

**Employment and Social Affairs Platform**

**Policy Brief**

**on**

**Undeclared work in Montenegro**

**-evidence and policy recommendations-**

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### **List of abbreviations**

**GDP** – gross domestic product

**ISSP** – Institute for Strategic Studies and Prognoses

**RCC** – Regional Cooperation Council

**UNDP** – United Nations Development Program

**UPCG** – Association of Employers

**WB** – Western Balkans

## 1. Introduction

Undeclared work – work that in itself is legal but not declared to the authorities for tax, social security and/or labour law purposes – plays an important role in all economies in the Western Balkans. This challenge has been recognized both in the national Economic Reform Programmes<sup>1</sup>, prepared annually by the Western Balkan economies as part of their economic governance dialogue with the EU, and the EU strategic documents related to the enlargement process<sup>23</sup>.

In this context, under its Employment and Social Affairs Platform project and in close coordination with Ministries of Labour and Social Affairs, the Regional Cooperation Council (RCC) has commissioned diagnostic reports for each Western Balkan economy, which review and assess in-depth direct and indirect policy approaches with regard to undeclared work and provide rapid appraisal of applicability and transferability of EU policies to the WB6 economies. The insights in these reports will be further discussed in national and regional fora and will provide the trigger for future collaboration and mutual learning in tackling undeclared work.

Inspired by the successful experience of the European Platform Tackling Undeclared Work, this work will support the establishment of a WB6 Network for Tackling Undeclared Work, with the immediate objective of enhancing cooperation on tackling undeclared work using a holistic and integrated approach, that joins up on the level of both strategy and operations the policy fields of labour, tax and social security law, and involving social partners.

This policy brief draws on the diagnostic report for Montenegro and aims to provide information related to the current size, character and drivers of the informal economy in Montenegro, a summary of policy measures employed so far by the government and outline some key indicative recommendations for policy makers and other stakeholders to better address informal economy.

## 2. Evidence and analysis

### 2.1 Informal economy

The assessment of the share of informal economy in GDP in the 1990s ranged from 35-60% of GDP.

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<sup>1</sup> [https://ec.europa.eu/neighbourhood-enlargement/policy/policy-highlights/economic-governance\\_en](https://ec.europa.eu/neighbourhood-enlargement/policy/policy-highlights/economic-governance_en)

<sup>2</sup> The communication of the European Commission on a credible enlargement perspective for and enhanced EU engagement with the Western Balkans, 2018 recognizes that economic development in the region is hampered by an entrenched grey economy.

<sup>3</sup> In its Communication on EU Enlargement Policy, the European Commission emphasized that all Western Balkan economies face high unemployment rates and persistently high levels of informal economy (European Commission, 2018)

On the basis of the surveys in 2005 (Omnibus survey, December 2005, ISSP<sup>4</sup>), the share of undeclared economy in GDP was estimated at 25%, or about €400 million. The results indicated that the less developed regions in Montenegro had a higher undeclared economy rate, in that the undeclared economy was recorded in the most developed Southern region to be 30.6% of GDP, 23.8% in Central region and 45.6% in the least developed Northern region of Montenegro. The key sectors where activities of undeclared economy were recorded included trade (38.1%), agriculture (18.2%), the hospitality industry (19.1%), construction industry (10.8%), and transportation (9.6%).

The report *Combating Undeclared Work in Montenegro* (under the auspices of the European Foundation for the Improvement of Living and Working Conditions) that analysed the scope and character of undeclared labour in Montenegro as well as measures aimed at reducing informal economy, found that the level of informal economy, i.e. undeclared work is significantly higher than in the EU27.<sup>5</sup>

The IPSOS survey “Informal Employment and Grey Economy in Montenegro”<sup>6</sup>, conducted in 2014, indicated that the share of informal economy in Montenegro in 2014 amounted to 24.5% of GDP. The average share of undeclared economy in GDP in European Union in 2012 amounted to 18.4% of GDP, where the lowest share of the undeclared economy was in Austria (7.6%) and the highest in Bulgaria (31.9%).

## 2.2 Undeclared work

Besides undeclared work, the Montenegrin labour market is marked by negative demographic trends, low activity, high unemployment, and the insufficient creation of new and high-quality employment. Different methodological approaches used for the estimation of the magnitude of undeclared work indicate that the share of employees partially or fully engaged in undeclared work, in the last ten years, is more or less stable at roughly one third of the total number of employees (UNDP, 2016)<sup>7</sup>.

Centre for Development of Industrial Democracy in 2000 conducted a survey among employees in the private sector, concluding that 38.6% of employees in trade, catering and constructing were unregistered employees. Labour force survey conducted by the Institute for Strategic Studies and Prognoses in 2007 identified three key forms of unformal economy of the labour market:

- Employment in informal sector – work in unregistered companies or unregistered self-employed individuals;

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<sup>4</sup> Estimates of the *Institute for Strategic Studies and Projections* (ISSP) from 2001-2005 published in Montenegrin Economic Trends and Survey of Households (available at [www.isspm.org](http://www.isspm.org)).

<sup>5</sup> Williams, C. and Barić, M. (2012), *Combating undeclared economy in Montenegro*; Williams, C. and Barić, M. (2012), *Tackling Undeclared Work in Montenegro*, EFILWC

<sup>6</sup> IPSOS (2014), *Informal Employment and Grey Economy in Montenegro 2014*

<sup>7</sup> Katnic, M. (2016), *National Human Development Report for Montenegro 2016*, *United Nations Development Programme* (UNDP).

- Unregistered employment in formal sector – work for registered companies without registration for social security; and
- Employment in formal sector with partial registration – persons for whose employees register and pay taxes and contributions only on part of salary.

The results indicated that 22.6% of the total number of employees in Montenegro were unregistered employees. In addition, for 17.5% of total number of employees, employers underreported salaries in order to avoid paying taxes and contribution on the whole amount of employees' salaries. Regarding the structure of unregistered employment - 40% of unregistered employees were females and the largest share (32.7%) was aged from 20 to 29.

The 2014 IPSOS survey of general population about the working conditions, was conducted for the Ministry of Labour and Social Welfare under the auspices of UNDP. Informal employment in this survey included: (a) employers, self-employed persons and persons employed for salary in unregistered companies; (b) employees that work in the registered companies without any contract and employees with contract but with partly paid contributions. Key findings of the 2014 survey indicate that the share of unregistered employees was 22.3% out of total number of employed, while in addition to this 10.3% of employees had underreported salaries.

**Table 02. Structure of Employees by Status**

Structure	%
<b>Total employees</b>	<b>100.0%</b>
Formally employed persons	77,7%
Formally employed persons with the full salary declared	67.3%
Formally employed persons with a part of salary declared	10.3%
Informally employed persons	22,3%
Informally employed persons in a registered company	5.0%
Informally employed persons in an unregistered company	1.8%
Self-employed persons	15.5%

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

Despite the differences in levels, findings of the survey show that the structure of the informal sector in Montenegro does not differ significantly from those for other European economies. Data from the Eurobarometer survey 2013<sup>8</sup> indicated that engagement in informal economy is higher among men than among women, while there are no significant differences between urban and rural areas. In addition to this, the probability of engagement in grey economy is higher for young people, less educated individuals, elderly and single or divorced persons. The rate of undeclared work in Montenegro is the highest among young people (34% for the age group 15-24) and the oldest (73% for persons of 65+). Additionally, if we observe only formally employed persons with partly paid taxes and contributions, we can see

<sup>8</sup> [https://data.europa.eu/euodp/data/dataset/S1080\\_79\\_2\\_402](https://data.europa.eu/euodp/data/dataset/S1080_79_2_402)

that the highest share of these employees (19%) is in the group of young persons, i.e. employees of the age group 15-24. This situation is similar to the situation in the neighbouring Serbia (Koettl, 2013)<sup>9</sup> and EU economies (William, Horodonic, 2015)<sup>10</sup>.

## 2.3 Policy approaches

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

The measures of combating undeclared economy were related to the **reduction in the costs of doing business, reduction in the administrative and tax burden and the strengthening of the control by the state aimed at eliminating undeclared employment**. Implementation of these measures included the **weakening of the motivation to employ undeclared workers** and **reducing the tax burden on salaries of employees** in order to encourage employment. The reduction of the tax burden on salaries created an incentive for reductions in undeclared work and for the improvement of the business environment. However, all these measures mainly contributed to the creation of new jobs in the declared economy, while the number of undeclared workers more or less remained constant over time.

Starting from 2012, the Ministry of Finance took a leading role in the fight against the undeclared economy and established a work team composed of all relevant institutions including the Ministry of Labour and Social Welfare, Inspection Authority, Tax Authority, Customs Administration, and Police Authority, which at a later stage included unions, employers association and the Parliament. The work team/committee for combating undeclared economy reduced membership to solely government representatives in 2017. The committee is chaired by the vice-president of the Government for economic policy, while members are representatives of Ministry of Finance, Tax, Customs, Police and Inspection Authorities.

The set of measures for combating the undeclared economy has been defined in the annual action plan, including the measures necessary for strengthening institutional capacities and human resources of the state administration bodies responsible for the control and collection of revenues.

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<sup>9</sup> Koettl, J. 2013. "Does Formal Work Pay in Serbia? The Role of Labor Taxes and Social Benefit Design in Providing Disincentives for Formal Work." in *Poverty and Exclusion in the Western Balkans: New Directions in Measurement and Policy*, edited by C. Ruggeri Laderchi and S. Savastano, 133–54. Vol. 8 of *Economic Studies in Inequality, Social Exclusion, and Well-Being*. New York: Springer

<sup>10</sup> William, C., Horodonic, I.(2015) "Marginalisation and participation in the informal economy in Central and Eastern European nations, Post-Communist Economies", pp.153-169

**The enhancement and increased frequency of controls** is one of the constant activities in action plans aimed at combating the undeclared economy. The Labour Inspection, as part of the Inspection Administration, is charged to control the application of the Labour Law and other relevant legislation. In the period from 2015 to 2017, the Labour Inspection has conducted on average 10,000 controls per annum. Labour Inspection has detected 3085 cases of unreported workers in 2015, while the number has decreased by roughly one third in 2016 and 2017, when there were 1977 and 2065 registered cases of undeclared workers.

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

The institutional approach to combating undeclared work in Montenegro is rather based on intimidation and penalty policy, as well as on the additional regulation aimed at combating the undeclared economy. Montenegro does not have any system of incentives that would be focused on the formalization of economic activities.

### 3. Policy implications and recommendations

Persistently high share of undeclared work suggests weaknesses in regulatory framework, business environment as well as inefficiency in institutions. The consequences of high share of unregistered work, besides missing revenues today also mean higher cost of social security in the future. Therefore, transiting informal economy into the formal sector requires high level of political support, determination and also very energetic reforms. The policy approach to combat undeclared work will have to combine structural reforms with the implementation of measures that will assume improvement in organisation of fight against undeclared work as well implementation policy initiatives that proved to be successful and applicable, based on identified EU and regional best practice.

Relevant research and policy reviews identify drivers of the high and persistent undeclared work in Montenegro (ISSP 2007<sup>11</sup>, UPCG 2014<sup>12</sup>, UNDP 2016) as follows:

- Insufficient level of the rule of law, reflected in the inefficient public administration, selective implementation of legislation and inefficient inspection services, inconsistent interpretation of legislation by various instances of administrative services;
- Inadequate regulatory framework that primarily refers to high transaction costs, the burdening legislation, complicated, expensive an inadequate registration procedures;

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<sup>11</sup> ISSP/ZZZCG (2007), Labour Force and Unemployment in Montenegro, July 2007 (<http://www.zzzcg.org/shared/dokumenti/Izvjestaji/Radna%20snaga%20i%20zaposlenost%20Final%20-%20RATKO%20BAKRA%20C2%AC.pdf>)

<sup>12</sup> Unija poslodavaca Crne Gore (2014) - Neformalna ekonomija u Crnoj Gori - stvaranje ambijenta za održivi razvoj preduzeća - <http://www.poslodavci.org/biblioteka/publikacije/neformalna-ekonomija-u-crnoj-gori-stvaranje-ambijenta-za-odrzivi-razvoj-preduzeca-u-crnoj-gori>



- Rigid labour legislation in terms of administrative burdens and cost of compliance;
- High tax wedge on labour;
- High para-fiscal burdens, often imposed by local-self-governments.

The policy approach to combat undeclared work will have to combine structural reforms with the implementation of measures that will assume improvement in the organisation of fight against undeclared work as well implementation policy initiatives that proved to be successful and applicable, based on identified EU and regional best practice.

Having in mind all stated, formalisation policy should be aimed at short-term and long term policy measures such as:

- Overarching structural reform agenda that will tackle key drivers of undeclared work
- **Strategic management initiatives** through the introduction of a holistic integrated strategic approach towards tackling undeclared work, improvements in measurement of undeclared work and increasing the level of trust in institutions and especially inspection services through setting strategic objectives and KPIs in relation to undeclared work.
- **Policy measures to deter undeclared work**, such as through redesigning the system of fines and penalties, establishing a register of employers fined for undeclared work, setting up a small task force for improvement of the effectiveness of electronic systems for data mining, data sharing and data analysis and applying supply chain responsibility in public works contracts.
- **Supply side policy measures**, such as incentives for gradual formalization of self-employment, simplification of the procedures and taxation for registration of workers such as nannies, housemaids and similar jobs, decrease of incentives to use cash and increase incentives to use electronic payments to reduce undeclared work and introduction of a tax rebate incentive scheme for home owners to receive a rebate of tax when they employ (i) domestic workers, and (ii) registered building contractors or registered tradespeople who provide house repair and renovation services.
- **Changing citizens' values, norms and beliefs**, through public awareness campaigns on the benefits of declared work, educating citizens about the tax system and educating schoolchildren and university students of the benefits of declared work.
- **Reforming formal institutions** through the revision and modernization of labour regulation in order to remove obstacles for declared work and to adapt to the new emerging jobs, reduction of tax burden on labour, transfer of responsibility for payment of taxes and contributions from employers to employees, removing obstacles to formal work of young people/students beneficiaries of scholarships or stipends and training of labour inspectors.
- **Improving the involvement of social partners**, through engaging employers' associations to provide advice on formalization and launch awareness raising campaign among undeclared workers and business community of the benefits of declared work.

## 4. Research parameters

This brief draws from the undeclared work diagnostic report and action plan for Montenegro prepared as part of a regional exercise by a team of experts for the RCC. The methodology includes a review of existing surveys on undeclared work, a desk-based survey of policy measures initiatives to explore the policy instruments used by the government, social partners and employers' organizations, and in-depth interviews with representatives of Tax Administration, State Labour Inspectorate, and economic experts.

### References

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