main adjustment burden has been carried by easy-to-tax salaried employees and pensioners, while the richer, such as the self-employed (e.g., doctors, lawyers), and other high wealth individuals have continued to stay outside the tax net.'

If citizens do not receive the goods and services that they think they deserve given the taxes they pay, non-compliance increases. This may occur for example, when corruption is extensive, and the citizen has little trust in formal institutions. In such situations, there will be a low incentive to cooperate. Corruption generally undermines the willingness of citizens to comply, causing them to become frustrated. Citizens will feel cheated if they believe that corruption is widespread, and their tax burden is not spent well (Torgler, 2007, 2012). As Kirchgässner (2010, p. 28) thus puts it, 'If the willingness to pay taxes is to be enforced, a responsible use of tax revenue by the public authorities is necessary as well as a partnership relation (and not a magisterial one) between them'. The result is that governments need to educate citizens about where their taxes are spent. In situations where citizens do not know, or do not fully understand that public goods and services are due to taxes, then compliance will be lower than in situations where citizens are fully aware of the public goods and services they receive for their taxes and agree with how their taxes are spent (Lillemets, 2009). It is therefore important that the Serbian government explains to taxpayers how their money is spent.

Changing the products of formal institutions



It is not purely changes in the processes of formal institutions which are required to increase voluntary compliance. As outlined in section 2.1 and section 4, broader work and welfare regimes influence the size of the undeclared economy in a country. Larger undeclared economies are associated with lower levels of GDP per capita, a low quality of bureaucracy and higher levels of perceived public-sector corruption, lower levels of expenditure on social protection, less effective social transfer systems and greater inequality and deprivation.

Tackling the undeclared economy, therefore, is not solely about changing the penalties and risks of detection or providing incentives to work in the declared economy. It also requires changes in the macro-level economic and social conditions, if it is to be reduced. Unless this is achieved, there will continue to be an asymmetry between the informal and formal institutions in a country and undeclared work will remain rife.

To tackle informal work, it is also necessary to deal with other formal institutional failures that lead to norms, values and beliefs not aligning with the formal rules. This requires wider economic and social developments to be pursued. Until now, there have been **three theoretical standpoints** regarding the specific broader economic and social developments required to tackle informal work:

- the ‘modernisation’ thesis purports that informal work decreases as economies modernise and develop and therefore that economic development and growth, along with the modernisation of governance, is required to tackle informal work
- the ‘state over-interference’ thesis asserts that the prevalence of informal work is a direct result of high taxes, public sector corruption and state interference in the free market and therefore that tax reductions and reducing the regulatory burden are required.
- the ‘state under-intervention’ thesis asserts that informal work results from inadequate levels of state intervention in work and welfare and consequently, that greater social protection, reducing inequality and pursuing labour market interventions to help vulnerable groups are required.

Evaluations of these competing perspectives reveal that the modernisation and state under-intervention theses are positively confirmed, and the state over-interference is refuted (Vanderseypen *et al.*, 2013; Williams, 2013, 2014a,b,c,d, 2015, 2017; Williams *et al.*, 2013; Williams and Horodnic, 2016, 2017b). In other words, the finding is that informal work is more prevalent in countries where there is:

- Lower GDP/capita in personal purchasing power standards;
- Poorer quality governance, including greater levels of public sector corruption;
- Higher income inequality;
- Higher levels of severe material deprivation;
- Lower levels of expenditure on active labour market policies to help vulnerable groups; and
- Less effective policies of redistribution via social transfers to protect workers from poverty.

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ANNEX A Key Stakeholders Consulted

Ministries and Coordination Bodies

Coordination Commission for Tackling Shadow Economy
Inspection Coordination Commission
Unit for support of the Inspection Coordination
Working Group on Undeclared Work
Public Polices Secretariat
Ministry of Labour - Labour Inspectorate
Ministry of Labour -Social Protection Inspection
Ministry of Trade – Trade Inspectorate
Serbian Business Registration Agency

Social partners :

NALED
Trad Union “Nezavisnost”
Fair Competition Alliance (FCA)
Chamber of Commerce and Industry (PKS)

Universities:

Faculty of Economics, University of Belgrade (FEUB)
Faculty of Law, University of Belgrade (FLUB)