

The impact of tax changes on the shadow economy in the Croatian tourism sector

Tourism Master thesis

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Abstract

Over the past decade, the Croatian tax system has gone through many changes that have had a strong impact on private businesses and workers. In this research, the focus will be on exploring what impact different tax and regulation changes have had on the shadow economy, with the main focus on the tourism sector. As a source of primary data, the study uses conducted interviews with the workers and business owners who have provided “first-hand” information, as well as an interview with a researcher from the Institute of Public Finance. Existing researches and statistics were significant for gaining an insight into the changes that occurred in the tax system, as well as the size of the shadow economy through years. The analysis of the collected data shows how numerous changes in the tax system have caused more private businesses to engage in the shadow economy. In addition, a strong connection between the tax morale of the citizens and the scope of the shadow economy in the country has been found and analyzed. As a result of the research, it was concluded that the instability of the tax system provokes a lack of trust in the state, which leads to the growth of the shadow economy.

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1. Introduction

Schneider, Buehn, & Montenegro (2010) explained that the shadow economy includes all market-based legal production of goods and services that are purposely hidden from the authorities to avoid paying taxes, social security contributions, as well as to avoid legal labor market standards and administrative procedures (Schneider, Buehn, & Montenegro, 2010). The greater the difference between the total cost of labor in the official economy and the work earnings after-tax, the more people are choosing to work in the shadow economy. Because the difference is dependent on the social security costs and tax burdens, they can be considered as a cause of the shadow economy. (Schneider, Buehn, & Montenegro, 2010).

It is necessary to find a proper way to reduce the shadow economy because its consequences are quite unfavorable. The main consequence of tax evasion is that public funds are decreased, which can lead to a lower quality of the public service. Furthermore, tax evasion creates an unfair advantage for the businesses that are working behind the law. As explained by Katrechka & Dahlberg (2014) shadow economy creates adverse conditions in a country because it reduces tax revenue which leads to the reduction of the allocation of public goods and eventually hinders economic development (Katrechka & Dahlberg, 2014).

Kesar & Čuić (2017) explained that because tourism includes diverse activities, they are often a part of the shadow economy. These are mostly activities such as hospitality, transport, tourist attractions and retails, sports facilities and equipment, events, excursions, charter boat operations, and many more (Kesar & Čuić, 2017).

This thesis investigates to what extent the changes in the tax system that occurred in the last decade affected the size of the shadow economy in the tourism sector in Croatia. This topic is interesting because often, people have encountered and fueled shadow economy activities without even being aware of it. I have also experienced the shadow economy in Croatia. One night while having dinner with my friends in a restaurant, I

noticed something that before I hadn't been paying attention to. At the bottom of the bill, it was written that this is not a fiscalized bill, but just a printed note. The note had the prices of our order, and the waiter used it as a bill. My friends and I started a conversation about it. Some of my friends shared experiences of people that they know who work in hospitality businesses and according to the stories, not issuing receipts was a common practice. Moreover, from the general public, it is not perceived as an issue. Therefore, after having that experience, I got an interest in this topic and decided to investigate why the shadow economy was such a common practice in tourism businesses in Croatia. As found out from the interviews, as well as supported by different theories, what triggers working behind the law are tax burdens, both on the employer and an employee. Secondly, there is an issue of the instability of the tax system and regulations where, if the regulations are changed, businesses are forced to work partly or fully in the shadow economy to survive. Another significant factor that influences the size of the shadow economy is tax morale, which is closely connected with the past experiences that citizens had with the government, and that caused distrust in the state.

In the case of Croatia, tourism income has a huge significance for the country. In the year 2018, the share of tourism in total GDP was estimated to be 19,6% (Ministarstvo turizma Republike Hrvatske, 2019). As a result of the developed tourism industry in Croatia, many people are choosing to work in the industry, but the question is, how many of them are working behind the law, and more importantly, what are their reasons for that? According to Kesar & Čuić (2017), the shadow economy in Croatia is quite present (Kesar & Čuić, 2017). Schneider, Buehn, & Montenegro (2010) pointed out that so far, many studies have discovered that total tax and social security contribution burdens are among the major triggers of the shadow economy (Schneider, Buehn, & Montenegro, 2010).

The data were gathered via the interviews with business owners and workers who had participated in the shadow economy as well as with a public institution, in order to get a practical insight into the core of how increases in tax rates and other changes of regulation affect businesses and workers.

1.2 Research question

What is the impact of tax changes on the shadow economy in the tourism sector in Croatia?

1.3 Aims of the research

This research aims to explore the following:

- What significant changes have happened in the tax system in Croatia during the previous decade?
- Analyze how the implementation of significant tax changes has influenced the size of the shadow economy over the years.
- Present the experience of people who have participated in the shadow economy activities.

1.4 Hypothesis

- Increase in taxes leads to the increase in the shadow economy.
- Increase in regulations leads to the increase in the shadow economy.
- Instability of the tax system leads to the increase in the shadow economy.

2.Literature review

This thesis investigates how did different changes in the Croatian tax system influence the size of the shadow economy in the tourism sector in the country. This theoretical chapter will review the literature on the following topics: Taxation and the tourism sector, Impact of the VAT rate on the tourism sector, Fiscal law in the Croatian tax system, PIT and CIT on workers and businesses, Shadow economy, The shadow economy in the tourism sector, The shadow economy in Croatia, Tax changes and the shadow economy, and finally Tax morale and the shadow economy.

2.1 Taxation and the tourism sector

As reported by OECD, the majority of countries base their tax system on two primary groups, direct and indirect taxes. Even though the line between these two types of taxes can be blurry, they can be distinguished by considering direct taxes as those that are imposed directly on income while indirect taxes are charged through expenditures, for example, VAT. Nevertheless, tax systems can be different depending on the country (OECD, 2014). According to Kaplow (2006), the main purpose of taxation is to increase revenue that the government uses to finance public goods and services. The second purpose of taxation is connected to increasing revenue in order to reduce inequality (Kaplow, 2006).

Durbarry (2008) explained the advantages and disadvantages of taxes in the tourism industry. By raising taxation rates or imposing more taxes on the tourism industry governments can increase their revenues, which can be used for infrastructure and facilities that are important for tourism. Increase of taxes can have negative distortions in the economy and decrease the revenue that is collected by the taxes. This is determined by how much of the tax increase is transferred on to the prices and on the price elasticity demand for tourism in the destination (Durbarry, 2008). Surugiu & Surugiu (2018) explained that the tourism industry contributes to government revenue from taxation through different types of taxes, such as value-added tax, airport tax, room or bed tax,

environmental tax, property tax, transport tax, profit tax, import duties. Taxes serve as an economic tool that helps obtain money for funding tourism development (Surugiu & Surugiu, 2018). According to Ihalanayake (2007), besides the tax income, governments can obtain financial resources in different ways as for example borrowing income from government businesses, foreign aid, and grants as well as charges for government services. Considering all the sources, taxation has the largest part of the budget (Ihalanayake, 2007). Bird (1992) explained that by developing the tourism sector, countries are gaining economic benefits such as earning foreign currency, higher employment rate and the rise of economic activities generally. Most (tourism) developing countries are pressured to increase tax revenues in order to cover increasing expenditures as well as to meet the requirements of external creditors. The degree to which tourism contributes to an increase in government revenues creates an important element of tourist policy (Bird, 1992).

World Travel & Tourism Council¹ introduced 5 economic principles (Equity, Fair revenue generation, Efficiency, Simplicity, Effective stimulus to growth) to be used in the creation of taxes and user charges in all industries as well as in Travel & Tourism:

1.EQUITY: In order to minimize political, social, and economic instability, all the sectors should be treated in a fair way when it comes to taxation. It is often forgotten that for some countries international Travel & Tourism is an export industry. Because of that, it should be taxed as other manufactured goods. In comparison with other industries, that are exporting their product to the customer's location, in Travel & Tourism products are fixed while consumers are mobile (World Travel and Tourism Council, 2018).

2. FAIR REVENUE GENERATION: In Travel & Tourism, taxation should be carried out equally. A good instance of that is progressive taxation, where the rate is determined according to the spent amount (World Travel and Tourism Council, 2018).

¹ World Travel & Tourism Council gathers CEOs, Chairpersons and Presidents of the Travel & Tourism major companies from all over the world, raises awareness about Travel & Tourism as one of the biggest economy sectors, supports one in ten jobs globally and creates 10.3% of global GDP (WTTC: Home, 2020).

3.EFFICIENCY: Taxes have to ensure financial resources without decreasing demand or rising costs of production, also, taxes should be applied only to the last phase of production/service. Results of heavy taxation are increases in prices, reduction of Travel and Tourism demand which leads to a decline of the general economy. It is known that some governments have changed taxation policies because of their negative impact on the demand of tourists. Moreover, others have witnessed more success after lowering the tax rates in Tourism & Travel sector or providing a possibility of a tax refund to foreign visitors (World Travel and Tourism Council, 2018).

4. SIMPLICITY: The tax system should work in a simple way. Otherwise, administrative costs could cause expenses for taxpayers and for the government. To have a standardized way of applying taxes, to clearly defined rates as well as how the revenue will be spent is crucial (World Travel and Tourism Council, 2018).

5. EFFECTIVE STIMULUS TO GROWTH: Taxes are supposed to be used for purposes of economic growth and creation of employment. Travel & Tourism is a labor-intensive industry and it indirectly impacts broader economy. In the sector, tax revenue should be invested in fostering possible growth through relevant infrastructure projects (World Travel and Tourism Council, 2018).

According to, Gago, Labandeira, Picos, & Rodríguez (2006) tourism activity is being used as a taxable item, in line with different formulas and circumstances. The imprecision of these formulas is that all the activities that we describe as tourist activities are also non-tourist activities. It is because we are not taxing tourism itself, but activities that are widely used, such as restaurants, hotels, flights, car rentals, etc. As a result, by the term tourism taxation, what is meant are taxes affecting tourist activities (Gago, Labandeira, Picos, & Rodríguez, 2006).

According to the European Commission, the tourism industry consist of a wide range of economic activities and most taxes will probably have an impact on the industry. The European Commission introduced a review of taxes that probably influence tourism

businesses (European Commission, 2020). Types of taxes were divided into three groups:

1. Direct taxes – corporate and personal income taxes

1.1 Corporate income tax (CIT), known as company tax, the tax is applied on the company's income after deduction of expenses and depreciation. In the EU countries, the rate is between 9% and 35.53%, with the lowest rate in Hungary and the highest in Belgium (European Commission, 2020).

1.2. Personal income tax (PIT) depends on the income of the person. In general, it is calculated according to the following formula: Total Income - Expenses and other deductions = Taxable Income (European Commission, 2020).

2. Indirect taxes - VAT

VAT tax applies on the sale of majority products and services throughout the EU. Within the EU countries, Luxembourg has the lowest rate (17%) while Hungary applies the highest rate (27%) (European Commission, 2020).

3. Specific taxes for tourism

3.1 Occupancy taxes are imposed on short term residence in paid accommodation, charged per person, per night or as percentage of the room cost. Depending on country rates are between 0.10€-7.50€ (European Commission, 2020).

3.2. Tourist taxes to improve the sector serve for the investments in tourism in the area (European Commission, 2020).

3.3 Tourist taxes earmarked for specific purposes help to raise financial resources which will be directed towards environmental protection and recovery of the resources as well as to raise environmental awareness (European Commission, 2020).

2.2 Impact of VAT rate on the tourism sector

According to PricewaterhouseCoopers² report for the European Commission, the lower VAT rate increases the price competitiveness of the destination which could lead to an increase in demand. Consequently, the revenue base in the tourism sector on which VAT is levied will be higher. Besides attracting foreign tourists with a lower VAT rate, more residents would be encouraged to go for homeland holidays instead of going abroad. Moreover, reducing the VAT rate could lower the scope of the shadow economy. This means that the share of businesses inside the VAT regime could increase (PricewaterhouseCoopers, 2017).

According to Schneider (2009), in comparison with the USA, European, especially German market's inflexibility, heavy taxation, and social system contributions are the reasons for a wide scope of the shadow economy (Schneider, 2009). The increase in the VAT rate that came into force in 2007 is not a good way to decrease the shadow economy. Some European countries reduced a VAT rate on labor-intensive services for a certain period of time. Lowering the VAT rate will cause decreases in the tax revenue, but if that measure will help to transform part of the shadow into the official economy, the loss of the tax revenue will be compensated (Schneider, 2009).

Indecon Research Economists³ have made a report about the impact of VAT reduction on the Irish tourism sector. A reduction of the VAT rate on tourism-related goods and services was a part of the Government's 2011 Jobs Initiative to support the tourism industry. A new reduced rate of 9% had the purpose of improving the tourism sector. With the new VAT rate Ireland significantly improved trips from European countries, the USA and Canada. Significant improvement has been seen in rates of hotel occupancy. In 2015 the rate was higher than in the period before the crisis, also improving results were recorded with the employment in the tourism sector. Furthermore, the lower VAT rate

² PricewaterhouseCoopers is one of the leading professional services networks in the world which is providing organizations and individuals with services of Assurance, Tax and Advisory services (PwC, 2020).

³ "Indecon is a leading independent economic research organisation." (Indecon International Economic Consultants, 2020)

changes the perception of value for money when it comes to foreign visitors (Indecon International Economic Consultants, 2017).

According to Copenhagen Economics⁴, Portuguese restaurants are taxed with a VAT rate of 12%, while Spanish have a 5% lower rate. Besides, Spain allows VAT deduction to commercial undertakings on hospitality services which is not a case with Portugal. Accordingly, Spanish restaurants are cheaper than Portuguese (Copenhagen Economics, 2007).

According to Titlić (2018), the VAT system has been applied in Croatia since January 1st, 1998. Today, the VAT rate in the country is 25%. The rate in the tourism services is 13% and it is applied for the services of accommodation, in half board and full board accommodation services, in hotels and objects with similar purpose, camps, and vessels that have a purpose for nautical tourism. The 13% rate is also applied to the services of preparing food and serving food, non-alcohol drinks, wine and beer in these objects (Titlić, 2018). Titlić (2018), made a survey regarding the tax rate of 13% in the tourism services in Croatia, with 25 respondents that were all part of the tourism sector in the country, where 92% agreed that the tax rate of 13% is not appropriate, while 8% of the respondents were satisfied with the tax rate. In addition, when asked if the rate of 13% should be reduced, increased or remain the same, 84% agreed that the rate should be reduced, 8% wanted to increase the rate, while 8% agreed that the rate should remain the same (Titlić, 2018). Later on, from January 1st, 2020, the VAT rate of 13% has been expanded. Now, the rate also applies for preparing and serving food and desserts in and outside the accommodation services, which includes catering facilities and facilities of simple services such as bench, stand, trolley, or similar (Porezna uprava: Republika Hrvatska - Ministarstvo Financija, 2020).

As reported by Jokanović & Morosin (2013), because of high taxes in the tourism sector, a destination could face lower competitiveness and fewer earnings in the sector. Moreover, it can have negative impacts on other sectors as well, because tourism

⁴ Copenhagen Economics is economics firm. (Copenhagen Economics, 2020)

significantly impacts the general economy in a country, especially in the countries where the tourism industry makes a significant proportion of GDP. Therefore, fiscal politics should work in the direction of lowering the tax rate in the tourism sector (Jokanović & Morosin, 2013). Titlić (2018) explained that the general VAT rate of 25% and the reduced rate of 13% in Croatia are higher than the average of the EU. The average VAT rate in the EU countries is 21,5%, while in the tourism sector, other EU countries have a rate of 10% or lower (Titlić, 2018).

2.3 Fiscal law in the Croatian tax system

According to Zrinušić & Kudeljan (2016), since Croatia became a member of the European Union on the 1st of July 2013, the tax system has to be in sync with the standards of the European Union. In other words, the position of all taxpayers (domestic and foreign), natural and legal, is equalized. Besides the mandatory EU legislations, which are mostly focused on the harmony of the European Union market, and freedom of movement of people and capital, member countries are left to implement other tax policies in accordance with their economy (Zrinušić & Kudeljan , 2016).

Croatian Tax Administration is a part of the Ministry of Finances and it is in charge of enforcement and monitoring of the implementation of tax regulations and contributions (Porezna uprava: Republika Hrvatska - Ministarstvo Financija, 2020). Fiscal law has been introduced in Croatia on the 1st of January 2013, with the main purpose of monitoring payment transactions. The law refers to payments in cash, credit or debit cards, cheques, and other methods excluding direct payments to an account. Through its system, the Tax Administration has access to all receipts, for the purpose of reducing the shadow economy, and consequently increasing public expenditures (Ministarstvo Financija - Porezna Uprava, 2016.)

2.4 PIT and CIT on workers and businesses

According to PricewaterhouseCoopers report for the European Commission, corporate income tax and personal income tax are imposed on the businesses and individuals that are part of the tourism sector, but they are not tourism-specific taxes. For large accommodation provider businesses, travel agents and other large entities, the CIT rate is imposed on the net income, and it impacts the attractiveness of investments, while the PIT rate impacts the supply of the workforce (PricewaterhouseCoopers, 2017).

Current PIT rates in Croatia are 24% for an income of up to 30.000 HRK per month, and 36% for an income above 30.000 HRK per month. (Središnji državni portal, 2020). As reported by the European Commission, In the EU countries tax burden on labour in 2017 amounted on the average 20.9% of GDP, and it is considered to be one of the highest in the world. Personal income tax and social security contributions are the most significant tax revenue sources for many governments. High tax burdens on labour disrupt economic growth and the rise of employment. Lowering PIT and social security contributions potentially stimulates labour supply and creates work incentives (European Commission, 2020).

Current CIT rates in Croatia are 12% for annual-earnings up to 7.500.000,00 HRK, and 18% for annual-earnings of 7.500.000,01 HRK or higher (Porezna uprava: Republika Hrvatska - Ministarstvo Financija, 2020). According to Karpowicz (2018), during the past decades, CIT rates in the EU countries were decreased or remained unchanged (Karpowicz, 2018). Karpowicz (2018) stated how the cost of the tax is a significant factor that influences the shadow economy. Further, the study gives an example of Austria, Luxembourg, and the Netherlands as countries with quite high CIT rates, but at the same time, with the lowest shadow economy. On the other hand, Bulgaria and Romania have low tax rates while having a high shadow economy. That shows that developed countries are capable of levying higher tax rates, but at the same time, having control over the shadow economy (Karpowicz, 2018).

According to Lee (2018), in the USA during the year 2001, the estimated \$197 million of income tax revenue has been evaded, while in Italy, in the year 2012 the amount is considered to be €285 billion, which constitutes 18% of GDP. Developing countries are facing an even larger scale of income tax evasion (Lee, 2018).

2.5 Shadow economy

Schneider (2012) explained the term shadow economy and stated the reasons why people had chosen to work in a shadow economy. “The shadow economy includes all market-based legal production of goods and services that are deliberately concealed from public authorities for the following reasons:

1. to avoid payment of income, value added or other taxes,
2. to avoid payment of social security contributions,
3. to avoid having to meet certain legal labor market standards, such as minimum wages, maximum working hours, safety standards, etc., and
4. to avoid complying with certain administrative obligations, such as completing statistical questionnaires or other administrative forms.” (Schneider , 2012)

According to Tanzi (1999), the main triggers for the shadow economy can be divided into four categories: taxes, regulations, prohibitions, and corruption (Tanzi, 1999). With the appearance of more taxes and the rise of tax rates, more people are avoiding it by operating in the shadow economy. Because of the tax evasion, prices on the illegal market will be lower which will create demand from buyers and on that way both sides (seller and buyer) will benefit. If the tax administration is efficient, well-motivated, well-organized and well-funded it would be harder to engage in shadow economy activities (Tanzi, 1999). The second category is regulations, which apply to many aspects of a business. Some regulations are regarding certification needed to perform certain duties, also there are regulations regarding working hours, wages, age, pension, vacation, and similar. Regulations could cause higher costs or create obstacles for performing an activity legally. Therefore, people choose to perform business in the shadow economy. Countries

with heavy regulations often have a wider scope of the shadow economy (Tanzi, 1999). The third category is prohibitions, and it refers to activities that might be prohibited in certain countries, and because of that people choose to perform them illegally (Tanzi, 1999). The last category is corruption which can be political or bureaucratic, where participants can obtain high earnings (Tanzi, 1999).

Sujster (2002) explained that with the stability of the tax system, tax administration, and tax control more business activities are joining the formal sector. Frequent changes in the tax system are triggering tax evasion and complications for tax inspections. The state should be an example when it comes to payments and it should not finance non-transparent subsidies to certain economic agents in the form of write-offs of tax claims, repayment of their debt, and similar (Sujster, 2002).

Katrechka & Dahlberg (2014) explained that as a consequence of the shadow economy, tax revenue will be reduced and that will cause the reduction of the allocation of public goods and as a result, it could interfere with economic growth. The reduction of tax revenue causes a reduction in state expenditure, which leads to poorer social conditions and creates more illegal activities (Katrechka & Dahlberg, 2014).

Since the participants of the shadow economy do not want to be discovered, it is hard to get precise data about the activities going on in the illegal market (Torgler & Schneider, 2009). Fleming, Roman, & Farrell (2000) explained why the concern about the shadow economy is justified, because of undeclared economic activities the data in official national income accounts statistics is not precise, therefore statistics do not show the actual state of the country's economy. Considering that economic policies are created in accordance with these statistics, it can lead to inadequate policies (Fleming, Roman, & Farrell, 2000). Further, unreliable national accounts statistics can cause an inadequate distribution of welfare programs. With the existence of the shadow economy, unemployment cannot be estimated right and consequently, welfare benefits will be distributed to those who already have an income originating from participating in the

activities of the shadow economy, while those without any income could be in need for increased aid. Moreover, there is a connection between formal and informal markets, where formal markets can be affected by the informal markets regarding prices and capital allocation. (Fleming, Roman, & Farrell, 2000).

According to Schneider (2008), the shadow economy in Greece and Italy is estimated to be nearly one third as large as the official GNP. In Spain, Portugal and Belgium shadow economy is estimated to be from 19-23% of the official GNP. In Scandinavia, the rates are from 17-20% of the official GNP, and it is considered to be due to a high fiscal burden. On the contrary, countries with lower fiscal burden have a lower rate of the shadow economy, rates for Ireland, the Netherlands, France, Germany, and Great Britain are from 12-15% of the official GNP (Schneider, 2008).

2.6 The shadow economy in the tourism sector

Jaliu & Răvar (2017) explained that the existence of the shadow economy in the tourism sector could cause stagnation in the sector in many ways. Here are a few examples:

- Businesses operating in the shadow economy have lower costs in comparison with formal businesses that follow regulations, therefore informal businesses are distorting competition and development. Eventually, that could repress formal businesses from the market.
- Tax evasion lowers tax revenue, which decreases public investments and have a direct effect on the development and maintenance of infrastructure.
- Avoidance of labor and health regulations creates inadequate working conditions, without social security and unskilled workers being employed (Jaliu & Răvar, 2017).

According to Kesar & Čuić (2017) the amount of shadow economy in Europe in the year 2013 was €2.15 trillion. It is considered that 2/3 is a result of undeclared work and 1/3 is a result of incomes that were partly reported to avoid paying taxes, such a practice is common for the businesses that work with a lot of cash, for example shops, bars and taxis

(Kesar & Čuić, 2017). As reported by Din, Habibullah , Baharom , & Saari (2016), the shadow economy is a part of tourism industry and it is in activities such as wholesale, retail, hotels, restaurants, transportation and communication. In Turkey, Spain, Italy, Germany and Poland 25% to 35% of the activities in each of the previously mentioned activities consists of shadow economy. The informal economy part in the tourism, hotel and catering industry in the case of Croatia is 22%. In the case of Greece, the shadow economy in the tourism sector is 22% of the official economy (Din, Habibullah , Baharom , & Saari , 2016).

Examples of practices of the shadow economy in the tourism sector have been mentioned by many authors. According to Kesar & Čuić (2017), hotels and restaurants in Norway are using official and unofficial cash registers, not reporting an extra income from events to the tax authorities and providing forbidden alcoholic drinks (Kesar & Čuić, 2017). As reported by Milić (2014), in Montenegro, the shadow economy can be found in almost every sector. In the tourism sector, the most common problems are illegal accommodation facilities by which renters earn money during the season, lack of cash registers in bars and restaurants, avoidance of issuing bills, workers who do not have a contract, evasion of tourist taxes and similar (Milić, 2014).

Schneider (2009) explained the way to shift shadow economy to the formal sector successfully is to focus on its cause. One of the main triggers for shadow economy is considered to be growth in tax burden and labour contributions (Schneider, 2009). “In the middle and long run, the size of the shadow economy can be efficiently reduced only through such measures as lowering the non-wage labour costs, introducing flat-rate tax and social security contributions for side jobs and the increase of the tax-free amount. Other measures include the reduction of regulatory burden and the decrease of the value-added tax rate on labour intensive services.” (Schneider, 2009)

2.7 The shadow economy in Croatia

Bejakovic & Williams (2017) explained that even though Croatia is a member of the European Union, in comparison with the other member countries it is still among the

countries with the lowest GDP and employment rates. It causes unstable conditions for employers, employees, and industrial relations. As a result, it creates circumstances where people rather choose to work in a shadow economy (Bejakovic & Williams, 2017). Further, Bejakovic & Williams (2017) explained that the tax system in Croatia had gone through many changes that resulted in the distrust of people towards the system. Since the implementation of personal income tax in 1994, it has been changed 18 times. The company income tax has gone through 10 changes since the year 2004. Furthermore, the economic system and the process of privatization have reduced the trust in the government even more. Additionally, procedures regarding construction permits, starting a business and obtaining credit are aggravating (Bejakovic & Williams, 2017).

Bejaković (2008) explained that in comparison with the western countries, in Croatia people lack knowledge about basic factors of public finance and that is one of the reasons for tax evasion. There is a belief that the government should and can take care of all the existential problems in the country. Moreover, it is believed that the government is supposed to finance a variety of public goods from another source than tax income (Bejaković, 2008). On the other hand, distrust in the Government is caused by a high rate of corruption and the perception of income inequality (Bejaković, 2008).

According to Kesar & Čuić (2017), in the analysis of 31 countries in Europe in the year 2015, Croatia was fourth on the list of countries affected with the shadow economy, while Turkey, Romania, and Bulgaria took the first three positions. Besides the other numerous causes, it is considered that the tourism sector highly contributes to the development of the shadow economy. Findings from other studies mentioned by the authors explain that wholesale and retail, hotels and restaurants, transportation and communications are activities where the shadow economy is the most common (Kesar & Čuić, 2017).

Radosoljić (2018), explained that some of the reasons for tax evasion in Croatia are the unstable system that over the years has gone through numerous changes, a high level of unemployment, and high costs of social contributions. Tax evasion is not well measured

and tracked in Croatia, there are only unofficial estimations, and there are no recent calculations and evaluations (Radosoljić, 2018).

2.8 Tax changes and the shadow economy

According to Enste & Schneider (2000) one of the most important triggers for the growth of the shadow economy is the increase of taxes and social security burdens. Taxes have an impact on labor choices and also stimulate labor supply in the shadow economy which is viewed as distortion. As the gap between the costs of labor in the official economy and the earnings that are received after taxation widens, the incentive to work in the informal economy becomes stronger. As mentioned in the previous part of the text the main determiners for the rise of the shadow economy are social security systems, and taxes (Enste & Schneider , 2000).

One of the studies mentioned in the paper by Enste & Schneider (2000), analyzes what are households supply of shadow economy labor and demand for goods provided by the shadow economy. The findings were that an increase in the marginal tax rate on income implies a bigger supply in labor that is willing to be part of the shadow economy, but also that higher wages in the formal economy imply a lower supply in the labor willing to work in the shadow economy. The same study also managed to show that the demand for underground labor and the supply of goods produced in the shadow economy are positively dependent on indirect tax and wage rates in the formal economy. This shows that increased marginal income tax rates and increased indirect taxes raise the amount of labor and goods that are part of the shadow economy (Enste & Schneider , 2000).

Following that study, another paper was mentioned by Enste & Schneider (2000), focused on analyzing the impact of direct and indirect taxation on the shadow economy of Austria. The study estimates a currency demand function where it is using the next mentioned variables as the factors that impact the shadow economy: direct taxation, indirect taxation, the complexity of the tax system and the intensity of government regulations. The results showed that direct taxation had the largest impact on currency demand, with the intensity

of regulation and complexity of the tax system being less impactful (Enste & Schneider , 2000). In addition, there was a study made on the impact of income tax rates, penalty policies and the likelihood of an audit by the IRS on the relative size of the shadow economy. The finding showed that if the top marginal income tax rate was not increased with an increase in IRS audits and penalties could lead to a decrease in the shadow economy. The study also found that an increase in the marginal federal income tax rate of 1 percent, ceteris paribus, leads to an increase in the shadow economy by 1.4 percent (Enste & Schneider , 2000).

2.9 Tax morale and the shadow economy

According to Kirchgässner (2010), in German-speaking countries, tax morale is commonly identified with tax compliance. Tax moral is a moral attitude, while tax compliance is a way of behaving, and the two do not need to be in accordance (Kirchgässner, 2010). Tax morale shows the willingness of the citizens to pay taxes beyond legal reasons. In other words, for what other reasons, are citizens willing to pay taxes (Kirchgässner, 2010). Further, Kirchgässner (2010) explained that taxes are the price for provided goods and services by the government, but the question is whether the price of taxes is always proportional to the value given by the government (Kirchgässner, 2010). Kirchgässner (2010) stated that tax morale is dependent on institutional conditions as well as on the behavior of tax authorities towards the citizens, trust in the state, and the level in which citizens are involved in fiscal decisions (Kirchgässner, 2010).

Bejaković & Bezeredi (2019) investigated determinants that shape the tax morale of people in Croatia. Data was collected from 2.000 interviews during the year 2015 in Croatia. According to the study, 52.1% of participants have a high level of tax morale, 26.0% of participants have low tax morale, while 8.4% and 13.5% of participants have mid-low and mid-high tax morale (Bejaković & Bezeredi, 2019). The study shows that depending on the geographical area level of tax morale is changing. Those who live in Slavonia, Gorski Kotar, costal part and Istria have a lower level of tax morale (Bejaković & Bezeredi, 2019). Furthermore, the study shows that women and people in older age

groups have a higher tax moral. Having stable finances and being aware of the seriousness of sanctions for the involvement in the shadow economy helps in the increase of the tax morality level of the citizens. Irrational labor law and numerous changes in the tax system often serve as an excuse for being a part of the shadow economy. Low tax morality and distrust in the state because of the irrational use of tax money causes more citizens and businesses to choose to be a part of the shadow economy. If the state is spending tax money responsibly and citizens can see the benefits of paying taxes, it is more likely that they would respect the law (Bejaković & Bezeredi, 2019).

3. Methodology

This chapter will focus on the methodology, starting with the elaboration of the philosophy of science. Secondly, the section about research design will give an insight into different research designs and justify the choice of the descriptive research design. Thirdly, the section about the research method will justify the choice of qualitative research method. Finally, the data collection part will give an insight into the ways of collecting data for the research.

3.1 Philosophy of science

In this research, pragmatism has been chosen as a philosophy of science. According to Kaushik & Walsh (2019), a foundation of pragmatist epistemology is that knowledge is built on experience. The way a person sees the world is based on the social experiences that the person has, and every person has a unique knowledge defined through their own experiences (Kaushik & Walsh, 2019). Goldkuhl (2012) explained that pragmatism deals with action and change as well as the interaction of knowledge and action (Goldkuhl, 2012).

According to Kaushik & Walsh (2019), pragmatism does not stand for a specific method or mixed methods as well as it does not reject other methods. It seeks to address the research question, explore a phenomenon, or test a theory with the most convenient research method (Kaushik & Walsh, 2019). Pragmatism as a research paradigm focuses on solving practical problems in the physical world (Kaushik & Walsh, 2019). By using the qualitative method this research will investigate how the frequent changes in the tax system triggered people to engage in the shadow economy.

3.2 Research design

According to Kabir (2016), research design serves as a framework for conducting the research. It helps us to structure the research, to justify that all of the major project parts go hand in hand to address the central research questions (Kabir, 2016). According to Boru (2018), there are three types of research design: exploratory, descriptive, and explanatory. The descriptive design helps us to present a situation, a person, or an event as well as relation between things. The descriptive design cannot answer the 'why' question and it is more appropriate for new or unexplored research topics (Boru, 2018). According to Kabir (2016), the exploratory design is used when there is not much information or previous studies about the topic that the researcher could refer to. The exploratory design is often used to determine the best way to study certain problems or which methodology would serve the best in collecting data (Kabir, 2016). Boru (2018) explained that the explanatory study explains the descriptive information. In contrary to the descriptive studies where the question is 'what', the explanatory study is oriented on questions 'why' and 'how' (Boru, 2018).

In this thesis, the focus is on describing the relations between changes in the tax system and the shadow economy in the tourism sector in Croatia. Desk research will help in better understanding of the tax regulations as well as their changes over the years. Further, it will provide the information about the size of the shadow economy during the time. On the other hand, data collected from the interviews with private business owners and workers will serve as a "description" of what is actually happening on the field. When collected data are put together, it will give us the picture in which laws and regulations

create a frame for the actions taken by private businesses in the industry. As Nassaji (2015) stated “The goal of descriptive research is to describe a phenomenon and its characteristics. This research is more concerned with what rather than how or why something has happened.” (Nassaji, 2015) Since the connection between tax changes and the shadow economy in the tourism sector in Croatia has not been researched yet, it is necessary to provide an insight into the phenomena by describing what is happening. Therefore, a descriptive research design is the best choice for this thesis.

3.3 Research method

“Qualitative research methods involve the systematic collection, organisation, and interpretation of textual material derived from talk or observation. It is used in the exploration of meanings of social phenomena as experienced by individuals themselves, in their natural context.” (Malterud, 2001)

In this thesis, qualitative research method has been used, where data was collected through structured interviews. According to Mohajan (2018), in qualitative research, the researcher investigates the meanings and insights of certain circumstances (Mohajan, 2018). As explained by Palmer & Bolderston (2006), through an interpretative approach, qualitative research gives an insight into the experiences of a particular social phenomenon by presenting participants' personal experiences (Palmer & Bolderston, 2006). Malterud (2001) explained that considering positions and perspectives, researchers can have different approaches with the same validity of the representations of the studied situation. Having a different approach on the same subject leads to an outcome of a better understanding of the tangled phenomena, not a failure of reliability (Malterud, 2001).

According to Queirós, Faria, & Almeida (2017), qualitative research lead into a deep understanding of a certain problem but it excludes data in form of figures (Queirós, Faria, & Almeida, 2017). Atieno (2009) explained that the base for quantitative data is qualitative judgment. Numerical data cannot be understood in the absence of knowledge of the assumptions they are based on (Atieno, 2009). In this research, the focus is on the

connection between the tax changes and the shadow economy where qualitative data was gathered through interviews. Furthermore, already existing numerical data is crucial to carry out the research and it has been collected from already existing statistics, reports, and official documents.

3.4 Data collection

Primary data of the research were collected in the interviews. For this research, the people interviewed were the ones who used to work or still work illegally in the tourism sector in Croatia. This includes workers and business owners. The interviews gave an insight into the details of illegal working practices, provided a better understanding of the reasons to engage in the shadow economy, and most importantly, presented the participants' suggestions towards the solution of the issue. Because of personal and business issues that people experienced due to the Coronavirus outbreak, many were not willing to participate in the interviews. Considering the number of the conducted interviews and the sensitivity of the topic, surprisingly many valuable details that are significant for the research were discovered. The network of friends and acquaintances that I have in Croatia was crucial in finding relevant interview participants, and having been guaranteed anonymity, participants felt safe to speak on the topic. The interview participants were two illegal workers, one restaurant owner, and one illegal accommodation provider. Structured interviews were conducted via email. Illegal workers (Appendix 1) were asked the same set of questions, while the restaurant owner (Appendix 3) and the accommodation provider (Appendix 4) were asked questions adapted to their business.

Further, a structured email interview was also conducted with the Institute of Public Finance⁵ (Appendix 2) where the interviewed researcher, Predrag Bejakovic spoke more about the policy measures and their impact on the tourism industry in Croatia. The

⁵ “The Institute of Public Finance is a public research institute which performs applied and theoretical research in the field of public sector economics. The Institute researches public sector and its components – tax, pension, health and educational systems, social security system, public administration and state owned enterprises.” (The Institute of Public Finance , 2020)

Institute of Public Finance was chosen as a relevant source of information for this thesis because the researchers from the institute had been studying the shadow economy in Croatia from many different perspectives. Since they are quite familiar with the topic, I decide to reach them and find out more from them in the connection with the topic.

Structured interviews were chosen for this research, because the interview questions were aiming at specific information regarding the shadow economy in practice. Some questions required a practical example, which is specifically significant for the questions with workers and private businesses since they are the ones who are creating the shadow economy in different ways, depending on their business and opportunities. In that way, even standardized questions can provide a broader story. Therefore, there was no need for follow-up questions. As explained by Doody & Noonan (2013), a structured interview is considered to be time-friendly, restricting a researcher's subjectivity and partiality. Further, the researcher has control over the topics as well as the format of the interview, which results in being easier to code and compare as well as analyzing data (Doody & Noonan, 2013). According to Queirós, Faria, & Almeida (2017) through structured interviews, the participant is asked about past experiences or certain hypothetical situations. The process is the same for all the participants. Usually, structured interviews give a high response rate and the interviewer ensures that the questions are well understood to prevent misinterpretation (Queirós, Faria, & Almeida, 2017).

Secondary data will be collected through desk research, considering existing statistics, available studies, books, websites and documents containing laws and policies. Secondary data are significant for the research because they will provide an insight and a better understanding of the changes that occurred in the Croatian tax system. The existing data about the shadow economy and its trend over the years will be significant in finding the connection between the changes that have occurred in the tax system and the size of the shadow economy over time. Data collected through desk research will be compared with the findings from the interviews in order to carry out the research.

3.5 Trustworthiness of data

The issue of the trustworthiness of the data can be raised, as this is a qualitative study where interviews are the main source of gathering data. Each of the interviewed individuals has a subjective perspective on the issue, which has evolved through the course of a lifetime and has been shaped by personal experiences. Therefore, if the study would be replicated, there could be different findings that would come up. This issue has been raised in the following quote by Elo, et al (2014), “With descriptive data collection, it can often be challenging to control the diversity of experiences and prevent interviewer bias and the privileging of one type of information or analytical perspective” (Elo, et al., 2014).

The triangulation technique is an approach that can be used to ensure the trustworthiness of data collected from interviews. As stated by Salkind (2010) “The term triangulation refers to the practice of using multiple sources of data or multiple approaches to analyzing data to enhance the credibility of a research study.” (Salkind, 2010) This was done for this thesis, as demonstrably diverse participants of the shadow economy were interviewed. The interviews were carried out with people in different positions of power and responsibility, such as workers and business owners, as well as people in different industries, such as a waiter, cleaner, restaurant owner, and accommodation provider.

According to Shenton (2004), to ensure confirmability it is crucial that the findings are coming from the experiences of the interviewed participants, instead of the characteristics and preferences of the researcher (Shenton, 2004). To ensure confirmability, the interview questions for this research were deliberately formed in a way that prompted participants to talk about their own personal experiences on the topic, which provided first-hand examples from their practice. For example, participants were asked about the unique challenges they face personally and the distinct effects of government policy on their own businesses.

Transferability refers to the question of whether the findings of conducted research can be used in theory, practice as well as future research, in different contexts (Moon , Brewer , Januchowski-Hartley, Adams , & Blackman, 2016). In the case of this thesis, the findings of the research can surely serve future studies. In this thesis, the focus is on the Croatian tourism sector, similar studies can be done with the focus on other sectors or another country. Although interviews with members from another section of the economy might provide different, contrasting perspectives in the future, the findings of this research should still be transferable and valuable, both theoretically and practically, as they are based on genuine lived experiences. Furthermore, by presenting the movement of the shadow economy after the implementation of the specific changes in the tax system, the thesis offers an overview that could serve for the creation of future governmental laws and policies to reduce the shadow economy.

3.6 Limitations

As a consequence of the Coronavirus outbreak, it took a significant amount of time to get in contact with the people who were willing to participate in the interviews. The interviews were carried out during March and April 2020, and because of the situation with the Coronavirus, there was no point to travel to Croatia and do the research on the field as planned. Therefore, the interviews were collected via e-mails. Unfortunately, many businesses are facing huge financial losses, especially in the tourism industry. The country mostly relies on the tourism sector, and because of the current situation, it is expected that the season this year will suffer huge losses. Many small businesses in the tourism industry have already closed. With all this happening, many private business owners were not in the mood for participating in the interviews. The study will be conducted with as many interviews as possible. Another limitation is that the two governmental bodies, whose main tasks are the control of tax frauds and the shadow economy in general, were not willing to participate in the interviews with an excuse that they do not have the answers on the topic.

4. Analysis of findings

In the following chapters, the relationship between changes in the tax system and the shadow economy in Croatia will be analyzed and discussed. The foundation of the analysis will be the earlier collected data and findings. The most significant changes that occurred in the Croatian tax system in the period between 2009-2017 and had an influence on the size of the shadow economy will be analyzed in chronological order. Further, the focus will be on the specific causes of the shadow economy, as well as the connection between the level of tax morale of the citizens and their involvement in illegal working practices.

4.1 Impact of tax changes on the shadow economy

Predrag Bejakovic, a researcher from The Institute of Public Finance who agreed to be interviewed for the purpose of this thesis, answered the question regarding the impact of taxes on the shadow economy in Croatia in the following way:

“Tax rates are important but more important are constant changes in the tax system, which creates legal instability and increases compliance costs.”(Interview 3)

With constant changes in the tax system compliance costs increase, as businesses have to hire lawyers or invest in additional education of the work force to meet the requirements imposed by the tax authority. Therefore, businesses that are financially constrained have trouble meeting those compliance costs, and often due to the inability of compliance they end up participating in the shadow economy. If changes in the tax system were not so frequent, the business owners would easier comply and eventually, there would be reduction in the shadow economy. Zrinušić & Kudeljan (2016), explained that because of many changes that the tax system in Croatia has gone through, it is considered unstable. Data shows that 44 changes occurred in the period between the years 2012 and 2015. Frequent changes in laws and policies can lead citizens, business owners, and Tax

Administration workers to inadequate knowledge of the tax system (Zrinušić & Kudeljan , 2016).

Clearly, the changes that the Croatian tax system have gone through caused insecurities in the private sector. The comparison of data from Franić (2019) about the size of the shadow economy in the same period shows that the size of the shadow economy in total GDP was growing (Franić, 2019). Changes that caused instability of the tax system could be considered as some of the reasons for the growth of the shadow economy in the observed period. Schneider, Buehn, & Montenegro (2010), explained that governments should work more on the improvement of current laws and regulations instead of creating new ones. Some governments will rather implement more regulations and laws in tackling the shadow economy since it gives more power to bureaucrats, increases employment in the public sector, implementation is more simple, it is easily perceived, and it is well accepted by the citizens (Schneider, Buehn, & Montenegro, 2010). The most significant changes in the tax system between the year 2009 and 2017, as well as their effects, are explained and analyzed in the following paragraphs.

Before getting into the changes in the tax system that have influenced the growth of the shadow economy, it is essential to mention the financial crisis in 2008 because it certainly contributed to the overall instability of the economy. Franić (2019), observed the size of the shadow economy in Croatia on an annual basis, in the period from 2004-2017. In the year 2008, the rate of the shadow economy in total GDP was the lowest in the observed period. It amounted 7.28%, even though the shadow economy in absolute numbers was pretty high, 26,219.4 million HRK⁶. It is presented that since the year 2008, the amount of the shadow economy in total GDP has been growing, while the shadow economy in absolute numbers has been declining (Franić, 2019). The reason is the financial crisis that happened in 2008 which certainly slowed down the growth of GDP and therefore, the shadow economy was growing faster than the total GDP. Further, the crisis is the reason for the decline of the shadow economy in absolute numbers.

⁶ 1,00 HRK = 0,98 DKK

4.2 Changes of the standard VAT rate

A significant reason for the increase of the shadow economy is the rise of the standard VAT rate, as found out from the interview with the restaurant owner:

“... VAT on drinks and procurement costs, in general, have risen as well. Also, the tax on workers’ salaries is high. As a result of high expenses, prices are rising, and customers cannot afford that, which leads to a decline in our business.” (Interview 4)

In 2009, the standard VAT rate increased from 22% to 23% (Bejaković, 2016). Further, in 2012 the standard VAT rate was increased again, this time from 23% to 25% (Bejaković, 2016). According to Franić (2019), the amount of shadow economy in total GDP grew from 7,57% in 2012 to 7,81% in 2015. Also, the shadow economy in absolute numbers was growing in that period, from 24,261.4 to 25,433.1 million HRK (Franić, 2019). The growth of the shadow economy is partly caused by the increases in the standard VAT rate, which is in line with the theory that explains that the shadow economy is often triggered with the increase of taxes (Enste & Schneider , 2000).

4.3 Implementation of the fiscal law

In the interview with Predrag Bejaković, a researcher from the Institute of Public Finance one of the questions was, how the implementation of the fiscal law affected the shadow economy in the tourism sector and his answer was the following:

“It certainly had an impact, but we should not overestimate the impact of fiscalization.” (Interview 3)

Since the implementation of the fiscal law in 2013, the shadow economy continued increasing in the absolute numbers as well as in total GDP (Franić, 2019). As previously mentioned in the interview with Predrag Bejakovic, the constant changes in the tax system are the major factor of instability and shadow economy growth (Interview 3). This

was another big change in the tax system, therefore, the businesses had to invest new funds for the education of workers and legal advices. These costs are significant for small business owners who hence had issues to comply with the new rules. After the introduction of fiscal law, the situation changed for private businesses. The interviewed restaurant owner explained what he considers as a positive effect of fiscalization:

“So, the benefit of the fiscal law is that those who were not paying any taxes finally had to start reporting some income.” (Interview 4)

Clearly, the introduction of fiscal law in the year 2013 has brought significant changes to the country. This led private businesses to experience a strong disruption in their previous business practices. Although the law had the purpose of reducing the shadow economy, according to Franić (2019), the shadow economy in absolute numbers and its share in total GDP increased in the following years (Franić, 2019).

Before the year 2013, much of the income that both, business owners and workers received remained unreported or underreported to the tax authorities. This changed with the introduction of fiscal law, which also increased controls. The following was found from one of the interviews with the illegal worker:

“In recent years, it has become more risky to work as an unregistered worker because there are inspections going on and they are controlling employees’ contracts, cash balance, printed receipts and similar and if things are not in order it is a big problem. At the time when I was working in 2012, the risk was much lower, and almost every bar/restaurant had at least one unregistered worker.” (Interview 1)

According to Štimac (2015), during the year 2013 in the hospitality activities in Croatia, small legal persons, and natural persons declared 40,52% more taxable earnings, in other words, 2,6 billion HRK more than in the year 2012. In the year 2013, small legal persons and natural persons in the trade activities declared an increase in taxable earnings for 13,89% (5,2 billion HRK) in comparison with the year 2012. Natural persons, lawyers

declared 6,7 million HRK in total which is 4,83% more than in the year 2012. In total, small legal and natural persons in all mentioned activities (hospitality, trade, and lawyers) in the year 2013 declared 17,82% (8 billion HRK) of taxable earnings more than in the year before (Štimac, 2015). As data shows, both legal and natural persons were highly engaged in the shadow economy. The interviewed bar owner explained how the fiscal law affected working practices of bars and restaurants in terms of declaring income:

“First of all, I will divide bar/restaurant owners into three groups. The first group are those who do not pay any taxes, in other words, those who do not issue receipts at all. After the introduction of the fiscal law, they had to start reporting some income because of the inspections, fines, and a possibility to get a work ban. The second group are those who do report some income but not everything (I belong to that group). With the fiscal law, the situation is a bit more difficult because of the inspections. If we want to report more income, prices should go up, and that would result in fewer customers. The third group are those who report everything. The situation is quite difficult for them, if for example, they have one bad month, they have to close the business because they do not have enough money left after paying all the taxes.”(Interview 4)

Further, from his experience, he explained who has a bigger advantage in terms of employment and reporting the income, considering all the rules, laws, and taxes:

“Those who follow the law can barely survive on the market so, we have to operate in the shadow economy, at least partly. Workers are mostly reported, but we are evading taxes through the receipts. Some bars hire workers without a contract for a short period, and then they fire them without giving them pay.” (Interview 4)

The interviewed illegal worker, that had been working in a bar before the introduction of the fiscal law, revealed more on issuing receipts:

“It is hard to tell what the ratio of issued/unissued receipts was. During the weekdays, we were mostly issuing receipts, but during the weekends, the bar was working as a night club, and then we were not issuing receipts at all.” (Interview 1)

The increase in reported earnings after the introduction of the fiscal law can be largely attributed to controls that came with the fiscal law. With frequent controls, the risk of illegal working practices became high, but employees found other ways to reduce their expenses and cover illegal working practices. One interviewed illegal worker explained how it works now:

“Often employers will make a part-time contract for their workers, but workers will work full-time. In that case, the worker will get part of a salary on his bank account, and the rest of the money will be paid in cash.” (Interview 2)

Workers and employers have an incentive to engage in illegal activities as both have benefits from it. The employers benefit by evading social security contribution payments while the employees get a part of their salary in cash. Young illegal workers prefer to be paid in cash on a more frequent basis so therefore, they are motivated to engage in the shadow economy. This was confirmed by the interview with the person who was illegally employed in a bar during the year 2012:

“From this point, I would say that it would have been better for me if I had been registered as a worker. Back then, the only thing that was on my mind was the fact that I would get the money immediately after my shift. Now when I look back, it would have been better if I had been registered because in that case, I would have had different benefits, such as pension and security as a worker.” (Interview 1)

Further, according to Štimac (2015) a yearly income tax report in hospitality activities for the year 2010 shows that the average daily income was 100 HRK while the data for the year 2013 shows an increase for more than 100%, in other words, in the same activities the daily income increased on 210,23 HRK (Štimac, 2015). The findings lead to a

conclusion that before the year 2013 (when the fiscal law was implemented), half of the income that the workers had been receiving had been paid out in cash.

Since the year 2013, Croatian GDP has been uninterruptedly recovering (Državni zavod za statistiku, 2019). The introduction of the fiscal law could be a reason for that because it has certainly contributed to the more workers getting an official contract as well as businesses declaring more income. On the other hand, business owners have found different ways to reduce or evade paying tax expenses. Therefore, even though the GDP was growing, the shadow economy was growing faster than GDP.⁷

4.4 Tax inspections and illegal working practice

In the interview with Predrag Bejakovic (The Institute of Public Finance), one of the questions regarded the plans to reduce the shadow economy in Croatia, and his recommendation was the following:

“...it is more important to focus on removing the consequences instead of punishing.”(Interview 3)

Clearly, work prohibition as a consequence of not following the law should be avoided because it can cause permanent damage to the business and result in job loss for both, the business and the employees and therefore it brings more harm than good to the economy.

The Tax Administration frequently warns about fiscal inspections, especially during the summer months, predominantly on the coastal part of the country. The purpose of the inspection is to cut down the shadow economy that will consequently protect tax revenue, taxpayers, and citizens (Porezna uprava: Republika Hrvatska - Ministarstvo Financija, 2016). Even though the fiscal law was established in 2013, in the year 2016 around 36%

⁷ This can be seen from the “figure 3” presented in (Franić, 2019) on the page 25.

of businesses, found their way to avoid fiscal law (Porezna uprava: Republika Hrvatska - Ministarstvo Financija, 2016). Fines for those who are not following the fiscal law are between 10.000 and 50.000 HRK while the amount of fine for those who are not issuing receipts is between 20.000 - 500.000 HRK, whereas for some inaccuracies, a business can get a temporary prohibition of work (Porezna uprava: Republika Hrvatska - Ministarstvo Financija, 2016).

One of the interviewed illegal workers gave her perspective on illegal working practices and increased inspections in recent years:

“Many things have changed, I haven’t been in that business for many years now, but I do not think that many people would risk a fine or even worse, closing the business. Since the law is stricter, and there are frequent inspections, it makes it harder than before to work illegally.”(Interview 1)

According to data published on the official web site of the Ministry of Finance - Tax Administration, from 01.01. - 28.07.2014., authorized inspectors of the Ministry of Finance - Tax Administration did 6.604 inspections to check if the businesses were following the fiscal law. Inspections found a total of 2.002 inaccuracies, which is 30% of total inspection. Out of 2.002 cases with inaccuracies, 388 businesses got a temporary prohibition of work. During the same time in the year 2013, from a total of 21.590 inspections, 2.186 cases of inaccuracies were found (10%), while 465 businesses got temporary prohibition of work (Porezna uprava: Republika Hrvatska - Ministarstvo Financija, 2014).

The increase in inaccuracies in 2014 can be explained partly by the changes in the tax system that came up, on the 1st of January 2014, when the reduced VAT rate of 10% (for selected goods and services which also include hospitality and tourism) was increased to 13% (Vlada Republike Hrvatske, 2014). Due to the change in the tax rate, bars and restaurants had to deal with the reduction in revenue. Therefore, they started engaging in the shadow economy to be able to pay their employees.

4.5 Personal income tax changes

Income tax expenses might also trigger participation in the shadow economy. When asked if tax relief or a higher non-taxable wage would reduce the number of unreported workers, interviewed illegal worker answered the following:

“...Surely, every form of tax relief is beneficial in reducing the shadow economy.”(Interview 1)

Further, the other interviewed illegal worker explained how her employer benefits from hiring workers illegally:

“I believe he benefits from hiring workers illegally. He does not have to pay any taxes or contributions for us. Therefore, he has significantly reduced the costs of labor, which puts him in a better position on the market. He can reduce prices, and in that way, more clients will choose him, which results in higher total income. It is the same with bars and restaurants. If they have more illegal workers, they can reduce their prices and be more competitive in the market.”(Interview 2)

The interviewed business owner explained his way of paying workers, which is, according to him, beneficial for him as well as for the workers:

“...Also, my workers have contracts on a minimum salary, which I do pay tax on, but the rest I pay them in cash, it is better for me and the employees. Also, we are safe that way, because in case of inspection the employees do have a contract.” (Interview 4)

Every increase in tax burdens on the salary will result in more workers being paid illegally. As seen from the interviews, business owners, as well as workers, have an incentive to engage in illegal activities because they both benefit from it. Although there have been more inspections going on, business owners have found a way to avoid being “caught red-handed”.

An important change that occurred in the year 2014 was the increase of contribution for health insurance from 13% to 15%. It had been expected that the revenue would increase for 1.6 billion HRK in the year 2014, and 2.4 billion per year from the year 2015 (Vlada Republike Hrvatske, 2014). With the increase in the contribution for health insurance, employers have higher costs of salary for reported workers. Therefore, employers are choosing to save themselves from these costs, and as a result, they are paying workers illegally. As confirmed from the interview with an illegal worker, employers are financially benefiting from evading payment of salary contribution:

“I do consider that the employer benefited significantly. Firstly, unreported workers were not paid per hour, instead the salary was fixed as “daily”, no matter how many hours we worked that day. Secondly, he did not have to pay health insurance, pension and other contributions for unreported workers, which was beneficial for him.” (Interview 1)

For the year 2015 the Croatian government came up with the new regulations. This time, a significant change regarding the personal allowance reduced tax burdens. The government increased income by changing the amount of personal allowance. From the 1st of January 2015, the monthly amount of personal allowance was increased from 2.200HRK to 2.600HRK, while the personal allowance for pensioners increased from 3.400HRK to 3.800HRK (Vlada Republike Hrvatske, 2014). The change could be partly responsible for the growth of GDP. As Franić (2019) showed in his study, even though the size of the shadow economy was still growing after the year 2015, the GDP was growing faster than the shadow economy and therefore, the share of the shadow economy in the total GDP fell from 7.81 in the year 2015 to 7.77 in the year 2016 (Franić, 2019). A rise in the absolute amount of the shadow economy was present but it did not significantly increase its share in GDP (Franić, 2019). That indicates that the measure resulted in strong GDP growth.

In 2017 there was a growth in employment in Croatia from 55.9% to 61% (Trading Economics, 2020). The growth in employment was partly caused by the income tax change that happened in 2016. Depending on the income, there were three income tax

rates. The rates were following, 12% on the tax base up to 2.200,00HRK, 25% on the amount of the tax base between 2.200,00 and 13.200,00HRK, and 40% on the tax base above 13.200,00HRK (Ministarstvo financija, 2014). That changed in late 2016 when three income tax rates merged in two, one 24% and the other 36% (Hrvatski Sabor, 2016). The rate of 24% applies on the monthly income up to 30.000 HRK, while the rate of 36% applies on the monthly income above 30.000HRK (Središnji državni portal, 2020). This decrease in the tax burden on the workers was partly responsible for the increased employment. Part of that growth can be attributed to shadow economy workers getting an official contract from their employers as the tax burden got smaller, which is in line with the theory presented by (Schneider, 2009).

4.6 The size of the shadow economy and the fight against it

Measuring the shadow economy is a complex process. There are different methods of estimating the shadow economy, but currently there are no official estimations for Croatia. One of the latest studies of the size of the shadow economy in Croatia has been done by Franić (2019). In his research Franić (2019) analyzed the undeclared economy in Croatia in the period from 2004-2017 by using Multiple Indicators and Multiple Causes, the so called MIMIC method (Franić, 2019). According to Franić (2019), to evaluate how successful the measures against the shadow economy are, the government should have an insight into these activities. In the case of Croatia, a systematic and transparent approach toward the quantification of the issue does not exist. There are studies for the period before the recession but because of differences in the range of the analyzed activities, the data can barely be compared (Franić, 2019).

In the interview with Predrag Bejakovic (Institute of Public Finance), when asked if he considers the current measures adequate in combating the shadow economy in Croatia, the answer was the following:

“In general the measures are good, but it is necessary to better the trust of the people in public institutions, improve the quality of public goods, make the judiciary more efficient

and fight corruption. All of this requires commitment and persistence, which I am not sure are our strongest traits.”(Interview 3).

The focus should be on bettering the public system which taxpayers would benefit from and, on that way motivate more businesses to work legally, instead of charging them high fines and not improving the system. From the interview with the illegal accommodation provider it is clearly stated that the benefits of higher earnings outweigh the risks from being caught:

“Fines for unregistered renters are high, but on the other hand, earnings are way higher than if the business is registered.”(Interview 4)

Tax relief would be a good solution for reducing the shadow economy because high tax rates are forcing business owners to operate in the shadow economy in order to survive on the market. Also, the general perception of the public is that citizens do not benefit enough from paying taxes and other contributions to the government, as found out from the interview:

“If taxes were lower, there would be no need to work in the shadow economy. Employees would not be reported on the minimum salary, instead the whole salary would be paid on the bank account. Reducing taxes is the only way to improve the situation with the shadow economy. In Croatia, taxes are the enemy of workers and business owners.”(Interview 4)

“Again, the reason why we do that is that the government is taking too much from us through taxes, and we do not want to raise our prices because if we did that, our local guests wouldn’t be able to afford that, and it would not make sense to work that way.”(Interview 4)

According to Franić (2019), after the year 2013, there has been a growth of the shadow economy in the country, despite the policy measures that the Croatian government came up with after joining the EU, and that pulls the question about the effectiveness of the

measures (Franić, 2019). As reported by Franić (2019), in the year 2012, the shadow economy is estimated at 24.3 billion HRK, and in the year 2017, the amount climbed to 26.9 billion HRK. The data shows that the shadow economy is higher than it was before the crisis and that points out that the government should find a more systematic approach in tackling the shadow economy (Franić, 2019).

4.7 Main factors determining the degree of the shadow economy

The research conducted by Schneider & A.T. Kearney (2010), a global strategic management consulting firm, about the shadow economy in Europe, explains that there are four main factors that affect the degree of the shadow economy (Schneider & A.T. Kearney, 2009). The interviews conducted for this thesis also confirmed the theory. According to Schneider & A.T. Kearney (2010), the first factor are savings. It is explained that those involved in the shadow economy do not have to pay taxes, social security payments, follow regulations and they are free from paperwork. Further, there is a strong connection between the tax rate and a rate of the shadow economy in a country. Specifically, during a crisis, to save money people will engage in the shadow economy (Schneider & A.T. Kearney, 2009).

“I do consider that the employer benefited significantly. Firstly, unreported workers were not paid per hour, instead the salary was fixed as “daily”, no matter how many hours we worked that day. Secondly, he did not have to pay health insurance, pension and other contributions for unreported workers, which was beneficial for him. Also, there was not any paperwork or bureaucracy involved.”(Interview 1)

With savings, the business owner who operates in the shadow economy makes his business more competitive entity on the market, especially when compared with the businesses that operate completely legally. With less of a tax burden being put on the businesses, this unfair advantage could be significantly reduced.

According to Schneider & A.T. Kearney (2010), secondly, because of the low state of “guilty conscience” people consider the shadow economy as acceptable. Shadow economy is common in countries with low privileges, especially Eastern European countries, where citizens do not have much trust in the state. In those countries benefits from the shadow economy are higher than from the official economy (Schneider & A.T. Kearney, 2009).

“I think that I am fairly paid, and if I would have a contract, I would get less money, because in that case, the employer would have to pay taxes and contributions. Because I am hired without a contract, the employer does not have these expenses. Therefore, my salary is higher than if it would be if I was registered.” (Interview 2)

“I cannot complain about anything concerning this job. It is well paid, and this as an advantage.” (Interview 2)

The lack of trust in the state, high levels of corruption, and the lack of fiscal discipline created a perception that the money paid in taxes will eventually be wasted. As the interviews confirmed, the workers would rather accept a bit higher salary paid out in cash illegally than being legally employed and receiving a lower salary after tax.

According to Schneider & A.T. Kearney (2010), the third trigger is the ease of participation, the use of cash makes transactions impossible to track, therefore, cash is used as payment for undeclared work and underreporting. Lastly, a low risk of detection triggers more people to participate. The smaller the chances to be detected, and the lower the fines, the more acceptable the risk is (Schneider & A.T. Kearney, 2009).

“As I have already mentioned, in my case the benefit was the fact that I was getting paid every day after the shift, in cash. I am not sure if the following should be considered as a drawback or a benefit, but since I did not have a contract as a worker, in case anything had happened, my name would not have been mentioned anywhere, in other words, officially I was not responsible for anything. Once we had a situation when different

inspections came, together with the police and all the workers without contract had to hide or pretend that they were guests. I would say that one of the drawbacks was that often unreported workers were afraid of being caught by the police, but if that had happened, we had an agreement with the boss to say that it was our trial shift, so we did not have a contract yet.”(Interview 1)

The participation in the shadow economy is very easy and often low risk as the inspections cannot constantly surveil all the places. The business owners find creative ways to hide their involvement in the shadow economy, and therefore, make it nearly impossible for the inspectors to detect their illegal activities. In the interview, the business owner explained his experience with the inspection:

“...Unfortunately, at the time I did not have any connections with the people who work with the inspections, otherwise, I would have got a notice that inspection would be going on that day. That is how it works. If you know someone, you get a notice and you can make sure that all is perfect in case they come to inspect your business.”(Interview 4)

As we can see from the answer, there is a lot of corruption inside the public institutions where the business owners often get a notice in advance that the inspection could visit their business. According to Transparency International (2019) Croatia ranks number 63 out of 198 countries when it comes to corruption and it is considered as one of the most corrupted countries in the EU, only surpassed by Romania and Bulgaria (Transparency International, 2019).

In the case of Croatia, another significant factor that contributes to hiring workers illegally in the hospitality business is caused by the law that regulates employment. In the interview with the bar owner, he explained how this law causes a conflict between the owner and employee.

“...If the boss fires an employee, the boss is not allowed to hire a new employee for a certain period, and if an employee quits, he is not allowed to receive unemployment

benefits. It often leads to conflict between the boss and the employee and that motivates hiring without a contract.”(Interview 4)

This creates a situation where the boss cannot fire a bad worker in order to replace him with another worker. On the other hand, if a worker is not satisfied with the job, he cannot quit because he will not be able to receive unemployment benefits. This law creates an environment where a conflict between a worker and an employer occurs easily and therefore it is more beneficial for both not to be bonded with an official contract.

4.8 Tax morale

In the case of Croatia, the people’s perception of public institutions is that there is a very high amount of corruption. The following was found from the interview with the restaurant owner:

“The government is taking a lot of money, and we do not get anything in return for the taxes that we pay. The government spends money on financing the salaries of employees in the public sector. Considering that there are way too many people employed in the public sector, public administration is too expensive to finance and it is not efficient.”(Interview 4)

Besides the government’s responsibility to establish effective policy measures and keep track of the measure results, increase the tax morale of the citizens is also an important factor in tackling the shadow economy. Torgler, Schaffner, & Macintyre (2007) explained that there is a strong connection between tax morale and the shadow economy, meaning that with higher tax morale, the size of the shadow economy decreases (Torgler, Schaffner, & Macintyre, 2007). From the interview with the illegal renter, it can be clearly seen how the mind of a low tax morale person justifies tax evasion being perfectly aware that what she is doing is illegal, but from her point of view, justifiable. When asked if she had ever had experience with inspections, the answer was the following:

“Luckily no, but in case of the inspection I have a story to tell. If I found myself in that situation, I would tell that the guests were my family and that they did not pay for their stay. Also, I always inform my guests about the situation and the story. So far, all the guests have been ok with that.”(Interview 5)

“The biggest advantage is that I do not have to pay any fees and taxes and I can invest that money in the development of my business. The disadvantage is that I always have to be careful and inform guests what to say if the inspection comes.”(Interview 5)

As mentioned in the literature review, Bejaković & Bezeredi (2019) found that people living in the coastal part of the country mostly have low tax morale (Bejaković & Bezeredi, 2019). The people living in the coastal part mostly depend on tourism income which is volatile and therefore, there is a larger amount of people with a lower level of tax morale. The interviewed illegal workers were asked, what was their reason for participation in the shadow economy. The woman who was illegally employed in a bar stated:

“For me, it was not important if I had been working as a reported or unreported worker since I had already had health insurance because at the time, I was a student. Another reason was the fact that I was getting money in cash every day after my shift and it was ideal for me.”(Interview 1)

The other interview participant has a similar motive.

“My main motive is the extra income that I am earning by working illegally. During the weekdays, I work legally as a cashier in a grocery store, and every Saturday (June-October) I am cleaning yachts illegally. The daily income that I am earning on Saturdays is 3 times higher than in the grocery store where I have a contract.”(Interview 2)

In both cases it can be seen that workers benefited from the illegal working practice. In an environment where an illegal worker has more advantages than the legal worker, it is more common that people have low tax morale. Therefore, they often choose to engage

in the shadow economy. According to Torgler (2011), in corrupted countries, where it is not clear how the government budget is being spent, paying taxes is most likely not accepted as a social norm. Corruption lowers the level of tax morale of the citizens and causes distrust in the government (Torgler, 2011).

5. Conclusion

In this thesis the focus is on how the significant changes in the tax system in Croatia that have occurred over the years have impacted the shadow economy in the tourism sector. By observing the motion of the shadow economy after implementation of each of these changes, all three hypotheses have been confirmed. In addition, from the conducted interviews with the people who had experience of being a part of the shadow economy, it has been presented how the phenomena were performed in practice. Moreover, the interviews confirm that high tax rates, as well as frequent changes in the tax system force workers and business owners to work illegally.

As a conclusion of the research, first and foremost, the Croatian tax system should be more stable in order to reduce the shadow economy. Changes that provoke compliance costs from businesses should not occur so frequently because often, small businesses cannot cover these expenses and therefore, businesses end up fully or partly participating in the shadow economy. Frequent changes of taxes, in form of increases of tax rates and implementation of new taxes, also create adverse conditions for private businesses and workers. Their income is getting lower, and in the situation as it is in Croatia, where taxpayers do not receive adequate return from taxes that they are paying, it is truly more beneficial to participate in the shadow than the official economy.

With the reduction of tax burdens, more businesses would decide to work in the official economy. This is supported by both, the conducted interviews and existing theories as for example Tanzi (1999) stated, that the implementation of more taxes, as well as increasing tax rates will increase the shadow economy (Tanzi, 1999). A similar theory

was presented by Enste & Schneider (2000), explaining that the growth of taxes and social security burdens are one of the key factors for the growth of the shadow economy (Enste & Schneider , 2000). Another important fact is that with the reduction of the shadow economy, more workers would have an official contract which means that more citizens would have regulated working conditions and safety at their workplace. Altogether, that would create a stable environment for the businesses and the workers in the country, It could also encourage the creation of more private companies, which means more workplaces for the citizens and more taxpayers for the government.

Revenue of the tourism sector is significant for Croatia. Therefore, it is necessary to ensure that people working in the industry have favorable working conditions as well as stability for the development of the businesses in the field. That is important for the industry in the country because only in organized and favorable conditions businesses can offer adequate service to the tourists, which would result in more sustainable tourism development in the country. The businesses operating in the shadow economy are not subjected to regulations and therefore, they often do not follow any worker or environmental safety regulations.

Furthermore, with the tax moral of the citizens being low, fighting the shadow economy becomes a nearly impossible task. The reason for the low tax morale of the citizens is that most of the citizens do not trust the government to use the funds efficiently. The perception of the interviewed individuals is that the money is “disappearing” when put in the system because of systemic corruption that plagues the country as well as the inefficiencies of the system. Therefore, the general perception of the public is that paying taxes is a waste of money as people do not get nearly enough in return. To fight the shadow economy, as Predrag Bejakovic (Institute of Public Finance) mentioned in the interview: " ...it is necessary to better the trust of the people in public institutions..." (*Interview 1*). This could be only achieved by people seeing a strong stand against corruption from the government as well as the reduction in state costs, optimizing the public system, organizing taxes and the tax system in a more user-friendly way. In the long run, that would increase the tax morale of the citizens and consequently it would

have a huge impact on the reduction of the shadow economy. According to Torgler, Schaffner, & Macintyre (2007), increasing tax morale reduces the shadow economy (Torgler, Schaffner, & Macintyre, 2007).

The research conducted is significant because it adds to the existing literature an important insight into how increases and changes of taxes and regulations impact workers and businesses in the tourism sector in Croatia. The paper presents the phenomena from the perspective of illegal workers and businesses that are partly or fully involved in the shadow economy in the Croatian tourism sector. The study was conducted during the outbreak of COVID-19 which limited the number of interviews. Therefore, the recommendation of the author is to repeat the study with a larger number of interviewed participants in order to confirm the results and get a broader insight into the relationship between illegal working practices in the Croatian tourism sector and changes in the tax system.

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Appendixes

Appendix 1 – interviews with illegal workers

Interview 1

1. Explain briefly, what kind of work did you do as an unregistered worker?

While studying, I was working illegally in a bar in Split Dalmatia County, it was during the summer of 2012.

2. What was the reason that you chose to work as an unregistered worker?

For me, it was not important if I had been working as a reported or unreported worker since I had already had health insurance because at the time, I was a student. Another reason was the fact that I was getting money in cash every day after my shift and it was ideal for me.

3. Do you think that you were fairly paid, or would it be more beneficial for you if you had been registered as a worker?

From this point, I would say that it would have been better for me if I had been registered as a worker. Back then, the only thing that was on my mind was the fact that I would get the money immediately after my shift. Now when I look back, it would have been better if I had been registered because in that case, I would have had different benefits, such as pension and security as a worker.

4. Do you consider it risky to work as an unregistered worker in Croatia?

In recent years, it has become more risky to work as an unregistered worker because there are inspections going on and they are controlling employees' contracts, cash balance, printed receipts and similar and if things are not in order it is a big problem. At the time when I was working in 2012, the risk was much lower, and almost every bar/restaurant had at least one unregistered worker

5. According to your experience what are the drawbacks and what are the benefits of working as an unregistered worker?

As I have already mentioned, in my case the benefit was the fact that I was getting paid every day after the shift, in cash. I am not sure if the following should be considered as a drawback or a benefit, but since I did not have a contract as a worker, in case anything had happened, my name would not have been mentioned anywhere, in other words, officially I was not responsible for anything. Once we had a situation when different inspections came, together with the police and all the workers without contract had to hide or pretend that they were guests. I would say that one of the drawbacks was that often unreported workers were afraid of being caught by the police, but if that had happened, we had an agreement with the boss to say that it was our trial shift, so we did not have a contract yet. The fact that unreported workers do not have health insurance, pension or any other benefits that official workers have is definitely a drawback. The whole situation highly depends on who you are working for when it comes to payments since you cannot prove that you had been working for that person and it is not in your hands if you will be paid, that is a drawback with new employers.

6. Do you consider that your employer benefited significantly from hiring workers illegally?

I do consider that the employer benefited significantly. Firstly, unreported workers were not paid per hour, instead the salary was fixed as “daily”, no matter how many hours we worked that day. Secondly, he did not have to pay health insurance, pension and other contributions for unreported workers, which was beneficial for him. Also, there was not any paperwork or bureaucracy involved.

7. What was the ratio between registered and unregistered workers in the business?

At the time, there were 4 official workers and between 6-8 unreported workers. Unreported workers mostly worked during weekends but sometimes it would happen that we would work during the weekdays too.

8. What was the approximate ratio of issued/unissued receipts?

It is hard to tell what the ratio of issued/unissued receipts was. During the weekdays, we were mostly issuing receipts, but during the weekends, the bar was working as a night club, and then we were not issuing receipts at all.

9. Do you think that tax relief or a higher non-taxable wage would reduce the number of unreported workers?

Many things have changed, I haven't been in that business for many years now, but I do not think that many people would risk a fine or even worse, closing the business. Since the law is stricter, and there are frequent inspections, it makes it harder than before to work illegally. Surely, every form of tax relief is beneficial in reducing the shadow economy.

Interview 2

1. Explain briefly, what kind of work did you do as an unregistered worker?

Every summer season I work illegally as the cleaning staff on yachts.

2. What was the reason that you chose to work as an unregistered worker?

My main motive is the extra income that I am earning by working illegally. During the weekdays, I work legally as a cashier in a grocery store, and every Saturday (June-October) I am cleaning yachts illegally. The daily income that I am earning on Saturdays is 3 times higher than in the grocery store where I have a contract.

3. Do you think that you were fairly paid, or it would be more beneficial for you if you have been registered as a worker?

I think that I am fairly paid, and if I would have a contract, I would get less money, because in that case, the employer would have to pay taxes and contributions. Because I am hired without a contract, the employer does not have these expenses. Therefore, my salary is higher than if it would be if I was registered.

4. Do you consider it risky to work as an unregistered worker in Croatia?

It is not risky to work without a contract with this kind of job. There are a lot of illegal workers during the summer season, in all kinds of jobs, restaurants, bars, shops, etc. Often employers will make a part-time contract for their workers, but workers will work full-time. In that case, the worker will get part of a salary on his bank account, and the rest of the money will be paid in cash. That way, the employer pays fewer taxes and contributions. A few years ago, in a small city near Zadar, a man register his business as a hair salon, because that way he was paying fewer taxes. After some time, te inspection closed his business.

5. According to your experience, what are the drawbacks and what are the opportunities of working as an unregistered worker?

I cannot complain about anything concerning this job. It is well paid, and this as an advantage.

6. Do you consider that your employer benefits significantly from hiring workers illegally?

I believe he benefits from hiring workers illegally. He does not have to pay any taxes or contributions for us. Therefore, he has significantly reduced the costs of labor, which puts him in a better position on the market. He can reduce prices, and in that way, more clients will choose him, which results in higher total income. It is the same with bars and restaurants. If they have more illegal workers, they can reduce their prices and be more competitive in the market.

7. What was the ratio between registered and unregistered workers in the business?

In the company for which I work, for each registered worker there is one unregistered.

8. What was the approximate ratio of issued/unissued receipts?

- 9. Do you think that tax relief or a higher non-taxable wage would reduce the number of unreported workers?**

Appendix 2 – Interview with the Institute of Public Finance

Interview 3

- 1. What do you consider as the main reason that Croatia is one of the countries with the highest rate of the shadow economy in the EU?**

There are many reasons, but the most significant ones are high tax burdens and social security contributions.

- 2. In which sectors is the shadow economy the most common in Croatia?**

Wherever there is a need for live labor, in tourism activities such as hospitality and services, while almost certainly, due to technological reasons, it is not the case in petrochemistry or electricity distribution.

- 3. How do tax changes affect an increase or decrease in the shadow economy?**

Tax rates are important but more important are constant changes in the tax system, which creates legal instability and increases compliance costs.

- 4. How did fiscal law affect the shadow economy in the tourism sector?**

It certainly had an impact, but we should not overestimate the impact of fiscalization.

- 5. In which activities in the tourism sector is the rate of shadow economy the highest?**

We can assume that the rate is the highest in the activities that require human labor, such as hospitality but also the double-entry bookkeeping is present through the whole sector.

6. In your opinion, are the current measures adequate in combating the shadow economy in Croatia?

In general, the measures are good, but it is necessary to better the trust of the people in public institutions, improve the quality of public goods, make the judiciary more efficient and fight corruption. All of this requires commitment and persistence, which I am not sure are our strongest traits.

7. What are the future plans to reduce the shadow economy in the tourism sector in Croatia?

Again, it is more important to focus on removing the consequences instead of punishing.

Appendix 3 – Interview with a restaurant owner

Interview 4

1. For how long have you been in the hospitality business?

I started the business 14 years ago.

2. What are the biggest challenges that you face, in terms of governmental rules and laws?

Rules and laws are not such a big problem, taxes are creating way more issues to hospitality businesses.

3. What changes in the tax system influenced your business and on what way?

Utilities have grown quite a bit in the last ten years, and that is a big expense. VAT on drinks and procurement costs, in general, have risen as well. Also, the tax on

workers' salaries is high. As a result of high expenses, prices are rising, and customers cannot afford that, which leads to a decline in our business.

4. Did the growth of the standard VAT rate affect your business?

The growth of prices influenced the life of people, and therefore, it affected our business because people cannot afford to pay high prices for our service.

5. Do you consider that the shadow economy is a common practice in your business and is it controlled enough?

Mostly we do not issue receipts to our regular guests because it is safe to do so. In general, there are many workers employed illegally. Inspections are frequent and they are wearing civilian clothes and because of that, we have to be careful with the new guests, because you cannot tell if it is an inspection or a guest, also the fines are too high. The government is taking a lot of money, and we do not get anything in return for the taxes that we pay. The government spends money on financing the salaries of employees in the public sector. Considering that there are way too many people employed in the public sector, public administration is too expensive to finance and it is not efficient.

6. Have you ever (or still) worked behind the law (undeclared employment, non-invoicing, etc.)? If yes, please explain

Yes, as already mentioned, in my restaurant we do not issue receipts to our regular customers. Also, my workers have contracts on a minimum salary, which I do pay tax on, but the rest I pay them in cash, it is better for me and the employees. Also, we are safe that way, because in case of inspection the employees do have a contract.

7. From your experience, what are the benefits and what are the drawbacks of fiscalization? What was the effect of fiscalization on the shadow economy?

First of all, I will divide bar/restaurant owners into three groups.

The first group are those who do not pay any taxes, in other words, those who do not issue receipts at all. After the introduction of the fiscal law, they had to start reporting some income because of the inspections, fines, and a possibility to get a work ban.

The second group are those who do report some income but not everything (I belong to that group). With the fiscal law, the situation is a bit more difficult because of the inspections. If we want to report more income, prices should go up, and that would result in fewer customers.

The third group are those who report everything. The situation is quite difficult for them, if for example, they have one bad month, they have to close the business because they do not have enough money left after paying all the taxes.

So, the benefit of the fiscal law is that those who were not paying any taxes finally had to start reporting some income. The drawback is the amount of money that the government is taking from us through VAT and income taxes, which forces us to avoid invoicing to be able to survive on the market and to pay a decent salary to our workers. The way we do that, in the system, we print a receipt, but we do not fiscalize it, so the guests pay the full price, and then we delete the receipt from the system. Again, the reason why we do that is that the government is taking too much from us through taxes, and we do not want to raise our prices because if we did that, our local guests wouldn't be able to afford that, and it would not make sense to work that way.

8. Have you ever had an experience with the inspections?

Yes, once I had to pay a fine because the waiter had 6 HRK extra in the cash register and the inspection is very strict with that, they consider that if you have the extra money in the cash register, it is coming from unreported receipts. Anyway, the reason was that we had many guests when the inspection visited, and the waiter accidentally left the tip in the cash register, which resulted in extra money in the cash register. Unfortunately, at the time I did not have any connections with the people who work with the inspections, otherwise, I would have got a notice that inspection would be

going on that day. That is how it works. If you know someone, you get a notice and you can make sure that all is perfect in case they come to inspect your business.

9. In terms of employment and reporting the income, considering all the rules, laws, and taxes, what do you think, who has a bigger advantage, those who work according to laws or those who do not follow the laws?

Those who follow the law can barely survive on the market so, we have to operate in the shadow economy, at least partly. Workers are mostly reported, but we are evading taxes through the receipts. Some bars hire workers without a contract for a short period, and then they fire them without giving them pay.

10. Do you think that tax relief would reduce the shadow economy?

If taxes were lower, there would be no need to work in the shadow economy. Employees would not be reported on the minimum salary, instead the whole salary would be paid on the bank account. Reducing taxes is the only way to improve the situation with the shadow economy. In Croatia, taxes are the enemy of workers and business owners

11. How do you hire your employees?

I give them a full-time contract but with the minimum salary. In reality, I pay them more than that, but the rest is in cash.

12. Do you think that there is too much bureaucracy regarding hiring workers?

Not so much bureaucracy, but there is a rule that is making things more complicated for us and workers. If the boss fires an employee, the boss is not allowed to hire a new employee for a certain period, and if an employee quits, he is not allowed to receive unemployment benefits. It often leads to conflict between the boss and the employee and that motivates hiring without a contract.

Appendix 4 – Interview with an unofficial accommodation provider

Interview 5

1. How long have you been in the business of renting tourist accommodation?

I have been renting tourist apartments for three years.

2. What are your reasons for working as an unregistered renter?

High levies are the reason that I am working as an unregistered renter.

3. Do you have people employed illegally in your business? If yes, please explain how you found them and what motivated them to work illegally?

Yes, every season I hire cleaning staff and repairmen when needed, both of them illegally. They are more motivated with a higher payment than they would get if they had an official contract. Usually I find them by recommendations of friends or in Facebook groups.

4. How much do you “save” on average per year by avoiding payment of taxes and duties that official renters are obligated to pay?

I am investing most of the income for the future development of the business, so I do not see it as “saving”.

5. Have you ever had an experience with the inspection that controls renters? If yes, please explain.

Luckily no, but in case of the inspection I have a story to tell. If I found myself in that situation, I would tell that the guests were my family and that they did not pay for their stay. Also, I always inform my guests about the situation and the story. So far, all the guests have been ok with that.

6. What do you consider as advantages and disadvantages by working as an unregistered renter?

The biggest advantage is that I do not have to pay any fees and taxes and I can invest that money in the development of my business. The disadvantage is that I always have to be careful and inform guests what to say if the inspection comes.

7. Do you consider that the shadow economy is a common practice in the business of renting tourist accommodation and is it controlled enough?

It is a common practice and it is very hard to control that. Also guests are ok with staying in unregistered accommodation because otherwise they would have to pay a higher price.

8. Considering all the rules, laws and tax expenses that registered renters are paying, do you consider that unregistered renters are in a better position?

Yes and no. Fines for unregistered renters are high, but on the other hand, earnings are way higher than if the business is registered.

9. Do you think that tax reliefs would reduce the shadow economy?

Absolutely, but I do not think that that is something to expect soon to happen.