

**Undeclared Work in Croatia:   
A Social Exchange Perspective**

Thesis submitted for the Degree of Doctor of Philosophy

Marijana Barić  
Management School  
The University of Sheffield

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**Abstract**Across the world, studies of undeclared work have largely focused on measurements of its size rather than unearthing the nature and motives of those engaged in the undeclared economy, which is required if undeclared work is to be tackled. The aim of this thesis is to use social exchange theory (SET) to develop a theoretically informed framework for understanding participation in undeclared work. This framework views an understanding of both vertical (government-citizen) and horizontal (amongst citizens) relations as crucial when explaining participation in undeclared work. When analysing the former, social contract and elements of trust and justice are considered, whereas the latter considers the level of tolerance of undeclared work and influence of social norms. The aim of this thesis, therefore, is to use a study of Croatia to evaluate not only the validity of current theorisations of undeclared work, but also the validity of SET as a conceptual framework to explain participation in undeclared work. In doing so, this thesis provides not only the first contemporary study of undeclared work in Croatia, but also the first known attempt to use SET to understand this phenomenon. To achieve this, 300 face-to-face interviews have been conducted in the city of Split, along with 20 in-depth follow-up interviews in 2012.

The findings reveal not only the multifarious character of undeclared work and diverse motives underpinning the decision to participate in this realm, but also how SET provides a useful framework for explaining such engagement. The level of trust in the state and social norms are shown to explain to a significant extent engagement in the undeclared economy. This thesis then unpacks how citizens conceptualise the social contract with the state, as well as the complex formation of social norms surrounding undeclared activities. Having established the applicability and usefulness of social exchange theory as an underpinning framework for understanding undeclared work, the wider policy implications are then drawn out. This reveals that in populations where tax morale is low and the social contract weak, there is a need to focus upon indirect policy measures that seek to improve the vertical relations, as well as change the social norms embedded in the horizontal relations that currently normalise undeclared work.

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Chapter 1: Introduction

# 1.1 Contextualising the thesis

Each and every society has an economy to facilitate the production, distribution and allocation of goods and services. In portraying the nature of any economy, three main means to deliver goods and services are often identified; the market (private sector), the state (public sector) and the undeclared or community sector (e.g. Polanyi 1994, Giddens 2000, Gough 2000, cited in Williams 2004). This thesis examines one aspect of the latter means to deliver goods and services, namely paid transactions, which are not declared to the state for tax, social security and labour law purposes. It does not consider the unpaid sphere. In recent decades, there has been growing recognition that even this sphere of undeclared work is composed of multifarious forms of work conducted for a diverse array of reasons (Williams and Round, 2007). The outcome has been a growth of literature that wrestles with attempting to understand and explain this phenomenon (Williams, 2014). Although it was officially ‘discovered’ in 1973 by Keith Hart (Hart, 1973) in his study of Ghana, there is evidence that undeclared activity existed in many societies long before its official recognition by academics and policy-makers. Acemoglu and Robinson (2012), for example, provide many illustrations of the existence of undeclared activities in contexts such as fourteenth-century China, as well as England during the late 1500s and Austria-Hungary during the late 1800s. Informality has, therefore, stood the test of time, disproving the expectations that it would eventually disappear. Although some argued that it was gradually disappearing from view (Geertz, 1963; Lewis, 1959), Barta (2009) describes its persistence in the current century. In fact, the phenomenon has not only expanded in many areas of the world, but has also developed in new forms and unpredictable locations (Charmes, 2009; Rodgers and Williams, 2009; Williams and Nadin, 2012a, 2012b). It is shown to not only be a characteristic of under-development, but is also present in developed global regions such as the European Union (European Commission, 2014). In fact, Schneider (2011) estimates it to be 33 per cent of the global GDP, and some two-thirds of the global working population are asserted to have their main employment in this sphere (Jütting and Laiglesia, 2009). This phenomenon is consequently high on the public policy agenda. Despite an increasing interest in the undeclared economy, it is nevertheless only recently that its heterogeneous nature has been recognised. Research is emerging that undertakes a contextual analysis of the multifarious nature of the phenomena, but also even recognises that it has some positive social aspects (Williams, 2007; Williams and Round, 2007). Therefore, more in-depth studies are necessary to fully unearth the complexities behind the motives of those choosing to operate on an undeclared basis. Furthermore, due to its heterogeneity, there is also a need to investigate the phenomenon in specific contexts.

This thesis seeks to do this by studying undeclared work in Croatia. To do so, it employs for the first time, a social exchange theory (SET) conceptual framework. Although this theory was originally developed to explain the development and maintenance of interpersonal relationships (Homans, 1958; Thibaut and Kelley, 1959; Blau, 1964), it has so far been largely used by scholars to explain the nature of the employee-organisation relationship (Cropanzano and Mitchell, 2005; Cropanzano and Rupp, 2003; Settoon et al., 1996) and more specific organisational relations such as workplace mentoring (e.g. Majiros, 2013), as well as organisation-customer relations (e.g. Füller, 2010). There is a close relationship between SET and other frameworks, such as the psychological contract (e.g. Rousseau, 1995), equity theory (e.g. Lapalme et al. 2011), leader member exchange (e.g. Wayne et al. 1997) and, Perceived Organisational Support (e.g. Zagenczyk et al., 2011).

In using SET as a conceptual basis, this thesis frames social exchange in terms of vertical and horizontal relations. The vertical relationship refers to the exchanges between the citizen and the state, which is theorised to have an impact on the decision-making process with regard to participation in undeclared work. The horizontal relations, on the other hand, refer to the relations between the citizens themselves, which, as will be revealed, are important in shaping attitudes towards such work, and whether or not people decide to engage in undeclared activity.

The relationship between the state and the citizen (vertical exchange relations) is here conceptualised in the form of the social contract. It is theorised that if the contract is strong in the eyes of the individual, then this individual will exhibit commitment in the form of a lack of tolerance of, and engagement in, undeclared activity. If the social contract is on the other hand weak or broken, it will be characterised by a perceived lack of fairness and a lack of trust in the state. This would result in tolerance of undeclared work and participation in such activity.

This thesis also investigates exchange relations between citizens (horizontal relations). Such an analysis is important to gain insight into both individual decision-making (personal norms), as well as broader macro processes of societal rules and norms. As Webb et al. (2009) argue, the undeclared economy encompasses activities that take place beyond formal institutional boundaries (i.e., codified laws and regulations), but within the bounds of informal institutions (norms, values and beliefs), regarding their tolerance of undeclared work (tax morale). Here, therefore, the decision-making process is also framed in the context of social norms (the perceived tolerance and activity of undeclared work of other individuals). The latter is investigated on two levels. The first level is that of identity group norms, which encompass the perceived tolerance of undeclared work of groups that the particular individual identifies with (e.g. occupation, neighbourhood and gender). The second level is that of societal norms that consider Croatia as a whole, or more specifically, the average Croatian citizen.

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# 1.2 Gaps in the literature

At present, the literature surrounding undeclared work investigates the phenomenon in a categorical manner (see Chapter 2). In doing this, the work and motives underpinning undeclared work are pigeonholed into certain categories. These include explanations such as exclusion/marginalisation, over-regulation, lack of regulation and work being carried out on a minor basis for friends and family. Such a categorical approach means that individual decision-making processes are simplified. Therefore, the complexities involved in each transaction, and decisions made, are not unearthed.

The current thesis seeks to fill this gap by placing the focus on individual decision-making. It does so by, in part, using social exchange theory as an underpinning framework for analysing and explaining such decisions. Social exchange theory has not before been applied to the study of undeclared work. The intention in this thesis is to show that, by taking this approach, a better understanding of motives for operating in the undeclared economy will be gained. This will reveal that there is a direct link between undeclared work, and not only the breach of the social contract with the state (vertical exchange), but also the social norms that prevail (horizontal exchange).

However, it is important to note that this thesis also seeks to advance social exchange theory. At present, many of the difficulties witnessed with SET are largely due to the conceptualisation of the paradigm being dominantly utilitarian. Such interpretations have ‘roots in behaviourism […], with concepts and principles borrowed from microeconomics’ (Cook, 2000: 687) and assume that individuals are rational choice actors who seek to maximise their benefits and minimise costs. Cropanzano and Mitchell (2005) argue that this leads to a narrow employment of methods and the further stunting of theory. Although it is recognised that social exchange theory has some criticisms in its utility, it is argued in this thesis that it does have the capacity to explain various exchange relationships. To fill this gap, therefore, a more integrated, multi-level framework is developed, by tracing the problems of social exchange theory back to its roots. From this arises the importance of merging theories from various backgrounds to achieve a more dynamic SET framework. In this thesis, this is done through the incorporation of anthropological/sociological interpretations of exchange that focus on generalised, rule-governed, as well as symbolic social exchange (Zafirovski, 2005). A further gap within the social exchange literature is that SET constructs have not been fully identified, and much research leaves out critical theoretical variables (Cropanzano and Mitchell, 2005). The current thesis fills this gap by clearly defining constructs such as trust and fairness, in the context of the phenomenon being studied (see Chapter 2).

A final gap is that the undeclared work literature in Croatia is scant, and focused mainly on producing estimations of the undeclared economy from macro data, collected for other purposes. There has been little, if any research, seeking to unearth the nature and extent of the undeclared economy in the country. This thesis fills that gap using a direct survey method in the area of the capital of Dalmatia- Split, Croatia.

# 1.3 Objectives of the thesis

Following these identified gaps in the literature, the overarching objective of this thesis is:

-To explain the nature and extent of undeclared work in Croatia, using a social exchange theoretical framework.

To achieve this overarching aim, the intention is:

-To evaluate the different theorisations of the undeclared economy (dualist, structuralist, legalist and complementary perspectives) in Split, Croatia

-To explore the relevance and utility of the social exchange theory framework in explaining the undeclared economy and unearthing undeclared actors’ motivations

-To evaluate the impact of the vertical relationships between the government and citizens on the decision to operate on an undeclared basis

-To evaluate the influence of the horizontal relations, such as personal and social norms, on the decision to operate on an undeclared basis

-To highlight the regulatory mechanisms of undeclared activity

-To identify relevant policy recommendations based on the findings

# 1.4 Contribution of the thesis

The contribution of this thesis is several fold. Firstly, it shows how a social exchange theory framework can be used to enhance the understanding of the complexities of undeclared work, as well as explain the decision to participate in such work. This is the first time that a SET framework has been applied to explain the undeclared economy. The findings unearth factors that contribute towards the formation of the social contract, and how these impact on engagement in the undeclared economy. This thesis also highlights the need to look at all levels of government interaction (from the broadest conceptualisation of the state to individual employees representing the state), and the need to study the role of norms in the formation of tolerance of undeclared work. The outcome is to reveal how social norms are central to explaining undeclared work.

The second theoretical contribution is that it also extends the SET framework by transcending the current utilitarian approach, and incorporating anthropological/sociological interpretations of exchange, which enable a more integrated multi-level framework of social exchange. This allows an exploration of issues such as fairness, trust and power as potential determinants for the decision by individuals to formalise. A more integrated dynamic relationship thus arises, in which deterrence, monetary rewards, facilitating rewards, fiscal exchange, fair treatment and decision-making procedures, all play a role in encouraging formalisation.

The third contribution to knowledge is that it provides the first contemporary study of the extent and nature of undeclared work in Croatia. Until now, little has been known about undeclared work in this country beyond a few studies that seek to use proxy indicators to measure the magnitude of this sphere. This paper fills this significant gap by beginning to unravel the extent and nature of undeclared work in this country.

The fourth and final contribution is that it provides a new perspective on how such work should be tackled. As will be shown, although there has been a recent shift towards an institutional approach, which seeks to reduce the asymmetry between formal and informal institutions as a means of tackling undeclared work (Williams and Horodnic, 2015), there has until now, been little understanding of either the vertical or horizontal relations that need to be changed in order to promote this symmetry. This thesis provides both a theoretical framework to identify which horizontal and vertical relations need to be focused upon, and helps to advance this new emergent policy approach towards tackling undeclared work. Although here the emphasis lies with which vertical and horizontal relations need to be focused upon in Croatia to create a tailored policy approach, the approach is transferable to other economies similar in nature.

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# 1.5 Outline of the thesis

This chapter has provided an underlying context for the forthcoming chapters by introducing the subjects of undeclared work and social exchange theory. It has outlined why these should be studied together, as well as the aims and objectives of the thesis. The following chapter, Chapter 2, will review the literature relating to undeclared work, as well as the literature on SET. This allows the development of the SET framework for studying undeclared work. Chapter 3 provides an insight into the context of research, which is important for understanding the presence of undeclared work in the particular empirical setting of Croatia. Chapter 4 presents the methodological approaches utilised during this research project, and also outlines how the author engaged with relevant ethical issues within the research project. Chapter 5 outlines the quantitative and qualitative findings of the empirical study. This serves appropriately as a platform for Chapter 6, where the data is placed in a more focused frame to address the research questions. Furthermore, links to the wider literature and the meaning of the data in the context of existing theories are made in this chapter. Chapter 6 also expands the discussion of the findings to consider the implications for policy design.

Chapter 2: Literature Review

# 2.1 Introduction

This chapter reviews the extant literature on undeclared work to identify the gaps in the knowledge that this thesis seeks to fill. To do so, it commences with a discussion of how to define undeclared work. Following this, it then reviews the competing theoretical perspectives, which have been used to explain undeclared work. Identifying how each of these competing theoretical perspectives provide only a partial explanation of undeclared work, the final section then turns to developing a new way to synthesise these previous explanations, in order to provide a potentially fuller explanation for participation in undeclared work, namely a social exchange theoretical perspective.

# 2.2 Undeclared work: Defining the phenomenon

## 2.2.1 Introduction

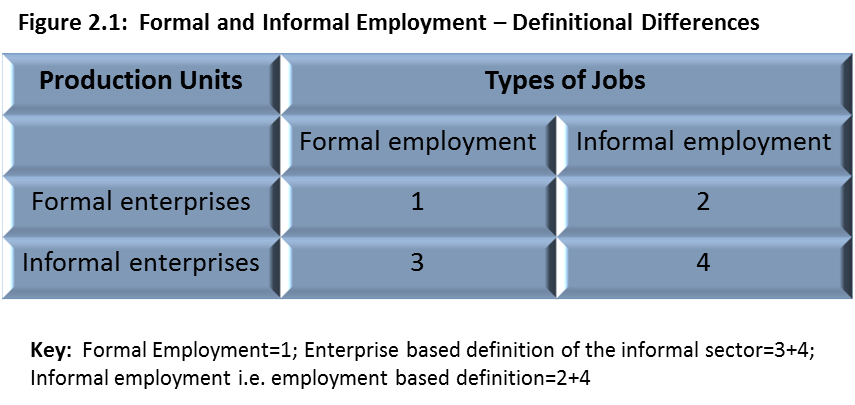
Undeclared work is identified by a host of different names. It has been referred to as: the informal sector (Hart, 1973), subterranean economy (Bawley, 1982), shadow economy (Schneider and Enste, 2002), underground economy (Simon and Witte, 1982), irregular economy (Ferman and Ferman, 1973), black economy (Dilnot and Morris, 1981), informal economy (Williams, 2007) and undeclared work (Williams, 2014). Furthermore, terms such as invisible, hidden, submerged, shadow, irregular, non-official, unrecorded are often used in the media (U.S. Department of Labor, 1992), or twilight economy, if the intention is to emphasise the clandestine character of these economic activities.

Just as there is diversity in the names used to portray the undeclared economy, there is also diversity in the definitions used to delineate the scope of the activity being considered. Castells and Portes (1989:12) depict the undeclared economy as a ‘common sense’ idea, but one that cannot be captured by an exact definition. Although there are many variations across definitions in the criteria used to delineate what is being discussed, the commonality across nearly all definitions, is that the activities are not recorded or are improperly detailed in official national accounting systems. Castells and Portes (1989:2) define it as activities that are ‘unregulated by institutions of society in a legal and social environment, in which similar activities are regulated’, such as for tax and social security, as well as health and safety purposes. However, this thesis rejects such a definition because, as will become apparent when examining this activity through the lens of social exchange theory, a range of personal and social rules and norms regulates such activities. Others, however, use simpler definitions. For example, Schneider and Enste (2002:78) define such activity as: ‘all economic activities that contribute to the officially calculated (or observed) gross national product but are currently unregistered’, rather than unregulated. Whether this definition suffices will now be evaluated by reviewing the issues involved when seeking a definition and the range of definitions being used in the literature.

## 2.2.2 Definitional issues

The origins of the notion of an ‘informal sector’, lie in an ILO report on urban labour markets in Ghana, where this concept was used to describe the range of subsistence activities of the urban poor (Hart, 1973). Since then, there has been extensive literature that has sought to more precisely define the scope of such activity. During the 1970s and 1980s, such endeavour was often broadly defined as unregulated enterprises or economic activities (ibid). The first more precise definition appeared in 1993, when the International Conference of Labour Statisticians (ICLS) adopted an international statistical definition, based on production units or enterprises, rather than on employment relations (ILO, 2002b). This defined the undeclared sector as including ‘all unregistered or unincorporated enterprises below a certain size, including: micro-enterprises owned by undeclared employers who hire one or more employees on a continuing basis; and own-account operations, owned by individuals who may employ contributing family workers and employees on an occasional basis’ (ILO, 2002: 11). Using the enterprise as the unit of analysis, and as Figure 2.1 displays, this defines what the ILO term as the informal sector, as including all activities in cells three and four.

However, as time passed, the ICLS noted that an enterprise-based definition misses a multitude of undeclared wage work arrangements, and thus fails to capture the multi-faceted nature of informality. The result was that an employment-based definition was recommended. This employment-based definition observes the nature of the work being performed and expresses the undeclared economy as being made up of cells two, three and four (Figure 2.1). Both the ILO and the International Conference of Labour Statistics now recommend this definition.

  
**Figure 2.1: Formal and informal employment: Definitional differences**

Despite these attempts to more clearly define such activity, others have been rather more critical of attempts to define such endeavour. Peattie (1987), for example, critiques the term ‘informal sector’ as an ‘utterly fuzzy’ concept and suggests that those involved with policy and analysis of this endeavour should abandon the use of the term. The definition of such activity has however evolved over the years, as has the depiction of the character of the activity that it aims to describe. Indeed, although few authors today would reject the use of the informal as a concept, there is a growing recognition that the formal and informal are not separate sectors, but rather that activities exist on a spectrum, from wholly formal to wholly informal (Latouche, 1993; Williams et al., 2007). As Latouche (1993) argues, the undeclared cannot be explicated as a ‘sector’, as it is often present at the very heart of the declared economy and functions in close interaction with it. Thus the division of the declared and undeclared ‘sectors’, as if there was a clear line to divide the two conjures definitional problems. However, there are those who view them as separate sectors, namely dualists, who will be later revealed in this chapter, argue that the undeclared economy is a distinct marginal economy, not directly connected to the declared economy (ILO, 1972). Although this is the most traditional school of thought, academics across different fields are nevertheless increasingly accepting that there is interdependence and overlap between the formal and informal economies (as will be further discussed in the next section).

Before doing so however, it is important to be clear regarding the activity being included in the category of the ‘undeclared’. In recent years, the term ‘economy’ has begun to replace ‘sector’ with regard undeclared work (e.g. ILO, 2002; Kabeer, 2010). This is because the word ‘economy’ suggests a wider range of activities than sector, overcomes the idea that informality is confined to a specific sector of economic activity, and reflects the notion that it cuts across many different sectors. An undeclared ‘economy’ also perhaps better emphasises the existence of a continuum of activity, from wholly undeclared to wholly declared (Bromley, 1995).

When defining the undeclared economy, the tendency is to differentiate it from other related realms that lie beyond the declared economy (ILO, 2002b), which distinguishes it from the criminal economy and reproductive or care economy. The undeclared economy is defined as work that is not ‘formal employment’, that is, paid work registered with the state for tax, social security and labour law purposes (Williams and Round, 2007: 426). By definition, the character of the undeclared economy is seen as operating beyond the scope of the world of regular, stable and protected employment. However, within this definition, all goods and services that households provide for themselves are omitted from the undeclared realm. It is estimated by Kacapyr (1998) that the most substantial type of production excluded from official accounts, is undoubtedly both lawful and moral. Examples of this include, do-it-yourself activities, such as auto repairs, vegetable gardening, self-provided child and elderly family member care. This definition, which is the most widely adopted, does not include the reproductive or care economy (compromised of unpaid domestic activities and care work), because it is not paid, and thus, by definition, would fall under ‘unpaid community work’ or ‘self-provisioning’, rather than undeclared employment.

Neither is the undeclared economy used interchangeably, or confused with the criminal economy. Activities falling under the scope of undeclared are on the fringes of the law, and therefore public authorities often fail to differentiate them from criminal activities such as drug trafficking, people smuggling and money laundering (ILO, 2002). The notion of ‘undeclared’, albeit unofficial, is nonetheless characterised by rules or norms regulating the activities of workers or enterprises. While production or employment arrangements in the undeclared economy are often conducted through illicit means, the goods and services that are produced and distributed are legal in nature. In contrast, it is the ‘criminal economy’ that comprises illegal goods and services, such as drug trafficking (ILO, 2002a; Williams and Round, 2007). As such, the only illegitimate aspect of the undeclared economy is that it is not declared to the authorities for tax, social security and/or labour law purposes. If illegal goods or services are being traded, then this activity is part of the wider criminal economy.

As is evident, therefore, the undeclared economy is often difficult to formally define, as one has to differentiate between goods and services produced and consumed within the household, ‘soft’ forms of illegitimate work and illicit employment and social fraud, as well as criminal economic activities. Mogensen et al. (1995:5) argue that a precise definition is very difficult, if at all achievable. The shadow economy is constantly developing and transforming, as it adjusts to factors such as moral attitudes, changes in taxes and sanctions from tax authorities (Schneider and Esnte, 2000). Thus, due to its nature, the phenomenon of formal employment will continually evolve and its definition adapt. It is partially for this reason, that the undeclared work literature is riddled with vast and occasionally contradictory definitions.

Nevertheless, three contrasting types of definitions can be identified; namely enterprise, jobs and activity-based definitions (Williams and Round, 2008). Such definitions define undeclared employment by categorising absent elements or insufficiencies. Whereas, enterprise-based definitions convey the insufficiencies of undeclared enterprises compared to formal ones; job-based definitions focus on insufficiencies of undeclared, relative to declared jobs, and activity-based definitions denote insufficiencies of undeclared, compared to declared activities (Williams and Round, 2008: 369). This is reinforced by Eapen (2001) who notes how analysts have defined informality in terms of the absence of characteristics that belong to typical ‘declared’ employment such as security and regularity of work, better earning, existence of non-wage and long-term benefits, protective legislation and union protection. For example, the ILO (2002) state that groups are termed informal because they are not recognised or protected under the legal and regulatory frameworks, as well as characterised by a high degree of vulnerability. In doing this, they are forced to depend as best they can on undeclared, frequently exploitative institutional arrangements, whether this be for information, markets, credit, training, or social security.

Eapen (2001) criticises such definitions, as she argues that in a situation where activities within the formal economy are becoming informalised, the borderline becomes blurred. This means that groups can often be formal, as well as informal, and possess only some, none or all of the characteristics outlined by the ILO. Latouche (1993:127) states that businesses, employers, consumers and citizens have one foot in the formal, and the other in the informal. This exemplifies that certain groups can be protected by legal and regulatory frameworks for the formal aspect of their work, receive education, training and social security amongst other benefits, yet engage in informal activities.

This is especially true in OECD nations and European countries, where the widespread consensus is that an activity-based definition should be used (Williams, 2006) because it covers a wider array of informal aspects. A frequently used, activity- based definition describes informal employment as all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards, such as minimum wages, maximum hours, safety or health standards etc. (OECD, 2002: 139, cited in Williams and Round, 2008). Fundamentally, as is defined here, informal employment is undeclared work. Criminal activities (illegal goods and services), self-provisioning (if a household member engages in unpaid work for themselves or another member of their household) and unpaid community work (unpaid work carried out by household members by and for family members and friendship or community networks) are not regarded as a part of the informal economy in this thesis. Whereas, the latter two are often categorised as sub-sections of informal employment, along with undeclared work (Williams and Round, 2007); they are excluded within activity-based definitions, as in this case, the only deficiency of undeclared relative to declared activity, is that it is not registered to the authorities for tax, social security and/or labour law purposes. Therefore, if activities possess further deficiencies, they are not defined as informal employment (Williams and Round, 2008). This activity-based definition is advantageous, as it includes a form of informality, exceptionally pronounced in East-Central Europe, namely ‘envelope wages’, where a formal employee receives part of their wage on a declared basis and part cash-in-hand (ibid). Envelope wages are excluded from both job-based and enterprise-based definitions; as for the former, the worker is in a formal job, and for the latter, because the work is in a formal enterprise (Hussmanns, 2005). More precisely, envelope wages are where employees receive two wages: an official wage which is registered by the state for tax and social security purposes, and an unofficial ‘envelope’ wage that is not declared, and which allows employers to avoid their social insurance and tax liabilities (Williams, 2008). Although enterprise- and job-based definitions have until now dominated in studies of third world countries, in OECD nations and European countries, the widespread consensus has been that activity-based definitions should be used (Williams and Round, 2008).

It can also be argued that the definitional discrepancies are a result of how different academic disciplines engage with the phenomenon. For example, economists seeking to estimate the total size of the informal economy concentrate their research on unregulated, but cash based exchanges (Feige, 1979). On the other hand, anthropologists and sociologists pay more attention to the broader nature of the informal economy and its role as a household economic strategy, or as a foundation for community cohesion, which includes both cash and non-cash exchanges between and within households (Levitan and Feldman, 1991). Schneider (2000) also states that the definition often varies, depending on the chosen method of measurement. Consequently, to denote the informal economy without further stipulation, easily creates misunderstandings, as it could be unclear which groups or segments are included. Many debates and political deliberations arise because of divergent or insufficient definitions (Schneider et al., 2003). It is therefore, important to understand what exactly is meant when discussing the informal or undeclared economy, and necessary to be aware of the different available definitions.

## 2.2.3 Undeclared work: The adopted definition

In this thesis, ‘employment in the informal economy’, or what is here termed undeclared work, includes firstly, informal enterprises (i.e., the enterprise-based concept of the ‘informal sector’) and second, informal jobs (i.e., the jobs-based concept of ‘informal employment’). As defined by the 15th International Conference of Labour Statisticians in 1993, the ‘informal sector’ (i.e., informal enterprises) is defined as private unincorporated enterprises that are undeclared or small with regards the numbers of those employed. An unincorporated enterprise is a production unit, not composed as a detached legal entity independently of the person in ownership, and for which no whole set of accounts is maintained. An enterprise is unregistered, when it is not recorded under certain forms of national legislation (e.g., tax or social security laws, professional groups' regulatory acts). Trade licences or business permits being issued does not qualify as registration. Meanwhile, an enterprise is small when its size of employment falls below a particular threshold (e.g. five employees) decided in accordance with national circumstances (Hussmans, 2004; ILO 2011, 2012).

Given that this definition of the ‘informal sector’ (A+B) does not include those in informal jobs in formal enterprises (C), the 17th ICLS in 2003, adopted an alternative jobs-based definition of ‘informal employment’ (A+C) to capture such workers. This defines the employment relationship (i.e., a job) as ‘informal employment’ (A+C) when it lacks basic social or legal protection or employment benefits and may be found in the formal sector, informal sector or households. Persons in informal employment include the following types:

(a) own-account workers and employers employed in their own informal enterprises;

(b) members of informal producers’ cooperatives (not established as legal entities);

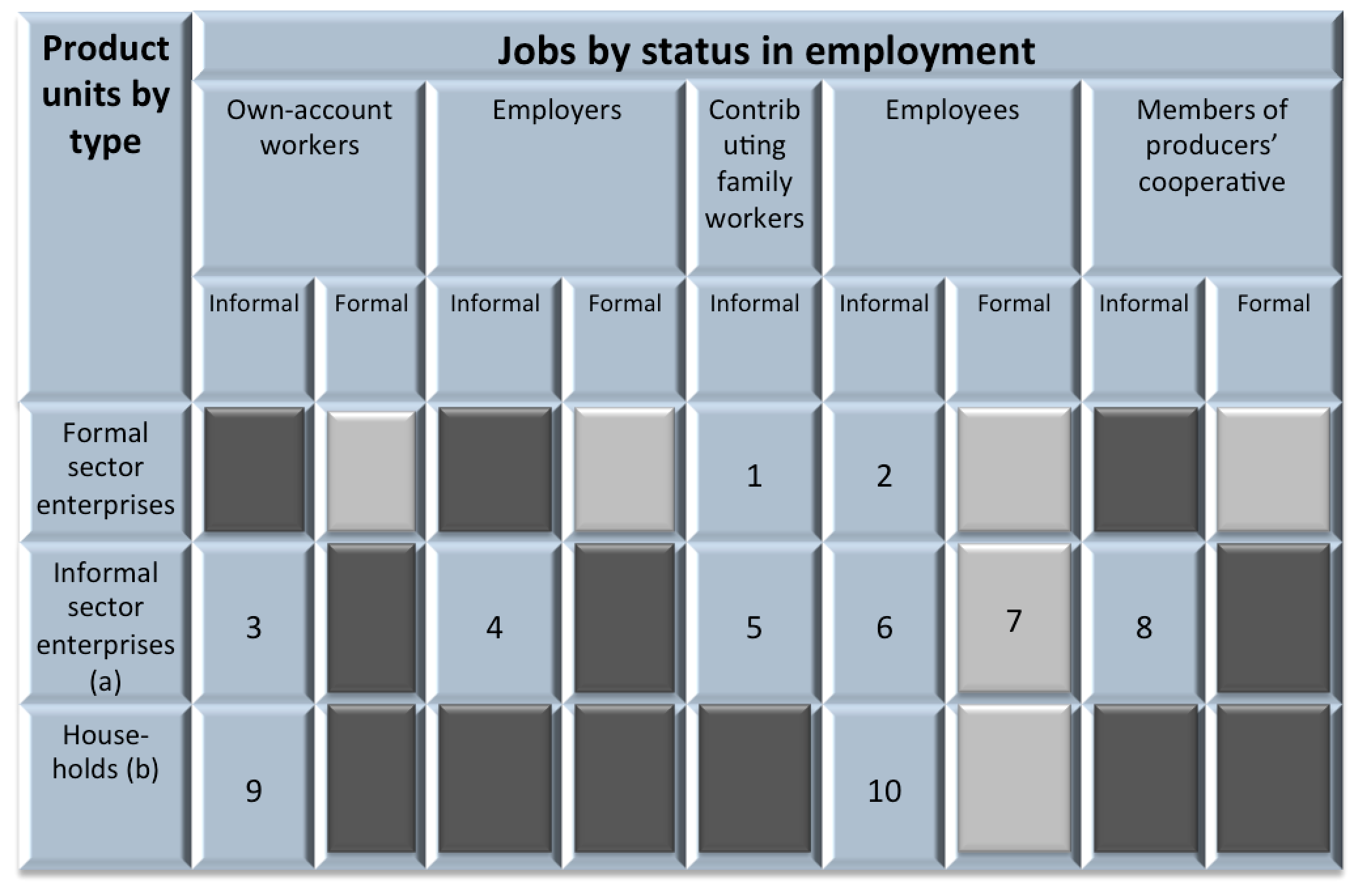
(c) own-account workers producing goods exclusively for own final use by their household (if considered employed, given that the production comprises an important contribution to the total household consumption and is included in the national definition of employment);

(d) contributing family workers in formal or informal enterprises; and

(e) employees holding informal jobs in formal enterprises, informal enterprises, or as paid domestic workers employed by households.

As regards (e), employees have informal jobs if their employment relationship is, in law or in practice, not subject to national labour legislation, income taxation, social protection or entitlement to certain employment benefits (e.g., advance notice of dismissal, severance pay, paid annual or sick leave) and may be found in the formal sector, informal sector or households.

Figure 2.2 provides a graphical portrayal of the definition of adopted in this thesis of undeclared work (Hussmanns, 2005). This is also the standard definition adopted across the world. As such, the definition adopted in this thesis of what is here termed undeclared work, is the same as the standard ILO definition of employment in the informal economy.



**Figure 2.2: Conceptual framework: Informal employment (source: Hussmanns, 2005: 27)**

(a) As defined by the Fifteenth International Conference of Labour Statisticians (excluding households employing paid domestic workers)

(b) Households producing goods exclusively for their own final use and households employing paid domestic workers.

Note: Cells shaded in dark grey refer to jobs, which, by definition, do not exist in the type of production unit in question. Cells shaded light grey refer to formal jobs. Un-shaded cells represent the various types of informal jobs.

Informal employment: Cells 1 to 6 and 8 to 10

Employment in the informal sector: Cells 3 to 8

Informal employment outside the informal sector: Cells 1, 2, 9 and 10

Fig. ILO framework on informal work, (Hussmanns, 2005: 27)

* Cells 1 and 5 encompass contributing family workers, irrespective of whether they work in formal or informal sector enterprises. Due to the nature of such jobs, the workers often have no written contracts of employment and are consequently not protected by labour laws, social security guidelines, collective agreements and so forth.
* Cells 2, 6 and 10 consist of employees having informal jobs, whether employed by formal sector enterprises, informal sector enterprises, or as paid domestic workers by households.
* Cells 3 and 4 comprise own-account family workers and employers employed in their own informal sector enterprises. Because it is difficult to differentiate the own-account workers and employers from the kind of enterprise they possess, the nature of the individual’s jobs, follows directly from the characteristics of the enterprises they own.
* Cell 7 is a portrayal of workers having formal jobs in informal enterprises. This will occur when enterprises are defined as informal, based only on size as the criterion, or where there is no administrative link between the registration of employees and the registration of their employers. However, such situations are likely to be small in numbers.
* Cell 8 consists of members of informal producers’ cooperatives. Here too, the informal nature of the individuals’ jobs, is constructed directly from the characteristics of the cooperative of which they are a member.
* Cell 9 represents own-account producers of goods wholly for own final use by their households (e.g. subsistence farming or do-it-yourself construction of own dwellings).

This definition has the advantage of depicting a continuum of production and employment relationships. This is important, as discussed above, because there is a spectrum of formality and informality from wholly informal to wholly formal. Depicted by the grey areas are the aspects of the blurred relationship between the formal and informal economies. The usefulness of this definition, therefore, lies in the encapsulation of not only those who are working for an undeclared business, but also those who may be working in formal enterprises but are in undeclared jobs, and those working in formal jobs within informal enterprises. As such, it allows the definition of various levels of informality, in the sense that it includes those in informal jobs in informal enterprises, but also those in formal jobs in informal enterprises and those in informal jobs in formal enterprises. Recognising the blurred boundaries is important, as there is a certain level of agreement (as will be discussed) that formality and informality are dependent on each other, both in a national and global sense (e.g. Guha-Khasnobis et al., 2006). As already discussed, these informal activities are separated from criminal and illegal acts, such as smuggling illegal drugs.

Given this definition of undeclared work (i.e., what the ILO term ‘employment in the informal economy’), attention now turns to examine the different ways in which scholars have sought to explain the extent and nature of the informal economy.

# 2.3 Undeclared work: An overview of different schools of thought

## 2.3.1 Introduction

Having defined undeclared work in the same way as the ILO defines ‘employment in the informal economy’, this section turns attention to understand the competing ways in which participation in undeclared work has been explained. To do this, other authors have asserted that there are four dominant schools of thought, regarding how to explain undeclared work, its defining characteristics and its links to the formal economy. These are the dualist, structuralist, legalist (Chen, 2004) and complementary schools of thought (Williams, 2007). This section begins by providing a review of each of these competing theoretical perspectives. It is, however, suggested more recently (e.g. Williams and Round, 2008) that such universal theorisations are not desirable, due to the diverse nature of informality. A contextual perspective is therefore presented as a fifth theoretical perspective to explain participation in undeclared work.

## 2.3.2 Dualist school (Residue perspective)

The dualists, popularised by the ILO in the 1970s, view the undeclared economy as a separate marginal sector, not directly linked to the declared sector, that provides income or a safety net for the poor (Hart, 1973). Studies based on this school of thought, convey the undeclared economy as a marginal or residual activity (Gerxhani, 2004). According to this school, the persistence of undeclared activities, and rise of a dual economy, is due largely to the fact that insufficient modern job opportunities have been created to absorb surplus labour. What is now termed the informal economy or undeclared work, is characterised by small-scale economic activity, which is seen a temporary response to an unemployment problem, brought on by mass urban migration and high rates of population growth (Moser, 1994). The view is that this could be easily resolved with foreign investment and the development of a modern industrial sector (ibid).

In this discourse, the undeclared economy is read as a residue or leftover from an earlier mode of production and consumption, and its continuing occurrence is viewed as a sign of ‘under-development’ and ‘backwardness’ (Williams and Round, 2007; Williams, 2014a). Such a view led to a lack of interest being shown in informality. This is because it was widely assumed that the undeclared realm would disappear as countries gained a certain level of economic development (Chen et al., 2004; Hart, 1974; ILO, 1972; Williams, 2006, 2007, 2014). Within this view, it is held that this undeclared mode of production and trade has been transitioning towards formality (Williams and Round, 2008b). Williams and Round (2008a: 299) state that ‘the dualists perceive formalisation as organic and immutable, and the [undeclared] economy as a leftover from pre-capitalism that is disappearing as the unstoppable march towards formalisation takes place’. As Debrah (2007) posits, the undeclared sector is only a feature of peripheral economies, and is therefore a transitory stage in economic development that is bound to disappear with the development of modern capitalism or free enterprise. This perspective, therefore, implies that economies with high levels of undeclared work are developing or under-developed. Based on the ‘experience of rebuilding Europe and Japan following World War II, and the expansion of industrialisation in the United States and Britain’ (Willman-Navarro, 2008: 369) it was believed that industrialisation would result in labour shifting from the unproductive undeclared, to the modern and industrial declared economy (Willman-Navarro, 2008).

This subordinate role of the undeclared economy (Tokman, 1989), leads this school of thought to depict the undeclared economy as negative, and the declared economy as the positive and desirable, with a sharp contrast between the two types of economy. The disparity can be described as between that of ‘modern’ and ‘traditional’, or simply between that of a dynamic, profit-making modern sector and everything else - a vast sponge of surplus labour (Peattie, 1987). As Peattie (1980:4) states, ‘marginality may be presented as a lag in the cultural and social assimilation of the rural peasant into modern urban life, with shanty town neighbourhoods characteristically seen as rural slums within the city’. The marginality that occurs is seen as the result of a failure to incorporate rural migrants into modern urban life and modern urban institutions. The undeclared is often referred to as the ‘backward’ and underdeveloped (ibid). As such, managing to produce or sell informally, is a way of generating an income for those who could not obtain a well-remunerated job (Tokman, 1978). It is considered a sector for survival, and the workers capacity to survive under unfavourable conditions, and ingenuity to make a living out of a situation lacking access to official resources and markets, is the proof that they have the potential to further develop their activities (ibid). As the supposedly inevitable and natural shift towards the declared economy occurs, through goods and services increasingly being produced and delivered via declared channels, the ‘traditional’ undeclared work disappears (Williams and Round, 2007). The formal, therefore, is considered as a reflection of ‘progress’, ‘development’ and ‘advancement’ (Lewis, 1959), thus establishing a hierarchical sequencing of declared and undeclared work (Williams and Round, 2007).

Both the residue view and its wholly negative portrayal of the undeclared economy have, however, resulted in widespread criticism of this perspective. The 1970s saw increasing informality around the world, destroying expectations of the sector’s reduction. Therefore, the theorisation that informality is marginal and dispersed across the economic landscape was disproven, as a number of studies (both in developed and developing economies) show that the undeclared economy is not a temporary feature (Chen et al., 2004; Debrah, 2007; Potts, 2008; Williams and Round, 2009). As Chen et al. (2004:22) state:

‘It is not just a traditional or residual phenomenon but also a feature of   
 modern capitalist development, associated with both growth and global   
 integration. For this reason, the [undeclared] economy needs to be seen   
 not as marginal or peripheral sector but also a basic component, the base,   
 if you will, of the total economy’.

Not only has there been acknowledgment of the phenomenon’s persistence, but its growth has also been shown in many regions (Buehn and Schneider, 2012; ILO, 2011; Jütting and Laiglesia, 2009; Schneider, 2011; Sassen, 2009; Standing, 2011). Furthermore, it is argued that it is not just confined to particular areas such as the global south or the margins of big cities (Sassen, 2009). Instead, it is an integral part of many economies across the globe. Chen et al., (2004), amongst others, therefore argue that the residue theory needs to be reconsidered, because not only has informality grown with modernisation, it has also emerged in various forms, as well as in unexpected locations. Sassen (2009) provides examples of artists, designers and architects in arguing its use as an escape of the corporatisation of creativity. In her discussion of ‘urban manufacturing’, Sassen (2009: 65) refers to this aspect of undeclared work, as being a ‘leading’, rather than ‘backward’, sector. With the undeclared realm being a low-cost option compared to its interconnected counterpart, it serves as a source of opportunity and networking potential. This undeclared aspect of the urban economy, therefore, contributes innovativeness by escaping the corporatising of creative work (ibid).

Several authors see the undeclared sector as an autonomous segment (ILO, 1972; Oshima, 1971), where the inability of the declared economy to absorb surplus labour force is assumed to create a segmentation of both activities and jobs (Tokman, 1989). This highlights the representations of the undeclared economy, as not only temporally and hierarchically sequenced, but also as separate from the declared economy (Williams and Round, 2007), creating the notion of the dual labour market. The undeclared economy caters to a different segment of the population to the declared economy, and is ‘characterised by providing employment and goods and services for the lower income groups of the urban population’ (Tokman, 1978: 1066). Thus, as described above, undeclared work is concentrated amongst individuals who are excluded from declared employment. Hart (1973:68) turns the previous emphasis from unemployment, to that of poverty, and states that the ‘the distinction between [declared] and [undeclared] income opportunities is based essentially on that between wage-earning and self- employment’. The contrast between the two sets of economic activities is stressed as that of the declared economy is relatively profitable and privileged, and the other relatively disadvantaged (Peattie, 1987), further exemplifying the discord of the two ‘sectors’ and the negative depiction of the undeclared. Oshima (1971: 170) describes how the two economies remain separate as ‘proprietors and their family help and employees work for each other and buy each other’s products’ thus creating a further divide, one of networks, with the rest of the economy. The main assumptions lie with undeclared actors being those sections of the population that have been marginalised from formality, and thus undertake undeclared work, due to a lack of alternative opportunity and out of economic necessity (Button, 1984; Sassen, 1997; Williams, 2006, 2007, 2014). As such, the undeclared sector tends to be occupied by those in urban locations that have no place in the declared sector (Hart, 1973), or retrenched workers, such as women and migrants. Formal and undeclared work are also depicted as occupying separate spaces in the economic landscape (Williams and Round, 2007), as the marginalisation thesis views undeclared work as being concentrated in marginalised areas, as well as groups. McFarlane and Waibel (2012) discuss this, suggesting that spaces such as ‘slums’, were previously seen to be separate from formal areas, such as ‘the market’.

Potts (2007, 2008), amongst others, has strongly criticised the disconnected conceptualisation of the two economies (undeclared and formal) portrayed in this dualistic perspective, when discussing less developed economies. Potts (2007) states that the manifestation of differing characteristics is not necessarily an indication of different underlying economic forces. In fact, a number of researchers have now highlighted the similarities of the two (e.g. Chowdhury, 2007; Pollard et al., 2009; Williams 2005). In pointing to difficulties with adopting the dualist explanation, Potts (2008) argues that the theorisation ‘has descriptive value but is dangerously misleading if translated into policy that is founded on an idea that the sectors are functionally separate’ (Potts, 2008: 152-153). Given that there are many blurred boundaries within the undeclared economy (see the discussion in the previous section), it is clear that the proposition that the declared and undeclared are separate, is disproven.

Although the marginality thesis has been largely proven invalid (Castells and Portes, 1989; Gutmann, 1978) there is evidence to support it in certain circumstances (Hart, 1973). Therefore, although relevant to certain types of undeclared work, the dualist perspective is now considered out-dated (Chen, 2004) due to its main assumptions. The core criticisms of the dualist thinking are those that will be outlined within the forthcoming structuralist and legalist schools of thought; namely that the undeclared economy is no longer considered either a temporary phenomenon or to be confined to certain areas or groups. It is to these alternative explanations, therefore, that attention now turns.

## 2.3.3 Structuralist school (By-Product perspective)

The structuralist perspective, largely popularised by Moser and Portes in the late 1970s and 1980s (Chen et al., 2004), is used to explain the subordinate relationship of labour and small producers to big businesses, namely of sub-contracted firms and workers to the lead firms who sub-contract work to them (Chen, 2004).Therefore, unlike the dualist perspective, there is an acknowledgment of the interconnection between the declared and undeclared. Through this literature, state unregulated economic activity is argued not to be a temporary phenomenon, as authors like Balassa et al. (1986) insinuated, but a by-product of advanced forms of production (Fernandez-Kelly, 2006).According to writers within this school, the persistence and even expansion of the undeclared production relationship, is a consequence of the nature of capitalist development, rather than a lack of growth (Chen et al., 2004; Willman-Navarro, 2008). The undeclared economy is seen as a mechanism which large capitalist firms use to increase competitiveness, through reducing input and labour costs by exploiting subordinated micro-firms and workers. Due to the pressures of global competition and information and communications technology, such relationships are more common, as displayed in the increasing flexibilisation and informalisation of production and employment relationships. More and more firms are decentralising production and reorganising work by forming more flexible and specialised production units, some of which remain unregistered and undeclared (ILO, 2002).

Through dismissing the dualist notion that describes undeclared employment as comprising of survival activities in marginalised parts of society, ‘this by-product thesis represents the undeclared economy as a core and integral component of contemporary capitalism’ (Williams and Round, 2007: 428). Research carried out by this school in the 1970s and 1980s, has epitomised the extent to which subcontracting arrangements link declared and undeclared activities (Tokman, 1982). Challenging the early dualist interpretation, this school provides evidence that informality grows with, and depends on, urbanisation and industrial expansion; which are two markers of modernisation (Fernandez-Kelly, 2007).

‘Although rejecting the temporal sequencing of the residue thesis, however, the same normative hierarchical reading is maintained’ (Williams and Round, 2007: 428). The structuralist school still sees formalisation as the route to progress and considers only the negative impacts of undeclared work. Large firms compensate for costly tax and labour codes, through restricting the size of their ‘formal’ labour force and subcontracting to undeclared entrepreneurs (Beneria and Roldan, 1987). In support of this, Beneria (1989) presented several examples, describing the increasing competition of the subcontractors and the lengths they are willing to go, in order to obtain a subcontract. This creates a mechanism that contributes to political stability and economic viability of poorer nations. Governments sometimes ‘allow’ for undeclared work because of the social arbitrage created, and because often there is not enough work in the declared economy. Thus, according to this perspective, although undeclared activities may provide relief during downturns in the modern economy through cheaper labour and goods and service, it is this very functionality of undeclared activities that upholds the continuation of economic underdevelopment and political backwardness (Castells and Laserna, 1989).

Portes and Centeno (2006) believe that the determinants of the shape and size of the undeclared economy are that of the state’s ability to pass laws, as well as its capacity to enforce them. Furthermore, Portes and Centeno (2006) argue, that the benefits of the Latin American undeclared economy, are only compelling, due to the ineffectiveness of the state and stagnation of its economies. The advocates of this perspective thus argue that these supposed benefits would be irrelevant if conditions for modern development were created. Through generating more ‘good’ jobs, the state is persuading those in the undeclared economy to formalise. This view is epitomised through the ILO recommendations for formalisation (ILO, 2002b).

The ILO (2002b) explains that a much higher proportion of those working in the undeclared, relative to the declared economy, are poor. This statement adequately depicts the perspective undertaken by structuralist writers, and emphasises the negative view projected within the school of thought. The characteristics of those active in the undeclared economy are quite specific and can be considered under the general heading of downgraded labour (Sassen-Koob, 1984). The negative perspective of the undeclared is further portrayed through descriptions of working conditions. Those employed in the undeclared economy receive little legal or social protection security, are unable to enforce property rights and have no ability of enforcing contracts more generally (ILO, 2002). Formalisation is considered as the route to progress, due to the access to public infrastructure and benefits, rights at work, as well as social protection and the right to representation and voice. The employment of those in the undeclared economy is represented by a lack of stability and their incomes are considered to be low and irregular. Given that these actors are highly dependent on the attitudes of the public authorities, as well as strategies of large declared enterprises, it leaves them open for exploitation. This vulnerability is not random and depends upon certain social characteristics that allow companies to enforce their demands (Portes, 2001). Due to a lack of ‘voice’, these actors are unable to make their work recognised and protected. The ILO (2002) argues that this places undeclared workers at a competitive disadvantage, as it means that they are unable to exert the same influence as those in the declared economy. Indeed, this view is adopted throughout structuralist writing. Light and Bonacich (1991) highlight the occurrence of ‘disguised workers’ being exploited through indirect channels, emphasising the lack of protection of the government or trade unions. Formalisation is the key, as those in the undeclared economy ‘experience worse working conditions than those prevailing in the [declared] economy’ (Castells and Portes, 1989:26). As such, the work carried out in the undeclared sphere, is characterised by ‘sweatshop-like’ dependent employment. The workers engaged in such work are considered as unwilling actors engaging in exploitative global system out of necessity.

The dualist picture of exploited workers and bad working conditions has been disproven on a number of different levels. For example, the legalist perspective (considered below) shows that many self-employed individuals enter informality as a matter of choice, rather than a lack of options. As Jütting, Parlevliet and Xenogiani (2008) explain, individuals often make a considered choice about the sector and type of employment they want to engage with. Furthermore, according to Williams and Round (2008:316), ‘in Western economies, relatively affluent populations have been found to engage in paid undeclared work on a self-employed which is relatively well-paid and rewarding’.

Structuralist theories are evidently grounded in the class-based assumptions of neo-Marxist economic theories (Rakowski, 1994), which view capitalists as exploiting the poor in order to advance their personal well-being, both within and between states (Oatley, 2006). Through the eyes of structuralists, activity within the undeclared economy is often perceived as ‘petty commodity production’, a term referring to the small size of the undeclared activities, relative to their declared counterparts (Murphy, 1990). The view is one of a strong interdependence between the declared and undeclared sectors, in particular the dependency of the latter on its larger declared counterpart. It is recognised that there are varying degrees of subordination and exploitation within the individual relationships, however structuralists predict that independent producers will eventually fall victim to the domination of large firms (MacEwen and Scott, 1979).

As Williams and Round (2007:11) state, ‘support for this theory can be found not only when examining forms of undeclared waged employment such as envelope wages and sweatshop-like work, as well as routine self provisioning, but also when wider trends are recognized, such as the fact that participation in the undeclared economy is much greater among lower-income populations’. Envelope wages, namely the under-declaring of declared employees’ salaries, has been found to be more prevalent than originally anticipated, with evidence of significant existence within the EU as a whole. More focused research has also identified its particular pervasiveness in countries such as Estonia, Latvia, Lithuania (Meriküll and Staehr, 2010), Romania (Neef, 2002), Russia (Williams and Round, 2007) and Ukraine (Onoschenko and Williams, 2013) showing the appropriateness of the structuralist perspective. Furthermore, Beneria and Roldan (1987; cited by Fernandez-Kelly, 2006) explain that evidence is also found in small businesses that often turn to undeclared productive arrangements during times of financial crisis and describe how larger, as well as declared firms, occasionally utilise home workers to supplement production during periods of high demand. However, to represent all of the undeclared economy through this lens is a misnomer (Williams and Round, 2007).

Moving away from the characterisation of the working conditions and type of informality, support for the by-product perspective is also found when examining the role of the state. Williams (2013), in examining 27 EU member states, provides tentative support for the structuralist theorisation, that the undeclared economy is a consequence of the under-regulation of economies. Williams (ibid), examining spending on social protection benefits (as a percentage of GDP) and levels of state redistribution by social transfers, shows that higher levels of state intervention result in a decrease in the size of the undeclared economy. This gives support for the structuralist perspective of welfare state interventions, being positive in terms of reducing the undeclared economy. Meagher (2015), on the other hand, shows that inclusive initiatives in northern Nigeria, result in stronger actors crowding out those that are poorer and less educated, therefore furthering alienation. This shows that, although more state intervention might be necessary, policies have to be designed carefully to have the desired effect.

Due to its neo-Marxist foundations, structuralists see informality as linked to the poverty trap. The scholars blame the capitalist economic structure for this trap’s existence and undeclared employment in general (Murphy, 1990). However, there is an array of data contradicting this theory in supporting that informality is not merely a result of the capitalist system problems. Contradicting the view that socialist countries were characterised by relatively small undeclared sectors (in comparison to developed countries), Kornai (1993) and Lacko (1998) provide empirical evidence that shows its pervasiveness to be more widespread than in average market economies. Grossman (1982) adds substantially to the body of research on socialist countries by providing evidence of informality, particularly for the USSR. He shows the intricacies that characterise the manifestation of informality in such places by revealing the occurrence of the exchange of favours in the form of access to goods and services, as well as the private lucrative use of state property and corruption in the form of bribery. What is termed as *blat* in such a context, makes use of family ties and networking in commodity exchange and gift-giving. Ledeneva (1998:36) argues that such use of informal channels is an ‘enforced practice, necessitated by perpetual conditions of shortage’ and therefore does not have a direct analogy in the Western world. Rehn and Taalas (2004) argue that the use of blat adds elements of entrepreneurship into the Soviet life as well as dampens the shortcomings of a planned economy by injecting flexibility into a rigid system. The undeclared economy, therefore, plays a key role in such contexts. Schneider and Bajada (2005) also find significant undeclared activity in three Communist countries (China, Lao PDR and Vietnam). Kim (2005) also describes the presence of a large undeclared economy during the Communist period in Eastern Europe. Kornai (1993), Schneider (1997) and Lacko (1998) contribute important additional theoretical and empirical evidence, with regard the nature of undeclared work in former socialist countries. They observe that such undeclared activities, especially during the periods leading up to the transition, consist of higher proportions than countries representative of ‘average’ market economies. This, therefore, potentially calls into question the foundation of some of the arguments provided by the structuralist school. Although the structure of the capitalist system may be a determinant of the growth of the undeclared economy in some countries, it is not always a valid explanatory factor.

Peattie (1990) criticises the applicability of the structuralist approach to real life situations. She states that research should focus on the ‘real world’ for grounding policy action. Furthering this, she explains that this would involve investigation of institutions, instead of ‘the economy’, entrepreneurs and firms instead of ‘industries and sectors’, employers and workers with particular purposes and characteristics, instead of labour and labour markets, and the state would be just another actor to be studied. She argues that economic modelling and academic theorising, merely contribute to the ‘fuzziness’ of the undeclared economy concept (ibid). Many researchers support this, and the structuralist school is often criticised for not presenting an analysis of the undeclared economy as embedded in a socio-cultural context. From this perspective, structuralist theories provide us with only a partial explanation of the complex phenomenon being studied. Moreover, this criticism is true for all mono-causal explanations of the undeclared economy. This general approach conceals the complexity of phenomena, over-simplifies overlapping areas of interest and leads to abstract generalisations. Following this, the biggest criticism of structuralist views, is that studies in this field tend to focus on the relationship between large firms and small producers, therefore, missing out a wide array of undeclared actors (Moser, 1994). The legalist school, on the other hand, and as will now be shown, focuses on a different type of undeclared work.

## 2.3.4 Legalist school (Alternative perspective)

The legalist school, popularised by Hernando de Soto in the 1980s, subscribes to the notion, that informality is an entrepreneur’s logical response to over-regulation by the state (Rakowski, 1994). According to this neo-liberal perspective, the undeclared economy consists of micro-entrepreneurs who choose to operate on an undeclared basis, and in doing so avoid costs, time and effort associated with declared registration (de Soto, 1989). The approach includes broader economic issues, such as the functioning of the market, competitiveness, entrepreneurship and so forth (Rakowski, 1994:33). Since legalist scholars argue that cleavages are legal, bureaucratic and of the state’s making (ibid), they predict that the removal of such barriers, which compel businesses to evade government regulation, will allow those in the undeclared economy to formalise and excel the country’s economic growth. Reflecting the dualist school in this aspect, the undeclared and declared economies are often seen as separate and discrete (Williams and Round, 2007). However, inverting the hierarchical portrayal of declared and undeclared work in the previously described approaches, undeclared work is depicted as possessing positive attributes and impacts (ibid), rather than purely negative impacts, as with the dualist and structuralist perspectives.

Legalists believe that undeclared actors could propel competitive capitalist development forward, conditional on the state not interfering with the market, and eliminating the bureaucratic maze and costs associated with legalising business operations (de Soto, 1989). Undeclared actors help to reduce imports and indebtedness with provision of goods and services as well as construction of necessary infrastructure (ibid). They assert that some businesses are too small to endure the costs of formalising if state regulation is high, and that a move towards the free market would be beneficial. Over-regulation makes the declared economy more costly, making the switch to the undeclared sector relatively more attractive (Gerxhani, 2004). The degree of flexibility is often higher in the undeclared labour market (Renooy, 1990), making for more and wider employment opportunities. The undeclared economy is also characterised by ease of entry (Gerxhani, 2004), making it more appealing than the declared route. Many of the workers find more autonomy, flexibility and freedom in the undeclared sector, rather than the declared one.

This perspective, unlike the dualist or structuralist, therefore argues that informality has positive elements and that its engagement is a result of choice, rather than necessity (Cooper and May, 2012; Gerxhani, 2004; (Jütting, Parlevliet, and Xenogiani, 2008; Perry, 2007). Maloney (2004) suggests that individuals rationally choose undeclared employment over declared employment, through weighing up costs and benefits. Within this evaluation, considerations might be those such as job availability, as well as considering which realm and type of employment is more likely to result in job satisfaction (Jütting et al., 2008).

There are many examples of the legalist school (e.g. Dreher and Schneider, 2010; Friedman et al., 2000, Johnson et al., 1998). As cited in Gerxhani (2004), Johnson, Kaufmann and Zoido-Lobaton (1998) find that in certain countries of Latin America, the high level of undeclared activities can be explained by the high tax and regulatory burden, the weak rule of law, and a high level of corruption. Johnson et al. (1997) present empirical evidence, suggesting that higher levels of regulation do in fact lead to a greater undeclared sector.Furthermore, there is much support for this school of thought through there being a culture of resistance to immersion in the declared economy (Williams and Round, 2007). In many situations, undeclared work is viewed as a chosen alternative, as is depicted within the extensive hidden enterprise culture and off-the-books enterprise, and entrepreneurship being pursued as a widespread resistance practice to be perceived over-excessive regulation and state corruption (ibid). A wide range of literature recognises that a large proportion of informality, is characterised by a matter of choice (rather than lack of one) and is conducted on a self-employed basis (OECD, 2012; Williams and Nadin, 2012a; Williams et al., 2012; Williams, 2011, 2010; Neuwirth 2011; Williams and Round, 2010, 2008; de Soto 2001, 1989).

However, there is also evidence, that it is not always appropriate to apply the legalist approach to understand informality. Advocates of the approach argue that regulation and labour protection disadvantage small firms, and thus that the state favours large firms. According to de Soto (1989), informals are depicted as representing true democracy, through rebelling against state favouritism, and are not passive or in need of assistance programmes. This is, however, criticised by the structuralist researchers, such as Portes (1991) who argue that the elimination of state controls would remove the undeclared firm’s competitive advantage. Portes (1991) argues that small firms manage to survive, by taking advantage of state regulations that apply to large firms. According to this view, de-regulating policies would not result in the expansion of entrepreneurial activity and reduction in poverty as suggested by de Soto. This is because the removal of regulation and labour protection could hurt small firms by making large firms more agile and competitive, relative to the informals (Portes, 1991). As Jenkins (1988) describes, many of the most advantageous activities would no longer be profitable if markets were liberalised. Nonetheless, some structuralists acknowledge that more de-regulation and greater flexibility is necessary to allow firms to adapt to fluctuations in economic conditions. However, they argue that this should be combined with capital investment in the modern industrial sector that aims to reduce survival activities (Portes and Schauffler, 1993).

As a further criticism of the legalist school, Bromley (1990) describes that it overlooks the occurrence of inefficiency and bureaucratisation within advanced economies. As there is lower undeclared employment within developed countries, there is an indication of other factors influencing the existence and growth of the undeclared economy. Maloney (2004) discusses how the appeal of working informally and the reasons for choosing informality are markedly different for women compared to men, and for workers compared to owners. This implies that informality does not represent a choice for all workers, but a relatively privileged subset. Furthermore, Williams (2013), examining the 27 member states of the European Union, finds that only a small number of people attribute their own or other’s undeclared work, to be a consequence of too high taxes or burdensome levels. Akin to the findings of Maloney, it is however the case, that this explanation is more likely amongst certain population groups. In this instance, it is for example the East-Central Europeans, as well as men, whose informality is better explained by the legalist approach (Williams, 2013). Williams (2013) explains that no correlation between rates of taxes and the size of the undeclared realm was identified, and no relationship between informality and levels of state intervention in the economy. Furthermore, it was found that higher levels of state intervention (e.g. social protection), correlate with a decrease in the scale of undeclared work. Likic-Brboric et al. (2013) also state that recent research of former socialist countries within Central and Eastern Europe, indicates that deregulating the economy, results in more, rather than less, informalisation. This evidence, along with the criticism that the role of culture is minimised (D’Hernoncourt and Méon , 2012), therefore calls into question the overall applicability of the neo-liberal perspective in the context of Europe.

It therefore becomes evident that, whilst legalist views provide strong grounding for the position that informality is a result of over-regulation in certain situations, the assumption that this is the only factor of concern, is inadequate. Legalist theory, in isolation, leaves many aspects of the undeclared economy to be explained. It fails to consider the wider contextual environment, as well as non-monetary incentives; much like the dualist and structuralist schools. Rakowski (2004: 42)argues that ‘the importance of the work of de Soto and other legalists is that it draws attention away from characteristics of workers, activities and exclusively economic factors in development and toward the role of institutions, power and politics in development’.

## 2.3.5 Complementary perspective

As discussed above, none of the schools of thought so far discussed, take into consideration non-monetary benefits of involvement in the undeclared economy. Doing so, the final, and most emergent discourse, portrays the undeclared economy as possessing positive attributes and impacts, and views the declared and undeclared economies as inextricably interconnected (Williams and Round, 2007).

Gaughan and Fermand (1987) suggest that, depending on the type of social setting, undeclared economic activity often arises due to family or community needs, instead of financial benefits. However, due to its economic roots, much of undeclared economy literature applies the maximine principle: to maximise outputs, by mobilising all the means available and by organising them in the most efficient way; to minimise energy, expended to attain a given objective (Latouche, 1993: 134). Nonetheless, the ‘anthropological tradition that sees exchange mechanisms in advanced economies as less embedded, thinner, less loaded with social meaning and less symbolic than those in pre-industrial societies’ (Williams, 2004: 7), has been subjected to critical scrutiny. Thus, through the view of the undeclared economy being embedded within a socio-cultural context, the notion of the economic maximine principle can be rejected. Recognising this, a further approach is emerging, namely the complementary perspective that considers the non-monetary benefits of entering the undeclared economy (Williams, 2005). Although dualist, structuralist or legalist theories can be applied in certain contexts, the reality of undeclared work is more complex than these perspectives would suggest. The undeclared economy comprises a wide array of different forms of work, much of which, is neither primarily motivated by the need to avoid state regulation nor regarded as low-paid exploitative actions of marginalised individuals. In fact, quite the opposite is true, as nearly half is comprised of not-for-profit activity, motivated by social, rather than economic intentions. In recognition of this, a ‘thicker’ reading of undeclared work is emerging (ibid). As suggested by Leonard (1998), all this is part of an increasing recognition that economic activity is a far less straightforward and much more blurred and ambiguous category than often assumed.

Williams and Windebank (1998) argue that the complementary perspective, best explains the manifestation of informality in developed countries. As such, people engage in the undeclared economy with the motive of developing and maintaining their social networks. Furthermore, Levitan and Feldman (1991) find undeclared exchanges as being particularly common in households in rural settings, although they seemingly did not have dramatic influence on the economic contributions of such households. Instead, the networks developed within this realm, served as potential sources of economic support in times of hardship. The exchanges were, as such, more likely to exist in areas with stronger social networks. Symbolic and reciprocal underpinnings to exchanges are, however, also found in other contexts.

The importance of this perspective is clear, especially in understanding the nature of undeclared work for women and those within lower-income areas. Research within this perspective allows for a more socially, culturally and geographically embedded understanding of the nature of undeclared work (Williams, 2001). It draws important distinctions between different types of undeclared work, showing that not all types are conducted under market-like, profit-motivated conditions. There is a need for greater recognition of undeclared work serving as an activity that is predominantly a community-oriented form of paid mutual aid (Williams, 2005).

## 2.3.6 The nature of undeclared activity

The outlined schools of thought agree on certain characteristics of undeclared employment, including its small scale of operation, basic technology, and that informality is a way of organising production (Rakowski, 2004). All the perspectives subscribe to the notion that, in dealing with growing informalisation, the government has undertaken activities which may be considered contradictory or indecisive. This is illustrated through the government constructing policies that intend to result in a reduction of the undeclared economy, yet tolerating or even stimulating small firms in undertaking undeclared activities, as a way to resolve potential social conflicts or promote political patronage (ibid).

‘The sphere of the undeclared has, incontestably, a major economic significance. It is characterised by a neo-artisanal activity that generates a lot of employment and produces incomes comparable to those of the modern sector’ (Latouche, 1993: 134)**.** Latouche (1993) describes how, within economic literature, it is evident that all deviations from modern norms, are considered failures to conform to universal reason. However, more recently, undeclared economy researchers, have recognised the relative ‘success’ of undeclared enterprises and the phenomenon is being viewed in a more positive light (ibid). Both dualists and structuralists tend to associate undeclared actors with poverty, as described above. Hart (1973) discusses how, due to undeclared jobs often being characterised by exceedingly low wages, undeclared employment can lead to a vicious circle, trapping undeclared employees in a cycle of poverty. However, contradicting this, Hart - among other researchers - also identifies that the undeclared economy, can also serve as a platform for aspiring business owners to launch their businesses, which would then be formalised in later stages. The emergence of the legalist school, and therefore recognition that undeclared work is not always exploitative, leads to a questioning of whether greater attention needs to be paid to some of the undeclared economy’s more positive aspects (Williams, 2005). Ypeij (2000) argues that the negative view of the undeclared economy has been altered and undeclared activities are no longer purposeless, but productive and profitable. Studies are increasingly investigating the positive effect of the undeclared economy on a country’s growth rates, as well as its potential to reduce poverty. Bromley (1978) describes that the undeclared economy acts as an income redistributing force, in that it provides an unregulated, tax-free market for the relatively poor individuals. Vaknin (2000), outlining further positive features of informality, states that it injects foreign exchange into the economy and inadvertently increases the effective money supply and the resulting money aggregates. He, however, also points to the negative aspect of exploitation.

Researchers are also increasingly recognising the positive impact of undeclared activity on the declared and whole economy. For example, Schneider (1998) found that in Germany and Austria, at least two-thirds of the income earned, in what he terms shadow economy, is immediately spent in the declared economy, resulting in a considerable, positive stimulating effect on the declared economy. On the other hand, research also suggests that the undeclared economy is associated with slow economic growth. For example, Loayza (1996) claims that the undeclared economy causes tax revenue losses, which fund essential public services, whilst at the same time increasing the necessity of those very services. Studies such as this, which are especially prominent within Latin America, support their argument with findings, that there are strong negative correlations between the undeclared economy and economic growth. However, it can be concluded, that given an acceptable level of regulations, the undeclared economy can serve to propel economic growth. For example, Williams (2005a) finds that one third of undeclared individuals wanted to formalise. There are many difficulties attached to the notion of formalisation and those in the undeclared economy are often simply evading the burden of excessive taxes and regulation. In this context, they are not seen as contributing to the reasons for slow growth.

A subset of legalist scholars, view certain aspects of the undeclared economy as a springboard for integrating people into declared employment. Within this subset, the undeclared economy is viewed as merely the initial step in the process of formalising a business. The road to legitimacy through the declared economy is long causing individuals to enter it with cautiousness. The flexibility and ease of entry to the undeclared economy described above, provide the characteristics of a perfect setting for potential entrepreneurs to hold a trial run for their proposed businesses. This can be seen as temporary and a stage in the development of their enterprise, after which they may wish to eventually formalise. There is much empirical support for this, and Williams (2005) found that a third of those engaged in undeclared endeavour for the purpose of creating a business, view their participation in the undeclared economy as ‘getting ahead’ and ‘wanted’ to eventually formalise. There is a growing view that governments do not want to eradicate undeclared work, but also want to shift this work into the declared economy, in order to achieve better levels of employment. As informality in this case seems to serve as a kind of incubator, easing on the process of formalisation through government policy, whilst increasing incentives for entering the declared economy may be more desirable (ibid). Punishing undeclared businesses, when they may eventually formalise, seems imprudent.

As can be seen, whether the undeclared economy is positive or negative is highly subjective, as well as dependant on the context (e.g., the size and nature of the particular business as well as the type of work).

## 2.3.7 A contextual perspective

Within this thesis, I follow the route of the new context-bound approach towards the undeclared economy. As already touched upon above, within the criticism of the existing schools of thought, these are one-dimensional analyses of the undeclared economy. Whereas the structuralist approach sees informalisation originating in large firms’ attempts to evade costs, legalists see informalisation originating in small-scale entrepreneur’s efforts to avoid costs (Chen, 2004). However, there is the issue of a lack of real-world comprehensiveness of such mono-causal perspectives. As can be seen, legalists and structuralists define two different groups of activities (which consequently give rise to different policy recommendations). Given the heterogeneity of the undeclared economy, there is truth to aspects of both schools of thought. Economic relations and institutions are an integral part of the political, social and cultural contexts they exist within (Stilhoff Sorensen, 2006). Latouche (1993) depicts the undeclared as a form of social life. He describes its reinsertion of the economic within the larger social texture of life, which implies the need for a contextual approach. Cowell (1990) also observes that the nature of the undeclared economy, differs significantly among countries with different structures. Taking into consideration that the wider contextual environment affects the undeclared economy, creates a more holistic and intricate picture.

Due to its complex multi-causal origins, the undeclared economy encompasses a whole range of different forms of work (Williams, 2005) and thus each of the outlined perspectives, in isolation, are not sufficient to understand the nature of the undeclared economy. Gerxhani (2004) contends that there is still a strong focus on the cost and benefit calculations of entering the undeclared economy and little attention is given to the behaviour of individual agents. A limitation of such literature is that it overlooks the considerations that include the intersection of the social and political aspects. Viewing the undeclared economy as embedded in a socio-political and cultural context, however, allows us to develop a more holistic view to investigate further its complex and heterogeneous nature. According to Williams and Windebank (1998), the undeclared economy is characterised by a cocktail of explanatory factors. This cocktail is composed of a range of economic, social, institutional and environmental influences; including unemployment and affluence levels, social networks, local culture and regulatory regimes. This implies that the nature of undeclared employment, whether it is increasing or decreasing, the factors for its development, aims of employers and employees amongst other aspects, will differ in the context of time and space. It is unrealistic therefore, to consider that the development of undeclared work takes place according to a unique ‘logic’ and no one articulation can fully capture its diverse and multifarious nature (Williams and Round, 2007).

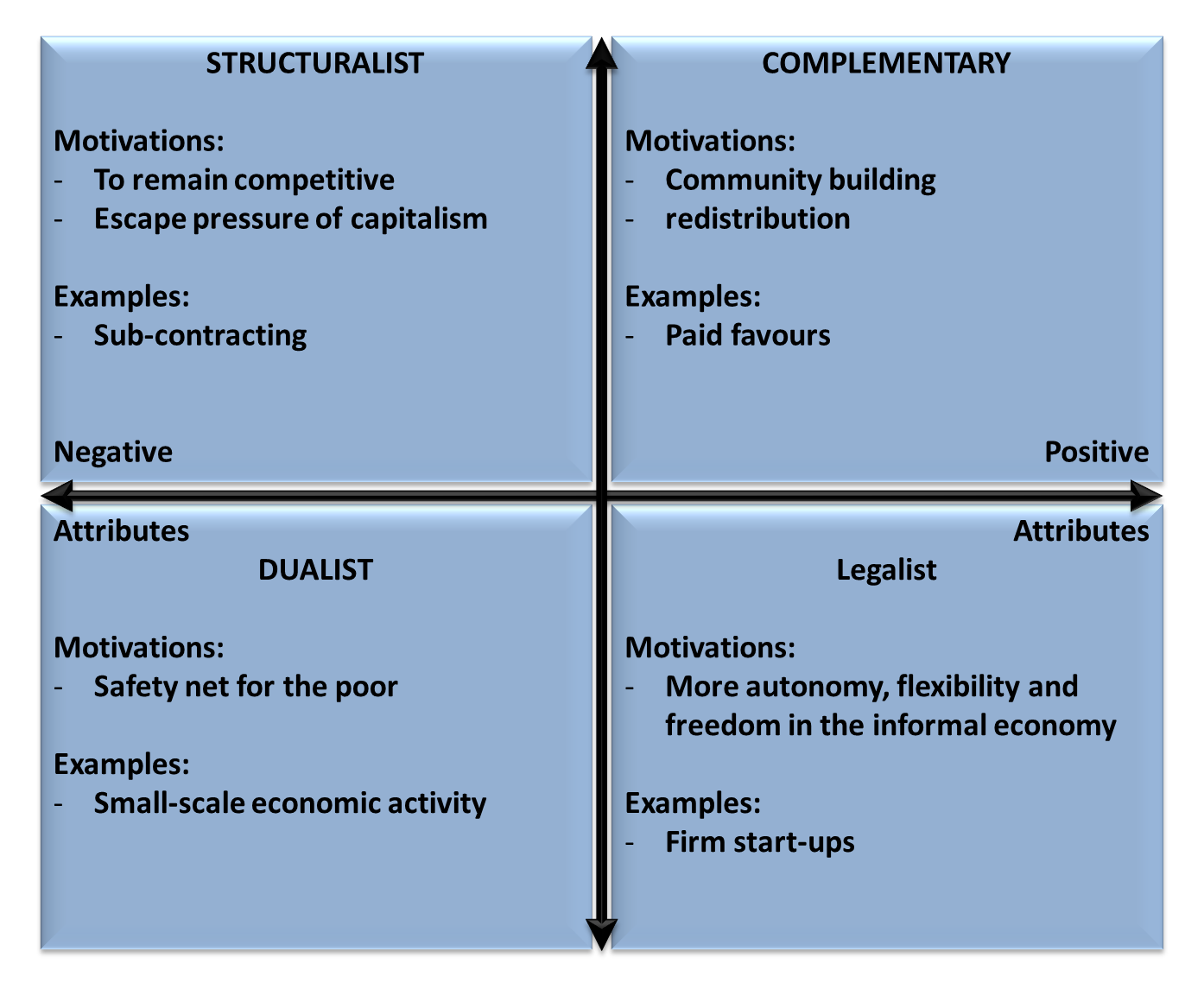
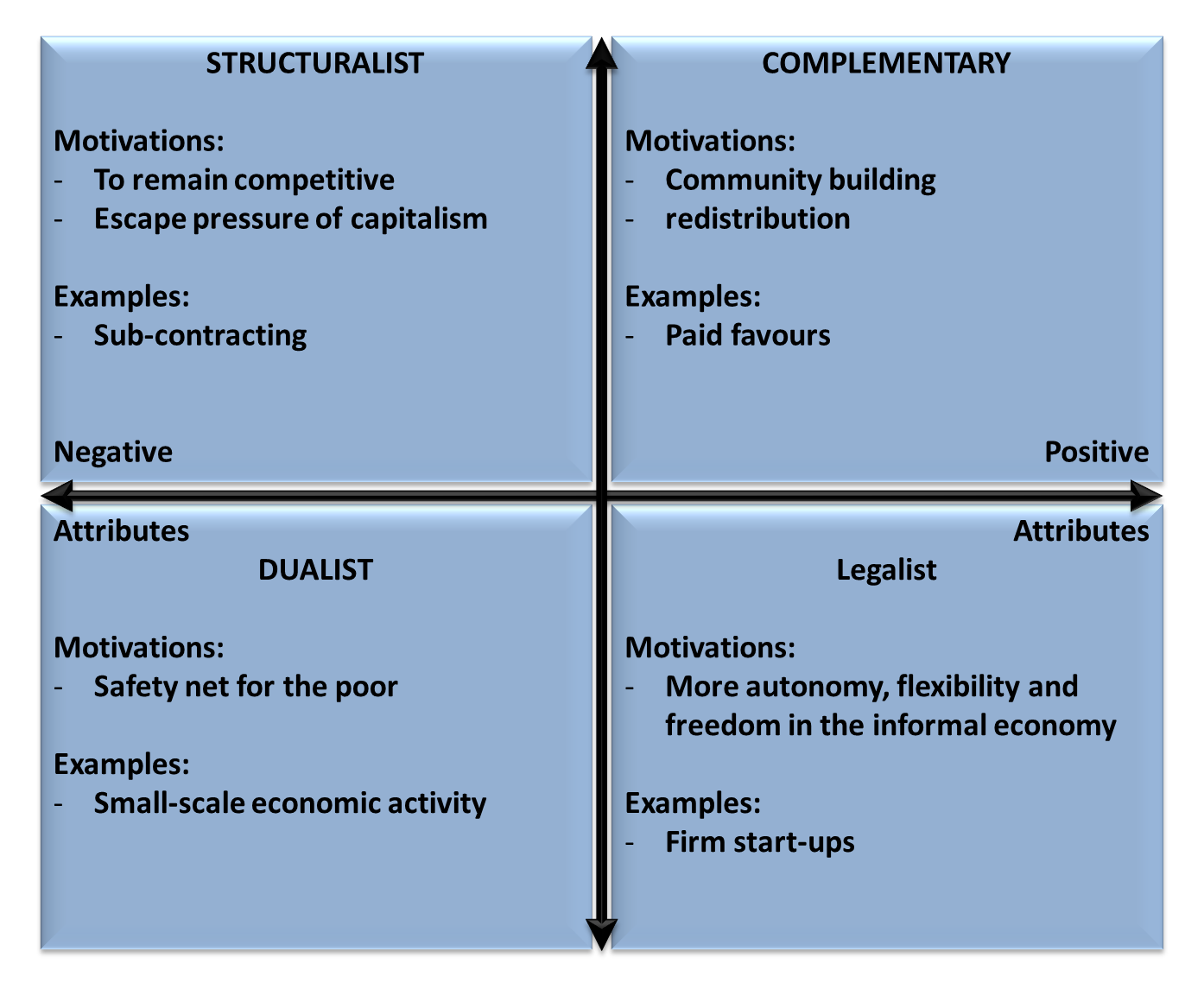
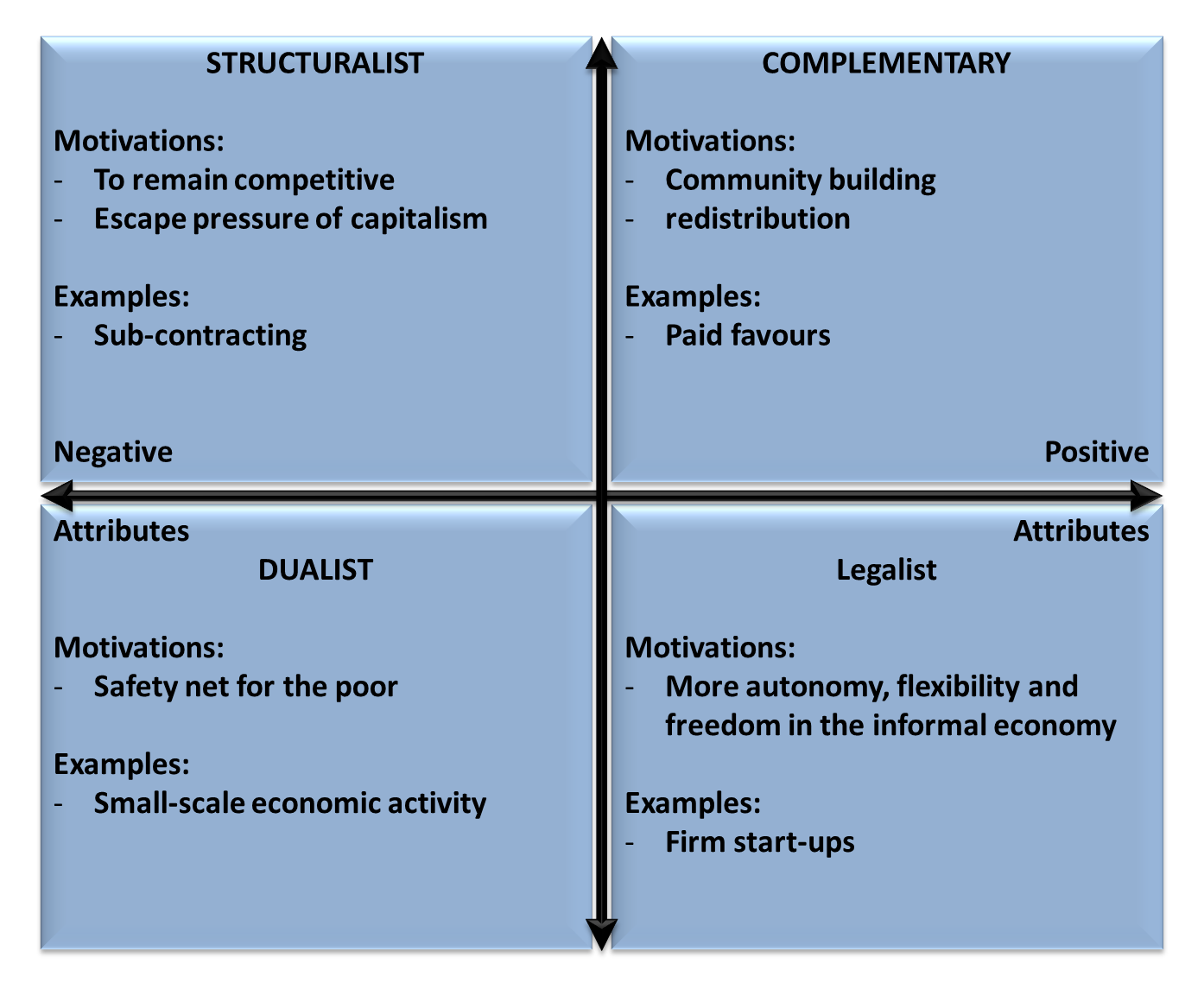
Chen (2004) also describes the need for an integrated approach that comprises appropriate elements of the different schools of thought, through looking at which aspects are the most appropriate to which segments of undeclared work and in what contexts. This would lead to a comprehensive framework that considers that the ties and power relations between the undeclared, declared and the public sector diverge, depending on the aspect of the undeclared economy being discussed. Chen et al. (2002) illustrate this through a practical example:

‘street vendors often have to vend informally either because they are not   
 incorporated in existing regulatory frameworks or because existing   
 regulatory frameworks are too punitive or constraining. That industrial   
 outworkers typically have little (if any) bargaining power with the   
 economic units or agents who put out work to them, especially when they   
 work in global commodity chains that place a great distance between lead   
 firms and their workers. And that self-employed, particularly home-  
 based, producers typically have limited market knowledge, market access,   
 or bargaining power compared to large manufacturers, especially in the   
 competition for emerging global markets.’ (Chen et al., 2002: 15).

Incorporating the competing discourses, and recognising that each is a depiction of particular types of undeclared work, leads to a more comprehensive understanding of the complex nature of the undeclared economy (Williams and Round, 2007). As can be seen, although much literature recognises that there is a need for an integrated approach, the research doing so is scant. Williams and Round (2007: 200), taking this stance of contextual analysis, investigate four perspectives of the undeclared economy in relation to informality in Ukraine. They argue that ‘Depending on the types of [undeclared] work and populations studied, different representations of the [undeclared] economy are appropriate’. The outlined representations are that of: the undeclared economy as a residue which corresponds to the thinking of the dualist school; the undeclared economy as a by-product of the declared economy as a reflection of the structuralist school; the undeclared economy as an alternative to the declared economy, which encompasses legalist thinking, and the undeclared economy as a complement to the declared economy.They argue that there is a diverse array of types of undeclared work and that for various types, a different representation of the undeclared economy could be suitable. For example, for the spectrum of forms of undeclared self-employment, they find substantial support for the representation of undeclared work as a positive alternative to the declared economy and resistance practice. On the other hand, when undeclared waged employment is analysed, the by-product representation of the undeclared economy explains the situation better, and where paid favours for friends, neighbours and kin are considered, they find support for the complementary representation of undeclared work. The study thus finds support for all of the outlined representations of undeclared work and concludes that universal generalisations regarding undeclared work are not possible; further recognising the need for an integrated approach.

Encompassing the outlined arguments, a framework taking into consideration all four schools of thought will be used in this thesis and is summarised in Figure 2.3. The use of this matrix allows the recognition, that not only is the undeclared economy heterogeneous, but also that some of the work undertaken is underlined by non-monetary benefits that quite closely parallel mutual aid.

Figure 2.3: Contextual perspective matrix



**DUALIST**

**LEGALIST**

2.3.9 The need for further developments of the framework

However, in splitting the activities of undeclared work into such categories to explain them, it is necessary to be aware of certain limitations. The matrix should not be seen as composed of mutually exclusive categories. The boundaries between certain activities will be blurred and there can be some that encompass the characteristics of more than one school of thought. This is why it is important to explore the nature of each activity, with an approach that focuses on some underlying issues, rather than the type of activity. In this thesis, importance is placed on analysing the perspectives of those engaged within the undeclared economy, rather than making judgments based on macro data. It is therefore imperative to distinguish where the individuals would position themselves in the matrix. However, it is also necessary to recognise that one person can have some relationships that are captured by, for example, the legalist perspective, but also, others that fall under the complementary perspective. Due to such complexities, it is important to consider underlying themes that might run across all categories. If, on the one hand, an individual is engaging in undeclared work as a matter of choice, it is therefore their underlying willingness that should be the focus of the research. This ‘tax morale’ is defined as ‘an individual’s intrinsic willingness to pay taxes’ (Alm and Torgler, 2006: 224). If, on the other hand, a person works on an undeclared basis, due to a lack of choice, the point of interest should become the institutional settings that gave rise to this activity.

It is therefore clear that, despite the usefulness of the described matrix in characterising undeclared work, and as such, enabling better-designed policy measures, it fails to fully encompass socio-cultural factors, by its lack of emphasis on institutions and tax morale. As such, although activities can be classified using this framework, a framework that seeks to gain greater depth of individual (rather than categorical) decision making processes, will be developed in the next chapter. The next section therefore focuses on developing an integrative theoretical basis, using social exchange theory, on the basis of literature that is related to tax morale, and on which this broader conceptual framework can be developed, to explain participation in undeclared work.

# 2.4 Social exchange theory: Introducing the framework **2.4.1 Introduction**

To develop a more context-bound understanding of undeclared work, the argument of this thesis is that social exchange theory provides a useful conceptual lens for doing so. In this section, social exchange theory is introduced and how it can be applied to understanding participation in the undeclared economy. To do this, firstly, the rationale for studying undeclared work through the lens of social exchange theory is presented, and second, the current use of social exchange theory.

This is then followed in section 2.5 by a review of the contrasting perspectives that exist regarding social exchange theory, while section 2.6 reviews the underlying concepts and section 2.7 sets out the elements of the model used to explain participation in undeclared work. In order to do so, this will set out two distinct, but inherently related relationships, namely the relationship between the government and citizens (i.e., the vertical relationship) and the relations amongst the citizens themselves (i.e., the horizontal relations). For each type of relationship, the regulatory nature of relationship is explored through issues such as power, trust, reciprocity and norms. The net outcome will be a new context-bound perspective to explain participation in undeclared work, which is grounded in social exchange theory and which provides a multilevel conceptualisation of social exchange that draws upon social psychology, classical sociology and anthropology. This thesis, therefore, not only applies social exchange theory to understand undeclared work, but in doing so, also seeks to advance social exchange theory itself, by creating a more integrated approach to the understanding of social exchange than is currently the case.

## 2.4.2 Rationale for use of social exchange theory

The rationale for using social exchange theory (SET) to investigate undeclared work is two-fold. Firstly, this framework allows a focus upon the relationship between the government authorities and citizens, which it will be argued is crucial to understanding the motives underpinning engagement in undeclared work. Second, it enables the exchange relations between the undeclared actors themselves to be studied, to provide insights into both individual decision-making, as well as the broader macro processes, such as the influence of societal rules and norms.

By using the SET framework to analyse these relationships, the argument is, that greater understanding is achieved as to why people operate in the undeclared economy. A social exchange relationship implies duties and rights on each side (Feld, 2007). The government should provide public goods and services to the citizens, in exchange for their commitment to fully operating in the declared economy. However, this relationship needs to be framed in a broader function, reaching beyond simple exchanges of public goods and services for the declaration of work, in that issues such as fairness, trust and power, arise as potential determinants of whether work is declared by citizens.

The SET framework also enables an investigation of the way exchange relations are formed between undeclared actors. Castells and Portes (1989: 2) provide a definition of the undeclared economy that characterises the activity within this sphere, as ‘unregulated by the institutions of society, in a legal and social environment in which similar activities are regulated’. This definition, however, ignores that the increasingly accepted notion that undeclared work, like any other activity, is embedded within a socio-cultural context and is regulated by social norms, values and beliefs; whether it be by individualist or collectivist interpretations of rules and norms.

Whilst recognising the criticisms of some variants of social exchange theory, it will be argued that this is no reason to reject SET as a means to explain the complexities of undeclared work. As will be shown below, by tracing the problems of SET back to their roots, and also introducing an anthropological/sociological lens, allows the inclusion of contextual analysis, macro structures, a multiple party perspective, a broadening of the meaning of (as well as nature of) contents exchanged, and the expansion of rules and norms operating within the exchange. The view adopted will be that exchange should be conceptualised along a continuum, in which, wholly social exchange is at one end of the spectrum and wholly economic exchange at the other end. Below, therefore, the ways in which this thesis advances SET are explicated.

# 2.5 Social exchange theory: Reconceptualising the framework

## 2.5.1 Origins of social exchange theory and schools of thought

The theoretical underpinnings of SET can be traced back as far as the 1920s (e.g. Malinowski, 1992), although different variants of social exchange have emerged, rooted in disciplines such as anthropology (e.g. Mauss, 1925; Firth, 1967), sociology (e.g. Levi-Strauss, 1949), economics (e.g. Blau, 1964; Emerson, 1976) and psychology (Homans, 1958), as well as interdisciplinary representations (e.g. Collett, 2011; Cropanzano and Mitchell, 2005; Zafirovski, 2005).

As Cropanzano and Mitchell (2005:875) state, the ‘difficulties facing SET are systemic: the core ideas that comprise SET have yet to be adequately articulated and integrated’. Although there is widespread support for focusing upon social exchange as a framework, how to do this is currently ridden with theoretical ambiguities and methodological problems (Coyle-Shapiro and Conway, 2004). This is in part due to the narrow focus adopted, which often concentrates on strict contribution-inducement exchanges measured through correlations. Given that it is often argued that social exchange remains theoretically underdeveloped, calls have been also made for a more integrated, multi-level framework (Cropanzano and Mitchell, 2005). Indeed, the utilitarian (i.e., rational economic actor) and individualistic nature of SET is the most criticised aspect of its approach. Reflecting this view, that SET has its origins in socio-psychological and rational choice views of exchange, figures such as Homans, Thibaut, Kelley, and Blau are often cited as being largely responsible for the emergence of social exchange theory (e.g. Emerson, 1962). The emphasis on the self-interest of actors engaged in social exchange, displays a disregard for altruism and emotion, as well as the influence of the context the actors find themselves in.

Broadly speaking, the theorising of SET can be separated into two approaches. Ekeh (1974) describes the on-going polemic between individualist (e.g. Comte, Spencer) and collectivist (e.g. Durkheim) schools of thought within sociology, which is mirrored in the development of SET. Although researchers such as Blau (1964) attempted an eclectic approach, Ekeh (1974) argues that Blau’s theory is largely individualistic in its assumptions. Although both schools of thought have contributed to the development of modern SET, it is nonetheless clear that the basic principles of SET are founded largely upon a narrow individualistic view of self-interested actors. This has clear limitations for fully understanding exchange, as will now be shown. Therefore researchers such as Collett (2011) and Zafirovski (2005), argue that there needs to be a better incorporation of sociological interpretations in social exchange theoretical frameworks.

## 2.5.2 Dominant conceptualisation of SET: Utilitarian theorisations

Social exchange theory, in its utilitarian form, was conceptualised by Homans to explain relationships between individuals (Homans, Hamblin and Kunkel, 1997). Central to his ‘individual self-interest theory’ (1955: 15) are the combination of economic and psychological needs. Within his conceptualisation of social exchange, emphasis lies with universal motivations of actors as the springboard for action. Such an approach clearly dismisses the influence of society and context. In sharp contrast to Levi-Strauss’ (1949) and Mauss’ (1925) representations of social exchange, Homans (1955) indicates that the purpose of social exchange is of a utilitarian nature, driven by psychological needs. Whilst adopting similar underlying assumptions as Homans (1965), Blau (1964) progresses to dealing with more complex situations beyond direct dyad relationships.

With roots in both behavioural psychology and rational choice theory, Homans’ social exchange theory posits that individuals view interaction in a purely rational way, much akin to rational economic actors in classic economic theory. It is suggested that an individual’s analysis of costs and benefits, are tied to their experience of past relationships (Homans, 1965) and anticipated future outcomes (Blau, 1964). The theory is often applied as a framework, to understand why individuals are motivated to continue or end relationships and used to examine how such relationships develop and change over time. It is in this sense that we can view the interaction between each individual and the government as a social exchange relationship. The individual, on their part, declare their earnings, therefore, providing the government with compliance to regulations and money through taxation, and in return, the government provides security and support, as well as public goods and services. Thus, reciprocity and mutual dependency are inherent to the relationship. However, if the individual was truly utilitarian, they would only engage in the declared economy if the benefits of informality were lower than the expected costs of detection. This explanation however, fails to explain the fact that, in some countries with low deterrence measures, there are higher levels of compliance (Alm et al., 2006; Richardson et al., 2006; Torgler, 2007). Through a micro-perspective of relationship formation, Homans speculates how an individual’s history of the consequences of a behaviour, impacts on the nature of their current behaviour. Relevant examples would be consequences of having been detected and punished by the government, knowing personally that others have been caught, or on the other side of the spectrum, having experienced positive benefits of engaging in the declared economy, such as protection at work. He theorised that once an initial relationship is formed, the rewards received serve as a basis of building and amplifying bonds, whereas, insufficient rewards cause the relationship to weaken and eventually end (Ritzer, 2008). Such bonds created between individuals and the state shape individual tax morale, therefore affecting tax compliance positively (Feld and Frey, 2007).

Blau (1964) states that the purpose of each exchange is to maximise benefits and minimize costs. Taking such conditions into consideration, it can be theorised that the individual actor will weigh up the costs and benefits of operating on a undeclared and declared basis, and choose the most rewarding option. Looking at the relations between the actors, it can be concluded that each exchange between them is more rewarding (in terms of monetary gain) if carried out informally. However, each actor will also weigh up the costs of being caught (i.e. action taken by the government) and other benefits of being formal (e.g. employee rights and representations), based on previous experience. According to this, individuals are less likely to operate informally if they have been caught (and punished) previously, or if they know someone that has. Taking all of the propositions into consideration, it is evident that social exchange theory is based on the assumption that an individual is a rational profit-seeker.

Indeed, it is argued by Rhoades, Eisenberger and Armeli (2001) that individuals build relationships with others who can give them needed resources, and in exchange for resources, individuals exhibit commitment (Rhoades, Eisenberger and Armeli, 2001).This further supports the argument, that if the use of fiscal policy by the government is perceived to be efficient and provides needed resources, the individuals will exhibit commitment. Given that commitment can be directly linked to citizen duty (Kirchler, 2007), the decision to operate in the declared economy will become prevalent. However, as criticised by Coyle-Shapiro and Conway (2004), one of the most prominent limitations of modern social exchange theory, is that of reductionism. Certain aspects of human behaviour cannot be reduced to behavioural psychology or elementary rational choice economics. As is evident, many such reductionist elements have been adopted by the modern conceptualisation of SET, and are therefore unable to explain a wide variety of social exchange activities.

Although Homans’ approach to psychology has fluctuated through his work, the influence of Skinner’s behavioural psychology in arguing against Durkheim’s ideas, solidified in his social exchange theorisations. Such a perspective assumes that the laws of behavioural psychology, derived from *animal* behaviour, can explain *human* behaviour. As Homans states ‘not only shall we adapt the propositions of individual behaviour to the social situation, but propositions about pigeons to the human situation’ (1973:31), he contends the notion, that behaviour is distinctively human and exclusive to people, does not exist. White (1949), on the other hand, argues that, whereas conditioned behaviour is common to humans and animals, symbolic behaviour is ‘the universe of humanity’ (1949:22) and is outside the reach of animal behaviour. Analysing Homans’ theory through the lens of such ideals, leads to the conclusion that the manner in which he frames social exchange, provides us with an understanding of only certain behaviour, namely those that are learned through rewards and punishments of past experiences. However, this results in a wide range of symbolic and institution driven behaviour left unexplained.   
Blau presents a more complex model of social exchange, through advocating the importance of relationships in social life, mediated by friendship, status and the division of labour. However, the view of social exchange that is adopted, is that of emergent properties with the theoretical argument resting on reinforcement ideas. Thus Blau, admittedly, takes on the same starting position as Homans and Thibault and Kelley (1978). Blau’s interpretation of human nature is epitomised through the statement that ‘there are, to be sure, some individuals who selflessly work for others, without any thought of reward and without even expecting gratitude, but they are virtually saints, and saints are rare’ (Blau, 1964). Following his argument, altruism may be encountered infrequently, but psychological hedonism would be an overly simplistic general explanation of behaviour.

The psychological assumptions of such exchange theories, construct a universal model of human nature in the image of a rational egoist or optimising agent. This presents a controversy around the extent to which social exchanges can be explained, solely by principles derived from individual psychology. A difficulty with utilitarian models, is that over-rational actors can be reduced to irrational subjects, as undoubtedly ‘hyper-rationality [is] irrationality’ (Elster, 1989:9). This is representative of homo economicus, often criticised because humans have a ‘hard time doing what homo economicus does so easily: [rationalising and optimising]’ (Blinder, 1997: 9). The inclusion of aspects such as ‘utility seeking’ within individualist conceptualisations of social exchange, reflects the derivation of the theory’s key assumptions, as corresponding to those established in conventional rational choice economics. Despite distinctions being made from economic transactions such as the inclusion of intangible and non-material goods, the theories are based largely around economic frameworks. This is exemplified by Emerson (1976), who argues that the laws of supply and demand and other microeconomic features are operative in social exchanges. Blau concurs in stating that ‘the principle of marginal utility, for instance, applies to non-economic situations just as economic exchange’ (Blau, 1994:158-159). Following a deductive approach, Homans (1961) argues that elementary economics must be extrapolated to men and to social situations, so as to coincide aspects of social life, such as imperfect information. Homans fails to outline this process of extrapolation. Abrahamsson (1970:284) criticises this, as he comments on the theory’s ‘absence of inductive and deductive clarity’. The logical adequacy of Homans’ theory is examined by Maris (1970) who states that ‘major premises and conclusions are presented, without an indication as to how the two are related. The book abounds in suppressed premises and incomplete arguments’ (Maris, 1970: 1075). Chadwick-Jones (1976) however, states that even though the deductive steps are not formally presented, closer examination ascertains that the necessary corollaries can be found in Homans’ exposition.

Although Homans (1962) acknowledges intangible benefits and Blau maintains that considerations of exchange in a variety of forms are important for all social mediated goals, the underlying principles render their approaches mono-causal. Exchange behaviour covers a very wide substantive content, such that it may be ‘oriented to the pursuit of ultimate values rather than to the pursuit of immediate rewards’ (Blau, 1964: 5). Although this takes into consideration a forward thinking actor, unlike Homans, whose operationalisation of goals is based merely on previous experiences, the definitive driving force is individual self-interest.

Further portraying the reductionist nature of social exchange models, based on elementary rational choice ideas, it can be argued that, utilitarian approaches ‘are in fact stimulus-response theories because they explain behaviour on the basis of knowledge of individuals’ external circumstances (price, income, etc.)’ (Smelser, 1997:13-14). Moreover, the propositions outlined by utilitarian theories, are also psychological and not sociological in nature. However rational choice theorists, such as Coleman (1990), strongly reject such an interpretation. The reason for depending on the assumptions of individual psychology ‘that there are no general sociological propositions…that hold good for all societies or social groups…[and that] the only general propositions of sociology are in fact psychological (Hamilton, 1964: 817).

Social exchange theory as formulated by Homans and Blau, assumes that an appraisal of goods exchanged is conducted, and the most desirable outcome chosen. This is epitomised through the contention that ‘an individual is attracted to another if he expects associating with him [sic] to be in some way rewarding for himself [sic], and his interest in the expected social rewards draws him [sic] to the other’ (Blau, 1964:19). Conversely, in reality, actors are not always rational and may not choose the outcome that yields the highest utility. Examples lie within symbolic exchange, and in such cases, determining an accurate value is neither feasible nor sensible (Levi-Strauss, 1949). In the case of undeclared work, even though money is exchanged, in certain cases, the ‘value’ might lie beyond monetary gain. For example, the receiver might value the gesture itself or the relationship gained, as well as a combination of these. The choice of ‘who’ the exchange happens with might not be a rational calculation, as for example, an actor might get work carried out by a friend, rather than looking for a supplier able to quote the lowest price. Likewise, the friend might charge less than the market price, not because it is undeclared, but to forge or strengthen a relationship.

Blau emphasises the part played by social approval as a prized reward from others. He notes, that while social disapproval effectively deters persons from certain conduct, there are many subtleties in the expression of this. For example, Blau (1964: 17) comments that: ‘the social approval of those whose opinions we value is of great significance to us, but its significance depends on its being genuine’. Unlike material rewards in economic exchange, social approval is a basic reward of social interactions and cannot be achieved by a selfish disregard for others. As such, “seeking approbation” discredits the egotistic behaviour advocated by utilitarian theorists. Through his perspective, exchange is underpinned by the rational pursuit of reward, although social exchanges, with their satisfying experience are the key reward, compared to which, material gains are incidental. Indeed, the drive for such relationships, such as the ‘pleasure of socialising’, governs social exchange for their own sake, rather than merely for the material benefits that arise. However, such motivations are difficult to measure, due to the paradox associated with ‘altruistic’ intentions, where such acts do generally cause a positive return.

Homans’ (1955) conceptualisation of social exchange differentiates patterns of behaviour of social institutions from individual motivations. He states that ‘an institution is what it is because it results from the drivers or meets the immediate needs, of individuals or subgroups within a society’ (Homans and Schneider, 1955:15). Through this viewpoint, Homans clearly disregards the influence of society on the individual, but rather conforms to Spencer’s (1898) argument, that society is shaped by the behaviour of individuals, which is ultimately, at least according to Homans, based on their psychological and economic needs. However, this ignores Durkheim’s perspective, that ‘sociology is not a corollary of psychology’ (1927:125). The argument of this anthropological view (Durkheim), is that a person becomes a product of their own society and this is evident, in that there are large variations in behaviour between cultures. The intervention of society in individual life is the underlying philosophy of conceptualisations of SET that adhere to this anthropological/sociological school of thought (e.g. Mauss and Levi-Strauss as will be described in the forthcoming chapter). Although Blau (1964) raises the question of whether social exchange relations are culture-bound, this is not taken further within the operationalisation of the model, thus taking on an individualist view of society.

Given that Homans sees no difference in the behaviour of dyads and that of collectives, it is believed, that once individual behaviour is explained, no new propositions are needed to illuminate social behaviour. However, when faced with a social situation, individuals often do what is good for the society, rather than being motivated by their personal gain. As Schwartz (1970) argues, individuals have a sense of fairness and duty, out of which they forego the act of free-riding. ‘People often behave altruistically and pro-socially, contributing to the welfare of others without apparent compensation (Wasko and Faraj, 2000:162). Although Blau (1964) develops the theory towards more complex social structures, he adopts the same deductive approach in believing that the most complex aspects of social structure, are to be explained by working from the basic social process between individuals, and are ultimately rooted in primitive psychological processes. One of the deeper insights in Blau’s (1964) social exchange theory is his recognition that Simmel saw a qualitative difference between the operation of dyads and that of larger groups. However, in spite of this recognition on an abstract basis, Blau does not incorporate the implications of it into his theory and reverts back to dyadic exchange (Ekeh, 1974). This leads one to conclude, that although Blau recognises that society influences the individual, his deductive approach is not adequate to deal with collectives. Therefore, it is because the utilitarian theories see no generic difference between individual and social behaviour that they are deficient in allowing for contextual analysis.

Although network theories of social exchange have been developed by figures such as Cook and Emerson, these are based on individualist assumptions and deal with multiple dyadic exchanges, rather than recognising relationships beyond dyads. As is brought up by critics, utilitarian models disregard macro variables such as structures and institutions, reconstructing them on psychological grounds, rendering the framework constricted in scope (Willer et al., 1989). From such a utilitarian perspective, the theory is framed in terms of variables, and provides an explicit plan to investigate concretely, why given individuals act as they do (Singelmann, 1972). However, it can be argued, that rather than ‘why’, the theory merely extrapolates the ‘how’ of the situation. The widely applied quantitative approach within this utilitarian school of thought yields a good predictability value and is able to, for example, portray the behaviours exhibited by different types of relationships. However, some of the depth of the meaning behind such behaviour, that an anthropological/sociological approach would provide, is lost. This therefore calls for a combination of the two approaches.

Utilitarian interpretations propose a single class of explanatory variables for motivations of social exchange, the basis of which are self-interest pursuits. Such mono-causal, reductionist models seem inappropriate tools for enlightening a multivariate, heterogeneous phenomenon, such as undeclared work. Due to their inability to provide explanations for a wide variety of situations, such models are methodologically insufficient. As is evident, utilitarian representations of social exchange theory, limit the exchange actor to rational calculations, self-interest motivations and pseudo-market exchanges. This utilitarian school of thought neglects the classical anthropological/sociological viewpoints, rendering it incomplete through disregard of alternative motivations, and the influence of context and symbolic interaction. According to this utilitarian perspective, the undeclared work activities would be governed by such individualistic motivations. For example, reciprocity would occur with the individuals who allow the actor to achieve the highest utility and if the relationship was no longer beneficial, it would be terminated.

## 2.5.3 An alternative SET perspective: Anthropological/Sociological theorisations

The following section discusses an alternative account of social exchange theory and the relevance of this alternative perspective to explain behaviour within the undeclared economy. Social exchange theories, developed from an anthropological/sociological perspective, draw upon the classical insights of the works of Durkheim, Weber, Marx and Simmel, amongst others. Durkheim famously attacked utilitarian economic assumptions in sociology, as well as the introduction of psychological variables into sociological explanation (Ekeh, 1974). Instead, emphasis is placed on ‘complicating’ (Hirschman, 1984) rather than simplifying exchange relations. Thus, the macro-social underpinnings of micro-level behaviours are stressed (Blau, 1994), as well as the overall co-determination between structure and agency. Complex human social relations become viewed as commodified, when methodological concepts consistent with utilitarian approaches (such as risks, investment, opportunity cost and utility maximisation) are applied in a forthright manner. A limitation of this is the comparative disregard of contextual issues as well as cross-cultural variations in the norms and rules that govern exchange relations. However, the studies of social exchange within anthropology have an advantage in this respect (Cook, 2000).

As mentioned, the dominant utilitarian conceptualisation of exchange theory has shed little light on why many behaviour patterns in human groups, appear manifestly unrewarding to an observer (Singelmann, 1972). Thus, exchange often continues, despite the imbalance described by rational and calculating perspectives. In order to explain such behaviour, it is important to explore and understand the subjective meaningfulness of human action. Abrahamsson (1970) indicates that understanding and predicting human behaviour, requires an understanding of the experience and interpretations of the actors. Especially Homans’ behaviourist approach does not suggest that human behaviour is subjectively meaningful and that there are multiple dimensions along which behaviours can be meaningful for actors. These dimensions have ‘logical’ as well as ‘non-logical’ aspects, but they all provide the framework in which behaviour is motivated (Pareto, 1966). Such an understanding of behaviour is feasible through the incorporation of a classical anthropological/sociological approach within SET.

As Weber (1947) asserts, in order to explain social behaviour, sociology must encompass the subjective motivations of actors. Through this lens, the subjective experience must be approached with a methodological tool, termed ‘verstehen’, implying that the understanding of the actor’s own interpretations is central to understanding of exchange processes. From this, we can conclude that importance lies in the way individuals view the government provisions within the exchange relationship, rather than the objective provisions themselves. Furthering this, Kirchler (2007) advocates for the importance to investigate the subjective tax knowledge, as this has high significance in determining why people behave as they do. Moscovici (2001) states that we should focus on what knowledge people have of the tax law and the government, regardless of whether this knowledge is correct or not. People’s behaviour intentions, judgements and attitudes, are more affected by what they think, than what actually is (Lewis, 1978). It is, therefore, what Moscovici (1961, 2001) coined as, social representations that shape behaviour. Derived from Durkheim, Moscovici’s (1961/1976) theories offer explanations of the effect of attitudes, values and norms, stereotypes, myths and ideologies on behaviour. Although it is individuals that hold social representations, the social representations themselves emphasise the shared social construction process and the effect of society on the individual. Schmölders (1960) also discusses similar concepts, defined as tax morale. His work focuses on socially shared concepts, evaluations, norms and opportunities to comply or not comply and fairness considerations. Such tax morale is perceived to operate at the collective level. As tax laws are criticised as being too complex for comprehension by ordinary taxpayers, the representations and evaluations that arise, are mainly products of myth and misperceptions (Kirchler, 2007). Focus should thus rest with how people perceive the government, as a regulator or a facilitator, and not necessarily purely on what the government actually does.

Malinowski (1922) is often recognised as the first social scientist to draw a distinction between economic and social exchange, through arguing that in ‘ceremonial exchange’, the items traded have symbolic, rather than economic value. In such cases, it is the relationships that are central, regardless of the material benefits that arise. Durkheim’s polemics against utilitarian economic assumptions and psychological reductionism in social explanation are directly reflected in the development of Levi-Strauss’ (1969) social exchange theory. Contesting the notion that social exchange is deductive in nature, he constructs a model, where the items of exchange are culturally defined. Characterised by their symbolic extrinsic value, rather than their economic intrinsic value, social exchange is not envisaged from the economic viewpoint, as it is the act that is important, rather than the materials exchanged (ibid). At any rate, ‘the exchange relationship comes before the things exchanged, and is independent of them. If the goods considered in isolation are identical, they cease to be so when assigned their proper place in the structure of reciprocity’ (Levi-Strauss, 1969:139). As is stressed by Simmel (1978), even material exchanges in the market are not solely economic, as described in orthodox economics. He further argues that even economic phenomena become the subject of sociological analyses, investigating its ‘preconditions in non-economic concepts and facts and its consequences for non-economic values and relationships (1978: 55). Boudon (1996) concludes that social exchange is not reducible to market forms on the underlying premise that it is a distinct phenomenon. However, in this thesis, the view that even economic transactions are embedded within a society context is advocated.

Mauss’ ‘total sociology’, on the one side of this polemic debate, led him to recognise that any one transaction, including the so called ‘pure gifts’, could not be isolated from the rest of society (Mauss, 1954: 71). According to Mauss (1954), social institutions in ‘primitive or archaic’ societies are undifferentiated, and are at once ‘religious, legal, moral and economic’ and therefore, may directly shed light on the interrelationships between economic life and other areas of society. His argument followed that the discovery of basic morality in simple societies, will sanction considerable knowledge on the moral nature of modern complex societies. The theories rooted in anthropology argue that groups, rather than individuals, lie at the centre of exchange relations. It is groups that make contracts and are bound by duties and commitments. The persons represented in the contracts are moral actors, such as families, and it is therefore the groups, or its intermediaries, that confront and oppose each other (Mauss, 1954). Park and Burgess (1922:5) write: ‘The person is an individual who has a status. We come to this world as individuals. We acquire status, and become persons’. It is in this sense of a role-free and status-free individual that Mauss (1954) excludes from social exchange processes. Individuals are isolated actors, unrepresentative of any other units but themselves. Persons are representative of certain social roles, and therefore, do not act on their behalf exclusively, but on behalf of social groups in society. This approach therefore, has obvious usefulness with regard to studying the relationships between the government and social actors in connection to observing their group processes and intergroup relations. Exchange theories rooted in sociology and anthropology, are more capable of dealing with ‘non-economic’ collectives through establishing micro-macro links. They have the ability to explain processes within and between different social groups, be they ethnic, racial, religious or ideological in nature. However, it is important to note, that individuals are most influenced by the social norms of a salient group to which they belong and with whose members they identify (Sigala, Burgoyne and Webley, 1999). When considering the exchange relationship with the government, the individual could place themselves within their occupational group, income group or a minority group to which they belong. The individual evaluates whether the group they place themselves within has a balanced relationship with the government, therefore influencing their decision, regarding whether to operate on a declared basis. There is also the possibility of clashing perspectives between the situations the individual belongs to.

The problem with utilitarian models of actors, is that exchanges cannot be treated as the result of some ingrained human ‘propensity to truck, barter, and exchange’ (Smith, 1974: 320) and should be seen as embedded in society. As an extension to this, Mauss’ conception of social exchange, implies a denial of self-interest. In his view, the morality of social exchange is to be sought in the relationships between groups or subgroups, or between their representatives. The triple obligation of social exchange (to give, to receive and to repay) is to be understood, not in terms of self-interest, but in terms of interpersonal relevance. Hence, inter-group relations become of high importance. Although the focus on reciprocity captures many activities that the aforementioned conceptualisations of SET disregard, it neglects a vast array of relationships that are based on self-interest. For example, often the broadening of social networks and gaining of social capital is not carried out for the good of the society, but to gain a bigger market within which the individual obtains or sells goods and services.

Given that the individual is de-emphasised in anthropologically positioned models of social exchange, psychological factors are largely disregarded. Not only does this therefore reject the possibility that an individual might make decisions independent of societal influence, based for example on rational calculations, it also leads to the disregard of emotions. Such emotions and instincts may influence the actor to stop conforming to the rules of society in favour of self-interest. Although some emotions are socially constructed, those of a neurologically wired nature can also lead the actions of individuals (Kemper, 1978). Lawler and Thye (1999:218) argue that ‘emotions both enter and pervade social exchange processes’ and should thus be considered part of a multidimensional explanation. Therefore, although a strength of utilitarian representations, issues surrounding individuals and their psychological nature are often overlooked in anthropological/sociological accounts. As previously intimated, another problem of anthropological/sociological approaches towards social exchange, is that they are not well defined and developed, and thus issues of ambiguity arise. Individualist theories have more defined and structured frameworks used to examine social exchange activities, admittedly borrowed and adapted from economics and psychology.

## 2.5.4 Conclusion

This section has outlined two schools of thought in relation to social exchange theory that represent two sides of a polemic debate. Although the rational and calculating view of exchange is limited, due to single-factor assumptions, it is of high importance for understanding certain circumstances. Expanding the framework to include symbolic interaction, an individual’s own interpretation and multiple parties, ensures a deeper and more meaningful understanding of the nature of exchange relationships. Consequently, adopting a contextual analysis approach, leads to a multi-level, multi-causal model, allowing the inclusion of a wide variety of activities and situations.

The concept of social exchange theory can therefore be viewed as a discourse. Discourses are ‘practices which form the objects of which they speak’ (Focault, 1997: 49). Hence, SET can be viewed as an assumption that has constructed the reality of the exchange relationship. To understand the different elements of the relationship, it is useful to draw on the discourses of the context the relationships are placed in. With this in mind, social exchange theory brings different conclusions of the relationships that are analysed, which depend on factors such as the economic situation, age, belongingness to social groups, status and culture, among others. This makes it useful for contextual analysis of undeclared work, as the surrounding environment has an impact on the nature of undeclared work, and consequently the nature of the relationship that characterises such activities. For example, women from high-income neighbourhoods, as a subgroup, might engage in different types of relationship than men from low-income neighbourhoods. In turn, this will affect issues, such as the type of reciprocity, the level and type of trust, the balance of power, as well as the parties involved. Such a conceptualisation of SET is valuable, because it allows different interpretations that encompass the broader social context and as such, provide a greater depth of understanding.

Viewing the relationship between the government and social actors from a combination of scales of analysis, allows for a multilevel consideration of its operation. An analysis can be conducted on an individual level, a group level and on a societal level, acknowledging both intergroup processes and personal norms as aspects of behaviour shaping. Through relaxation of rational choice and behaviourist assumptions, macro as well as micro properties become encompassed within the framework. The distinguishing nature of this multilevel social exchange theory approach is that it draws upon both the classical insights of sociologists (e.g. Weber, Simmel) and anthropologists (e.g. Mauss, Levi-Strauss), as well as traditional economists (e.g. Blau, Emerson) and behaviourists (e.g. Homans). The contention here is thus, that this is more grounded in social reality and history, thus providing greater validity than the currently dominant utilitarian model. Having established a theoretical underpinning for the SET framework to be adopted in this thesis, the next section seeks to, whilst encompassing both schools of thought, outline some concepts relevant when applying SET to the understanding of undeclared work. This is then followed by the development of a multilevel SET framework that is to be used in this thesis to explain participation in undeclared work.

# 2.6 Social exchange theory: Underpinning concepts

This section focuses on outlining two important underpinning concepts, namely reciprocity and the state of the indebtedness that will be drawn on in section 2.7, which develops a multilevel SET framework for understanding participation in undeclared work.

## 2.6.1 Reciprocity

The utilitarian interpretations of social exchange theory focus on balance in the relationship, profit maximisation and individual satisfaction as governing the social exchange activities and relationships. According to Homans (1958), actors strive for balance in their exchanges with their partner, as well as aiming to maximise profit from the exchange. ‘Profit’ is measured through the difference between the value of what is received and the cost of what is given. As is argued by Blau (1964:19) ‘the basic social processes that govern associations among men [sic] have their roots in primitive psychological processes, such as the underlying feeling of attraction between individuals and their desires for various kinds of rewards’. For Blau, ‘The reason a person is an attractive associate is that he [sic] has impressed others as someone with whom it would be rewarding to associate’ (Blau, 1964: 35). The psychological nature and needs of an individual, determines which rewards are particularly salient for them. This then has an impact with who is attractive for this individual in terms of exchange relations. With Blau’s (1964) conceptualisation of reciprocity, the moral obligations that arise, are not to be assumed as given by the social exchange actors, but slowly arise as the relationship that is beneficial to both parties, develops. In Meeker’s (1971) view, rationality is denoted, using logic to determine the likely consequences of action (ends), as well as how the rewards should be achieved (means). Weber (1946: 115) termed this as zweckrationalitat. Rational processes, as such, focus on both the end value of maximisation, as well as the means through which this is realised.

Blau also discusses the complex structures of large collectives and refers to the indirect exchanges, which develop from the direct ones when individuals receive rewards from a group, rather than from another individual. In such a situation, the group would act as an entity, therefore representing dyadic exchange. In the context of such indirect exchange, Blau recognises that the underlying social norms prohibiting force and fraud, govern the exchange activities. However, emphasis still lies with the maximising principle. Whether the individuals are able to maximise their utility through the aforementioned relationship, is determined by a rational calculation of costs and benefits (material and non-material), as well as consideration of alternative choices available. However, although the rules that govern social exchange include, they are not limited to, the rational calculation of costs and benefits that structure purely economic exchange (Meeker, 1971). This is because, for the relationship to be upheld, loyalties and emotional ties must develop.

### 2.6.1.1 Moral norm of reciprocity

Gouldner’s research (1960) extends beyond the ‘self-interested’ actor and provides a more exhaustive and realistic perspective. Here, reciprocity is often referred to as the vital principle of society (Hobhouse, 1906) and the schema upon which all contacts among people rest (Simmel, 1950). Gouldner (1960:170) defines ‘a generalised moral norm of reciprocity which defines certain actions and obligations as repayments for benefits received’. As norms and morals define and maintain the relationships between individuals, they are by nature interpersonal. The ‘norm of reciprocity’ is a moral norm and principle that operates to confine the effect of ‘individual self-interest’, in order to achieve more congruent relationships in social life.

At the core of this perspective is a view that individuals engaged in social exchange activities, do not create the norms and values that regulate their behaviour. Rather, they carry with them, institutional definitions of these norms and values into their behaviour. However, this would depend on the situation, due to the possibility of new norms and values arising out of interpersonal relationships. Sahlins (1965) defines three main types of reciprocity (generalised, balanced and negative), which are associated with social distance. Although his proposal was designed for lineage tribal societies, it has in fact been used as a universal typology of forms of reciprocity. Social relations govern the flow of the economy, and in the presented continuum model of reciprocity, exchanges alter in a moral way, depending on how much concern for self or others is shown. According to Sahlins (1965), the type of reciprocity is judged by social distance, so that the further one moves away from kin to strangers and enemies, the more the nature of exchanges moves to negative reciprocity.

The use of anthropologically-based theories within this framework, allows the inclusion of collective action, thus encompassing the concept of generalised exchange. Generalised reciprocity is altruistic by nature, as there is a lack of concern over the timing and the content of exchange (Sahlins, 1965). Reciprocity then, is defined as a moral norm, structuring the giving and returning of help: ‘if you want to be helped by others you must help them’ (Gouldner, 1960:173) corresponding to the moral norm of reciprocity outlined above. Although Sahlins (1965) states that this type of reciprocity is most likely to occur amongst family members and close friends, there are exceptions where the schema is modified by certain factors. Rank, wealth and the nature of items given, can extend generalised reciprocity further in terms of social range. For example, wealthy actors might give to poorer communities with no direct expectation of repayment.

Within generalised exchange, ‘the rewards that an actor receives usually are not directly contingent on the resources provided by that actor’ (Yamagishi and Cook, 1993:235). Ekeh (1974) identifies two main types of generalised exchange, that of chain generalised exchange (network-generalised) and group focused generalised exchange. The former is characterised by goods and services being directly exchanged by individuals within that network. The latter, however, involves the parties to exchange, contributing towards ‘public’ goods, whereby they then receive benefits from the use of this public good. Therefore, in such a scheme, the resources are pooled centrally. This is different to the decentralised nature of network based generalised exchange, where a direct exchange of goods occurs between individuals in a chain-like or cyclical pattern (Cook et al., 2013). Group focused generalised exchange encompasses examples, such as citizens of a village pooling their resources to build a school (Yamagishi and Cook, 1993), and joining resources for business ventures (Ruef, 2003). Given that, in such examples, the rewards are not exchanged directly, there is a need to trust, as well as rely on the willingness of others within the exchange. Such exchange systems become subject to social dilemmas (Yamagishi and Cook, 1993) due to the problem of ‘free riding’, where receiving occurs without any giving. Those taking part in generalised exchange systems benefit more, if they do not give to others whilst still receiving from other individuals in the system. However, if following this logic, all refuse to give, then everyone is worse off, compared to the situation where everyone gives (see Yamagishi 1995). Many studies have been conducted in attempts to explain the manifestation and process of such complex exchange systems (Bearman, 1997; Takahashi and Yamagishi, 1999; Ziegler, 1990; Takahashi, 2000; Mark, 2003; Cheshire, 2005). This has brought about an understanding that the phenomenon may help to cushion resource variations (Cashdan, 1985), as well as contribute to the development of moral norms (Nowak and Sigmund, 2005). Furthermore, they serve as mechanisms to enhance social solidarity (Mauss 1925, Sahlins 1965).

Balanced reciprocity, extends to the edge of the social field and is direct in nature, characterised by less personal exchange with precise calculating. It is more akin to the utilitarian interpretations of exchange. There is greater likelihood of similarity in the type and value of objects and defined expectations regarding giving and receiving. However, Sahlins (1972:194-5) states that ‘balanced reciprocity may be more loosely applied to transactions which stipulate returns of commensurate worth or utility within a finite period of time’. Negative reciprocity is the furthest afield of the three categories, and can be viewed as the unsociable extreme, embracing activities such as barter and gambling, impersonal by nature and involving opposed interests.

## 2.6.2 State of indebtedness

Social exchange is fostered by the psychological state of indebtedness an individual is put in after receiving a resource from another. Such a state is assumed to have motivational properties, leading the individual to engage in attempts to deal with or reduce the arousal and discomfort associated with it (Greenberg, 1980). This phenomenon therefore has important implications, both in the context of the government-citizen relationship and exchange relations.

The norm of reciprocity has an important place in the development of social exchange relationships, by maintaining the on-going fulfilment of obligations and strengthening indebtedness. As an advance on Homans’ utilitarian conceptualisation, Greenberg (1980:5) argues that the strength of obligation to reciprocate indebtedness, is likely to be influenced by (a) the donor’s motives (b) the magnitude of the rewards and costs incurred by the recipient and donor as a result of the exchange (c) the locus of causality of the donor’s action, and (d) cues emitted by comparing others. Furthermore, Greenberg (1980) argues that the greater the magnitude of the indebtedness, the greater the discomfort experiences and the stronger the attempts to deal with or reduce the felt indebtedness. To reduce the indebtedness, an individual may cognitively restructure the situation or engage in reciprocation. Eisenberg et al. (1987:744) note that ‘partners may differ in their readiness to reciprocate benefits on the basis of ideologies concerning the most effective ways to strengthen exchange relationships’. Such ideologies will be formed as influenced by the society (anthropological/sociological perspective), as well as psychological intuitions (utilitarian perspective).

Greenberg (1980) states that acts of reciprocity are often multi-determined, as he defines three motivational bases for reciprocating a benefit. The first factor he outlines is of the utilitarian nature, where reciprocity is motivated by the recipient’s desire to receive future rewards. Secondly, it could be a result of the recipient’s increased attraction to the individual contributing the reward. Finally, Greenberg (1980) outlines reciprocity, motivated by the need to reduce indebtedness that is not contingent upon external rewards, but is motivated by the feeling of obligations. Furthermore, Greenberg (1980) argues that, as an alternative to reciprocity, individuals are able to engage in cognitive restructuring as a way to reduce the state of indebtedness. If the government exhibits behaviours that are unjust, individuals are able to more easily construct the situation as not feeling indebted, due to them not receiving an adequate service from the government, in return for their taxes.

# 2.7 Social exchange theory: Developing the framework in the context of undeclared work

Given the above outline of the contrasting variants of social exchange theory, and how a multilevel SET approach may provide a way forward that enables greater understanding of participation in undeclared work, this section seeks to outline the various aspects of such an approach. Here, the focus is upon examining the vertical relationship between the individual and the government, as well as the social norms that arise through social interactions between individuals themselves. The personal norms referred to in this thesis, refer to the tax morale of citizens. It is theories that this is influenced by the relationship the individual has with the state (vertical), but also by social norms and the perceived tax morale of others, within the given societal arrangements (horizontal). Each is here considered in turn.

## 2.7.1 The vertical relationship (Government-citizen relationship)

2.7.1.1 Defining the relationship

Examining the social contract between the government and its citizens, issues such as quality of public services and incentives, would create positive content in the focus of the dominant utilitarian schools of thought. However, examining alternative anthropological/sociological representations, other issues, such as justice and fairness also play a role. The bond between the state and its citizens shapes individual tax morale, and therefore affects the decision of whether to operate on a declared or undeclared basis. In order for the individual to be and remain declared, incentives are necessary. However, these are more multilevel than considered in the traditional utilitarian approach. Indeed, government policy, tax authorities, state institutions, as well as norms that arise outside of the relationship and among intergroup processes of the social actors influenced the relationship. However, it is also important to note, that trust in the state should also entail fair treatment and trust for all citizens, rather than merely particular individuals.

An exchange relationship implies duties and rights for each involved party. If, for example, setting the price too high for the resources given in return violates the resource of taxation, then citizens are provided with a justification for operating on an undeclared basis. However, as is theorised in the exchange literature, citizens may view their contributions as ‘common goods’ in the perspective of generalised exchange, in that they are prepared to declare their income honestly, even if they do not perceive themselves to be receiving resources equivalent to their tax payments. The notion of income redistribution, tends to be more accepted by affluent individuals when the political process is perceived to be just and policy outcomes acceptable. The social exchange principles therefore, have aspects of distributive justice and procedural justice (further described below).

### 2.7.1.2 The role of trust

It is argued that relationships require trust (Hom et al., 2009) and many consider it to be a key ingredient within exchange relations (Lo and Aryee, 2003; Robinson, 1996; Rousseau et al., 1998). Rousseau et al. (1998:395) aptly define trust as a ‘psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behavior of another’. This would imply that the self-interest motive for engaging in positive citizenship behaviour has an underlying assumption of the state being fair and just in its intentions and behaviours.

In the tax compliance literature, scholars have been paying attention to the determinant of trust (e.g. Slemrod, 2004; Wintrobe, 2001; Torgler, 2003a). Trusting the state officials has been construed as important, in terms of building the citizen’s commitment and positive attitude to the tax system and the payments that go along with this. If citizens are pleased with the incentives and public goods and services offered, this may develop a positive transactional contract where trust is logical and rational, as explained by the utilitarian approach. On the other hand, if citizens have overall trust in the government, in that they are doing or trying to do the right thing, without specifically calculating the personal costs and benefits, then this is more akin to a relational contract involving emotional ties and loyalty. Such a contract, based on trust, can be maintained with positive actions. If government actions are perceived to be fair and just, the contract remains positive.

Trust is important, as according to Bergman (2009: 162), ‘Tax evasion is the outcome of a lack of trust’. Although it is not necessarily the only determinant, it is generally agreed that ‘it is important for politicians to be perceived as trustworthy in order to be able to collect taxes’ (Hammar, Jagers, and Nordblom, 2009:238). Other than the effects on tax morale, according to Diamond (2007), distrust can create alienation and a general retreat from political processes, leaving the state without the ability to form a collective vision for national development.

#### 2.7.1.2.2 Defining the parties involved in the relationship

It is of crucial importance to define who the parties to the social contract are when measuring trust. However, mirroring the difficulties found in organisational literature, when conceptualising the relationship with the government, it is difficult to exactly define who the contract is held with. This is because a wide variety of actors and structures are likely to influence the citizens’ perceptions of the state (e.g., political parties, individual politicians, different government departments and officials). The following section, therefore discusses this to clearly define the parties to the contract in the context of undeclared work.

Torgler (2004: 7) explains the relevance of two types of trust in relation to tax morale. These include trusting the state at a constitutional level (justice and the legal system), as well as the current politico-economic level. This is a popular conceptualisation in the tax evasion literature and is used in many studies (e.g. Raiser et al., 2001; Hayoz and Hug, 2007; Torgler et al., 2007). The usefulness of defining the parties in this way is the broad conceptualisation that allows the individual to think about their overall confidence in the government and as such, provides a good measure. Other more specific measures, such as the civil service (Norris, 1999) or national officers (Hayoz and Hug, 2007) might focus too much and as such, not capture the overall picture. Furthermore, they may bring up feelings of interactions with specific individuals that are contradictory in nature. Other measurements, such as political parties (Norris, 1999) may also cause contradictory feelings, due to differing levels of trust in different parties. Focusing on a broad conceptualisation therefore allows a more general and consistent measurement. As is argued by Hug and Spöorri (2007), an individual’s tax compliance, is based on how well the entire government works. With regards to the constitutional level, as explained by Torgler (2004), the legal system weakness is a problem, particularly during a country’s transition process. Levin and Satarov (2000:120) explain that after the collapse of socialism, ‘judicial weakness left a legal vacuum that remains unfilled’. This indicates the importance of investigating the judicial system in the transformational context of Croatia. The importance is further emphasised, due to the rapid pace of change of statue law (Schönfelder, 2004), causing a lack of stability and potential lack of confidence and trust.

However, the role of the tax authority is emphasised in many studies, as a factor affecting tax morale. Although this is a narrower conceptualisation, it is useful in the current context, due to its relationship to undeclared work. The argument here is that it is particularly trust in the tax authorities that is needed, in order to promote and maintain tax morale in the form of voluntary cooperation of honest citizens (Kitchler, 2007; Muehlbachel and Kirchler, 2010). Lisi (2014), for example, argues that according to the slippery slope framework, trust is a determinant for voluntary compliance, whereas the effectiveness of tax authorities in dealing with undeclared work, is a determinant for enforced compliance. Therefore, both the trust in tax authorities and the power such authorities hold, play a crucial role in fostering declared work. In fact, it is this vital interaction between power and trust that serves to increase the level of tax compliance (Muelbacher and Kirchler, 2010). Therefore, although the current thesis includes overall feelings of trust in formal institutions, it also incorporates the concepts of fairness and justice by focusing on the role of the tax authorities.

#### 2.7.1.2.3 Fairness and justice as measures of trust

When evaluating tax systems, citizens often focus on fairness concerns as the main issue (Braithwaite, 2003) and on a broader scale, this can be labelled as one of the main factors contributing to trust. Andreoni et al. (1998) argue that it is crucial to incorporate morals and social dynamics in economic theory. Besides moral principles and sentiments, the social dynamics that have received much attention, are issues of fairness, either of the tax code or its enforcement, and taxpayers’ evaluation of government expenditures. Wenzel (2003), amongst others, differentiates between three types of justice: distributive justice, procedural justice and retributive justice.

Distributive justice refers to the exchange of resources, both benefits and costs. Equity theories draw attention to the fair distribution of the results of exchanges between partners (Adams, 1965; Homans, 1961; Walster, Walster and Berscheid, 1978). If rewards and costs are borne equally and distributed fairly between partners, exchange is balanced and the relationship judged to be satisfactory. According to the equity rule, which is most likely applied to business relationships, partners are compensated in proportion to their contributions. In the field of tax compliance, distributive justice refers to taxpayers’ perception of the balance of their share to the commons, relative to the benefits they are entitled to receive, and to the contributions others make, relative to their share of public goods. As is understandable, the perception of the balance of the relationship strongly depends on environmental conditions. Much research shows evidence that the notion of fairness, influences the extent to which the exchange paradigm increases formalisation. In a study by Kinsey and Grasmic (1993) evidence was presented, that horizontal equity with regards to the tax system is of high importance. The attitude for operating declared, will therefore be stronger if an individual’s tax burden is of a similar level to that of comparable others. Schmölders (1960), who maintains that beliefs about unfair treatment, relative to others, and unfair treatment, relative to the benefits a taxpayer draws from public goods, are relevant components of tax morale. Therefore an imbalance in the relationship would cause lower tax morale. In his study, approximately three quarters of German taxpayers thought that their tax burden was too high, while one-quarter found it appropriate. In particular, the self-employed complained about too high a burden (83%), whereas civil servants complained the least (63%). This shows the importance of targeting certain groups with regard to improving tax morale. Most respondents in Schmölders’ work, believed that taxes are not only an excessive burden, but also unfairly allocated across occupational groups; furthermore, they felt that the government did not provide equitable recompense, in terms of public goods. A majority of people felt cheated.

Procedural justice, on the other hand, considers the process of the distribution of resources. Within this, if an individual perceives the method used to distribute resources as being fair and just, then procedural fairness is perceived as high. Furthermore, if the parties involved are treated in a manner they consider to be appropriate, then the procedures of resource allocation are considered to be fair (Thibaut and Walker, 1978; Tyler, 1990; Tyler and Degoey, 1996). Leventhal (1980), argues that, more specifically, treatments are considered to be fair if decisions made by the relevant state entity are perceived as being consistent, accurate and free of errors, representative and ethical, and correctable in case of errors. In discussing public trust and confidence in institutions, Tyler (2001) considers the key issue that shapes public views to be a process-based evaluation of the fairness of procedures that are used to exercise authority. Communication of respect for the taxpayer plays a crucial role in this process.

Retributive justice is concerned with the perceived appropriateness of sanctions in cases of norm breaking (Tyler, 1990). The central questions refer to attributions of responsibility to those guilty of wrong-doing, the restoration of damages to the wronged party and the punishment a norm-breaker deserves.  
It can be concluded with this that when evaluating whether the relationship is balanced, each individual will consider whether the outcome is fair, whether the process was fair and whether there is adequate punishment for those who do not comply. With regard to policy, this shows that there is a need for a combination of measures to tackle undeclared work, including commitment as well as deterrence. However, it is also important to investigate the process within which the citizens judge this.

Further to this, Scholz and Lubel (1998) highlight the significance of trust in government to increase tax compliance. Supporting the argument for an analysis beyond monetary exchanges, they state that trust in government is more than a ‘rough measure of the net benefits from governing institutions’ (1998:411) involving the government’s efficiency to develop and deliver its policies to the citizens. Therefore, trust in the state can be diminished if government waste is high or perceived to be high. Ahmed and Braithwaite (2004), for example, give empirical support to this, in finding that non-compliance is more likely in those who have lost trust or confidence in the government.

It evidently arises out of the discussion of justice and fairness that the notion of trust is of high importance with regard to the exchange relationship, in both utilitarian as well as anthropological/sociological conceptualisations of SET. However, in the former, emphasis is placed on the slow development of trust, and in the latter, trust is viewed as more freely given. In Levi-Strauss’ (1971) and Mauss’ (1925) conceptualisations, social exchange transactions take place within the matrix of social trust which exists before individual social exchange acts, and which therefore, individual actors assume as given. In Blau’s (1964) theory, on the other hand, every exchange actor must move with caution: trust is an attribute of the individuals engaged in exchange. Part of the social exchange process is for the social exchange actors to build up a framework of trust. ‘Typically social exchange relations evolve in a slow process, starting with minor transactions in which little trust is required because little risk is involved and in which both partners can prove their trustworthiness, enabling them to expand their relation and engage in major transactions’ (Blau, 1967: 454).

The notion of power, as a regulating process of the exchange relationship, also has a highly relevant position in the social exchange literature. The central focus of Blau’s extension of the theory was an examination of the role of power in relationships. An individual’s positional power or status within either dyadic exchange or an organisation, determines how relationships with others develop: those with more power, have more influence in the relationship (Homans, Hamblin and Kunkel, 1997). Blau discusses processes, such as group cohesion and conflict, and how those processes are related directly to power.If the state treats social actors as partners in the exchange relationship, rather than inferiors in a hierarchical relationship, the individuals have a better motivation to operate formally. Feld and Frey (2007) provide empirical evidence, that the government’s dedication to follow benefit principles of taxation, and provide public services according to taxpayers’ preference in exchange for a reasonable tax price, increases the motivation to comply with tax laws.

Both cultural and societal institutions are regarded as important in determining willingness to formalise. Schmölders (1970) frames the issue of tax compliance as a behavioural problem as the success of taxes depends on cooperation. Kirchler (2007) describes a demand in the revision of the relationship between citizens, government and institutions with the aim to reduce social distances between citizens and authorities, consequently establishing trust in political leadership and administration. This leads to cooperation from citizens, who in turn exhibit commitment and choose to operate in the declared economy.

Greenberg (1980) states that the given acts of reciprocity are often multi-determined, as he defines three motivational bases for reciprocating a benefit. The first factor he outlines is of the utilitarian nature, where reciprocity is motivated by the recipient’s desire to receive future rewards. Second, it could be as a result of the recipient’s increased attraction to the donor, following receipt of a benefit. Finally, Greenberg (1980) outlines reciprocity, motivated by the need to reduce indebtedness that is not contingent upon external rewards, but is motivated by the feeling of obligation. It is this final motivation that is interesting in the context of the social contract, because it means that even if the individual calculates a benefit in evading taxes or working informally, they will still choose to work on a declared basis. The more citizens develop this need, the higher the national tax morale. Social exchange is fostered by the psychological state of indebtedness an individual is put in after receiving a resource from another. Such a state is assumed to have motivational properties, leading the individual to engage in attempts to deal with or reduce the arousal and discomfort associated with it (Greenberg, 1980). Seeing whether an individual feels this state of indebtedness would help to measure their willingness to formalise, and this can be seen through the individual having feelings of guilt, due to their undeclared work. Furthermore, Greenberg (1980) argues that, as an alternative to reciprocity, individuals are able to engage in cognitive restructuring as a way of reducing the state of indebtedness. Therefore, if the government exhibits behaviours that are unjust, individuals are able to more easily construct the situation, as one where they do not need to feel indebted, due to the broken social contract.

## 2.7.2 The horizontal relations (exchanges among citizens)

Criticism of social exchange theory focuses on the lack of attention to macro social processes (Bal et al., 2011), as well as the simplification of complex social exchange (King, 2011). The incorporation of horizontal relations is done so to include social norms as a factor of the decision making process. The information exchange amongst citizens is seen as reinforcing group beliefs and sustaining social customs.

As there are many different types of relationships operating under the umbrella of undeclared work, the focus lies with discovering the different rules and norms these operate under, through the perspective of the individuals involved. This enables a better understanding of the resources exchanged, as well as investigating the motives and reasoning of the parties involved. Extending the framework of SET to include anthropological/sociological theorisations, as argued previously, allows us to research different dynamics of exchange and therefore alternative norms and rules that govern the activities encompassed by each relationship. Fiske (1991:13-16) provides some examples, such as the processes of political groups being mediated by factors such as power, or authority ranking, rather than market pricing or monetary values. However, although there is some research in the context of the exchange relationship in organisations, there is a lack of research in investigating the relationship between the state and its citizens.

Taking this perspective, groups in society, particularly enclaves of neighbourhood communities or family relationships, are regulated by processes that are better explained by anthropological/sociological interpretations (generalised reciprocity) rather than the utilitarian perspective (utility maximisation). From the multilevel approach towards social exchange adopted in this thesis, informal institutions are taken to be a multifaceted phenomenon and are as such conceptualised on three levels, namely personal norms, identity group norms and national level (cultural) norms. As such, it is theorised in this thesis, that at the individual level, a person is affected by their own personal norms. This is related to personality factors, such as moral reasoning, authoritarianism and Machiavellianism, egoism, norm dependency and values. However, on a collective level, a person will be affected by social norms. Fehr and Gachter (1998:854) define social norms as ‘behaviour regularity that is based on a socially shared belief of how one ought to behave which triggers the enforcement of the prescribed behaviour by informal social sanctions’. Collective norms can be further divided into those of a societal level and a national level (Kirchler, 2007). On a societal level, they determine the behaviour of social groups, based on shared standards, whereas, national level norms become cultural standards. Each is here considered in turn.

## 2.7.2.1 Personal norms

Personal norms, for the purpose of this research, are defined as an individual’s moral standards. These can, for example, be acquired through the internalisation of social or identity group norms (see Kelman, 1958). Given that consideration of personal norms in this instance, refers to acceptance of undeclared work, it is synonymous with definitions of tax morality, which refer to a person’s intrinsic motivation to pay taxes (McKerchar et al., 2013; Torgler and Schneider, 2007) and as such, general intolerance of undeclared activities. In support of this, Riahi Belkaoui (2004) finds a strong association between levels of tax compliance and tax morality. Richardson (2006) obtains the same association in a comparison using 45 countries. Looking at post-socialist countries more specifically, Torgler (2011) finds that cross-national variations in levels of tax morality, explain more than 30 per cent of variations in the size of the undeclared economy.

When looking to the broader exchange relationship between the government and social actors it is important to define whether the party of analysis is individual, group level or societal level. Through the use of individualist theory, we are able to look at the individual where ‘tax payers [are] concerned with their individual tax burden and with their [own] share of public goods’ (Kirchler, 2007: 42). On the other hand, the incorporation of anthropological/sociological theories, as discussed in the previous section, allows us to look at collectivities, where the perceived unit can be at a social group level (e.g. occupational group, income groups, minority groups) or at a societal/cultural level (whole nation tax morale). It is to these levels of analysis, therefore, that attention now turns.

## 2.7.2.2 Social norms

Social norms are those held by groups of people, or those perceived to be held by groups. Wintrobe (2010:10) asserts that ‘the more citizens can trust their fellow citizens to pay taxes, the more willing they are themselves to do so and vice versa’.. Through the use of individualist theory, we are able to look at the individual level, where ‘tax payers [are] concerned with their individual tax burden and with their [own] share of public goods’ (Kirchler, 2007: 42). On the other hand, the incorporation of anthropological/sociological theories (as discussed in the previous section) allows us to look at collectives where the perceived unit can be at an identity group level (e.g. occupational groups, income groups, minority groups) or at a societal/cultural level (whole nation tax morale).

### 2.7.2.2.1 Identity group level

Social norms are a function of an individual’s perceived expectation that one or more relevant referents would approve of a particular behaviour, and the extent to which the individual will be motivated to comply with such a referent’s beliefs (Ajzen, 1991). Alm, McClelland and Schulze (1999) define a social norm, as representing a pattern of behaviour that is judged in a similar way by relevant others, and therefore is sustained by social approval or disapproval. Taxpayers who perceive others as behaving according to socially accepted rules and who communicate with others about appropriate behaviour, will adopt the socially shared norms and behave appropriately. If the reference group signals that non-compliance will be tolerated, then compliance will decrease. In support of the relevance of social norms, Welch et al. (2005) found that the more prevalent tax evasion was considered within an individual’s community, the less likely this individual would be to judge the non-compliant activity harshly, the less likely they would be to worry about informal disapprovals/sanctions focused against the activity, and the more likely they would be to evade tax in the future.

Sigala, Burgoyne and Webley (1999) ascertain that when individuals are uncertain of what objectively appropriate behaviour is, they are influenced by the social norms of a reference group they belong to and with whose members they identify. Moreover, Wenzel (2005) argues that individuals are more likely to be influenced by other taxpayers who are considered members of their self-category. With the analysis of communication of behaviour focusing on the superordinate level of identification, it is important to uncover the different groups individuals associate themselves with. The diversity of groups and effects of their dynamics on social exchange is an aspect that needs greater attention within the social exchange literature. Allen (1954) advocates social change to establish neighbourhoods of people with a heterogeneous mixture of difference in racial, religious, age, and socioeconomic background, for a ‘community which includes a diversity of people, with different kinds and degrees of fortune, may be livelier and more productive than a standardised one’. Rubin (1973: 154) recognises that in order to adapt to a rapidly changing world, there is a need for individuals to engage in social interaction with others who are likeminded but also those who are dissimilar to them.

The nature of an exchange is further defined, by whether the individuals involved in the exchange, portray either leader or follower characteristics, as well as how those characteristics influence outcomes. Group members with the ability to impress and reward others are most likely to end up in leadership positions (Blau, 1964). Through this, it can be seen how personal norms can affect the formation of societal norms. If the individuals taking on the role of leader are more likely to evade tax, then this perception is likely to be disseminated throughout the group, especially to those who most strongly identify with the leader.

### 2.7.2.2.2 National/societal level

Braithwaite (2003) has emphasised that community responsiveness to the tax system and tax authority is multifaceted, variable and not only dependent on technical and administrative procedures, but also social relationships. Therefore, when faced with the decision of whether to operate declared or undeclared, an individual will draw from personal, societal and cultural norms, some of which might at times be conflicting. It is thus important to investigate which sets of norms have the largest effect on compliance issues. Coyle-Shapiro and Conway (2004) call for more attention to be given to the possibility that multiple rules might be employed simultaneously. With this comes the possibility of conflicting rules, as for example the pursuit of status by individuals, as well as collectives, can come into conflict with that of monetary or material objectives (Hechter, 1987) suggesting a compromise of the two, or domination of one. The marriage of anthropological/sociological and utilitarian perspectives, results in a framework that is able to research such issues. In order to fully understand the process that is undertaken through development of such norms, an understanding of the actors’ worldview is crucial.

Ultimately, because this thesis is concerned with individual decision-making, it will be personal norms that measure tax morale and as such, determine engagement in the undeclared realm. Nonetheless, this does not undermine the importance of identity group norms and national level norms, as these will influence the formation of individual tax morale. It is important to note that these norms are not only determinants of the decision of whether to engage in undeclared work, but will also have an impact on the nature of relationships amongst those engaging in such work. This relationship will be examined through the survey method detailed in the next chapter.

## 2.7.2.3 Micro exchange relations

Parties must abide by certain rules of exchange. Rules of exchange form a ‘normative definition of the situation that forms among or is adopted by the participants in exchange relations’ (Emerson, 1976: 351). Investigating such rules of exchange that operate in different working relations, enables a better understanding of the type of work that occurs informally, as well as why it is conducted on an undeclared basis. This section does not focus on the macro rules of exchange, such as acceptance of undeclared work and how this comes about, but rather on how this undeclared work is organised under which rules it operates under. This gives us a better understanding of why it occurs and how to (or whether to) translate it to the declared economy.

Following the contextual approach outlined in the previous section, it is important to take into account a wide variety of norms and rules of exchange that could affect the social exchange relationship. There is a primary focus of social exchange theory, as it is currently conceptualised, on principles of reciprocity through a utilitarian perspective. However, there is evidence that alongside or instead of reciprocity, other exchange rules govern whether undeclared activities take place. Considering the diverse and dynamic nature of undeclared work, it is possible that multiple rules are employed simultaneously. However, little research attention has been given to this notion generally because, as observed by Liden et al. (1997), very few studies examine the exchange processes directly, and consequently very little is known about such processes. The research focused upon in this section, is largely theoretical. Hence, utilising a framework that explores a number of rules underlying the social exchange relationship, produces a more broadly defined SET and satisfies criticisms of underdeveloped and untested models (Cropanzano and Mitchell, 2005). It is also consistent with the multivariate, micro-macro intention described in the first section.

The content of exchange in social situations can be material and non-material, tangible and intangible as well as symbolic and economic in nature. The view that is adopted, is that a single resource can carry with it many connotations, where for example the exchange of money for a service, may actually be much more than just that, if there is an emphasis on the relationship, rather than the resources exchanged. The strategy adopted by early anthropological/sociological works, limits the items of social exchange to one kind, as for example to women in Levi-Strauss theory. This is in effect challenged by Homans (1958: 606), who views social behaviour as an ‘exchange of goods, material goods but also non-material ones, such as the symbols of approval or prestige’. In his theory, therefore, Homans expands the range of social exchange items to all activities. Subsequently addressed by Blau (1964) is the type of relationship that emerges between exchange partners and the inducements involved. An illustration of the intrinsic nature of rewards, is epitomised through the statement that ‘it is not what lovers do together but their doing it together that is the distinctive source of their special satisfaction - not seeing a play but sharing the experience of seeing it’ (p.15). Extrinsic rewards are dependent on the activity, rather than the relationship itself, such as the act of giving favours and expressions of gratitude made in return for them (Ekeh, 1974).

Exhibiting social psychological influence and considering interpersonal relationships, the work of Foa and Foa (1974, 1980) adds greater precision to specify content of exchange relationships. Foa and Foa’s (1974, 1980) resource theory, poses the following types of resource in exchange: love, status, information, money, goods and services. These rewards are classified in a matrix, where one dimension denotes the particularism versus the universalism of the resource, and the other its concreteness or tangibility. Monetary payment is, for example, fairly low in particularism, because its value is not dependent on the party providing it. Acts such as care, however, are relatively particularistic; because the value depends on the person it is given by. It is important to note, that this is a continuum rather than a categorical classification. Having said this, most goods and services are to some extent tangible, whereas those resources that are less so, provide a symbolic benefit to the recipient. Blau’s (1964) distinction between economic and social contents of exchange is amongst the most recognised in SET literature. Through stating that both are part of a general phenomenon of exchange, Blau (1964) adopts a categorical interpretation. As will become evident, such a view is restrictive in the pursuit of discovering the full dynamic of a social exchange relationship. Although in agreement with Blau (1964,1968), in that there are similarities between economic and social exchange, I challenge the differences he puts forward. Adopting the argument that economic exchange is embedded within society (see for example section 2.5.3) I reject Blau’s view that ‘only social exchange tends to engender feelings of personal obligation’ (Blau, 1964:94). Second, he states that economic exchanges are transacted through a well-defined medium of exchange, viz. money (Blau, 1968) but this ignores other potential benefits received through an economic transaction, namely of a social nature, such as the broadening of social networks and acquisition of social capital. It is argued in this thesis, that the majority of transactions fall somewhere between two ends of the social/economic spectrum.

Whereas utilitarian assumptions and viewing people as self-interested actors might be appropriate for purely economic exchange, they are unable to capture the nature of purely social (or symbolic) interactions. Elements, such as macro processes and generalised reciprocity, which are ignored by individualistic models, are crucial for depicting such interactions. However, in reality, very few interactions are purely symbolic or purely economic. This is because, even if the intent is purely social (or altruistic) in nature, there are often positive ‘by-products’ that bring utility to individuals, such as pleasure gained from approval. In line with this, Blau’s theory can be used to explain certain aspects of exchange relationships, but a strictly utilitarian framework would lead to the omission of important elements that characterise each social exchange relationship.

Granovetter (1985) advocates that views of exchange, as purely economic or purely social, represent undersocialised and oversocialised views of human action respectively. It is his view that all economic action is embedded within structures of social relations, but individuals do not ‘adhere slavishly to a script written for them by the particular interaction of social categories that they happen to occupy’ (1985: 487). This corresponds with the position of contextual analysis and dynamic relationships, argued in the previous section of the chapter. It is not as simple as a categorical approach for a relationship to be purely economic or purely social, as such a method is difficult to employ, even for a single transaction within a relationship. It is best looked at as a continuum, where a certain relationship can have elements of both social and economic motivations. For example, looking within the complementary perspective of undeclared work, an employee might be doing some work for kin, to help them out - thus providing the social motivation. However, the money that he receives from this action (although lower than the market price) is useful and perhaps necessary for his standard of living, thus reflecting the economic nature. Here the transaction has both social (or symbolic) and economic value, and even though it is mainly social in this case, categorising it as such, would cause a loss of some of the depth and meaning, therefore limiting our understanding of the relationship. On the other hand, looking at a legalist school of thought, a self-employed actor is carrying out a job, but through this they may develop a friendship. Again, by classifying the activity as either economic or social, the full nature of the relationship is eroded. The balance between the social and economic facets may also change over time within a relationship, as for instance in the latter example, when the friendship progresses further and develops, the social value of the exchange may dominate over the previously powerful economic motivation. ‘Exchange relations can be quite narrow, occurring within a single resource domain (e.g. economic transactions) or quite broad, encompassing the exchange of many different resources (e.g. family relations)’ (Molm, 1994: 164) The integration of disciplines at the root of the model, as described in the first section, allows for the inclusion of different types of social and economic exchange.

Whereas the work of Homans and Blau emphasised dyadic exchange between individuals located in a group context, the focus of Levi-Strauss and Mauss lies with collective issues. Homans (1958) argues that further to maximising profit, individuals would also make an effort to ensure that no one else in the group earned greater profit, thus incorporating equity between group members into the theory. This is a sharp contrast to the aforementioned idea of generalised exchange, where the concern is with helping others. Blau (1964) develops the theory to more complex social structures, by considering the effects of groups on the exchange process between individuals, and also how the group as a collective reacts to the exchange relationship. The recognition of the social context is important, as it exerts a number of influences on the exchange process. At the foundation of Blau’s indirect exchange, are pairs of individuals interrelated. Each individual has a choice of breaking up their current dyadic exchange relation in favour of forming new dyadic relationships with others. Blau (1964) argues that a dyadic exchange is influenced by the ‘role set’ that each partner belongs, as this defines the alternatives foregone, and hence, the costs incurred to obtain the rewards from the present dyadic exchange. The group may also exert influence on exchange partners, so as to not deviate from the group standard governing transactions.

With the incorporation of the anthropological/sociological perspectives, we can add the assumption that not only do individuals belong to various social groups, but also that these groups (whether they be of an economic, cultural or kinship nature) can engage in transactions as particular forms of group processes and intergroup relations. According to this view, exchange actors can encompass social groups or collectives, broadening the current conceptualisation of individuals as actors. One individual can belong to many different groups, but their behaviour and type of relationship will vary between and within the group. For example, when looking at the same individual as belonging to a kin group or an interest group, different types of exchange relationships will arise that are governed by different norms. In the relationship characterised by kinship, the primary regulator might be trust, whereas with the interest group, it may be power or status.

## 2.7.2.4 Social capital

The concept of social capital, and similar phenomena, have been the subject of academic discussions across many disciplines, such as economics and sociology, as well as many locations. Social capital itself was largely popularised by Putnam (1993) with his works on civic culture in Italy. Akin to undeclared work, social capital is also ridden with conceptual, definitional and therefore methodological issues. Discussing this in depth is beyond the scope of this thesis. In the economic realm, it is generally conceptualised in terms of groups that individuals belong to or local associations. It might be argued that in the context of post-communist countries, it should be viewed from the perspective developed by Bourdieu:

‘the aggregate of the actual or potential resources which are linked to possession of a durable network of more or less institutionalised relationships of mutual acquaintance and recognition.’ (Bourdieu, 1986:248 cited by Adam and Roncevic, 2003:158)

Although this seems fairly utilitarian, also referring to it as ‘a capital of social connections, honorability and respectability’, Bourdieu (1984:122) shows the symbolic benefits of social capital. However, evidently the perspective lies in the individual, rather than the interactional or collective representations of such phenomena. In this sense, social capital is a micro-level phenomenon belonging to an individual, and reflects informal social networks. In Croatia, this is referred to as having ‘veze’ (contacts) or being well connected. Putnam, on the other hand, focuses more on aspects such as trust and civic participation, as well as the roles they play in development. He defines it as ‘features of social organization, such as trust, norms, and networks that can improve the efficiency of society by facilitating coordinated actions’ (Putnam, 1993:167). Raiser et al. (2001) give evidence of such social capital being important, in terms of growth in transition countries.

# 2.8 Summary

The first part of this chapter focused on reviewing literature related to undeclared work. It did so by discussing the four dominant schools of thought, to identify potential gaps that this thesis might fill. In doing this, the usefulness of recognising the heterogeneous nature of the undeclared economy and considering the schools of thought as a spectrum of different forms of activity was advocated. The value in using this framework lies with recognising different types of work, whilst unearthing the motives behind these, as well as with the ease of comparing different contexts and countries with clear categories. However, it is found that there is a need for a more contextual framework that considers relationships, trust and institutional factors. Although there is some usefulness in categorising undeclared activities to understand the motives behind their occurrence, there is also a need to move beyond this, and consider the decision-making process on an individual basis. With the aim to develop such a context-bound understanding of undeclared work, the chapter then turned its attention to social exchange theory.

In presenting the literature review of social exchange theory, it is found that there are gaps in research within this area. In order to fill these gaps and counter the criticism that the theory is largely based on utilitarian interpretations, anthropological/sociological interpretations of social exchange are embedded into the framework. The theory is then conceptualised in the context of undeclared work, and framed on the basis vertical (government-citizen) and horizontal (amongst citizens themselves) relations. The assertion is that understanding both these relationships is necessary if the nature of undeclared work in Croatia is to be explained, and the complexity of the motives that underlie such work are to be unearthed. The former allows an understanding of the ways in which undeclared activities are regulated through the operation of various norms, whereas the latter facilitates an understanding of the perceived state of the social contract with the government, and the influence of this on the individual’s voluntary willingness to operate on a declared basis. Given the adoption of the anthropological/sociological interpretation it is important to further consider the context of the study. With the aim of doing this, the following chapter focuses on contextualising the empirical study by considering issues relevant to Croatia.

Chapter 3: An Insight Into the Context of Research: Croatia

# 3.1 Introduction

To understand the nature of undeclared work in Croatia from a social exchange perspective, it is necessary to analyse the country’s history, because the institutions, resource factors and cultural norms that affect participation in undeclared work, have emerged from a particular historical context. As such, it is the aim of this chapter to provide a historic overview of Croatia’s economic development, touching upon political and societal issues. The view taken in this thesis that context matters, leads inevitably to a deduction that history is important, as societies and institutions shape and develop over time. Croatia can be said to be at a cross-roads in history, as well as at a cross-roads of many different cultures. A number of significant historical issues have influenced the current norms and values, not least amongst these are: its socialist/communist past; its scarce experience of self-governance; the Yugoslav war and more   
  
recently, its EU relations. As North (1993:154) argues, ‘We cannot understand the decisions of today, without tracing the gradual development of institutions’. This chapter therefore begins, by briefly outlining the history of Croatia, before reviewing some of the key contextual issues that help to explain the current manifestation of undeclared work in the country. The result will be the construction of a picture of Croatia in terms of the vertical and horizontal relations that currently exist, which begins to uncover the reasons behind undeclared work from a social exchange perspective.

# 3.2 History of Croatia

## 3.2.1 Introduction

Croatia is a country located in South Eastern Europe, bordering the Adriatic Sea, with a population of 4.5 million people and a landmass of around 56,000 square kilometres. Due to its history and geographical positioning, Croatia can be categorised within South East Europe but also Central Europe or the Mediterranean. Recently, it is more consistently classified as a Central-East European country (CEE). Croatia gained its independence from Yugoslavia in 1991 and operates a parliamentary democracy. The civil law system is influenced by the legal heritage of Austria-Hungary, but was fully brought into line with the community acquis in 2010.

## 3.2.2 Socialist influence

Prior to 1991, Croatia was a constituent part of the former Yugoslavia, thought to be a socialist country that stood apart from other centrally planned economies, due to a number of distinguishing characteristics. It is a country that has experienced social and political change on a vast scale over the last century (Goulding and Domic, 1986: 86). Post Second World War, the Yugoslav Communist Party attempted to formulate a new society, firstly implementing the Soviet model, then later developing socialist self-management (Duda, 2014). It appeared as though Yugoslavia had created a middle ground between the ideas of capitalism and Soviet central planning. On both the domestic and international levels, they relied on a unique model of Yugoslav market socialism to lead production and exchange. The ideas of ‘social ownership’ as well as self-management of enterprises by the workers maintained the element of socialism (Estrin, 1991: 87).

When juxtaposed with other socialist countries, however, there are a number of distinguishing elements associated with Croatia. ‘Its form of central planning was far more decentralised and market-related than in most other transition economies’ (Hoffman, Bićanić and Vukoja, 2012: 206). They entwined a degree of planning with market instruments, therefore permitting enterprises a greater level of freedom when it came to decision-making. There was also a notable structure to the Croatian economy; a fairly sizeable part was the manufacturing sector, which operated alongside an already significant and still growing services sector. The tertiary and quaternary sectors of the Croatian economy grew from an already large portion of the total businesses at 40.9% in 1961 to 51.2% by 1991 (Feletar and Stiperski, 1996). Another factor that stood out regarding Croatia was its ability and willingness to trade with both centrally-planned and market economies, which increased its international trade significantly.

Although the aforementioned elements of decentralisation and market-relatedness may have seemed to be an ideal environment for transformation to occur, these were very turbulent times for Croatia. ‘The case of Croatia is unique to other transition economies, not only did Croatia face an inflationary environment like other transition economies, but was establishing a sovereign economy while embroiled in a war and occupation of its territories’ (Payne, 2002: 220). Croatia’s tribulations continued in the post-war period; its export growth was much lower than the other eastern European countries, and to make matters worse, it was accompanied by faster import growth - which led to increased import competitiveness on the local market and the build-up of an unsustainable current account deficit (Vidučić, 2000). Furthermore, Croatia suffered from increasingly high levels of unemployment towards the end of the socialist system, with figures of between 160,000 – 170,000 between 1980 and 1990 and reaching 280,000 during 1991 (Feletar and Stiperski, 1996). Despite the Yugoslavian leaders trying to attain the perfect mixture of the market system and planned economy, it seems that Croatia generally tended to lend itself towards the traits of other European market economies. That being said, the Croatian economy still suffered from similar deficiencies to the other centrally planned economies - such as reduced efficiency and issues with inflation (Kraft, 1995). Much to the initial displeasure of the US and the European Community (EC), on June 25 1991, the Croatian parliament passed a Constitutional Act of Independence, which announced their separation from the Socialist Federal Republic of Yugoslavia (SFRY) (Iglar, 1992). However, following a Yugoslav army offensive against Slovenia, international opinion of Croatia’s actions shifted.

### 3.2.2.1 The role of undeclared activity in socialist times

Although undeclared work may have been different in nature during socialist times, than in the current context, it certainly played a role in Croatia’s economy and social life. As Rubić (2013a, 2013b) states, the socialist period saw a normalised role of undeclared operation for a number of different activities, such as cleaning services and construction work. Moonlighting was particularly common with individuals carrying out declared work during the morning hours, whilst undertaking undeclared work in the afternoon hours (ibid). According to Rubić (2013b), other than low levels of trust in the state, undeclared work also occurred, due to low formal wages, as well as the building of social capital within communities. Bejaković (2009) also argues that there was absence of state support during socialist times, as well as a lack of focus on social issues. Furthermore, citizens were faced with significantly high taxes (ibid), which may have been a contributing factor towards widespread undeclared practices.

## 3.2.3 The early period of Croatia’s transformation

Before discussing the period following Croatia’s independence, it is necessary to consider definitional issues surrounding the term of transition. Although it is widely used, the term carries with it many theoretical problems (for a full review see Chapter 2 in Williams, Round, and Rodgers, 2013). They describe how the term refers to countries that were in transition from a particular economic system to a market economy, implying that there is a definitive completion point where the reforms are accomplished and finished. Not only does this suggest that there is such a thing as a perfect market economy, it ignores social costs and assumes that the majority benefit. The discussion in this chapter shows that this has certainly not been the case in Croatia. Instead, the use of the term transformation, is gaining popularity as a ‘more nuanced term, to describe and theorise reforming economies as it recognises that there are a multitude of starting points and that there is no fixed, pre-determined outcome’ (Williams et al., 2013: 12-13). This is accepted in this thesis as a term that better encapsulates the contextual view that history, geography and institutions matter. There are many factors, issues and occurrences that cause different countries to follow different trajectories and at different speeds, resulting in diverse outcomes and results.

The unique model of Yugoslav market socialism sets apart the ex-Yugoslavian countries in terms of the system in place. An example of how Croatia differs is that, whilst in some transformation countries the vast majority of the unemployed were absorbed through self-employment, this was not the case in Croatia (Macura, 2005). This was due to high prices of capital, labour costs as well as taxation (ibid) and contributed to the development of the undeclared economy. Moreover, one merely has to look at the countries of ex-Yugoslavia now (Croatia, Bosnia, Slovenia, Macedonia, Serbia, Kosovo and Montenegro) to see the potentials of divergence in transformations. However, it is important to note, that even though there are a large variety of paths for transformation societies, there are some common features. According to Crowley and Ost (2001), these include features such as increasing unemployment and socio-economic inequality, as well as relatively weak trade unions.

The transition, as it is termed by much of the literature discussing Croatia, from the socialist system in the country, is formally recognised as having begun in 1989. However, such estimations are as loose as the boundaries are blurred. Having served as the Prime Minister of Croatia for a short term in the 1980s, in March 1989, Ante Markovi*ć* became the last Prime Minister of the Socialist Federal Republic of Yugoslavia. As a firm believer in Yugoslav unity, he intended to engage in radical reform of the country’s economy. Not only did he pass laws which enabled the market to operate freely, he also passed other laws which encouraged privatisation; the effects of which were felt by the end of the year and inflation soon dropped to single digits thereafter (Rogel, 2004). It was on the 25th June 1991 that Croatia declared its independence. The Yugoslav People’s Army, due to Croatia having a number of majority Serb-populated areas and the largest part of the coastline, opposed this action. A six-month war, followed by a ceasefire in January 1992, saw the occupation of Vukovar and the breakaway of the ‘Serbian Republic of Krajina’ until 1995.

Croatia’s credit rating increased, following its membership of the International Monetary Fund in 1992, giving much needed access to financial markets. The following period saw an increase in debt, which had some superficial success. However, the economic situation deteriorated, with the balance of payments being a particular problem, due to an increase in imports. The international debt increased to 33 per cent of the GDP in 1997 (Bartlett, 2003).

According to Vizek and Broz (2009: 87) the majority of transformation countries, whether they were new EU members or candidate countries, experienced increases in inflation during 2007 and 2008, but Croatia managed to keep its rate of inflation at around 3%. Also during the early stages of the transformation period, in order to try and repair some of the damage done in the war, the Croatian government invested heavily in structures such as: highways, bridges, universities and schools - which impacted output growth positively (Skare and Sinkovic, 2012). It must however be noted that, to an extent, the potentially positive climate in the early stages was counteracted by the disruptiveness of war and the dissolution of Yugoslavia. ‘Political instability increased the riskiness of investment throughout the region and discouraged inflows of foreign investment’ (Bartlett and Samardžija, 2000: 247). Furthermore, the role of corruption during the privatisation process throughout the 1990s (čučkovic, 2002), and lack of public trust in institutions relating to such issues (šundalić, 1999) were factors that were likely to contribute towards a weakening social contract and engagement in undeclared work during this period.

## 3.2.4 European Union relations

In order to mark Croatia’s agreement with the EU, the WB-EU summit was held during November 2000 in Zagreb and in May 2001. A feasibility report by the Commission discussed the opening of negotiations for an SAA, which came into effect in March 2002 (European Commission, 2004: 6). Croatia’s integration into the European Union proved to be a struggle, with a number of issues arising with regard to religion and its lack of self-rule, amongst other things. The EU was determined not to create the same problems that arose out of Bulgaria and Romania’s accessions, and what is more, the Croatian citizens needed convincing that the benefits of EU membership were worthwhile, even up until the day before their entry (Konitzer, 2014). The previously mentioned religious issues, stemmed initially from the clash of Catholic and Orthodox values. Croatia is in the majority a Catholic country, but an Orthodox component was introduced in the 16th century. There was a migration of Serbians to the military border (Vojna Krajina), the buffer zone of Austria against the Ottomans, where in exchange for their military services, they were awarded a high degree of autonomy and freedom of religion (Stallaerts, 2010: 277). This created tension between the staunch Catholics of Croatia and the Orthodox Serbs. After the Nazis invaded Yugoslavia during the Second World War, the Ustasha (a Croatian fascist government) created a puppet state in Croatia and mercilessly executed Serbs, Gypsies, Jews and other non-supporters, dividing the church hierarchy (Kunovich and Hodson, 1999).

Furthermore, according to a European Commission report (2003), the pace of the reform was affected by a lack of internal cohesion of the government coalition. The end of 2002 saw a mixed combination of outcomes. There were some positive features in terms of political stability and democratic consolidation. However, there were issues in terms of freeing the media from political intervention, poor cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY), as well as corruption. Furthermore, the structural reforms were delayed and there was public opposition to unpopular measures (ibid). It is clear that such issues hampered progress towards EU membership but issues such as public opposition, could have also been indicative of a weak social contract between the citizens and state.

Croatia proceeded to apply for EU membership in February 2003. By the end of this year the Croatian Democratic Union (HDZ in Croatian) returned to power with a pro-Europeanist manner. The issued opinion of the European Commission in 2004 showed overall satisfaction with the Stabilisation and Association Agreement (SAA) related legislative progress and the acquis. The country gained candidate status later in the year and began extensive reforms to comply with relevant membership criteria. Although progress was slow, in part due to poor judiciary and administrative capacities, Croatia eventually joined the EU in July of 2013.

## 3.2.5 Conclusion

In no more than 25 years, Croatia underwent a significant transformation, developing and evolving both its economy and its political system. It not only went through economic system changes, starting the process from social ownership to privatisation, in order to create a market economy, but also engaged in a political transformation from a one party Communist system, to a pluralist democracy. Policies were introduced and reforms were undertaken as a means to negate macroeconomic imbalances, establish a market economy framework and reintegrate the national economy into the EU and other global economies (Vidučić, 2000:47). As if that was not enough of an undertaking, Croatia also had to go through war and struggled with religious unrest – a wide array of challenges. Over the last century, social systems have become increasingly diverse; various technological advances, such as widespread foreign travel and mass media causing increased exposure, have blurred the distinctions between different cultures.

# 3.3 Framing undeclared work in Croatia from the perspective of vertical and horizontal relations

Given this context, attention now turns to understanding the vertical and horizontal relations within Croatia, to start to develop from a social exchange perspective, a contextual understanding of the reasons for undeclared work.

## 3.3.2 The social contract (vertical relations)

The influence of formal institutions in the development of undeclared work in the case of Croatia has a historical presence. Szelyeni and Kostello (1998), for example, state that undeclared work during the communist era in Eastern Europe, served as a compensatory mechanism, providing a source of adjustment to the limitations of the command economy’s formal institutions. Indeed, Ott (2013) argues that the pervasive problems that characterise Croatia’s economy have roots in such administrative and institutional shortcomings. Whilst describing bureaucracy and corruption related issues, she outlines the superficial nature and lack of tangible content of the already implemented reforms. Furthermore, Ott notes that there is absence of a long-term strategy, as well as policy coordination. Bejaković (2012) argues that the social contract that exists between the government and its citizens has deteriorated, due to a lack of procedural fairness, redistributive justice, a weak rule of law and widespread corruption. Franc et al. (2012) find that the lack of participation in political life in Croatia, is due to the perceptions of individuals who are unable to have any influence on decision-making that affects local or more global communities. This suggests a lack of participation, due to a weak social contract and the negative expectations that have arisen.

Corruption is a worldwide phenomenon and is one that is closely related to that of undeclared work. In practice, the two are often interlinked and it is therefore important to have an insight into the levels of corruption of the country being studied. Akin to the problems involved when studying undeclared work, the covert nature of corruption has led to differing estimations of its levels.   
Perhaps the most relevant estimations, in the context of this thesis, are those taken by direct surveys of the perceptions of the general public. This is because if an individual perceives there to be a high level of public sector corruption, even if the true level is miniscule, the actions of that individual will be based on their own perception levels. For example, this perception might cause them to have lower levels of trust in government, as well as a diminished consideration of the benefits of declared work, which may in turn affect their decision to work declared or undeclared. The Special Eurobarometer Survey on corruption, sheds some light on the extent of the problem, finding that 94 per cent of those surveyed, view corruption as highly prevalent in all aspects of society (European Commission, 2014b). A further 89 per cent, think that the easiest way to gain access to public services is through bribery and nepotism. The presence of corruption creates significant barriers in conducting business, and therefore can be considered an important barrier to formalisation. Indeed, 60 per cent of companies recognise it as an obstacle in their business, which is significantly higher than the average EU level of 43 per cent (European Commission, 2014a). Štulhofer (1997) shows that the lack of trust is not a consequence of the socialist era, but is instead a response to the new system, characterised by corruption. This acts as a significant barrier to both the perceived and actual fairness in the country.

As Acemoglu et al. (2002:10) state, ‘one should not try to understand or manipulate economic institutions, without thinking about the political forces that created or sustain them’. Beyond corruption, political structures also have an effect on the formation of the social contract. Schöpflin (1993: 268), for example, argues that ‘Almost hypnotically, people turned to personalities, virtually without regard to their political programmes, as a repository for society’s hopes and desires in particular, because persons were felt to be more reliable, more authentic and thus more likely to embody what the individual wanted.’. The implication here, is that such an occurrence would contribute towards the development and perceived legitimacy of formal and political institutions. Therefore placing the focus on individuals, rather than collectives, is likely to inhibit the role of institutions in developing tax morale, as well as causing an increased reliance on informal institutions. However, there appears no concrete evidence in showing a direct link. Others argue that it is unreliable behaviour of political elites and their abuse of power and institutions that causes democratic deficits (Gallina, 2010; Ledeneva, 2006). O’Dwyer (2004) points to practical and administrative inefficiencies caused by favour exchanges and corruption, leading to state employees not being qualified for the positions they get. This ability to exercise power by relying on informal networks and practices further reduces the accountability of the state (Ledeneva, 2006). The frequency of the Croatian change of political powers, further adds to political instability that can cause a lack of trust in formal institutions.

### 3.3.2.1 Economic and social factors

Although the state does not have full control over economic and social factors, the manner within which these are dealt with, are likely to have an impact on the way individuals perceive the state. Škare (2001), for example, argues that a bad macroeconomic strategy and postponing of structural reforms, contributed towards low economic growth. Furthermore, during the early period of the transformation in Croatia, the private sector was not able to compensate for the loss of jobs in the state sector, absorbing only a sixth of those who lost their jobs Macura (2005). A contributing factor towards this was a high level of taxes set by the state. Such views of government inadequacies are bound to contribute towards the worsening of the social contract between the individual and the state. Furthermore, it was only in 2009 that the Croatian Bureau of Statistics issued data on social spending. The information showed that, in 2007, Croatia’s social expenditures (17.5% of GDP) were much lower than that of the EU27 average (26.1%) (Stubbs and Zrinščak, 2010). This indicates that the government is not doing as much as other countries in terms of provision of public goods and services and is as such, likely to damage the social contract and make individuals attribute social and economic problems as the fault of the state.

Bartlett and Monastiriotis (2010) describe Croatia entering the recession during the latter part of 2008, slightly after most other European countries. This resulted in adverse economic trends that were only partly mitigated in 2011, with economic growth being negative in 2009 and 2010, but zero in 2011. However, 2012 again saw a drop by 2 per cent having further negative consequences on the labour market. The aggregate decrease of real GDP in the 2009-2012 period amounted to 11.2 per cent (European Parliament, 2013). Considering unemployment rates, the figure of 17.2 per cent in 2013 (Eurostat, 2014) is one of the highest unemployment rates within the EU, with only Spain and Greece higher. The fact that almost two thirds of those who are unemployed, have been without work for more than one year, suggests the longevity of the problem. Moreover, it is younger generations who are particularly affected, as according to the Croatian Bureau of Statistics (2013), 43.1 per cent of those aged 15 to 24 face a lack of declared employment. This provides some clarity as to why some individuals engage in undeclared work in Croatia. Macura (2005) states how many unemployed individuals are trying to make ends meet, because the monthly allowance from the state is not enough. As such, some choose to work in the undeclared realm. Crnkovic-Pozaic (1997) argues that during economic downturns, undeclared work acts as a necessary evil that allows those who would otherwise rely on the state to take care of themselves.

In 2013, the average annual net earnings in Croatia were 6,148.48 (Euros), which is low compared with the EU28 average of 16,088.49 (Euros) in that year (Eurostat, 2015). In fact, only Bulgaria, Romania, Latvia, Lithuania, Hungary, Poland and Slovakia have lower earnings (ibid). On a more positive note, compared with the EU28 (16.3%), Croatia fares very well in terms of having a low gender pay gap with 7.4 per cent as a difference between average hourly earnings of male and female paid employees, as a percentage of average hourly earnings of male employees (Eurostat, 2015). It seems, however, that certain groups are more at risk of losing their job, with job insecurity being higher amongst those with lower education levels (Galic and Plecas, 2012). Despite the generally low wages, there are some more positive financial aspects in Croatia. For example, as a result of mass privatisation of previously state-owned housing stocks in the early 1990s, three quarters of Croats own their own home (Eurofound, 2014). Given that the majority of these own their own home mortgage-free, this reduces financial pressures (ibid). On the other hand, a national survey of working conditions indicates that 82.8 per cent of Croatian employees experience psychosocial and occupational hazards (Bogadi-Sare and Zavalic, 2009). In terms of working conditions for self-employed individuals, Croatia ranks 5th out of 34 countries in terms of length of working hours (Eurofound, 2012). This is especially significant, considering that in Croatia, the proportion of self-employed individuals (17.6%) is higher than the EU28 average (Eurostat, 2013). These issues, in part, point to the failures of formal institutions in regulating the economy.

### 3.3.2.2 The business environment

Given that the legalist approach advocates the reasoning for undeclared work to be over-regulation of the government and bureaucratic barriers, the ease of doing business in Croatia is worth investigating. Evidence from the World Bank Doing Business Survey, allows some light to be shed on the general environment for business procedures in Croatia. Croatia ranked 89th (out of 189) in the Doing Business 2014 survey (World Bank, 2013a). In fact, the only other EU country that received a worse ranking, was Malta (103th place). Looking to more specific details, some crucial issues included the following:

-it takes 8 days to start a business in Croatia   
-starting a business encompasses 6 procedures  
-it costs 9.3% of income per capita and requires a pay-in of a minimum of 10% of income per capita.

The World Bank Doing Business Survey includes useful indicators as to obstructions of declared entrepreneurship, as it assesses eleven areas related to business life cycles (World Bank, 2014). The findings from the survey place Croatia at the 65th place out of 189 countries. Furthermore, it is shown that Croatia ranks lower than both Western countries with well-established institutions, but also than its neighbouring countries. As such, this might be a reason why certain entrepreneurs choose to work undeclared. The reason here might extend beyond the difficulty to conduct business in the declared market. The indicated failure of institutions might also reduce the trust in institutions, resulting in lower tax morale. Although it is unlikely that the disappointing results in conducting business are the sole reason for the persistence of the undeclared economy in Croatia, given the poor conditions, it is very plausible that it is a significantly contributing factor.

## 3.3.3 Horizontal relations

This section focuses on presenting literature that unearths the tax morale, which although potentially indicative of a weak social contract, might also be a result of the perceived social acceptance of undeclared work. If it is perceived that such a practice is more common, then it is more likely to be acceptable. From this perspective, tax morale is an important discussion in the context of horizontal relations, because it can be influenced by relevant social norms that either approve or disapprove of undeclared activity. According to the EVS (2011), every third citizen in Croatia tolerates tax evasion. Furthermore, Bejaković (2009) and Rubić (2013) point to the embeddedness of undeclared work. These findings indicate that undeclared work is deeply entrenched in Croatian society and has relevance across many informal institutions in the country. This indicates its importance in terms of studying the influence of social norms. Moreover, as it is younger generations who are inclined towards informality, the findings might suggest the long-term nature of undeclared work in Croatia (Štulhofer and Rimac, 2002). However, a direct connection between low tax morale (personal norms) and social norms cannot currently be drawn on an individual basis, as there is a lack of research investigating this link in Croatia. Therefore, we do not know how the actions or perceptions of others towards undeclared work impact on the individual decision making process. This is hence a gap in the research of undeclared work in Croatia, which will be filled through the use of the framework developed in Chapter 2.

# 3.4 Undeclared work in Croatia

Here, a review is provided of previous literature on undeclared work in Croatia in particular, but also in post-socialist transition economies more generally. The undeclared economy has been the subject of substantial academic interest in developing countries, due to its significant size and impacts (Charmes, 1990), whereas the attention given to undeclared work in transformation countries has been more recent. Contradicting the view that socialist countries were characterised by relatively small undeclared sectors (in comparison with developed countries), Kornai (1993) and Lacko (1998) provide empirical evidence that shows its pervasiveness to be more widespread than in average market economies. Whereas it was theorised that the undeclared economy acts as a safety regulator for political discontent in the West, socialist countries have a further problem of resources being withheld by states, due to the overall imposition of scarcity (Feige, 1989). According to Grossman (1982), the manifestation of informality in places such as the USSR, takes the form of exchange of favours in the form of *access* to goods and services, as well as the private lucrative use of state property and corruption in the form of bribery.

Ellman (1989) describes the presence of ‘second’ and ‘third’ economies as a usual characteristic of centrally planned economies. Where the second economy refers to privately produced hidden transactions of goods and services by individuals, the third encompasses activities hidden by large enterprises. The onset of the transformation period saw the legalisation of the ‘second’ economy (Gerxhani, 2004) whilst Dolgopiatova (1998) argues that the ‘third economy’ persists, and is unique to transition countries.

Considering the pro- or anti- cyclical correlation between the declared and undeclared economy, Arvay and Vertes (1995) carry out interesting research in Hungary. They find that the socialist era is characterised by a pro-cyclical relationship, which changes to one of an anti-cyclical nature during the transition period. Wallace and Haerpfer (2002) describe the then more ‘successful’ transformation countries such as Slovenia, Poland and Hungary, where the declared economy is becoming of increasing importance. However, it is also argued that the undeclared economy has been growing in some eastern and south-eastern European countries since the beginnings of the transition. Providing an analysis of the undeclared economy in post-socialist central and eastern European countries, Wallace and Latcheva (2006) use data from the New Democracies Barometer (NDB). The typology they provide is based on declared and undeclared activities concerning the main source of family income. On this basis, they divide countries into three groups, with Croatia falling within the first category of those where undeclared work is mainly carried out for reasons of improving household income, and is labelled the black economy. The second group consisted of those countries where social economies or household economies prevail (e.g. Ukraine and Romania), whereas the third categorisation falls to those where the declared economy prevails over the undeclared (e.g. Hungary and the Czech Republic).

As it is evident that undeclared activities in transformation countries pose significant difficulties, it is not the specific size of the undeclared economy that is of key interest, but rather the nature of its composition and the motives that underline the decision-making processes of individuals engaging in such work. Nonetheless, an overview of such data in Croatia is presented not only because it is useful to have a general estimate of the size of the undeclared economy, but also because it is useful in recognizing trends as well as comparing estimates with other countries. Before moving onto descriptions of estimates derived from direct methods an overview of indirect methods is presented.

Widely cited estimations of the undeclared economy are those generated by Schneider (2013). These estimates are particularly useful in the fact that they cover all of the EU countries and therefore allow for an international comparison. Using the MIMIC method that is based on a structural equation model with an unobservable dependent variable, it is estimated that in 2013 the undeclared economy accounted for 28.4 per cent of the country’s GDP. With the EU27 average being 18.4 per cent, this places Croatia’s shadow economy as much more significant than in many countries, with only Bulgaria and Romania having higher figures. Taking the data from Schneider (2012) of the shadow economy in Croatia in previous years, we can begin to see the pattern that forms.

**Figure 3.1: Estimate of the shadow economy in Croatia source: based on data from Schneider (2012)**

From the table, it is evident that according to these estimations, the undeclared economy’s relative size has shrunk over time (during the 2002-2014) period with a slight increase in the 2008-2009 period. These findings negate for Croatia the aforementioned assumption that the undeclared economy has been growing in transformation countries. Also, using the MIMIC method, Klaric (2011) defines the undeclared economy in a broader scope that includes, amongst other aspects, illegal and underground production. Interestingly, the largest share of the undeclared economy (as defined by his research) is that of 6.7 per cent (2000) with the most recent figure being 4.2 per cent in 2009, which is staggeringly lower than Schneider’s estimate of 30.1 per cent. However, Klaric also notes the decreasing trend, which is incidentally, once again found in the work of Galic Nagyszombaty (2012). However, although her trend of results corresponds to Schneider’s increase in the 2008-09 period, she also finds a subsequent increase in the 2009-10 period, where Schneider’s results indicate the return to a decreasing trend.

Although there has been much work using indirect methods to estimate undeclared work in the country, there has been a scant amount of estimations using direct survey methods. The exception is the 2013 wave of the Special Eurobarometer Survey on undeclared work. Croatia was unfortunately not included in the 2007 survey, and therefore we can only see the picture from a moment in time, rather than identify trends. In their analysis of the Eurobarometer data, Franic and Williams (2014) show that in Croatia, 7.3% of participants were engaged in undeclared work during the 12-month period, prior to completing the survey. The groups they describe as being more susceptible in terms of engaging in undeclared work by occupation (Figure 2.5) are manual workers, the unemployed and the retired. In total, these account for approximately 70 per cent of all undeclared workers in Croatia, with 31.5 per cent falling to manual workers.

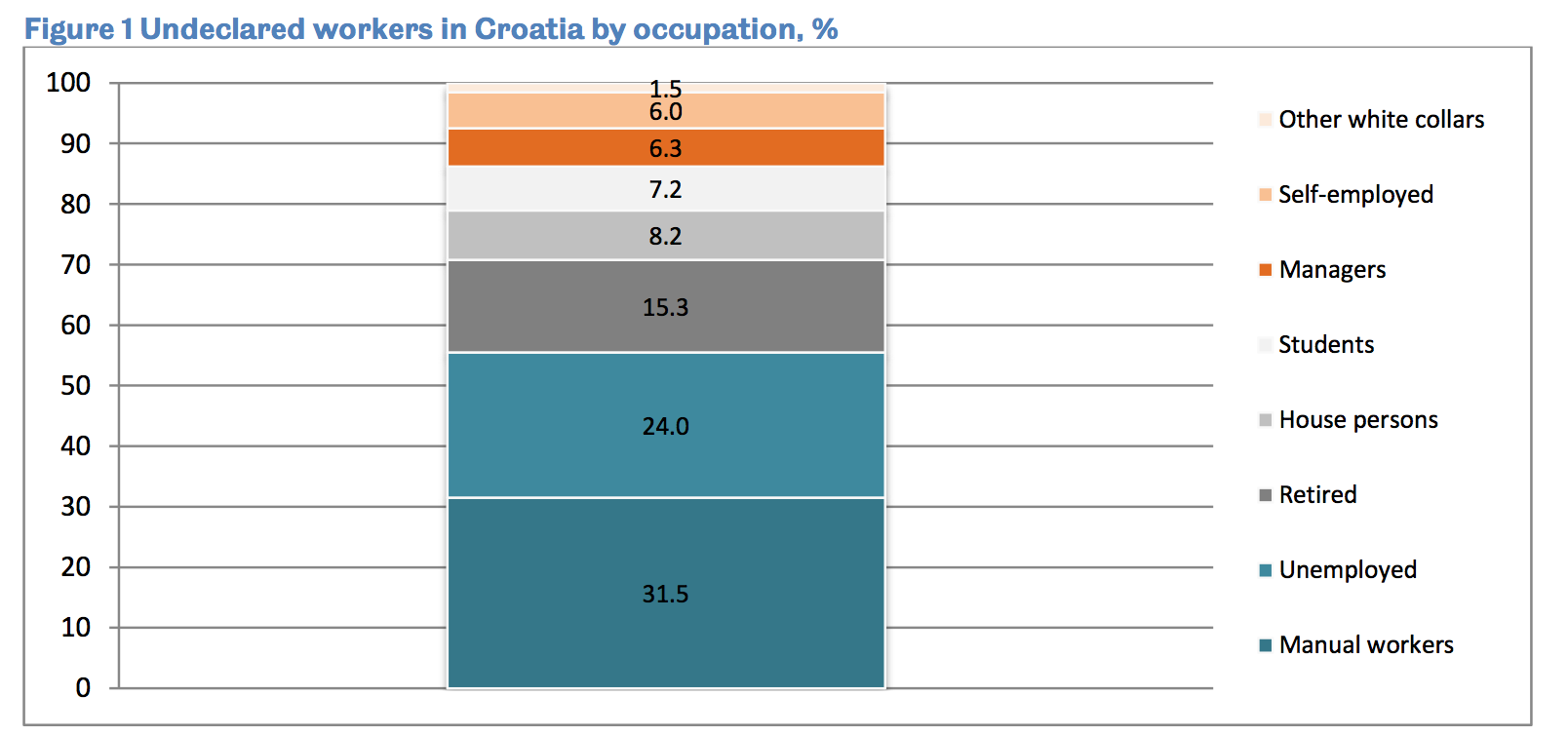


Figure 3.2: Undeclared workers in Croatia, by occupation. (Source: Franic and Williams (2014) Special Eurobarometer 402 calculations)

Grossman (1982) emphasises the social aspect of undeclared work in the context of centrally planned economies giving particular importance to the study of social networks. He also details the strength of the link between the state and non-state activities as a typical feature of undeclared work. In agreement, (Kaufmann and Kaliberda, 1996) argue that these two characteristics persisted during the transition period. The emphasis on community, ties in with the already discussed complementary perspective (Williams and Round, 2008), where individuals participate in the undeclared economy as a means of reinforcing social capital or simply helping friends and neighbours. The manifestation of this phenomenon is exemplified by the Eurobarometer data, where it was found that the most frequent purchasers of undeclared goods and services seem to be friends, colleagues and acquaintances, which is closely followed by neighbours (Franic and Williams, 2014).

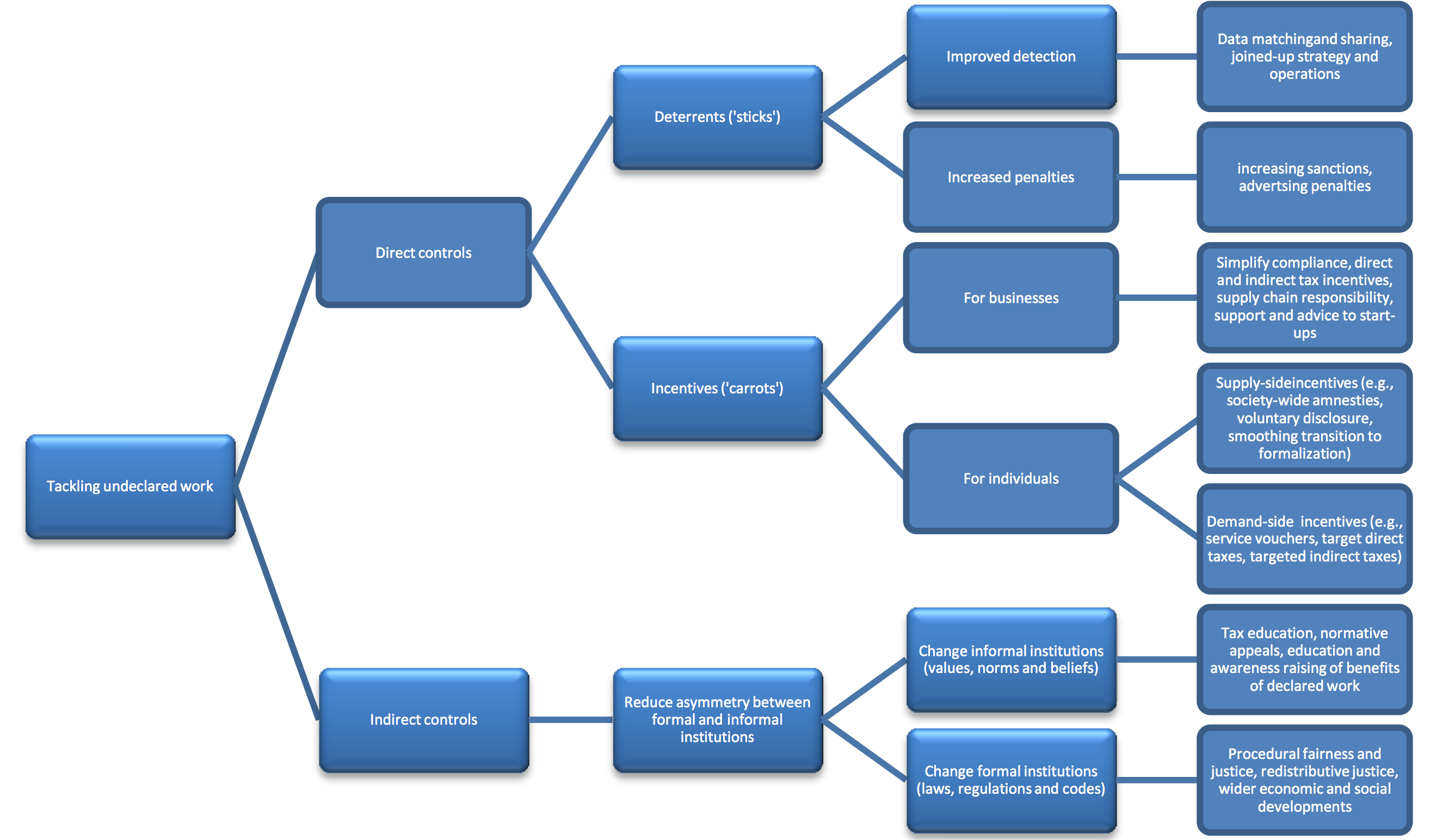
Framing the discussion of the context in such a manner has brought to the fore a number of gaps and research needs in Croatia. Firstly, it is necessary to more clearly determine the link between the perceptions of the state and engagement in the undeclared economy. Second, there is a need to consider the effects of social norms in, terms of tolerance of undeclared work. If social norms do indeed have an effect on such tolerance, then there is a need to investigate the role and formation of such norms. Having identified the specific gaps in literature surrounding Croatia, the following section looks at the current policy approach adopted in the country.

# 3.5 Available policy options and Croatia’s approach

## 3.5.1 A brief review of literature surrounding policy options for tackling undeclared work

This section firstly provides a brief overview of existing policy approaches to tackle undeclared work, before outlining the current policy situation in Croatia.

Usefully, Williams (2014a, 2014b) develops a heuristic conceptual framework that provides a summation and review of the main available policy approaches. In doing this, he explains the two contrasting approaches of direct and indirect controls. Whereas the former is focused on detecting and punishing evasion or non-compliance (deterrence), as well as rewarding and incentivising compliance (incentives), the latter seeks to foster internalised control in the shape of tax morale.



**Figure 3.3- A typology of policy measures for tackling undeclared work. (Source: Williams, 2014a)**

3.5.1.1 Direct controls

Direct controls focus on the employment of deterrents and/or incentives to tackle undeclared work. Representatively of such an approach, the OECD (2008: 82) states that ‘Combating [undeclared] employment requires a comprehensive approach to reduce the costs and increase the benefits to business and workers of operating formally’. Such an approach is consistent with the utilitarian perspective of social exchange, which assumes that an individual rationally considers the advantages and disadvantages of both the declared and undeclared economy in their decision-making process (see Chapter 2).

The use of deterrents can be viewed as the most traditional approach, as it is based on the utilitarian assumption that an individual will take the opportunity of exiting the declared economy unless the benefits of informality are lower than the expected costs of detection. Taking the view of informality from a microeconomic perspective, tax evasion can be understood from the viewpoint of consumer choice under uncertainty theory (Katz and Rosen, 2005). The general principle behind this is explained by (Becker, 1968:176):

‘[A] person commits an offense if the expected utility to him exceeds the   
 utility he could get by using his time and other resources at other   
 activities. Some persons become ‘criminals,’ therefore, not because their   
 basic motivation differs from that of other persons, but because their   
 benefits and costs differ’.

It is thus suggested that for a given probability of detection, penalties should be increased proportionally to tax increases, in order to discourage undeclared work. This is because a higher tax rate increases the benefit of operating on an undeclared basis and should therefore be countered by an increase in penalty or strengthening of control. An example of the latter might be increased intensity and frequency of labour inspections. The use of this policy, therefore aims to change undeclared behaviour by detection and punishment. Support for this utilitarian model of compliance is found both empirically and experimentally, in that generally a negative relationship between probability and severity of punishment and the level of crime is found (Andreoni et al., 1998) which has also been extended to tax compliance literature (for example Beck et al., 1991). However, it is also shown that increases in punishment do not necessarily have the same effect as increases in the probability in detection. Furthermore, it does not account for the presence of corruption, where an increase in punishment increases the benefits of bribery.

Based on similar utilitarian underpinnings, the approach of incentives seeks to use positive reinforcement by rewarding compliant behaviour. This represents a shift that has occurred in practice, towards incentivising formality, by making declared activities more accessible and beneficial (Renooy et al., 2004). As part of this shift, simplifying regulations and providing business support and advice (Williams and Renooy, 2009) are appropriate policy measures. Furthermore, curative measures such as amnesties for those willing to transfer to the declared realm or service vouchers, are thought to be efficient measures. However, both sets of policies encompassed by the direct approach, see individuals as rational economic actors equipped with perfect information. As such, the approach is limited in capturing behaviour that is ‘imperfect’ or driven by non-utilitarian motives such as fairness, reciprocity, norms and morality (Alm, 2011).

3.5.1.2 Indirect controls

The indirect controls perspective is built on the premise that in many societies, the laws and regulations of formal institutions are incongruent with the norms and values of the informal institutions (Williams, 2014a, 2014b). This asymmetry, in turn, gives rise to activities that are not aligned with the laws and regulations of formal institutions, but are accepted or tolerated within the boundaries of the formed norms of informal institutions/norms (Webb et al., 2013). Undeclared work is seen as one such activity that can be tolerated in societies where trust and confidence in formal institutions is particularly low. In this view, levels of tax morale are representative of the gap created. Tax morality can be defined as, an individual’s intrinsic motivation to pay the tax owed to the state (McKerchar et al., 2013), where a strong correlation has been found between the tendency to engage in undeclared work and the level of tax morality (Alm et al., 1995). As evident, the anthropological/sociological interpretations of social exchange fit well with this approach, as the tax morality (personal norm) can be explained as a product of the state of the social contract, as well as the influence of social norms. Therefore, the indirect controls sphere sees the role of policy, in attempts made to reduce the institutional asymmetry and ensure individuals and states act in accordance with one another. The options available to achieve this, thus, are changing the informal and/or the formal institutions of the context where incongruence is found.

As is outlined by Williams (2014a, 2014b), changing formal institutions can be achieved through procedural justice, fairness and redistributive justice improvements. This would entail improving the degree to which the citizens of a country find their tax authorities as respectful and impartial, ensuring that everyone is paying their fair share as compared to others, and citizens receive goods and service that are seen as deserving in relation to the taxes that are paid. Furthermore, it is also advocated that pursuing wider economic and social developments is imperative to change formal institutions (Williams and Renooy, 2013, 2014). Focusing on changing informal institutions, on the other hand, leads to the development of policies that seek to improve tax knowledge of the country’s citizens or change attitudes through awareness-raising campaigns and normative appeals.

3.5.1.3 Combining direct and indirect measures

The variety of measures can be used in tandem or independently, according to the nature of informality in the context that the policy is applied to. Choosing an approach that combines the different policy options, is more in line with the contextual view of informality explained in Chapter 2. Furthermore, it is in line with the multilevel approach to SET, which incorporates utilitarian and anthropological/sociological perspectives. In doing this, it is recognised that individuals are motivated by monetary considerations at some points, as well as their sense of social responsibilities to others (Braithwaite et al., 1994; Braithwaite 1995). Two popular approaches that seek to combine the policy approaches, are that of responsive regulation (Job et al., 2007) and the slippery slope framework (Kirchler et al., 2008).

The responsive regulation model focuses on initially facilitating the self-regulation of citizens, whereby the responsibility is placed on them. This is then followed by incentives to further encourage participation in the declared realm. Considered a last resort, punitive measures serve as a tool for capturing those who were not responsive to previous measures and incentives. The responsive regulation model is especially useful in terms of its flexibility in dealing with taxpayers. However, there is a lack of empirical evidence evaluating the model. The slippery slope framework also focuses on combining measures, but does so by emphasising the building of trust in formal institutions (voluntary compliance) as well as power (enforced compliance) (Kogler et al., 2015). This approach maps across direct and indirect controls as direct approaches are more focused on power, whilst indirect have greater emphasis on trust. The slippery slope model has research supporting the effectiveness behind its underlying assumptions, that it is necessary for both power and trust to be high, in order to foster compliance (Muehlbacher et al., 2011; Wahl et al., 2010). The next section looks at the approach currently taken by Croatia.

## 3.5.2 Croatia’s policy approach

In their organisation of the fight against undeclared work, Croatia does not have a single agency or coordinating body that is responsible for organising action of the various departments involved. Further still, no lead department has been assigned the responsibility to tackle undeclared work. As such, there are different governmental organisations responsible for varying elements. These departments generally have their own separate targets that lack a long-term perspective as they vary according to the set project (Baric and Williams, 2013). Nonetheless, positive action of cooperation and coordination was found with some projects as well as improvements in data sharing across departments (ibid). This shows that although the situation in Croatia is not well developed, steps are being taken in the right direction.

Based on Dekker et al.’s (2010) instrument used to study EEA countries, Baric and Williams (2013) report the results of a survey conducted in Croatia which show that practices for tackling informality in the country are fairly similar to those of other EU member states, in that deterrence is a largely predominant approach with the recent introduction of some preventative measures. Looking to curative measures, on the other hand, Table 2.2 shows that only three such measures have been adopted. Furthermore, although policies that seek to foster commitment amongst taxpayers are used to a certain extent, they are not widely or holistically recognised as major strategies for tackling informality in Croatia.

**Table 3.1 Policy measures used in Croatia and the EEA to tackle undeclared work**

|  |  |  |
| --- | --- | --- |
| Policy measure | Croatia | % of 31 European nations using measure: |
| REPRESSION |  |  |
| *Penalties:* |  | *93* |
| Administrative sanctions for purchasers/companies |  | 87 |
| Administrative sanctions for suppliers/employees |  | 83 |
| Penal sanctions for purchasers/companies |  | 74 |
| Penal sanctions for suppliers/employees |  | 52 |
| *Measures to improve detection:* |  | *100* |
| Data matching and sharing |  | 83 |
| Workplace inspections |  | 100 |
| Registration of workers prior to starting work or on first day of work |  | 74 |
| Coordinating strategy across government |  | 57 |
| Certification of business, certifying payments of social contribution and taxes |  | 65 |
| Use of peer-to-peer surveillance (e.g. telephone hotlines) |  | 39 |
| Coordination of operations across government |  | 61 |
| Coordination of data sharing across government |  | 65 |
| Mandatory ID in the workplace |  | 65 |
| *ENABLING COMPLIANCE:* |  |  |
| *Preventative measures:* |  | *90* |
| Reduce regulations |  | 48 |
| Simplify compliance procedures |  | 87 |
| Technological innovations (e.g. certified cash registers) |  | 43 |
| New categories of work (e.g., for small or mini-jobs) |  | 35 |
| Direct tax incentives (e.g., exemptions, deductions) |  | 61 |
| Social security incentives |  | 35 |
| Ease transition from unemployment into self-employment |  | 65 |
| Ease transition from employment into self-employment |  | 44 |
| Changing minimum wage upwards |  | 48 |
| Changing minimum wage downwards |  | 9 |
| Training & support to business start-ups |  | 61 |
| Micro-finance to business start-ups |  | 52 |
| Advice on how to formalise |  | 61 |
| Connecting pension schemes to formal labour |  | 61 |
| Introducing supply chain responsibility |  | 17 |
| Restricting free movement of (foreign) workers |  | 43 |
| *Curative measures:* |  | *64* |
| Stimulate *purchasers* to buy declared: |  |  |
| Service vouchers |  | 26 |
| Targeted direct tax incentives |  | 61 |
| Targeted indirect taxes |  | 17 |
| Stimulate *suppliers* to formalise: |  |  |
| Society-wide amnesties |  | 9 |
| Individual-level amnesties for voluntary disclosure |  | 17 |
| Formalisation advice to business |  | 30 |
| Formalisation support services to businesses |  | 30 |
| Targeted VAT reductions |  | 17 |
| Free record-keeping software to businesses |  | 13 |
| Fact sheets on record-keeping |  | 22 |
| Free advice/training on record-keeping |  | 22 |
| Gradual formalisation schemes |  | 13 |
| *Fostering commitment to declared work:* |  | *69* |
| Campaigns to inform undeclared workers of risks and costs of working undeclared |  | 61 |
| Campaigns to inform undeclared workers of benefits of formalising their work |  | 57 |
| Campaigns to inform users of undeclared work of the risks and costs |  | 61 |
| Campaigns to inform users of undeclared work of the benefits of declared work |  | 52 |
| Use of normative appeals to people to declare their activities |  | 52 |
| Measures to change perceived fairness of the system |  | 26 |
| Measures to improve procedural justice of the system (i.e., degree to which people believe government has treated them in a respectful, impartial and responsible manner) |  | 17 |
| Measures to improve tax/social security/labour law knowledge |  | 65 |
| Adoption of commitment rather than compliance approach (e.g., ‘responsive regulation’) |  | 30 |
| Campaigns to encourage a culture of commitment to declaration |  | 39 |

**Source: Baric and Williams (2013)**

Although positive examples such as voucher systems and incentives to help the unemployed move into self-employment exist, these do not seem to be particularly representative. Baric and Williams (2013) therefore conclude that there is a need for Croatia to better focus on curative and commitment policy measures, with the aim to transform informality into formality.

# 3.6 Justification for choice of location

As can be seen from the discussion in this chapter, the inadequacy of Croatia’s formal institutions and deep embeddedness of informality make it an appropriate country to study from a social exchange perspective. Furthermore, the position of Croatia at the time of the empirical study (2012) places it in a unique transformational phase. Given that Croatia was independent and not part of the EU at this point, the social contract parties that are relevant are those with the Croatian government. Therefore, it is the perception of these relations and justice related issues (see previous chapter) that are likely to have an influence on shaping personal norms and tax morale. Once Croatia joined the European Union, these relations will have become more complicated, as Croatian citizens will have developed a social contract with the EU, changing the dynamics of the parties to the relationship in the vertical relationship. As a preliminary measure, it is important to consider the perception of the citizens with regard to Croatia joining the EU. Borrowing from management literature, we know that the development of a psychological contract with an organisation can start to occur in pre-employment stages (Robinson and Rousseau, 1994). Therefore, considering the citizen’s social contract with the European Union, expectations are likely to start forming before actually joining the EU and will therefore be indicative of the social contract that will be established. Furthermore, measuring the extent and nature of the undeclared economy at this point is extremely useful as it provides a picture of the situation prior to the country’s entrance into the EU (July of 2013). This portrayal will therefore allow for comparisons with future studies after full integration into the EU to evaluate the effects of being within the European Union.

This study will focus more specifically on the city of Split, Croatia’s second-largest city and the largest city in the region of Dalmatia. There are a number of reasons for this particular city being selected. One reason is that Split is the capital of Dalmatia, which has different characteristics to the rest of Croatia, due to having attracted substantial levels of tourism. Another reason is Split being the hometown of the researcher. As this is the case, I have an inherent knowledge of the area and can easily identify with its people. As with any research of this nature, objectivity is essential and this will be discussed in the methodology chapter. Furthermore, having a “Splitian” accent is exceedingly beneficial for this type of research for several reasons. Firstly, people are immediately more at ease when approached if they hear the local accent, and secondly, it is easier to build up a rapport with the interviewees, who are then more likely to give honest answers if they feel they can identify with the interviewer. As such, it can also increase people’s willingness to engage with the research, making them more open to providing in-depth answers, rather than trying to complete the process as quickly as possible. Indeed, during the data collection process, it was found that most people were very willing to help.

Chapter 4: Methodology

# 4.1 Introduction

This chapter reviews the methodology used to answer the research questions, and discusses the philosophical assumptions underpinning this methodological approach. Any methodology has to be ‘fit for purpose’ in the sense that it is appropriate for answering the research questions posed.

It is useful at this point, therefore, to recap on the aims of the thesis. In light of the review of the literature in Chapter 2, it is evident that gaps exist in both the application of particular theoretical approaches towards undeclared work and also, as Chapter 3 displayed, explaining undeclared work in the specific context of Croatia. In order to fill these gaps, the overarching objective of this thesis is:

-To explain the nature and extent of undeclared work in Croatia, using a social exchange theoretical framework

To achieve this overarching aim, the following objectives have been identified:  
- To evaluate the different theorisations of the undeclared economy (dualist, structuralist, legalist and complementary perspectives) in Split, Croatia

-To explore the relevance and utility of the social exchange theory framework for explaining the undeclared economy and unearthing undeclared actors’ motivations

-To evaluate the impact of the vertical relationships between the government and citizens on the decision to operate on an undeclared basis

- To examine the influence of the horizontal relations, such as personal and social norms, on the decision to operate on an undeclared basis

- To highlight the regulatory mechanisms of undeclared activity

- To identify relevant policy recommendations based on the findings

These aims and objectives serve to inform both the philosophical perspectives adopted in the thesis, as well as the specific design of the research methods and tools. It is to these philosophical perspectives and research methods, therefore, that attention now turns.

# 4.2 Philosophical perspectives

All approaches to conducting research are informed by philosophical underpinnings about the world and the nature of knowledge. Denzin and Lincoln (2000:157) define a research paradigm as a ‘basic set of beliefs that guide action’. Whereas disciplines such as medical research embrace considerable ontological and epistemological consensus, this is untrue of management research in general (Tranfield et al., 2003). As Johnson and Clark (2006) note, it is thus important for management researchers to be clear about the particular philosophy that informs their approach, ensuring its compatibility with one’s ontological and epistemological beliefs. The assumptions that are made, and the methodology chosen, underpin the research strategy, as well as influence the interpretation of observations. Johnson et al. (2006) describe four modes of engagement: positivism, neo-empiricism, critical theory and affirmative postmodernism. The supporters of each encompass, within their approaches, different sets of ontological and epistemological beliefs.

Epistemology refers to the study of the relationship between the researcher and the researched (Saunders, Lewis and Tornhill, 2000). Epistemological assumptions underpin all research that is undertaken. As Johnson and Duberley (2001:1) state, the importance of one’s epistemological view is that ‘how we come to ask particular questions, how we assess the relevance and value of different research methodologies so that we can investigate those questions, how we evaluate the outputs of research, all express and vary according to our underlying epistemological commitments’. Therefore, a subjectivist view of epistemology, which is the epistemological approach adopted within this thesis, disclaims the possibility of neutral observation. It is accepted that individuals construct a sense of their own social reality through their interests, values and experiences (Dobson and Love, 2004). Hence, the aim is to understand the issues from the point of view of those being researched, whilst recognising that the researcher is not a detached and neutral observer in the process of data collection. Hammersley and Atkinson (1983:14-15) note that the researcher is a part of the social world being studied, and that although this is inescapable, such an ‘escape’ is not necessary to effectively research the phenomena in question.Positivist epistemology, on the other hand, assumes that there is an objective truth to each situation that can be revealed. The focus lies in measuring relationships between constructs, systematically and statistically (Cassell and Symon, 1994). Often relying on the use of quantitative methods, advocates of such an epistemological view argue that ‘real’ reality can be captured using methods more akin to the natural sciences (Bryman and Bell, 2007).

Ontology, on the other hand, refers to the study of the nature of reality (Dobson and Love, 2004). It ‘concerns the nature of what exists and the existential reality of the phenomena being researched’ (Hallebone and Priest, 2009:189). A subjectivist ontological standpoint, interprets reality as an output of human cognitive processes (Johnson et al., 2006) and therefore it is considered that there is no reality outside of those socially constructed by individuals. The view taken in this thesis, however, is that of a realist. Such a perspective assumes that social reality has an independent existence prior to human cognition and therefore exists independently of it.

It is important to consider ontology and epistemology in relation to each other (Hallebone and Priest, 2008). Positivism combines objectivist ontology and epistemology, whilst interpretivism combines the relativist/interpretivist views of ontology and epistemology. However, from a pragmatic critical realist perspective (Johnson and Duberley, 2000), the view that ontology and epistemology can therefore collapse into one another is rejected. This is the view adopted in this thesis, in that it chooses an interpretivist epistemology but realist ontology. The world, therefore, is seen as a real, but not objectively knowable. Interpretivist epistemology is here selected, because being present in the situation of interest, allows for a better interpretation of the context being studied. As Johnson and Duberley (1999:62) argue, the researcher becomes ‘an active social agent, conducting a value-laden enterprise in a particular context’**.** The usefulness of the positivist ontological perspective in this research, relates to investigating the spread and amount of undeclared work being carried out. However, the interpretation taken of the undeclared economy as embedded within society, requires an understanding of the participant’s worldview, thus making a positivist epistemological approach inappropriate. In terms of ontological beliefs in this study, therefore, it is considered that the accounts of participants reflect a specific construction of reality grounded in their own experience. This is because the focal point of the investigation is their engagement in undeclared work, and therefore, the experiences they have perceived have led them to the path they have chosen. As an example, an individual might believe that everyone else in Croatia carries out undeclared work (perceived norms) and for this reason chooses to engage in the realm themselves. There is an objective reality of the number or percentage of people engaging in undeclared work in Croatia. However, in this case, this is not relevant in their decision-making process. Therefore, the focus lies with unearthing the participants’ specific construction of reality, that has led them to engage, or not, with the undeclared economy.

The competing philosophical approaches therefore encompass different knowledge-constituting assumptions about the nature of truth, human behaviour, representations and reality. These implicitly and explicitly present different normative definitions of management research (Johnson et al., 2006). However, it is often recognised that the importance lies, not within the research being philosophically informed, but whether the researcher reflects upon the philosophical choices and defends them in relation to the alternatives (Saunders et al., 2009).

As Gill and Johnson (1991) argue, as researchers we need to make explicit statements and critically reflect upon the epistemological assumptions that underlie our work. The view adopted in this thesis, is that action does not occur in a social vacuum and therefore, by taking the wider social context into consideration, focus is placed on interpretative processes and an understanding of how the participants generate their own understanding of the issues being investigated. This, moreover, is wholly in line with the reconceptualisation of social exchange theory, which is the theoretical lens through which undeclared work is understood in this thesis. As Wiley (1998:408-409) phrases it, ‘interpretative methods generally operate on the basis that the natural order of reality is seen, conceived of and understood in different ways by descriptions of people’s representations and constructions of what is occurring in the world’ therefore allowing a movement away from reductionist ontology. Emphasis is placed on discovering the socially constructed nature of reality that the participants have developed through their knowledge, experiences and history. Such an approach is consistent with the call for a marriage of process, content and parties within social exchange literature (Coyle-Shapiro and Conway, 2004). Focus lies with unearthing underlying beliefs and values, so as to better understand how the perceptions of important constructs such as norms, justice and fairness, impact on the decision to engage with undeclared work. As such, the interpretivist epistemology and realist ontology adopted in this thesis, both reflects, and is reflected by, the epistemological and ontological assumptions underpinning social exchange theory, which is the lens adopted in this thesis through which undeclared work is understood.

Adopting this philosophical stance, by definition, calls for a reflexive stance to be adopted by the researcher to their own impact on the research process, particularly in relation to what can be known. Therefore, in this research, such an approach necessitates transparency and self-reflection, particularly with regard to how interpretations have been reached, recognising the active role of the researcher in knowledge construction. Shacklock and Smyth (1998:6) define the ‘process of reflexivity [as] an attempt to identify, do something about, and acknowledge the limitations of the research: its location, its subjects, its process, its theoretical context, its data, its analysis, and how accounts recognize that the construction of knowledge takes place in the world and not apart from it’. Reflexivity is seen as a difficult process (Johnson and Duberley, 2003). However, Nadin and Cassell (2006) argue that the research diary is a simple and efficient tool that can significantly aid researchers in achieving the aim to become more reflexive. This tool will therefore be used throughout the fieldwork process, with the aim of the researcher recording their experiences in a systematic way.

# 4.3 Choice of methods

## 4.3.1 Direct methods as a choice for studying undeclared work

A vast array of methods for estimating the size and nature of the undeclared economy has been used. These can be categorised into direct and indirect techniques (Williams, 2006). Indirect methods involve the use of macroeconomic data collected for other purposes, such as searching for statistical traces of undeclared work in non-monetary indicators, employing monetary indicators and analysing discrepancies between income and expenditure levels. There are advantages to the use of such methods, if it is believed that participants are unwilling to state their income gained from undeclared work. However, the approach is considered inappropriate in this study, because it is unable to reveal the nature of the work conducted or the perceptions of the participants. It is, furthermore, inconsistent with the interpretivist epistemological perspective that seeks to unearth the worldview of those engaging in the undeclared realm.

Direct methods, on the other hand, ask the participants of the undeclared economy directly about the issue of their involvement. They often appear in the form of surveys or interviews and are able to ‘ask suppliers and/or purchasers of underground work about the volume and/or value of their exchanges, what they did/received, for/from whom and why’ (Williams, 2004: 170). A common feature of many such studies is that they measure participation rates in undeclared work, through which a mapping of variations of types of work between different socio-cultural and geographic factors is feasible. Furthermore, because the general population is surveyed, capturing the opinions of those who do not engage with the undeclared economy helps to better understand the decision-making process.

Although this is the preferred method for the current investigation of the undeclared economy, it is useful to be aware of the limitations of direct survey methods. By taking a critical perspective of a research technique, the risks associated with it become more evident and therefore easier to avoid. One of the most commonly discussed issues to direct methods is that of the potential that individuals will be unwilling to discuss their engagement with the undeclared economy in an honest manner (Jones et al., 2004; Ram et al., 2002). This would result in an underestimation of the supply side of undeclared work. However, actions will be taken during the data collection phase, to maximise the willingness of disclosure of such activity. These include building rapport with the participants to make them feel more comfortable and will be described later in the chapter. A further disadvantage is that people may simply not be aware of whether their payments are being officially declared or not (Williams, 2007). Such an issue is likely to result in an underestimation of the demand side of undeclared work. Furthermore, as is argued by Alderslade et al. (2006), direct methods do not allow researchers to trace the development and growth of the undeclared economy over time, as they merely provide snapshot estimates.

## 4.3.2 Mixed methods research

As is argued throughout this chapter, methods that would generate as rich a picture as possible are needed. This leads to the decision to use a combination of qualitative and quantitative methods through choosing a pragmatist philosophy, placing emphasis on the research questions and the surrounding aims and objectives. A richer understanding of phenomena such as undeclared work and social exchange relationships can be captured through drawing from different data sources, facilitating a contribution to the development of both theory and practice.A summary of differences between the two approaches is provided in Table 4.1 (Bryman, 1988).

**Table 4.1- Some differences between quantitative and qualitative research**

|  |  |  |
| --- | --- | --- |
|  | Quantitative | Qualitative |
| Role of qualitative research | Preparatory | Means to exploration of actor's interpretations |
| Relationship between researcher and subject | Distant | Close |
| Researchers stance in relationship to subject | Outsider | Insider |
| Relationship between theory/concepts and research | Confirmation | Emergent |
| Research strategy | Structured | Unstructured |
| Scope of findings | Nomothetic | Ideographic |
| Image of social reality | Static and external to actor | Processual and socially constructed by actor |
| Nature of data | Hard, reliable | Rich, deep |

**Source: Bryman (1988: Table 5.1, 94)**

Some researchers (e.g. Guba and Lincoln, 1994) argue against the use of mixed methods, by advocating that such research methods carry epistemological commitments. It is suggested that the assumptions of values and methods of separate paradigms are incompatible. However, amongst others, Bryman (2008) strongly argues that these positions are difficult to sustain, as methods and philosophies are independent of one another, making mixed methods research permissible.

According to one school of thought, choosing between philosophical positions is unrealistic in practice, as ‘epistemological purity does not get research done’ (Miles and Huberman, 1984: 21). Tashakkori and Teddlie (1998) support this view, contending that in the “real world”, methodologies can be separated from the epistemology out of which they emerged. Hammersley (1992: 142) argues that ‘philosophical assumptions do not have strongly determinate implications for how we should carry out research’ and thus researchers can use practices normally associated with “differing” traditions. Tashakkori and Teddlie (1998) suggest that it is more appropriate for the researcher to think of the philosophy adopted as a continuum, rather than opposite positions. They contend that ‘at some points the knower and the known must be interactive, while at others, one may more easily stand apart from what one is studying’ (Tasakkori and Teddlie, 1998: 26).

The debate between ontology and epistemology is often outlined as the choice of positivist or interpretivist research philosophies. Crotty (1998:15) believes that research be ‘both qualitative and quantitative without this being in any way problematic’ as the distinction occurs at the level of methods used, rather than at the level of the epistemological or theoretical standing. Here, I adhere with the pragmatic outlook, in that the most important determinant of the adopted epistemology, ontology and axiology, is the research question, thus making mixed methods highly appropriate within one study (Saunders et al., 2009).

The use of mixed methods is beneficial to this study, as it allows for triangulation, which refers to ‘the use of multiple methods to study a single problem’ (Patton, 2002: 247). For instance, data obtained through both a survey and an in-depth interview, allows for interpretation of the phenomena from multiple angles, thus providing a more comprehensive understanding of its nature. The quantitative dimension satisfies the criteria of generalisation, whereas the qualitative aspect allows a better understanding of the socially constructed views of those being researched. It is thought that different methods are capable of being merged and that confidence in the findings of the research can be improved by the use of different methods to measure a concept(Bryman, 2001).

I adopt the view, that the choice of methodology must be made in reflection of the research aims and objectives, and advocate that in this case, a combination of both qualitative and quantitative methods is appropriate. Due to the nature of undeclared work, as well as social exchanges being complex and multifaceted, a mono method approach is not able to gather sufficiently rich data to adequately address the research questions. Using both qualitative and quantitative methods enables one to address the phenomenon from a number of perspectives. Although the survey enables the researcher to measure attitudes dealing with a large group of individuals, which is necessary to address the research question, it does not enable us to answer the ‘why’ of the attitudes being expressed. The following sections address the use of the two methods separately.

## 4.3.2.1 Quantitative methods

A research design based on quantitative methods, has the focus of controlling or measuring variables and the testing of pre-determined hypothesis (Kauber, 1986). Many argue that such research is unable to deal with complexities of discourse, as the focus lies with quantification (Waitzkin, 1990). This is why for a quantitative approach to be useful, the researcher must already have an awareness of the phenomenon and a general expectation of what the results will be. It is for these reasons that survey research is often used as a methodology for verification or measuring, rather than discovery itself. Gable (1994) argues that, due to its inflexible nature, the survey must contain exact questions, always asked in the same manner. Once the process is initialised, there is little the researcher can do if it becomes apparent that crucial items have been omitted from the questionnaire (ibid). This highlights the importance of a pilot study to ensure a questionnaire is well designed. Due to the emphasis placed on causal relationships within quantitative research, values, interests, purposes and beliefs of social actors tend to be neglected. However, all these issues are crucial to unearth the motives behind undeclared work, as well as to map the complex dynamics of social exchange relationships.

A survey or structured interview at the initial stages of the research, allows for a comparison with the published research on the nature and extent of undeclared work, within the chosen area of Croatia. Random spatial sampling is to be used and the unit of research are individuals within households. The data collected would represent a useful ‘snapshot’ taken from a larger group. However, a more in-depth approach is also required, in order to understand the perceptions of those engaging in undeclared activities, the relationships developed, the networks they operate in and the way in which they are regulated. Thus, although it is recognised that the use of quantitative methods is unable to fully unearth the complexities of social exchange theory or the undeclared economy, it is a useful aid to achieve certain aims and objectives of this thesis, such as measuring the nature and extent of undeclared work within geographic areas. A quantitative approach is also useful with regard to comparing variables and statistical analysis of data, such as socio-demographic or income details of participants.

## 4.3.2.2 Qualitative methods

Qualitative approaches are arguably more suited to explore questions from an epistemologically subjective perspective (Guba and Lincoln, 1994). Through an emphasis on understanding, rather than explaining, these approaches answer questions of what, why and how (Sarason et al., 2006).

Despite the recognition of qualitative techniques as a powerful tool amongst a variety of scholars (e.g. Gummesson, 2000; Tashakkorie and Teddlie, 2002), the emphasis within management research remains upon a quantitative foundation for empirical research. The sporadic occurrence of qualitative methods should not, however, deter the potential of qualitative research as a tool for understanding management phenomena. Due to the mainstream positivist approach, there is a lack of exposure to alternatives within publications and on management courses, resulting in a lack of knowledge and expertise surrounding the use of qualitative methods within the management field (Cassell et al., 2006).   
However, when used appropriately, the use of qualitative methods allows encapsulation of richer research data, enabling the understanding of the context it is set in. This is important, in line with the interpretivist approach taken, as well as the view described in the literature review of both social exchange theory and the undeclared realm, where economies are seen as embedded socially and historically. Waitzkin (1990: 474) contends that ‘to understand such complexities adequately requires an in-depth interpretive analysis’.

According to the positivist sphere, scientific research starts by making empirical observations with an ultimate aim to discover general laws. However this is challenged by the view that any human agent is capable of making choices based upon their inter-subjectively derived interpretation of the situation (Johnson et al., 2006: 135). Within this view there is an underlying emphasis on the importance of interpretation and deep understanding (Lukka and Kasanen, 1995), directly concerned with verstehen (Johnson et al., 2006).

Looking to research within the subject of undeclared work, much emphasis has been placed on quantitative studies. However, some discoveries would not be reached, had it not been for the qualitative aspect of research. For example, a subset of the ‘new thinking’ literature is emerging that considers non-monetary incentives of entering the undeclared economy (Williams, 2005). In order for these incentives to be exposed, an array of rich data was collected via qualitative methodology. The concept of ‘verstehen’, first outlined by Weber, is important in this situation, because a superficial investigation would not uncover the true incentive as viewed by the actor. The monetary involvement of the exchange is likely to lead to the activity being categorised as market like, akin to the behaviour of homo economicus. This example further emphasises the need for a qualitative approach in investigating heterogeneous phenomena.

The qualitative approach, being unable to follow strict processes, faces a variety of criticisms. It is much more time consuming with regard to both data collection and analysis (Cassell and Symon, 1994). Bryman and Bell (2007) argue that methods encompassed by this approach, rely too heavily on the researcher’s unsystematic views with regard to emphasis placed on aspects of the phenomenon. The personal relationship established during the study, compromises objectivity (ibid). Waitzkin (1990:476) explains that ‘theory that is grounded in empirical observation does not develop easily from unsystematic accounts of a few cases’. There is much contention surrounding the evaluation process for qualitative studies, which in turn has an effect on generalisation and reliability. This issue is discussed further within the next section.

The use of qualitative methods for epistemological reasons also reflects calls in the literature of both social exchange theory and the undeclared economy. In depth interviews allow for the content exchanged to be looked at in the context of the situation, giving it more meaning, as well as a better understanding of the on-going process and dimensions of the network of parties involved. The qualitative approach seeks to understand a phenomenon in its context, making sense of the observed, in relation to the meanings that society assigns to it. This promotes direct involvement of the researcher within the natural setting of the situation. An advantage of qualitative methods is the flexible nature attached to the research process. Cassell and Symon (1994) argue that the researcher is able to change the nature of their intervention as the research progresses, in order to better fit the changing nature of the context. This means that, as opposed to quantitative approaches, the researcher is able to explore different aspects of the phenomenon rather than merely test pre-determined theories.

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# 4.4 Criteria for evaluation

Although it is evident that criteria alternative to the positivist framework exists, Cassell et al. (2005) state that it is scarcely used in practice. It is important for the research to follow a set of criteria *within* its own epistemological and ontological standing. For instance, a social constructionist would criticise the ontological status of reality, in stating that there is no determined nature to the world or people (Burr, 2003). Such inter-philosophical criticism is reflected with Tinker (1998), questioning the credibility of the underlying epistemological stance with the use of critical ethnography. Jonsson and Macintosh (1997) support this view, in stating that the process results in subjective interpretations from the side of the researcher, as well as the actor. The peril here is that the critics are making an assumption that a neutral description of the “way things are” can be produced (Jonsson and Macintosh, 1997: 379) whereas this is irrelevant if the ethnographic researcher has adopted a different set of assumptions. Dey (2002: 112) expresses the concern that the use of critical theory to analyse such data, will ‘replace, obscure, or directly contradict the interpretative ethnographic approach to sense making’. One view is that critical theories will desensitise the researcher from empirical evidence and obscure the very social relations they are trying to study (ibid), which is generally a problem considered with certain forms of case study methodology. However, because there is no universally accepted set of theoretical and methodological commitments (Johnson et al., 2006) it would be unfair to use this kind of inter-philosophical analysis. The researcher needs to ensure that the methodology is well designed, according to the set of criteria *within* their chosen mode of engagement.

Furthermore, there is a debate regarding the criteria, which should be used for assessing the quality of mixed methods research (Bryman et al., 2008) as it is often argued that these represent opposing philosophies. However, the view taken in this thesis is that the importance lies within the chosen method and its design, enabling the satisfaction of its aims and objectives. Mason (1996) states that qualitative research should be conducted systematically and rigorously. In order to satisfy these criteria, the current research links the research questions to the methodological approaches, whilst considering issues of analysis and data collection as integrated. The issue of self-reflexive enquiry (ibid) has been described elsewhere in this chapter and the researcher will be explicit regarding the logic that results in the conclusions reached. To address the standard of research being conducted in a contextual way, outlined by Mason (1996), the research is designed to accommodate changing contexts and to allow for emerging and unanticipated issues to be explored as they arise.

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# 4.5 Research design

This section focuses on describing the design and process of the data collection element. The survey/interview is a methodology that has been adopted by many successive researchers (e.g. Williams, 2007). The inherent flexibility of the process allows the researcher to combine the use of quantitative and qualitative methodology. The interview, therefore, has key strengths that lend themselves naturally to the aims and objectives previously described. Its adaptive nature has significant advantages over other potential lines of enquiry, providing it is suitably designed and executed. The ability to interact with the participants on a face-to-face basis permits a level of intimacy especially useful when discussing sensitive issues such as undeclared work. Furthermore, placing the researcher directly in the situation of the researched has considerable advantages in allowing a mapping of contextual factors.

As Fontana and Frey (2000:646) note, ‘the focus of interviews is moving to encompass the how’s of people’s lives (the constructive work involved in producing order in everyday life), as well as the traditional what’s (the activities of everyday life)’. In this study, the interview was split into two key stages. Stage one involved 300 participants completing a structured survey focusing on the quantitative elements, whereas stage two consisted of a more in-depth, semi-structured interview with only 20 participants chosen out of the 300. All interviews were conducted face-to-face in the participants’ own homes and in the Croatian language. Upon commencement of the data collection process, the purpose and rationale for the study was explained to each individual and assurance given that any information provided will be used solely for academic purposes.The aim of this introduction is to instil trust and confidence with the respondent and familiarise them with the situation, as well as good practice in terms of ethical issues.

The following section describes the use of the survey, including the reasoning behind the questions used. Following this, the follow-up interview is explained before the choice of sampling procedure is outlined.

## 4.5.1 Stage one: Survey

Surveys are considered to be a key method of data collection in the social sciences, with one of the main advantages being their ability to generate quantitative data of a large number of people who are representative of wider populations (Bryman, 1988). Population surveys are an important means to examine individuals’ perceptions of the undeclared economy as it involves direct interaction with the source. Verheul et al. (2001) argue that such an approach is useful to examine culture because it is able to explore the values of people. This quantitative-based approach will enable an investigation of the robustness of existing research and identification of broad patterns that can be used to illustrate the more qualitative issues.

In this case, a structured design will be used in light of previous studies carried out with similar aims. Arguably, structured surveys are preferable, due to households struggling to remember instances where undeclared work was used and supplied. A structured survey method promotes a standardised approach where respondents have to fit their experiences into closed-ended questions, allowing an element of replication and therefore comparison between and within population groups (e.g. different demographics and types of undeclared work). The survey used, reflects the design of surveys such as the Eurobarometer survey, used for the EU27, to allow an element of international comparison. However, following the design of the conceptual framework in Chapter 2, there are also additional sections focusing on measuring constructs that allow the measurement of horizontal and vertical relations. The full structure of the survey, as well as the questions used, are outlined in the following section.

## 4.5.1.1 Survey design

The first section of the questionnaire includes a range of questions that aim to map the background information of the context the participant is set in. This includes closed questions enquiring of factors such as age, gender, employment status and work history, as well as the number of years spent living in the area. It also introduces the topic of undeclared work, with some questions that do not refer to the individual’s personal actions. Including such superficial questions that do not require sensitive information to be divulged at the start of the questionnaire, allows the participants to familiarise themselves with the situation, rather than being asked to disclose personal information about the households’ coping strategies straight away. This means they are more likely to answer such questions later in the questionnaire, once a degree of awareness and trust has been developed. A question addressing the household’s current total gross income is asked at the end of the survey, allowing the respondent to view it in the context of the discussion, therefore increasing the likelihood of response.

The second section of the survey focuses firstly upon the demand side of work carried out and then the supply. In doing this, participants are asked whether they purchased any goods or services that they believe were encompassed by the undeclared sphere, the nature of these and why they were purchased undeclared, rather than declared. Following this, individuals receiving wages were asked if any part of their income is given to them in the form of envelope wages by their employer, and if so for what type of work and if they were happy with this situation. Furthermore, individuals were asked to state any undeclared work that they had carried out in the last twelve months.

The next part of the questionnaire focuses on connections, personal norms, identity group norms and societal norms and as such tolerance of undeclared work. Using the Eurobarometer questionnaire as a basis, a similar set of questions was asked, to gage the level of tolerance towards undeclared work.

* An individual hires another individual for help in the house and they do not declare this work
* An individual hires a firm and the work is not declared
* A firm hires an individual and the work is not declared
* A firm employs another firm and the work is not declared
* A person does not, either wholly or partially, declare their earnings

Two questions denoting different types of illegal work were also posed to gather information on norms:

* Someone receives welfare payments without entitlement
* Someone uses public transport without a valid ticket

Before these questions, individuals were asked with whom they identify (profession, class, regional, national, social, religious, gender, generation, neighbourhood, other). The same questions as above, were then also used to test for identity group norms and societal norms but when asked:

* Please indicate how acceptable each situation is amongst the group you identified in the previous question (identity group norms)
* Please indicate how acceptable each situation is to an average Croatian citizen (societal norms)

Furthermore, on a societal level, citizens were asked the proportion of citizens they believe to be undertaking undeclared work, as well as the extent of their identification as a Croatian. (“I am proud being Croatian” scale and “Being Croatian is important to me”). Although social capital will largely be investigated during the qualitative leg, its manifestation in the form of connections will be examined during the survey. In light of this, a set of questions asking the importance of the use of connections for getting things done will be asked, as well as the levels of tolerance to using such connections. The latter will be investigated on a personal, reference group and national level). Separate questions were also asked for entrepreneurs/business owners to gauge their levels of perceived importance of connections in running a business in Croatia.

The following section of the survey focuses on the social contract, and as such seeks to ascertain the participants’ opinions of the government. As outlined in the development of social exchange theory, trust can be analysed on both the constitutional and current politico-economic level.

Constitutional level measurement:

* Please note the level of confidence you have in the legal system (12-point scale)
* Please note the level of trust and confidence you have in the government in your capital and your parliament. (12-point scale).

Following this, Likert scale questions were asked to determine the perceived levels of different types of fairness. The procedural justice scale used is one from Hartner et al.’s (2010) study as it is particularly tailored to tax.

* The tax office's decisions are fair.
* The rules and approaches applied by the tax office treat all taxpayers equally.
* The tax office's decisions reflect mainly its own stakes *[reverse-coding].*
* The tax office's decisions are mainly based on facts and not on opinions.
* *C*hanges or adaptations will be applied in case the decisions made by the tax office are found to be wrong or bad.

Although distributive justice can be measured with just one question, this can cause a lack of focus (Verboon and van Dijke, 2007) so here a 5 item-scale is used to capture a more holistic view:

* Compared to the tax I pay I receive too few public provisions *[reverse-coding].*
* Some groups in society profit more from the tax system than I do *[reverse-coding].*
* It is unfair that some people have to pay less taxes than me but at the same time, take advantage of all sorts of provisions *[reverse-coding]*
* I think I have to pay too much tax *[reverse-coding]*
* I think the Croatian tax system is fair

Retributive justice was measured in gathering opinions, as to the perceived level of risk of detection for carrying out undeclared work, as well as the level of sanction expected for this. Furthermore, individuals were asked who/what they would rely on in a financial crisis, as well as when they are too old to work (see questionnaire in appendix). This will aid in understanding the role of institutions such as the state, friends and family in financial support.

A section on participants’ perceptions of the EU generally and with regard to undeclared work was included to unearth their optimism of Croatia entering the union, as well as their opinion on what effects this will have on the size of the undeclared economy and on the lives of people. The questionnaire also had a number of questions dedicated to discovering their opinions of how social and economic life fairs now, in comparison to the times of socialism. Finally, concluding questions, such as the sector the participant works in were asked.

**Figure 4.1 – Structure of the questionnaire**

Throughout this thesis, emphasis has been placed on subjective meanings of experiences, which are unable to be captured through the use of a structured interview. The design of the closed questions means that there is limited personal scope for variation and improvisation. This results in experiences and thoughts of respondents being simplified, with importance being placed on issues the researcher, rather than the respondent, considers vital. Such a categorical framework neglects all possibilities that are not included in the design of the question. There are many instances where an answer to a closed question will prevent the respondent from disclosing information that is important with regard to unravelling the complex dynamics of phenomena, such as undeclared work and social exchange. Although useful in connection to mapping the geographies and extent of undeclared work, the rich and subjective responses that indicate its true nature are suppressed, due to the structure of the interview. This is why structured interviews and surveys are considered as appropriate for testing pre-determined hypothesis, instead of for exploration of new dynamics of phenomena. Due to such limitations, a structured interview is unable to fully satisfy certain aims and objectives of this study. It is unable to meet the requirements of investigating the regulatory mechanisms of undeclared activity. The structured interview is useful for determining the extent to which vertical and horizontal relations influence the decision to formalise. It lacks usefulness in investigating the details of this influence, as well as the reasons behind the opinions of the citizens. The structured interview will therefore be coupled with the use of a semi-structured interview.

## 4.5.2 Stage two: Follow-up interview

20 follow-up interviews were conducted to gather more in depth data, enabling a better understanding of the world- view of the participants. This ensures that the attitudes, motivations and barriers to formalising of actors are better understood. The individual is able to describe what they do, how, why, when and where. This allows the process of social exchange, decisions and perceptions to be examined, along with the contextual dimensions within which, different types of undeclared activities operate. Such issues can be termed soft, and are not amenable to quantification (Hammersley, 1992), making a qualitative approach more appropriate. Such approaches are particularity suited to examine social relationships involving personal experiences and perceptions. In addition, the follow up interview can be useful to further investigate the responses provided in the quantitative questionnaires (McNamara, 1999). The explorative nature means that interviews are particularly effective to obtain the story behind a participant’s experiences (ibid) and would therefore provide a better illustration of the motives behind the actors’ engagement in the undeclared economy.

The approach taken during this part of the study was semi-structured, with open-ended questions. This allows the focus of the discussion to remain on the issues emphasised in the research aims section, but also gives enough scope to the participant to talk freely about issues they consider vital as they emerge. This satisfies the aim of qualitative researchers of ‘those who are studied to speak for themselves, to provide *their* perspectives in words and other actions’ (Ely et al., 1991:4). The use of pre-prepared themes ensured that all relevant topics are covered (see Table 4.2). However, as the interview progresses and new issues arise, allowances were made to accommodate additional, unplanned questions, appropriate to the flow of the interview. This creates the potential to harness a much wider range of information and gives an exploratory dimension to the method.

**Table 4.2: Interview themes**

|  |
| --- |
|  |
| Supply and demand of undeclared work |
| Regulatory mechanisms of undeclared work |
| The vertical relationship (social contract) |
| Development of personal norms (tolerance of undeclared work) |
| Formation of perceived social norms |
| Regulation of undeclared work |
|  |

The topics discussed have been inspired by a number of themes outlined in the literature review, including nature of exchange, content of exchange, reciprocity, trust, social capital and mechanisms regulating undeclared activity. A better understanding of the norms and rules that guide undeclared activities will enable a better awareness of how to foster changing attitudes of formalising. This method will allow the subject’s perspective to be the central focus of the interview, providing a better understanding of their experiences, social constructs and meanings in a wider social context. Furthermore, this will produce a more multidimensional account, by discussing the social norms and macro processes across a period of time. This is crucial to the outlined integration of anthropology and sociology to the current (utilitarian) conceptualisation of SET and the contextual approach taken with undeclared work investigations.

A claim made by Burgess (1982:107) is that the ‘interview is the opportunity for the researcher to probe deeply to uncover new clues, open up new dimensions of a problem and secure vivid, accurate inclusive accounts that are based on personal experience’. One of the main motives for using face-to-face interviews is to develop an understanding of the respondents’ world-view and how they construct meanings and understandings within the context they operate. Face-to-face situations, as argued by Berger and Luckmann (1966:43) are ‘the prototypical case of social interaction’, therefore providing a first-hand account of undeclared work from the actors themselves, as well as an opportunity for participant observation which complements the interview (Lofland, 1971). The researcher is able to observe the facial expressions and gestures of the participants as they provide answers. Such a setting fosters a more accurate reflection of events and processes, in turn providing contextual, embedded and interpersonal based results. A face-to-face interview shows a ‘human-to-human relation with the respondent and the desire to understand rather than to explain’ (Fontana and Frey, 2000: 654).

However, the use of a semi-structured interview means that the soliciting of free responses results in less standardised data being produced, therefore making it more difficult to analyse. This is why it is stressed that the interviewer was well prepared before the initialisation of the questioning process, already having in mind the main questions to be asked, and the sequence of these.

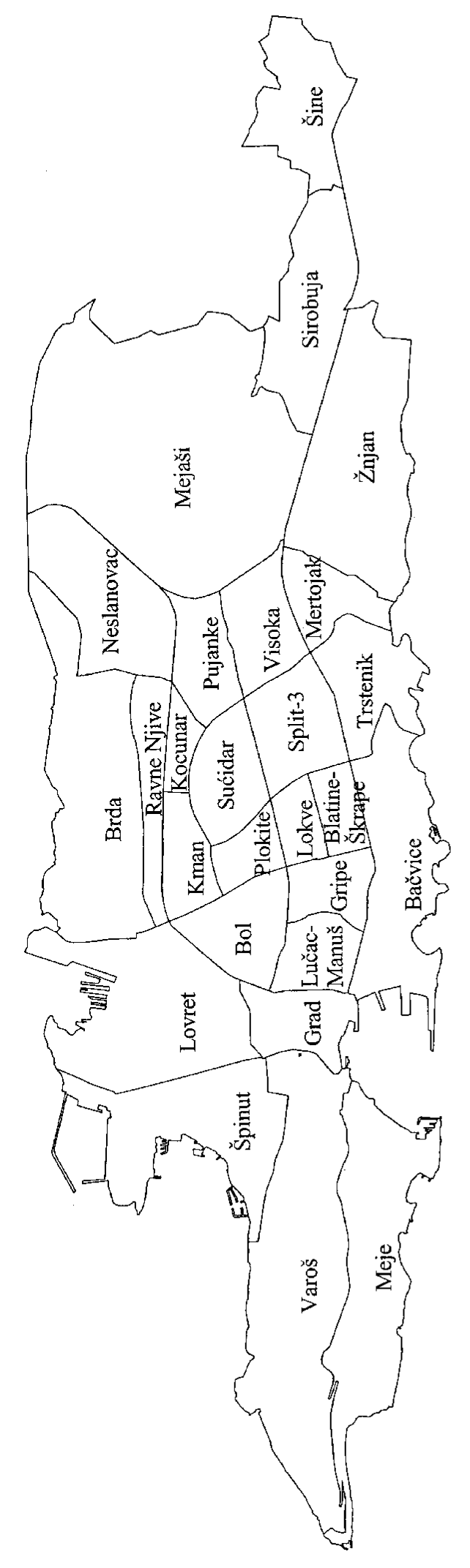
## 4.5.3 Choice of sample population

Within this thesis, it is argued that it is not the “objective” reality that is important in decisions of engaging in undeclared work, but rather the perspective of the individuals involved in the decision-making process. This is in line with the epistemological viewpoint of interpretivism, adopted in this thesis. As such, the populations of the sample will be the citizens themselves. As North (1993) argues, informal institutions are mental constructions. In this light, and as Kaufman et al. (2009:3) state, ‘perceptions matter because agents base their actions on their perceptions, impressions, and views’. This makes it imperative to capture the views of those engaging with declared or undeclared economies, in order to capture the decision-making process of whether to enter the undeclared economy. Although it would be useful to gather the opinions of the elites, the priority here is to gather the views of the citizens. This is because it does not necessarily matter what the elites do and how the policies are designed, but rather the way these are perceived. It is these perceptions that will then affect the attitude of the citizens that can impact on their behaviour. For example, if the citizens believe that the government is likely to catch them if they evade tax, this will affect their behaviour, regardless of whether this is actually true.

4.6.4 Data sampling

As Punch (2004) affirms, all research consists of a form of sampling because no one study is able to include everyone in the population. The aim for stage one of the study is for the participants surveyed to provide a representative sample of the population of the city of Split. Split has a population of around 176,500 (Croatian Bureau of Statistics, 2011). For the purpose of capturing a representative sample, 5 out of 27 areas of Split were chosen (Figure 4.2): Brda (population: 5,884), Plokite (population: 5,942), Gripe (population: 5,695), Varoš (population: 4908), and žnjan (population: 5375). As recommended by Kitchen and Tate (2001) a spatially stratified sampling methodology was used to select 60 households in each area, with a total of 300 surveys. If there were 1,500 households for example, then the researcher called at every 45th household. If there was no response and/or the interview was refused, then the 26th household was visited, then the 24th, 27th, 23rd and so on. This is done to ensure a spatially stratified sample of each area. All 300 surveys were carried out face-to-face between June and August of 2012. Considering the sample size, using a normal distribution, this has a confidence level of 90 per cent and a margin of error of 6 per cent. Although the data is not nationally representative, it will enable one of the first insights into the extent and nature of the undeclared economy in contemporary Croatia**.**

### Figure 4.2- Map of Split and selected areas



A different sampling procedure was used for the second stage of the study, with the 20 participants being chosen by purposive sampling. Purposive sampling (Patton, 2002) is suitable when the aim is not to represent a larger population but rather to provide depth and answers to the research question. This part of the study is designed to obtain richer data regarding the participants’ motives for operating in the undeclared economy, as well as to better understand the decision-making processes. The aim is therefore to reflect a wide variety of views and consequently criteria were chosen in such a manner. Gender and age were considered relevant, to reflect a mix of respondents in the sample. Furthermore, it was important to capture varying levels of the declared/undeclared spectrum, to get a better understanding of the decision-making processes. Therefore, the opinions of those that are not engaging in the undeclared economy are also equally important to capture. In addition, it was important to include individuals with varying levels of tolerance towards undeclared work, so as to better understand the impact of this factor on the decision to operate on a declared or undeclared basis. Purposive sampling (Patton, 2002) was therefore conducted to capture a broad range of responses that were appropriate for answering the research questions and giving more depth to the quantitative data. The participant information and pseudonyms used are presented in the following table. Even though no individuals identified themselves as business owners, but rather self-employed, the term business owner is here used to differentiate the magnitude of their work.

**Table 4.3: Interviewee pseudonyms and information**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Pseudonym | Gender | Age | Description | Employment (declared/undeclared) | Tolerance of UDW |
| Maria | Female | 38 | Waged employee: Bookkeeper | Fully Declared | Tolerant |
| Alan | Male | 39 | Waged employee: IT consultant | Declared (full-time job) and moonlighting | Tolerant |
| Tonia | Female | 51 | Waged employee: administrator | Envelope wages and moonlighting | Tolerant |
| Goran | Male | 48 | Waged employee: driver | Envelope Wages | Lack of tolerance |
| Karla | Female | 45 | Waged employee: teacher | Declared (full-time job) and moonlighting (tutor) | Tolerant |
| Milica | Female | 39 | Waged employee: customer assistant | Fully Declared | Tolerant |
| Antonella | Female | 28 | Waged employee: waitress | Undeclared | Tolerant |
| Sara | Female | 24 | University Student | Undeclared (tutor) | Tolerant |
| Jozo | Male | 72 | Retired | N/A | Lack of tolerance |
| Ivana | Female | 67 | Retired | Pension (undeclared: own vegetable sale) | Tolerant |
| Andre | Male | 42 | Self-employed: mechanic | Wholly undeclared | Tolerant |
| Deni | Male | 31 | Self-employed: handyman | Wholly undeclared | Tolerant |
| Tomo | Male | 40 | Self employed: e-commerce | Partially declared | Tolerant |
| Zlatko | Male | 54 | Self-employed: agriculture | Fully declared | Lack of tolerance |
| Lana | Female | 48 | Business owner: apartments | Fully declared | Lack of tolerance |
| Stipe | Male | 57 | Business owner: small hotel | Partially declared | Tolerant |
| Frane | Male | 52 | Business owner:  restaurant | Partially declared | Tolerant |
| Andjela | Female | 48 | Business owner: graphics design | Partially declared | Tolerant |
| Robert | Male | 35 | Business owner: construction | Partially declared | Tolerant |
| Antea | Female | 37 | Business owner: cleaning | Fully declared | Lack of tolerance |

# 4.6 Reflexivity and the research process

Memoing, as it is termed by Miles and Huberman (1984:69) is considered an important data source within qualitative research studies. This consists of field notes, which record what the researcher hears, observes, experiences and thinks during the course of collecting data and reflecting on the process. Lofland and Lofland (1999) argue that, because the human mind forgets quickly, such notes are crucial to retain the data gathered. Because this process involves ‘luck, feelings, timing, whimsy and art’ (Bailey, 1996:xii) there is a high degree of subjectivity, consequently the researcher has to be careful not to become absorbed in the data-collection process and instead to attempt and, as best as possible, capture the context the interviewees find themselves in. According to Bailey (1996:72) the ‘informal interview is a conscious attempt by the researcher to find out more information about the setting of the person’. However, reflective notes such as hunches, impressions and feelings must be balanced with the use of descriptive notes (Miles and Huberman, 1984). Morgan (1997: 57-58) argues that the involvement of interpretation with field notes means that they are a ‘part of analysis rather than the data collection’. However, as noted, the researcher should be careful to not prematurely categorise the data or lead the situation to best fit a theory outlined in the literature review.

A research diary for recording reflections was therefore kept throughout the process. Blaxter, Hughes and Tight (2001) argue that this is an essential part of undertaking qualitative research and is an important aspect of being reflexive. They outline the use of four sections, namely observational notes, methodological notes, theoretical notes and analytic memo, so that the researcher is prompted to reflect on a full variety of aspects of conducting research, as well as their own role within the construction of research knowledge. Furthermore, the researcher regularly debriefed with the individual that they checked in with after interviews, to offload the research experience.   
Within this, positive notes were made regarding the general willingness of participants to assist in the study, as well as to disclose undeclared work. Although rare, one issue of insecurity that arose was that of age. Whilst the researcher ensured to gather all necessary information about the context, as well as background from different academic sources, it was a couple of times felt as though the respondent felt that the researcher was too young to truly understand the complexity of the issues. Statements such as “you are too young to really know the extent of it” or “you were probably too little to remember how bad it was” were made, which made the researcher feel as though the study may not be taken as seriously. However, in these situations, time was taken to build rapport, but also to ensure that the researcher is interested in hearing the respondent’s views, to better understand the situation. This seemed to work well and therefore minimised the bias occurring from this.   
Notes were also made about the physical environment as the interviews were carried out in the participants’ homes.

One issue that is imperative to discuss, is the possibility of interviewer bias during fieldwork, as the participants sometimes exaggerate issues when faced with strangers. Given that the survey interviews were undertaken only once with each respondent, there is a high degree of formality. The use of multiple interviews, instead of the one-off approach used in this study, has the potential to erode such formality. It can be argued, therefore, that such an approach would achieve a better understanding of the participant’s views and interpretations. However, it is believed that in this case, sufficient relevant information, that enables the fulfilment outlined of aims and objectives, was gathered through the use of just one interview per participant. Because of the embedded nature of undeclared work, it did not seem as though participants were unwilling to disclose their unregistered activity, although they were often not consciously aware that they were participating in undeclared until prompted by the relevant questions.

It is also important to recognise the general involvement of the interviewer in the process of using the interview methodology. It is inevitable that the person’s historical and contextual background will have an influence on different aspects of data collection and analysis. However, the philosophical stance taken, assumes that such objectivity cannot be achieved and that interviewer involvement is important to the research process. I have from the onset, reflected on my influence as a researcher on the outcomes of the study, as well as the complexity presented by conducting research about a phenomenon outside of the scope of formal institutions, but often accepted within informal institutions.

Although I took care to not lead the participants to specific responses, the position taken in this thesis is that the presence of researcher has an effect on the interview. My purpose as a researcher, nationality, gender and age are just a few factors that may have contributed towards this. For example, it is probable that my accent of the locality that was researched, and my age, at least partly contributed towards peoples’ willingness to report that they carried out undeclared work. Me being from that area meant that it was easier to build up rapport and trust with the participants, but my age also meant that I was probably too young to be working for the tax authorities, therefore creating further trust. People seemed very proud that “one of ours” is doing a PhD in England and therefore seemed very willing to assist with the study. This is perhaps why the estimations of undeclared work are much higher in this study than that of the Eurobarometer study. However, in a few cases, I felt as though my age might have made me appear less mature to the respondent and I therefore spent more time building rapport before continuing to the questions. This was important to allow the participants to feel at ease but also feel confident in the study’s legitimacy and therefore take time and consideration to give true answers.

Furthermore, I took every care to present a neutral positioning of undeclared activities, to not show any personal assumptions or opinions about undeclared work that may sway the respondent’s answers in either direction. For example, whilst carrying out the pilot test, one person indicated that they do not carry out undeclared work now but that they can answer the questionnaire pretending it was 6 years ago when they did carry out such activities. Such data would obviously result in a skewed picture and therefore it was important to make sure that there was no moderator acceptance or expectancy bias. This is why I emphasised that the interest of the study is all work and the decision-making process, and that all responses, including those where no undeclared work is carried out, are valuable, so that we can get a realistic representation of the situation in Croatia. I used a standardised opening statement clarifying the process. Furthermore, this is why it was important for me to remain neutral, rather than show acceptance of undeclared work. The record was noted in the Croatian language, as this is the language the interviews were carried out in and the language of the notes made during the interview, as well as the researchers thoughts. The quotes were translated after the analysis was carried out, to avoid meaning being lost in the translation prior to analysis.

Although there are many contentions surrounding the use of an interview as a methodology, the data collection process itself was a pleasant experience. One of the main disadvantages considered in the literature, is that the process can be time consuming and resource intensive, due to issues such as travelling costs (Remenyi et al., 1998). Although travel costs were not a particular issue, the overall data collection process was very time consuming. The fieldwork was conducted during the summer period (June, July and August of 2012) with about 4 interviews per day. It was originally anticipated that more interviews would be carried out per day, but in many cases the participants were fairly conversational and shared stories. Therefore, to not damage the trust build-up or to be rude to the participants, they were not rushed to answer the questions. Combined with the wish to avoid researcher fatigue, this resulted in limited interviews being conducted each day.

A number of people declined to carry out an interview, due to being busy but there were no major constraints on the research in terms of participant willingness. A number of people requested for the questionnaire to be left so that they could fill it out in their own time. This was however not a viable option in this case, as there may be confusion with some questions and the building of rapport and trust is important to achieve honest responses. The participants were therefore informed that the interview should be carried out face-to-face and that the researcher could come back at a time most suitable to them. In order to accommodate for this and to complete the desired amount of questionnaires, the interviews were also carried out over the weekend.

# 4.7 Data analysis

The generation and analysis of quantitative data is used to determine the a) significance of declared and undeclared work in people’s daily lives; b) the extent to which services and the production of goods are declared, or undeclared; c) mapping the extent and nature of undeclared work d) level of trust in government e) procedural, distributive and retributive justice f) personal, identity group and social norms. This information was crucial to fulfil the overall objective of measuring the nature and extent of undeclared work in Croatia using the social exchange theory framework. A statistical software package, namely SPSS was used to analyse the data. The questionnaire was codified prior to distribution, with a number of variables created using the software package. The framework set out in Chapter 2 as well as the design explained earlier in this chapter led the analysis. Other than descriptive statistics and comparing means, regression analysis was used to determine the explanatory power of certain factors with regard engagement in the undeclared realm, as well as the tolerance of undeclared activities. Relevant assumptions were tested to see which tests would be most suitable for the data. This was to ascertain whether relationships between variables are linear, whether there is independence of observations, whether there is multicollinearity, and whether there are any significant outliers. As it is also important to consider the internal reliability of the above-discussed scales of personal norms, identity group norms and societal norms were also tested. It is argued that for newly defined scale, it would be acceptable to have an alpha of at least .70 for it to be reliable (Nunnaly and Bernstein, 1994) however Lance et al. (2006) argue that generally research should rely on a scale with a minimum reliability of .80. With respective scores of .917, .888 and .877 it is clear that the scales are reliable, according to both standards.

The qualitative analysis is derived from the 20 in-depth interviews, as well as the qualitative information given during the survey collection stage. The aim of such analysis is for the researcher to identify a number of themes, which adequately reflect the textual data collected. In order to identify a theme, research judgment is necessary. Data familiarisation is therefore a key factor and is why the researcher was involved in each part of the process. The data was read and re-read multiple times. The first few readings were without any frameworks or specific questions in mind. This helps to build theoretical sensitivity and brings the researcher closer to the data. Following this, a set of questions related to the research questions and the quantitative data was looked at whilst reading the data, and key themes noted and annotated in generating initial codes. A theme ‘captures something important about the data in relation to the research question, and represents some level of patterned response of meaning within the data set’ (Braun and Clarke, 2006: 82). Minority and contradictory features were also coded to help explain differing views and shed light on the quantitative results. As proposed by King (2011) a hierarchical template was used initially, with narrower sub-themes being created to accommodate the collected data. This method was appropriate for the current research, as it is suitable when underlying causes of observable phenomena are being investigated. Following the identification of themes, these were reviewed, defined, and named before producing the narrative. Individual quotations are used as a means to capture the commonly heard views in relation to the topic being discussed. This is done to aid in explanation but also for illustration and to enable voice (Bryman, 2015; Corden and Sainsbury, 2006). Finally the themes were embedded with the quantitative analysis to provide greater depth of understanding.

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# 4.8 Ethical issues

Ethical issues are of high importance when considering the phenomenon of undeclared work, due to its illegitimate status. The research was therefore carefully designed to ensure all ethical issues are considered and incorporated. These issues, together with the design of the study, were outlined to the University of Sheffield’s ethics committee, by whom the research was approved. It is important to note again, that the current research is concerned only with work that is monetised, but not declared to the authorities when it should be. As such, the goods and services themselves are legitimate and those that are not (e.g. criminal activity) fall beyond the scope of this research. Due to its nature, undeclared work might be viewed as an uncomfortable topic, but it is not viewed as sensitive for a number of reasons. Firstly, recent research shows that much of undeclared work is conducted for friends, neighbours and acquaintances and is akin to unpaid mutual aid, due to motives being associated with sociality and redistribution (Williams and Nadin, 2012b). Tax offices rarely treat such activities as a prosecutable offence, whilst a number of countries exclude it from consideration for prosecution (e.g. Denmark, Sweden). Furthermore, as is shown to be the case in Croatia within the literature review, many see little wrongdoing with many unregistered transactions, viewing it as a socially legitimate activity. Moreover, during the 2007 EU27 Eurobarometer data collection, only 2 per cent of all respondents showed minor signs of opposition to answering the set questions. The remaining 98 per cent discussed their engagement with the undeclared economy in a comfortable manner. Governmental authorities have never before, to the knowledge of the researcher, requested names of respondents that have admitted working on an undeclared basis for the purposes of academic research. There is, therefore, no potential harm to the participants engaging with this research.

Best practice is followed and as such, an informed consent form and an information sheet (see appendix) were presented to the potential participants, allowing sufficient time to consider whether or not they wish to participate. The content of the form is inspired by the items recommended by Bailey (1996:11):

* The purpose of the research
* The procedures of the research
* The voluntary nature of research participation
* The subject’s right to stop the interview at any time
* The procedures used to protect confidentiality

The importance of disclosure is emphasised by Bailey (1996) as he argues that deception might prevent insights, whereas openness, coupled with confidentiality, reduces suspicion and fosters sincere responses. Continuous reiterations will be made throughout the interview, of the participants’ right to not have to answer any questions and of their ability to withdraw at any time. It has been ensured that confidentiality of personal details is kept secure from the information provided (including analysis and reporting), remaining anonymous through interviewees being allocated ID numbers and pseudonyms, rather than real names being used.

Issues of personal safety were considered during the design of the research, and upon concluding that it may be unsafe for the researcher to interview individuals in their households in Croatia, a plan to manage safety was devised and followed. During each visit, an individual was informed ahead of the visit, who was then asked by the researcher to ‘call in’ at the house to confirm completion of the interview. At the end of the fieldwork, a de-briefing session was held to offload research experiences and unpack feelings and emotions involved during the conducting of the research. This is done according to good practice, outlined in the University of Sheffield’s guidance notes on ‘Principles of Safety and well-being’. It is also useful in terms of reflexivity.

4.8 Pilot study

As mentioned, a pilot study was carried out to enable the researcher to identify any difficulties that might arise during the administration of the questionnaire or the interview process. It was important to investigate whether the posed questions were understood in the manner intended. Issues such as lack of clarity, relevance or sensitivity of information were considered, therefore allowing alteration of such problems before the final data collection process.   
A number of alterations were made from the initial design. In the pilot questionnaire, one section composed of coping practices carried out by households. As part of this, the pilot study participants were questioned about 26 different domestic tasks (see Table 4.4). The questions included asking whether the task was carried out, who it was done by, if it was paid and if so how, as well as why they carried out the job, rather than someone else. It was found that participants were a little bored and frustrated with the questions, as they were quite repetitive and they had a hard time finding answers to questions such as ‘why they carried out the job rather than someone else’. Almost all of those participating in the pilot study said they felt those questions were a little repetitive and also trivial. As such, it can be concluded that this part of the questionnaire lacked validity, which might be detrimental to the whole study. Although it would be useful to know this information and it would certainly contribute some interesting analysis, it does not directly assist in answering the research questions. As such, the questions that do so were prioritised and this section was replaced by asking individuals if they acquired any services on an undeclared basis, and if they did so, to name the top three services this was the case for. The new version was then piloted again and it was found that interview time was reduced and individuals were more engaged throughout the whole questionnaire.

**Table 4.4: Domestic tasks**

|  |  |  |  |
| --- | --- | --- | --- |
| REPAIRS | ROUTINE HOUSEWORK | MAKING AND REPAIRING GOODS | CARING ACTIVITIES |
| Painting | Cleaning | Clothes making or corrections | Hairdressing |
| Wallpapering | Shopping | Shoe repair | Manicure |
| Tiling | Washing and ironing | Household textile making or corrections | Massage |
| Replacing a broken window | Cooking | Furniture making or repair | Baby-sitting |
| Maintaining or installing domestic electric appliances | Dish washing | Repair or making of household appliances | Tutoring |
| The installation of windows and doors |  | Car servicing |  |
| Plumbing |  | IT related repairs |  |
| Heater or boiler installation |  |  |  |
| Electrical mounting |  |  |  |

Another issue arose when discussing the participants’ satisfaction with receiving envelope wages. The participant who was receiving envelope wages stated that they were not happy and would prefer for their wages to be fully declared. However, it was noted by a few of the other participants that the question needed to be further clarified, as everyone would prefer to be declared if the amount they receive is still the same. Therefore, it was decided that during the main data collection process it would be explained that they would have to pay taxes on the additional amount they declare.

Furthermore, small changes to wording of certain questions were implemented to ensure clarity. Conducting the pilot test, therefore, allowed the researcher to alter and further hone the questionnaire to ensure clarity, consistency and participant engagement.

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# 4.9 Limitations

It is necessary to be aware of limitations that constrain one’s research, and whereas some have been flagged and addressed throughout the thesis, the remaining issues deemed important are outlined in this section.

There are limitations in terms of the scope of research. One issue resides with the measurement of undeclared work. Although the estimate of the undeclared economy can be calculated from the responses, the monetary value of such activity cannot be determined. During the pilot testing, it was found that individuals were more comfortable disclosing their undeclared activity, rather than their overall income. The implementation phase of the actual survey also found that many individuals, particularly the self-employed, found it difficult to estimate the proportion of declared/undeclared activity within their working activity. Indirect and econometric methods might, therefore, be more suited to measure the monetary value of undeclared work. Furthermore, it is considered that, whilst survey methods are useful to evaluate the nature of undeclared work, indirect methods are better suited to measure the general size of the undeclared economy (Jossart, 2010; OECD, 2012; Williams 2014). Although useful for unearthing the nature of undeclared work, there are some problems with the use of direct methods, even in this context. For example, it is likely that certain types of undeclared work are over-represented, due to their socially acceptable form (Williams, 2014). It therefore might be the case that undeclared work, carried out for reasons of mutual reciprocity is overestimated, and exploitative undeclared work is underestimated within the findings. Furthermore, the self-reporting nature of the study may cause the results to be a reflection of post hoc rationalisation of such activities (Birskyte, 2014). Therefore, according to this argument, statements such as “I did the work to help out a friend” or “I carried the work out on an undeclared basis, because it is too difficult to declare” might be a symbolic rationalisation for an otherwise utilitarian reasoning for engaging in undeclared work. It is also important to be conservative regarding the generalisation of the current study. Despite the interesting findings of the study in Split, a comparison with other localities within Croatia would be necessary, to further test and extend the conclusions reached in this thesis. It would also be interesting to see the extent to which the conclusions are applicable to other post-socialist societies, and further yet, other countries beyond this. Although the aim of the qualitative research was to achieve greater depth of research, some findings were inductive in nature, and it would therefore be useful to feed these back into the design of the questionnaire for future studies.

There are also methodological limitations with the current study. These include the limiting nature of the measurement of certain constructs. One example of this is the measurement of the perceived contract. Although, as explained, trust was measured on a number of different levels, it was not possible to encompass precisely all levels of government and all aspects of trust. Saavedra and Tommasi (2007), for example, argue that numerous domains of government ineffectiveness have an association with the undeclared economy, rather than merely those of taxation, redistribution and social protection. This is also something that became evident in the qualitative responses of the participants and points to a limitation of the framing of the “trust in government” questions in the survey. Although questions measuring overall trust in government are included, there were some areas that focused on taxation. Following the tax evasion literature, the questions surrounding procedural justice, focused on tax authorities, rather than the government more generally or any other departments. Although this is useful in some ways, the overall distrust of the government was shown as an immense factor in the qualitative aspect and this should be fed forward when revising the questionnaires for future research. Furthermore, individuals may not have had any contact with the tax office and would therefore find it more difficult to construct opinions of the tax office. It is particularly in this case that their behaviours would be based on their relationship with the government in a more broad sense or be specific to a different department. There are also further limitations with the design of questionnaire. With regard the question pertaining to the participants’ main source of income, 15 individuals reported to having no earnings. These are, therefore, more likely to be at risk to poverty. However, it is important to note, that this figure should be taken with caution, as it is possible that some individuals might be too embarrassed to state that they receive benefits, or are not willing to disclose their undeclared earnings. As such, this question might have fallen to a social desirability bias and might be an overestimate of those receiving no earnings. Another limitation of the questionnaire becomes apparent when looking to the type of payment made for undeclared goods and services. The majority of the payments were made in cash, 99 per cent and 97 per cent for supply and demand respectively. It is important to note, that a limitation of this question might be that many participants did not view exchanges involving payment in kind as undeclared work, and as such did not include these in their answers. If this is the case, the demand for undeclared goods and services is underestimated, as is the proportion of payments made in kind.

# 4.10 Summary

A number of methodological issues have been discussed within this chapter. The various philosophical perspectives have been described and the adoption of an interpretivist ontology with a realist ontology justified. Following this is a discussion of various available methods and the justification, as well as explanation for using a two-stage interview process. Changes implemented during the pilot study are described and the design of the final questionnaire and use of interviews outlined, showing how these meet the research aims set in the thesis. Ethical issues, as well as limitations of the study are considered.

Chapter 5: Findings and Analysis

# 5.1 Introduction

Whereas the previous chapter discussed the methodology, the current chapter presents the results obtained from the surveys and interviews. This sets the scene for Chapter 6, where the findings of the underlying theories outlined in the literature review are analysed. Here, therefore, firstly, the empirical findings on the nature and extent of undeclared work in Split are presented. Second, and following this, the findings related to the vertical relationship between the surveyed individuals and the state are presented, including the issues related to trust. Third, the other element of the theorisation of SET is explored, namely the horizontal issues of norms and tolerance regarding undeclared work. Fourth, the SET framework is tested by presenting an analysis of the factors that seek to predict engagement in undeclared work. The usefulness of the developed framework is shown, and factors that could be included in future analysis discussed. The outcome will be the presentation of some interesting qualitative findings regarding the use of informality as a people management tool, before discussing opinions of Croatia’s past and future. Before concluding the chapter, potential issues related to policy design are discussed.

# 5.2 Undeclared work in Split, Croatia

## 5.2.1 Introduction

To analyse the character and distribution of undeclared work, it is firstly useful to separate the supply-side from the demand-side. This is because it may well be the case that participants are more likely to disclose the purchasing of goods and services on an undeclared basis, than they are the supply of them.

## 5.2.2 Supply of undeclared work

It is difficult to provide a clear categorical percentage of the population engaged in undeclared work in Split. Table 5.1 reports the extent to which each individual engaged with the two economies. Those who are categorised as fully declared stated that they carried out no undeclared work, whereas those who were mainly declared carried out the majority of their work on a declared basis. Those who were mainly undeclared included individuals who carried out the majority of their work on an undeclared basis, such as self-employed individuals underreporting their activity. Those categorised as fully undeclared, carried out all their work, completely off the books. As can be seen, 61 per cent of individuals do not engage at all in the undeclared realm, of which 18 per cent are also not actively engaged in the formal economy; one group has no earnings and another receive only a pension or benefits and do not supplement this with undeclared work. Beyond this 61 per cent who do not engage in undeclared work, some 11 per cent conduct purely informal activities and do not engage in the formal economy, and 28 per cent of people engage in both undeclared and declared work, showing the intertwining nature of the two spheres in Croatia. As such, a total of 39.3 per cent of people engage in some way in the undeclared economy from the supply side. These results seem particularly high, compared with the 2013 Special Eurobarometer 402, where 7.3% of respondents are found to be engaged in undeclared work in Croatia (Franic and Williams, 2014). This can be explained in a number of ways. Firstly, the current study was carried out in the city of Split, whereas the Eurobarometer spans the whole country, and therefore it may be that undeclared work is more prominent within the specific area researched, which is a tourist destination with large amounts of seasonal work. Another reason might be that the researcher, who is originally from Split, took the time to build rapport with each participant, therefore getting a more realistic outlook of the situation. Indeed, it is well known that the longer the lead-in section to surveys on sensitive issues such as undeclared work, the greater is the participation rate identified (Williams, 2015). Franic and Williams (2014) also explain that the Eurobarometer figures should be considered as lower-bound estimates, due to the potential of false answers, as well as the 2.9% participants refusing to give an answer. The implications of the current study are therefore, that undeclared work in Croatia is more prevalent than predicted by some estimations.

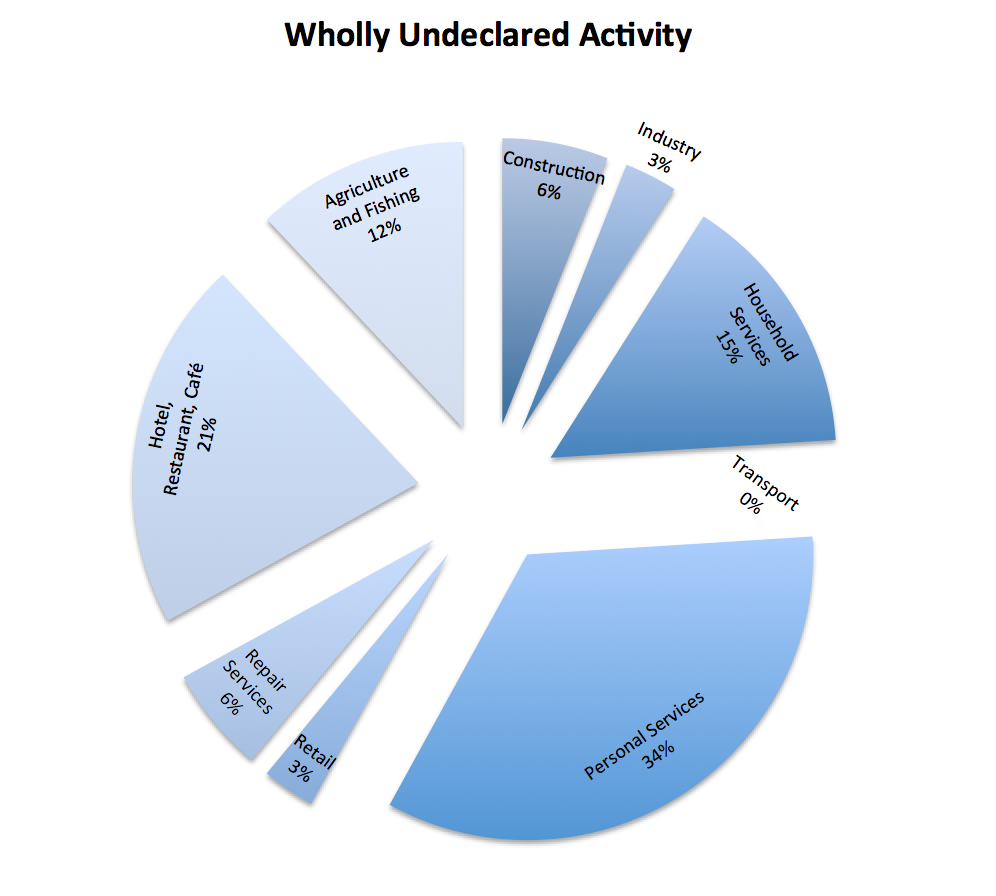
**Table 5.1: Extent of engagement in the declared/undeclared realm**

|  |  |  |  |
| --- | --- | --- | --- |
|  | | **Frequency** | **Per cent** |
|  | Fully Declared | 129 | 43 |
| Mainly Declared | 74 | 25 |
| Mainly Undeclared | 10 | 3 |
| Fully Undeclared | 34 | 11 |
| No earning | 35 | 12 |
| Pension‎/benefits only | 18 | 6 |
| **Total** | 300 | 100.0 |

To better understand the reliance of individuals on undeclared work, participants were asked what percentage of earnings they gain from undeclared work. According to this data, of all individuals surveyed, who have carried out some sort of paid work (N: 247), the average earnings, which were undeclared, were 26 per cent. Although this is not an estimate of undeclared work as a proportion of GDP, this figure is similar to the indirect method estimations of undeclared work in Croatia where, for example, Schneider (2012) estimates the undeclared economy to be 29% of official GDP. Furthermore, using select case analysis of those who *have* carried out undeclared work (N: 118), the average earnings, which were undeclared, was 54 per cent. This shows the intertwined nature of the two economies therefore conforming to the growing recognition that the declared and undeclared are not separate, but rather exist on a spectrum (Latouche, 1993; Williams et al., 2007). However, it is important to note, that during the data collection process, many individuals struggled to estimate the proportion that was declared or undeclared, especially the self-employed, and as such, the figures act as only broad approximations. Considering whether undeclared work is their primary source of income, this was true in 12 per cent of cases. Furthermore, there are 8 per cent of individuals who receive envelope wages, and 12 per cent who are self-employed declaring some income. The latter two groups are engaged, both in the declared, and the undeclared economies.

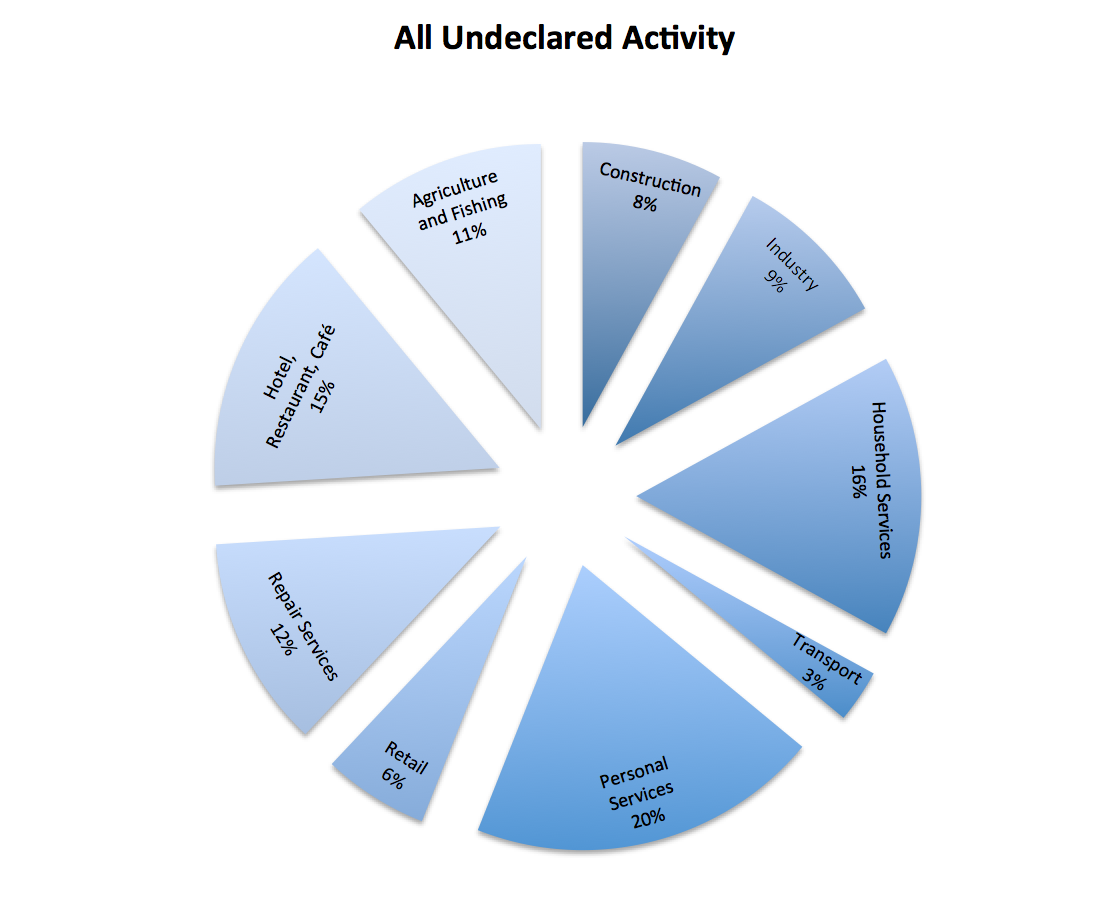
Moving to an examination of the industries that informality occurred in, Figure 5.1 shows that a large proportion of undeclared work is conducted in the personal (20 per cent), household (16 per cent) and hotel, restaurant and café services (15 per cent). However, the composition changes when looking at work provided wholly informally. Although the top three remain the same, personal services takes a much larger composition with 34 per cent, and hotel, restaurant and café services increase to 15 per cent. This is because many waitresses and seasonal workers stated they worked on a wholly undeclared basis.

**Supply of Undeclared Activity**



**Figure 5.1- Pie charts denoting supply of undeclared activity**

**Wholly Undeclared**



**All Undeclared Activity**

Figure 5.2, on the other hand, displays the motives for engaging in the undeclared economy. It shows that, similar to other countries, as shown by the Special Eurobarometer 402, there are a wide variety of reasons. The most commonly cited, however, is that ‘carrying out such a type of work on an undeclared basis is normal’ (23 per cent), indicating the strong acceptability and normalisation of such work. Comparing this finding with Special Eurobarometer 402 and the results for the EU28, the most cited reason, is that both parties benefited from the activities being undeclared, with a 50 per cent response. This shows a largely calculative mind-set of engaging in informality, whereas the findings of the current study show the embedded nature of informality in Croatia, and how it is deeply entrenched as a norm. This implies that it would be necessary to change opinions and attitudes in order to foster formalisation, rather than merely increase the benefits of formality. The perception that taxes are too high in the country was also commonly cited (by 21 per cent of participants in undeclared work). According to the Eurobarometer, this is also a common view in the EU as a whole (17 per cent) and is more pronounced in Southern Europe, where it accounts for 20 per cent of responses. We can also see from Figure 5.2, that 11 per cent of individuals undertake undeclared work because the pay is better. This indicates a utilitarian mind-set within the decision-making process. Furthermore, 9 per cent of people engage in undeclared work because this is of benefit to both parties. This also has a utilitarian premise, but only to a certain extent, as there is consideration of the party, rather than merely maximising own rewards. Following this the next most commonly given answer was “the government does not do anything for me, so why should I pay taxes” with 11 per cent of responses. This, along with the process of declaring work being too complicated (8 per cent), is a sign of a weak relationship between the citizens and the state.

**Figure 5.2- Reasons for engaging in the undeclared economy**

To further examine engagement in undeclared work, it is useful to separate the participants by employment status (see Table 5.2 for the employment status of the surveyed respondents).

**Table 5.2- Respondents according to employment status**

|  |  |  |  |
| --- | --- | --- | --- |
|  | | **Frequency** | **Per cent** |
|  | Employed full-time | 150 | 50.0 |
| Employed part-time | 9 | 3.0 |
| Self-employed | 40 | 13.3 |
| Unemployed | 43 | 14.3 |
| Homemaker | 6 | 2.0 |
| Retired | 17 | 5.7 |
| Student | 35 | 11.7 |
| **Total** | 300 | 100.0 |

Some 14 per cent of the surveyed population reported themselves as being unemployed. It might be the case that some individuals, due to social desirability factors, do not report themselves as being unemployed. However, considering that the employment level was 15.8 per cent in 2012 (Croatian Bureau of Statistics, 2013), the survey’s figure is fairly representative. Looking at the unemployed population (N: 43), 44 per cent engage in the undeclared economy. Of those carrying out undeclared work, 53 per cent do this on a regular basis, much like a full-time job, whereas the remaining 47 per cent carry out the work on a more sporadic or occasional manner. The former therefore benefit from a more consistent income, but neither enjoys the benefits gained from social security and pension contributions. However, they do benefit from the perceived higher income, due to not paying any taxes or contributions.

Looking at employees in full-time declared waged employment (N: 150), 86.7 per cent are fully declared, whilst 13 per cent receive envelope wages. A further two individuals have a second formal job and 28 moonlight on a fully undeclared basis. As such, 76 per cent of full-time waged employees are fully declared and 24 per cent are not, of which 52 per cent are women and 48 per cent men. A Chi-square test shows a significant association between gender and receiving envelope wages (Chi-square=7.443, p<0.01) with 21 per cent of men and only 6 per cent of women receiving envelope wages.

Part-time employees (a total of 9 individuals) are much more likely to receive envelope wages, with 56 per cent doing so, albeit a very small sample. Of those receiving envelope wages, this was mostly for either regular work (60 per cent) or for both regular work and overtime (35 per cent). 78 per cent are happy with this, whereas 19 would prefer to be declared. One individual stated that it would depend on his length of stay with the employer, where he prefers fully declared for a long-term job but if it is only temporary, he is happy with envelope wages.

It was often argued that envelope wages make sense for both parties. It was put forward by employers, that this is beneficial for the employee as they receive the safety and legitimacy of a contract for their declared wage but they also receive more money than they would if it was all fully declared. Many employees also mentioned the acceptability of envelope wages, and linked this to their lack of trust in government and pessimism about the future. Tonia, an administrator that is tolerant of undeclared work stated:

“I asked my employer to not declare my full wages. Some has to be declared because if not I have to go on benefits, and if I refuse to do this I become a target for inspectors”

This exemplifies the effects of a negative social contract on involvement in the undeclared economy. Such links will be discussed in greater detail below (section 5.3).

Examining both formally self-employed, as well as fully undeclared “self-employed”, and as such officially categorised as unemployed, 49 self-employed people were surveyed. Some 40 of these 49 engage in the formal economy, but only 3 state that they report 100% of their profits and as such are fully formal (i.e., 6 per cent of all self-employed). A further 9 people reported being fully undeclared and 37 that they were registered, but only declared some of their income to the tax authorities.

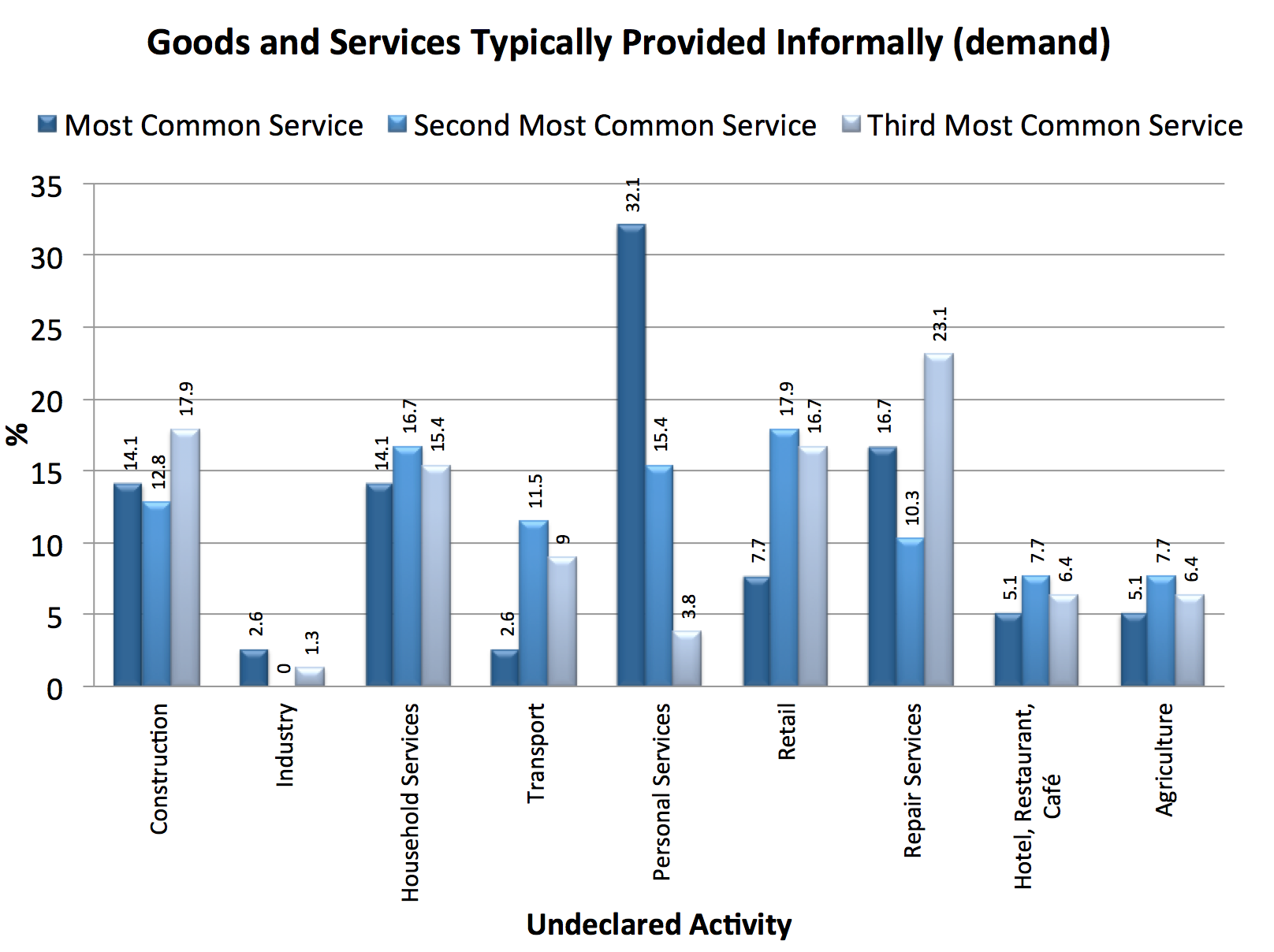
Of the 35 students surveyed, only 2 are fully declared, 3 receive envelope wages and 1 has a full time (hours) undeclared job. 15 students (43 per cent) have no earnings from work and 12 carry out undeclared work on an occasional basis. The latter normally consisted of seasonal work or tutoring for high school students. Of the 17 retired interviewed, 15 receive a pension and the remaining 2 no pension, and support themselves mainly by undeclared work, own production and assistance from family and friends. Only 6 individuals classified themselves as homemakers, of which 4 had no earnings and 2 carried out occasional work that was not declared to the authorities. All those within the homemaker category were women.

## 5.2.3 Demand-side: purchasing undeclared goods and services

Some 26 per cent of participants stated that they had good reason to believe that they acquired goods or a service, which they had reason to believe was undeclared in some way, 10 per cent were unsure and 64 per cent of participants stated they had not. A report of the 2013 Eurobarometer (European Commission, 2014) makes special note of countries that reported high levels of goods and services to have been purchased on an undeclared basis. As part of this, Greece, the Netherlands, Latvia, Denmark, Malta and Slovenia are singled out. Whereas Greece has by far the highest proportion at 30 per cent, Slovenia is also considered to be high at 22 per cent. The results of the current study would place Croatia in this list with 26 per cent. However, the estimations of the Eurobarometer are much more modest for the country, with only 17 per cent of purchases being undeclared.

For those purchasing goods on an undeclared basis, the most cited reason was that of a lower price, compared to the regular market (27 per cent), followed by no particular reason (16 per cent), and as a favour to someone (12 per cent). The fact that some individuals in Croatia stated that there was no particular reason for acquiring something on an undeclared basis shows the ingrained nature of informality. This is because it is indicative of a lack of consideration regarding whether goods or service is declared or not when making the purchasing decision. The least cited reason, was that it was because the good was not available on the regular market (2 per cent), although many discussed that this might have been a more frequent reason in previous years, such as during the socialist time, as well the war. This shows the changing nature of norms, according to circumstance and context. These findings seem broadly consistent with the rest of the EU, with ‘lower price’ accounting for 60 per cent of responses (Eurobarometer 402 calculations). The second most cited reason was doing a favour for friends, relatives or colleagues (22 per cent), whereas ‘no particular reason’ was not an option on this survey.

Examining the types of goods and services purchased, participants were asked to describe the goods and services they acquire on an undeclared basis. They were asked to indicate the three most frequently purchased. For the purposes of analysis, these were then categorised into industries. Figure 5.2 reveals that personal services were most commonly purchased on an undeclared basis (32 per cent). Within this category, services such as beauty treatments, hairdressing and tutoring were frequently mentioned. Repair services, such as car and computer repairs (17 per cent), household services (14 per cent) and construction (14 per cent) were also frequently purchased. Figure 5.3 provides a full analysis of which services were cited as the most common, second most common and third most common.



**Figure 5.3- Goods and services typically provided on an undeclared basis (demand)**

Looking to the type of payment made for undeclared goods and services, it is seen that the majority of the payments were made in cash, 99 and 97 for supply and demand respectively. This shows that if paid undeclared work is carried out, payment in kind is not likely. Individuals stated that they would receive payment in kind, only on occasions when the person could not give cash. However, a number of individuals stated that such payment was more common during the socialist era, indicating a change in norms. Although the current study does not investigate this, it is an interesting qualitative finding, and the reasons behind it would warrant further exploration. Nonetheless, although payment in kind was not accepted, it is not the case that people did not engage in symbolic transactions. However, this is because it is less common to accept money from close friends, family or neighbours, if the work is carried out infrequently or to help the other party. For such relationships, the exchange was less “direct” or quid pro quo, instead including long-term reciprocal exchange. Sometimes, however, token amounts of money were given for a “coffee” or “chocolate”, although this was not considered payment as such. This seemed a more common occurrence for younger generations, as older generations were less inclined to accept even token gestures. However, when the work is carried out more regularly, or is not done for help, this is monetised, but often charged at a discount rate for friends, family and neighbours.

## 5.2.4 Summary

Evidence shows that the undeclared economy is deeply embedded in Croatia and exists across different industries. Furthermore, the supply of undeclared work does not seem underestimated when comparing it with the demand side, and as such, it is probable that the participants were fairly open and truthful about their informality. It is important to note that there was some incongruence between the types of goods and services provided informally between supply and demand. This might have occurred because it is difficult to ascertain whether certain types, of services especially, are declared or undeclared. One such example is waitressing in a restaurant, which was commonly reported as informally paid in the supply section. However, this appears inconsistent with the demand, where hotels, restaurant and café services received 5.1 per cent of responses, as perceived to be the most commonly received informal good or service.

# 5.3 The vertical relationship

## 5.3.1. Characterising the relationship between the state and its citizens in Croatia

This section deals with the vertical relationship between the state and its citizens. The social contract that arises from these relations, is one framed as involving differing degrees of trust, which relates to whether there is perceived to be fairness and justice, concerning the benefits received from the state. As outlined in the methodology, trust in government was measured at both the constitutional and current politico-economic level (Torgler, 2004). Analysis indicates that only 6 per cent of participants have a great deal of confidence in the government at a constitutional level, whereas 70 per cent have either none or little confidence. The levels of trust on a current politico-economic level seem less optimistic, with only 4 per cent of individuals having a great deal of confidence and 17 having quite a lot of confidence. The remaining 79 per cent have either no confidence or very little.

According to the undeclared work and tax evasion, from literature reviewed in earlier chapters, as part of the government/citizen relationship investigation, three types of justice were measured, namely procedural, distributive and redistributive. A five-question scale, with a reliability score of .915 was used to measure procedural justice. Whereas, 12 indicated that participants “completely agree” with the statement, relevant questions were negatively coded to reflect the view that higher numbers represent more just/fair perceptions. As outlined in the literature review, the procedural allocation of resources is considered to be just, if the individuals perceive themselves to have been treated in a manner they consider appropriate (Tyler, 1990; Tyler and Degoey, 1996). The findings show a very low perception of procedural justice with a mean score of 4.3, where the possible scores ranged from 1-12. The standard deviation for this was 2.3, showing that the scores were clustered together fairly closely. Distributive justice, on the other hand, refers to the exchange of resources (Wenzel, 2003) in terms of both benefits and costs. It therefore refers to the individual’s perception of the balance of their share of tax payment, relative to the benefits they receive, as well as the contributions that others make, relative to their share of benefits. To increase the reliability of the distributive justice scale, one item was removed, reducing it to a four-question scale, with a score of .747. Although the results shown by the distributive justice scale are somewhat more optimistic, these are still fairly low, with a mean score of 5.7, a minimum of 1 and a maximum of 10. The standard deviation for this scale was 2.1. Retributive justice is related with the perceived appropriateness of sanctions in cases of breaking of norms (Tyler, 1990). In this case it was measured by asking the level of risk of being found out when working informally, as well as the consequence faced for this. 11 per cent of the participants thought that the risk was very high, whereas 18 per cent considered it to be fairly high. The vast majority (61 per cent) considered the risk to be fairly small, whereas 10 per cent considered it to be very low. With regard to the consequences, the majority of the participants stated that they believe that an individual would be due to pay their normal tax or social security contributions that were due, as well as a fine (62 per cent), whereas 24 per cent stated that they would have to pay the tax and social security contributions, but no fine. A further 13 per cent stated that they did not know or were unsure whereas only 1 person (.3 per cent) stated that they thought prison would be a consequence. However, although all the participants noted down an answer which they thought was likely, accompanied comments such as “it depends on who you know” or “depends how bribable the inspector is”, whether said jokingly or in a serious manner, indicated that often the options were not as clear cut as represented in the choice of answers. Although this was not a measure in the questionnaire, it indicates a high perception of corruption.

Participants were also asked whom they would turn to for help in a financial crisis. The results show that the majority (52 per cent) would turn to family, followed by banks (31 per cent). The government scored very low, with only 4 individuals (1 per cent) saying that they would turn to the government. A further 2 per cent said they would turn to the church and 1 per cent to a social partner organisation, further exemplifying the perceived weakness of formal institutions. Considering the expected medium of reliance when too old to work (multiple response question), Table 5.3 reveals that the largest proportion of citizens (39 per cent) expect to rely on their pension, but a substantial number of individuals (N: 191, 60 per cent) did not cite a state pension as something that they can expect to rely on in their old age. Furthermore, it is worrying that in 17 per cent of cases; individuals did not know what they would rely on. This indicates a lack of certainty or optimism about the future.   
  
**Table 5.3- Expected medium of reliance when too old to work**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | | **Responses** | | **Per cent of Cases** |
| N | Per cent |
|  | State Pension | 109 | 26.7 | 40 |
| Children | 45 | 11.0 | 16 |
| Family | 47 | 11.5 | 17 |
| Private Insurance | 52 | 12.7 | 19 |
| Savings | 108 | 26.5 | 39 |
| Don’t know | 47 | 11.5 | 17 |
| **Total** | | 408 |  |  |

It is therefore clear that in many cases in Croatia, the social contract between the government and its citizens is weak or breached, as perceptions of the state are often negative and expectations low. The direct effect between a lack of confidence in the state and engagement in the undeclared economy is evident in the perspective of the participants, such as the following statement made by Frane, a partially declared restaurant owner:

“The government asking us to pay taxes, is synonymous with a thief stealing my car and then pestering me to pay the registration”

This lack of confidence was mostly voiced by individuals discussing corruption of particular individuals or parties as representative of the government and its actions. The perspective taken in this thesis is synonymous with the view presented by Sapir (2006), who questions the narrow emphasis of the legal content of rules in mainstream research of informality, instead drawing attention to the role of social legitimacy of rules as a major explanatory factor. He argues the importance of the legitimate *perception* of the rule-making process and enforcement for compliance.

Due to the weak social contract consisting of unfairness and lack of trust, individuals do not expect much from the government and are accordingly not willing to reciprocate. At the broadest level, two main explanations were identified here. Namely, individuals either discussed low expectations from the onset or a breach of contract. One theme that arose from those who described an evidently violated contract was more dominant across the older generations. It was that expectations were high with Croatia’s independence and that the situation would be drastically improved, because the country would be in charge of its own future. However, the participants describe that in their view, rather than decisions being made for the good of the country, decisions that benefited private gain were made and corruption dominated. Participants describe that although some broad promises have been made and some corrective justice has occurred, not enough has been done to counter the breach in trust. This shows the importance of managing expectations so that they are not overly optimistic, but also to follow through with promises made and ensure that citizens’ views are known and addressed adequately. Therefore, this carries implications for the quantitative findings of the participants, signifying their optimism in Croatia entering the European Union. These findings are parallel to those of a social contract breach in organizations where a perceived breach of contract has many negative effects, whereby employee commitment and engagement is affected (Rayton and Yalabik, 2014). With the social contract this takes the form of tax morale and civic engagement, because it makes it easier for individuals to justify the moral implications of their undeclared activities. Furthermore, although those who were optimistic about the EU were in the minority, they have similarly high expectations. This raises the importance of managing these expectations and communicating a realistic, deliverable message to the citizens throughout the process of integrating within the EU, to avoid a perceived breach of contract. Having shown that a perceived breach of contract or a weak social contract in general was a clear justification for engagement or willingness to engage in the undeclared economy, the following section places attention on explaining the different parties of the contract.

## 5.3.2 Defining the parties of the relationship

It is theorised that the social contract is held between the individual and the state. Within the quantitative aspect of the study, this was framed in a general way (the government), as well as the tax office more specifically. However, the qualitative aspect revealed that the relationship was not so simple. When discussing the social contract, although the majority of the time people referred to central government, local authorities were often mentioned as defining the expectations of citizens and their perceptions of trust and fairness. Furthermore, there were occasions where particular individual politicians and their actions were named as representative of the state. Although at times hearsay evidence was mentioned, there were also many occasions where information from the media regarding such individuals was used to inform the individuals’ understanding. Often, even though one or two individuals were mentioned to be known as being corrupt, this was extended to a variety of politicians. This indicates that well-known individual figures, as well as the media, play a role in the shaping of citizens’ social contract. Maria, a fully declared individual that is tolerant of undeclared work, commented on this:

“You can be certain that the politicians or those making big amounts,   
 aren’t getting punished, because they have the right connections or   
 enough money for bribes. It is those who are struggling to earn enough to   
 get by, who pay if they get caught”

Large differences between individuals were found with regard to how they discussed public officials such as inspectors. If the inspectors were viewed positively, they were separated from the state as an entity, and individuals seemed more willing to cooperate with them on “local issues”, but still had negative perceptions of government as a whole, and had no problem not declaring their earnings fully. Andjela, a partially declared business owner, gave an example:

“the inspectors are quite good, they know that we wouldn’t be able to survive if we tried to follow every single rule exactly, so they check with their eyes half closed- I think as long as everything is safe and normal its fine”

While the inspectors were viewed negatively, on the other hand, they were considered as part of the monolithic state. As can be seen above, this was the case with Stipe, a small hotel owner, who had a very negative view of inspectors as well as the state more generally. Such individuals seemed completely demoralised and had a very negative social contract, often expressing wishes to work on a fully undeclared basis. Many of them stated disappointment, because they did not envisage the situation to be as such when they first started working. In this sense, they experienced a social contract breach because their expectations were not met. This can have quite drastic effects. As Andre, a completely off-the-books mechanic, stated:

“I was semi-formal before. I wanted to formalise fully and I want to contribute if I can…. quite obviously I still want to make sure I have enough left over to send my children to university so I would consider some evasion and do some jobs on the side, rather than on the books…. but it was too much hassle and now I work completely off the books - that way I avoid all of the complications”.

Whereas business owners discussed inspectors as partly framing their social contract, other individuals focused on other public service employees.

The frustration with bureaucratic procedures is evident. During data collection, the concept of “Fali Jedan Papir” (English Translation: One Paper Missing) was mentioned numerous times. Although there are serious implications behind this concept, a parody has been created that illustrates the problem in a joking manner. In the Serbian parody, a person is told that it does not matter what papers they have with them, because there will always be one paper missing. Although the parody is Serbian, many stated that it is very relevant for Croatia, whilst expressing their frustration with the reality of this portrayal, which further damages the social contract. Representative of Antonella’s, an undeclared waitress, weak social contract was her depiction of the state:

“Of course I will work on an undeclared basis, they do not let you work   
 any other way”

This frustration with bureaucracy was also one of the most common cited reasons for pulling strings. Individuals often stated that it was very difficult to get by without knowing the right people, which is shown in the quantitative analysis. Such views exemplify the need for training and consistency of public officials, before policies such as improved detection can have the fully desired effect. These are the individuals who deal with citizens on a more regular basis, and therefore substantially affect the development of trust in formal institutions, and in turn the social contract. Unless this is rectified, policies aiming to improve detection of undeclared work might therefore have a detrimental effect on the social contract.

Although dissatisfaction was found with the government, a distinction was often drawn. At times “front liners” were portrayed in a more positive light and at other times in a more negative manner. Deni, a self-employed wholly undeclared handyman, gave a relevant example:

“At least officials aren’t always as stupid or greedy as the government. For example, there was a law passed about having snow chains in your vehicle at ridiculous times. It was probably either a way to get money more quickly, or the government just got lazy and copied the law from a country where it makes sense because it snows for a longer period of the year. But luckily the policemen used their common sense to not fine people for not complying”

However, if the examples given, such as the one above are true, this sends mixed messages to citizens, because there is a lack of internal fit, which can have detrimental effects in managing expectations of the social contract. Although internal fit is an organisational culture concept (Arogyaswamy and Byles, 1987) it is very relevant here, because it advocates cohesion and consistency. This is because if some government officials are not following the rule set by the state, it can act as a wrong signal to the citizens.

Such inconsistencies and negative ways in which individuals are dealt with, have an escalating effect. This is because the situation has an effect beyond those individuals involved in the incident. Such issues are frequently communicated amongst friends and family and can have harmful consequences on others’ social contracts. These findings bring up two important questions that are crucial to understand the state of the social contract. Firstly, it is important to know with whom the contract is perceived to be held (figure 5.4). Second, there is a need to understand which of these parties have the most influence on the state of the contract. These indirectly impact on personal norms, and therefore the decision making process of engagement in the undeclared economy. There is scant literature on this issue, especially in terms of analysing entities that have the biggest impact on the formation of the social contract with the government and its citizens.

**Figure 5.4- Factors influencing the state of the social contract**

Similar issues have arisen in the social contract literature regarding employment relationship. Baker (1996), for example, points out that social contracts are present in any relationship in which there exist expectations between the parties. This idea stems from Rousseau (1995) who attempts to get around the problem of ‘agents’ but fails, due to there being multiple agents for the organisations, some of which may be advocating different contracts. Due to there being next to no research conducted in the area of multiple-foci psychological or social contracts, we know very little about the nature of them. However, this carries vast implications to manage the perceived state of the social contract in the eyes of citizens. The issues highlighted are just as relevant for the state-citizen social contract, as they highlight the difficulties of maintaining a positive contract, and in turn tax morale.

# 5.4 The horizontal relations

Although there are inextricable links between vertical and horizontal relationships, this section focuses on the latter, to uncover the norms developed by and through horizontal relations in Split, Croatia. Within this, the acceptance of undeclared work, influence of norms, development of norms, as well as mechanisms that regulate informality will be discussed.

### 5.4.1 Tolerance of undeclared work

This section focuses on personal norms of undeclared work, namely the individual’s tolerance of undeclared activity. This survey reveals that although participants understand what undeclared work is on a theoretical basis, the social embeddedness of the activities is exemplified by the fact, that many did not recognise such work as undeclared in practice. For example, when it was explained to Jozo, a 72 year old retired individual, that the next question of the survey will discuss undeclared work supplied to him, he stated:

“I do not engage in such activities, I know many people do but I have   
 personally never approved of this”.

However, when he was further prompted and asked about how he pays the cleaner and so on he went on to say that

“Ah, but that’s different, it’s just the girl from the neighbourhood, that   
 doesn’t count”.

Therefore, even though individuals knew that such work was *technically* undeclared, they did not consider it as such because they conformed more tightly to the rules set by informal, rather than formal institutions. Furthermore, participants seemed to be happy to quite openly discuss their undeclared activities with the researcher.

Five questions were used to compute personal norms on the basis of measuring an individual’s attitude with regard to acceptance of different types of undeclared work:

* (A) An individual hires another individual for help in the house and they do not declare this work
* (B) An individual hires a firm and the work is not declared
* (C) A firm hires an individual and the work is not declared
* (D) A firm employs another firm and the work is not declared
* (E) A person does not, either wholly or partially, declare their earnings

Two questions denoting different types of illegal work were also posed, mainly for comparative purposes:

* (F) Someone receives welfare payments without entitlement
* (G) Someone uses public transport without a valid ticket

Although the Likert scale questions were posed on a 10-point level, for the purpose of analysis, these are transformed to a 3-point level scale, where 1-3=1 and is categorised as unaccepting of the activity, 4-7=2 denoting somewhat tolerant, and 8-10=3 represents highly tolerant of the presented situation. From the graph illustrating the levels of acceptance broken down by category, it is evident that the least tolerated behaviour is receiving benefits without entitlement, with 91 per cent of the surveyed population finding this unacceptable. This is important as it shows a clear lack of tolerance of accepting something that an individual is not entitled and is similar to the Eurobarometer 402 finding across Europe, where 90 per cent of individuals found the activity unacceptable. The next least accepted activity is the action of one firm hiring another firm and failing to declare the earnings. The majority of participants (70 per cent) found this unacceptable and only 4 per cent found it highly acceptable. A likely explanation is that such an activity is less personal and not viewed as a survival or insignificant activity, but is instead more likely to be imagined as an activity that exploitative corporations undertake. On the other hand, the type of undeclared work that stands out in this situation is an individual hiring another private person for help in the house, without the work being declared. For this activity, 63 per cent of the surveyed individuals report being at least somewhat tolerant towards this type of work, with 32 per cent being highly tolerant. The reason behind this might be that this work is viewed as either too insignificant or too complicated to declare, or that the motives behind such work are not monetary.

Figure 5.5: Levels of tolerance towards various activities

It is useful to elaborate on the fact that individuals find, to such a high extent, the claiming of welfare payments without entitlement, socially unacceptable. Considering the low levels of perceived state legitimacy and trust in the state (as described above), there is some level of tolerance towards certain undeclared activities, because individuals viewing it as their right to keep all of these earnings as paying taxes would mean that the money would be redistributed by unjust hands.

Although it is beneficial to look at these questions individually, it is also beneficial to create a scale to include the five items that measures overall attitudes towards undeclared work. Categorising the tolerance of undeclared work in such a way produces a mean score of 4 and the majority of participants, 53 per cent, generally disapprove of such activities (1-3 on scale), whereas 31 per cent are fairly tolerant (4-7 on scale) and 16 per cent are highly tolerant (8-10 on scale). Although the latter number seems quite low, considering that 47 per cent of the participants were at least somewhat tolerant of informality has considerable implications. This means that this proportion of people is not deterred from engaging in the undeclared economy by their morale. Instead, they would only be deterred by factors such as the benefits of the declared economy and the disadvantages of informality. Furthermore, such individuals, because they tolerate undeclared work, would be less likely to contribute towards social deterrence of such activity.

## 5.4.2 Identity group and societal norms

The same questions were also used to test for identity group norms and societal norms but when asked:

* Please indicate how acceptable each situation is amongst the group you identified in the previous question (identity group norms)
* Please indicate how acceptable each situation is to an average Croatian citizen (societal norms)

Prior to these questions, each individual was asked with which group they most identify in relation to taxes, work and related issues. It was found that the majority of participants identify best with those belonging to their profession (42 per cent), with class (18 per cent) and generation (17) also being commonly chosen (Table 5.4).

**Table 5.4 - Frequency and percentage of chosen identity groups**

|  |  |  |  |
| --- | --- | --- | --- |
|  | | **Frequency** | **Per cent** |
|  | Profession | 127 | 42 |
| Class | 55 | 18 |
| Regional | 26 | 9 |
| Ethnic group | 11 | 4 |
| Social Group | 6 | 2 |
| Religion | 12 | 4 |
| Gender | 3 | 1 |
| Generation | 52 | 17 |
| Neighbourhood | 8 | 3 |
| **Total** | 300 | 100.0 |

Whereas the mean score for personal norms was 4 across the five items, it was 5 and 6 for the reference group and societal norms, respectively. This shows that the majority of people perceive themselves as being less tolerant of undeclared work than that of other people, both including in Croatia generally, as well as those who they most closely identify with in terms of norms. However, it is also important to consider the extent to which the perception of societal and identity group norms influence the formation of personal norms.

## 5.4.3 Predicting tolerance of undeclared work

As theorised, identity group norms and societal level norms will have a substantial impact on the formation of personal tolerance of undeclared work. Linear regressions are here used to test the level of variance that is explained by these. Furthermore, it was expected that an individual would be more influenced by their perception of what is acceptable for their identity group, rather than what is acceptable for an *average* Croatian citizen, and as such the nation as a whole.  
*Personal Norms=b*

A linear regression established that perception of identity group norms with regard tolerance of undeclared work, could statistically significantly predict the level of personal tolerance towards such activity F(1,298)=1027.085, p<.0005. Where this perception of identity group norms accounted for 78 per cent of the explained variability in personal norms. The regression equation was:  
*Personal Norms=-2.498+0.949 x (Identity Group Norms)*

Societal Norms, on the other hand, explained 28 per cent of variance.  
*Personal Norms=2.634 + 0.620 x (Societal Norms)*

This, therefore, confirms the theorisation that individuals are more influenced by their perception of the group they identify with, rather than the nation as a whole. This has important implications for policy, as it indicates that campaigns that seek to change informal institutions by making individuals aware of levels of undeclared work should be tailored to present the data by profession, class or generation, rather than the nation as a whole.

The quantitative aspect showed that generally there was a much tighter congruence of opinions in the acceptance of various types of undeclared work between reference group norms and personal norms, than societal norms and personal norms. However, as will be discussed in the next section, it was the qualitative aspect of the study that provided the richness of information on how the various norms form.

## 5.4.4 Formation of norms

### 5.4.4.1 Forming opinions about undeclared work

To understand how individuals form their opinions about undeclared work, three main themes that arose during interviews can be discerned. It was found that participants based their opinions on observation, communication and elites.

Observation of how other individuals act appears to play a large role in shaping their opinions. Such observations include noticing whether receipts are received, or being given different prices for goods or services. The most commonly mentioned medium forming opinions about undeclared work is conversation with family, friends, neighbours and acquaintances. As aforementioned, the topic of undeclared work does not seem to be considered taboo amongst the Split population. Therefore, perceptions stem from discussions with peers, where opinions of the relevant issues are shared, along with information about others’ activities.

Media information also shaped their opinions, as many interviewees referred to media stories when discussing undeclared work. Furthermore, when there are many media reports on this issue, respondents asserted that they assumed the problem to be significant and out of control. This, however, is perhaps linked to the lack of trust in the government, as the intended message is presumably that the government is looking after the economy and punishing those who do not conform to legal rules and regulations (retributive justice). Another example of how the media and hearsay forms opinions on undeclared work, are the references made to certain individuals who are famous or held highly in society. These can be referred to as elites, with Whitmeyer (2002:322) defining elites as ‘people with attributes that lead them to be ranked higher and accorded more prestige and respect than ordinary people’. Many respondents mentioned examples of successful politicians, directors, actors, businesspeople and even academics who engaged in the undeclared economy. Some of the stories told were claimed to be from first-hand knowledge, whereas others were hearsay or from media stories. Although some interviewees were happy for the names they mentioned to be included, they will remain anonymous because of the sensitivity of the information. Nonetheless, it is irrelevant whether the many stories told are factually correct or incorrect. Instead, the importance lies in the circulation of these stories and them being so popular. Given that these elite individuals have had no repercussions from either the state or social disproval, as some of them are held quite highly in society, this signals to citizens that there is no social punishment for engagement in informal activities. Indeed, there may be substantial reward in it. Although it is difficult for the government to be aware of or manage such opinions, having formal institutions that are trustworthy, moral, and seen as fair in their retributive justice, would help to prevent the circulation of such stories. Whereas those belonging to older generation focused more on elites, the younger generation often referred to known individuals in the descriptions of their opinions about the socially accepted nature of undeclared work. Family members and teachers were commonly discussed to describe the prevalence and tolerance of such activities. The effect of role models on the influence of attitudes and behaviours has been long documented (Bandura, 1977), and showing that undeclared work is highly relevant has important policy implications.

Figure 5.6- Factors that contribute towards formation of norms

### 5.4.4.2 Context and changes in social norms

Croatia provides an excellent opportunity to study the change in social norms. It was often considered how “things were different” during socialist times, during the war and now. One such example relates to the smuggling of goods (šverc), which arose in a small number of discussions with participants. Although this thesis covers only those activities that are legal *in nature*, broadening the discussion to those that are illegal is useful to show the changes in norms, and thus the acceptability of activities is contextuality important. During socialist times, and even more so during the war period, smuggling and selling stolen goods was an activity that was more accepted than it is now. Ivana, a retired individual that also sells vegetables on an undeclared basis explained the issue aptly:

“During a couple of years of the war it was normal to smuggle things   
 such as alcohol and cigarettes, but also sugar, oil and flour. This was even   
 more accepted in Bosnia and lasted for longer.”

Emphasis was given to the need for such activities to occur, and because now the perceived need is lower, such activities are tolerated to a lesser extent. Although social norms and perceptions of social norms take time to change, this example shows that this can happen within a relatively short time span and indicates that transition periods and outside shocks might be particularly powerful to speed this process up.

### 5.4.4.3 Conflict of norms

The findings also reveal how conflicts or competing rules between personal and social norms, as well as opportunities, affect the decision-making process and the resultant outcome of whether there is engagement in undeclared work. This conflict between personal and social norms became evident, when individuals quite strongly indicated personal norms that were not accepting of undeclared work, yet quite actively engaged in the undeclared economy. Such individuals’ perception of the acceptability of undeclared work on a social norm basis was very high. This corresponds, to a certain extent, to findings in previous literature, where reference is made to exit or exclusion of the formal economy (Maloney, 2004). It is theorised that individuals are excluded from the declared economy and as such, engage in the undeclared economy out of necessity (dualist view) or employer’s choice (structuralist perspective), rather than own personal choice. However, although this was the case in some situations, it was not always the reason behind engaging in undeclared work for individuals who are generally intolerant of such activity. In some situations, individuals said that although they are intolerant of it in some situations, it is the easier route because it is too complicated to declare (legalist interpretation), or that such work is so normalised that it would be strange to declare and they would not know how to go about doing it. In the latter cases particularly, the work was dismissed as being insignificant, due to it being such a small amount, or the participant argued that because so many individuals avoid taxes, this contribution would not save the situation. Explanations such as “unfortunately it is the way that things are done” (Goran, undeclared work in the form of envelope wages) and “My circumstance was different” (Jozo, retired) were given.

These findings reveal that even though a negative opinion of formal institutions does not necessarily always affect an individual’s *attitude* towards paying taxes or tolerance of such activities, engagement in the undeclared realm can still impact on their activities. In such situations, although the norms are not internalised and the undeclared economy does not cause a change in personal ethics, they do have an effect on a behavioural level.

From the discussion of factors that influence tolerance in undeclared work, it is evident that personal and social norms play key roles. The qualitative findings shed light on the quantitative finding that trust in government was a better predictor of the acceptability of undeclared work than actual engagement in undeclared work. This is because a number of other issues acted as overpowering factors in the decision-making process.

## 5.4.5 Mechanisms regulating undeclared activity

### 5.4.5.1 Introduction

As the undeclared economy falls beyond the scope of regulation of the state, social norms act as a mechanism to regulate the activities. A number of mechanisms are found to regulate undeclared activity. The majority of these, in some way or another, revolve around the issues of networks or social capital, and involve deeply ingrained and established norms in the ways of doing things.

### 5.4.5.2 Internalised norms

Clearly established social norms exist which regulate undeclared relationships between individuals known to each other or are part of the same or similar networks. Especially when the work is carried out more regularly or where the motive is not purely of a monetary nature, the rate is often decided at a discount. This is especially prominent amongst friends, family and neighbours. Alan, an IT consultant who has a full time job at a firm whilst moonlighting, illustrated:

“I carry out a lot of free repairs outside of my job in the  
 neighbourhood and for my friends and family. Normally this does not take   
 very long and is just small fixes, but because I am the computer guy, they  
 feel safer coming to me... I also carry out some work outside of my job for   
 a friend who has a company, but because this is not just for him and is   
 quite regular, such as setting up, repairing, maintaining software and so   
 on, we have agreed a reasonable price. It is of course much less because   
 he is a friend, but gives some nice extra money I can send to my children   
 at university.”

This shows how pay rates vary by motives and the relationship between the parties involved. Even when the primary motive is the money itself, the exchange becomes different when carried out with someone who is known. This is because, even though money is still exchanged, the focus is the relationship itself, and the rules that govern this type of exchange, are different. Indeed, emphasis is often placed on the need to trust each other and look after each other, because there is a lack of reliance on formal institutions. An example of this was a statement by Alan, an IT consultant, that “You just would not charge more if it was not necessary. We have to look after each other”. This shows the symbolic and community based nature of the exchange.

This exemplifies how a lack of trust in government brings individuals together because they rely more on each other and the mechanisms that have arisen through social interaction (informal institutions), than they do on the state and its regulations (formal institutions). However, the true nature of this trust is debatable and arises out of necessity because the government is not trusted. Furthermore, as will be explained in full, it can create issues of distrust with citizens unknown to the individual.

### **5.4.5.3** Social norms affecting behaviour rather than attitude

However, there are also examples where individuals seem to be slightly reluctant to have different types of exchanges with friends and family, but still did so. Sara, a 24 year old university student who gives tutorials to lower school and high school students in maths, explained how she “will charge less when the tutorials are for family friends or neighbours because [she feels] uncomfortable charging the standard rate”. Here, therefore, the focus is on describing feelings of discomfort and embarrassment if they were to charge a friend or neighbour the same amount as they would an unknown individual. As Tomo, a self-employed individual with tolerance of undeclared work, said:

“if you are a normal person you just would not do that. It is just not the  
 done thing”

In such situations, therefore, it seems as though the norm of charging family and friends is not fully internalised and as such, does not affect the attitude of an individual. However, it is evident that it still impacts their actions and as such, has an effect on behaviour.

### 5.4.5.4 Reputation

A usual benefit of having work carried out formally is the warranty and security associated with such work. Looking at this from the perspective of those carrying out the work, there are also a number of issues related to reliability, such as being paid on time and being paid the correct amount.

However, although such issues do exist in undeclared contexts, the impact of them is minimised because of the social regulation that occurs. As explained above, where the exchange is carried out between individuals close to each other (friends, family and neighbours), this is regulated by reciprocity. However, there are situations in which, although they belong to similar networks, the social distance between the parties is larger. Examples include acquaintances or individuals recommended by someone. In such situations, monetary values of the exchange represent a more substantial proportion of the relationship. Therefore, the norm of reciprocity is weakened as a mechanism, but other regulations such as reputation compensate. Deni, a wholly undeclared, self-employed, individual explained:

“I do well because I care, and people can see that. Because I am not   
 declared and am not as arrogant as some other informal workers, I do not   
 like to put adverts up. This means that I live from recommendations and if   
 I don’t leave a customer pleased, I won’t have a next job to go to”

Furthermore, it was found that even though some individuals believe that there are problems in engaging in undeclared work, they also believe that being formal does not resolve any such problems. Many discussed their feelings, that undeclared work does not pose any *additional* risks, due to the inadequacy of legal protection. Individuals said that they go through informal channels to hire workers because this is a safer option, due to the reputation element. It was often stated that a relative or someone who comes under a recommendation, is more likely to be reliable and care about the job. This therefore signifies how a breach in social contract and lack of trust in government, leads to the need for informal institutions to form their own mechanisms that regulate work situations. Goran, a 45-year-old waged employee, explained a situation he encountered with the demand side of labour:

“The people I had retile my bathroom did a terrible job […] But   
 even if they did issue a receipt there, I don’t see how it would have made a   
 difference, because taking these things to court is too much hassle and too   
 many people get away with things.”

This is indicative of low confidence in the judicial system, but also demonstrates that at the core, the issue is not about being declared or undeclared, because the sense of security arises from trust and personal relations, rather than formally established rules and regulations. The formal aspect does not, therefore, include the necessary protection; consequently individuals do not see a benefit of engaging in this economy. From a less utilitarian perspective, the individuals opt out, not because of the benefit gained, but as a form of protest, for formal institutions not providing what is needed in the eyes of the citizens.

The reputation element also protects the individual hired to carry out the job, but from a social, rather than business focus. This is because the recipient and supplier are part of the same network and if the supplier is not paid the agreed amount at the right time, there would be implications for their personal reputation. However, much akin to justifications to reduce the state of indebtedness within the scope of the social contract, the same phenomenon is evoked in micro exchange relations. Tomo, a partially declared, self-employed individual shared problems of this nature that he has encountered:

“I have had issues with payments before. Sometimes it is because they  
 claim I didn’t do the job well enough, or they are just trying to get out of it.   
 Other times people just run out of money and there is nothing that can be   
 done. In these situations I can accept payment in kind or just wait”

Therefore, although there are regulatory mechanisms that operate within the undeclared economy, these are not always successful, much like those that fail in the declared sphere.

### 5.4.5.5 Identification and exclusion

Although trust acts as a regulatory mechanism in situations where individuals are known to each other, it appeared that there were very low levels of trust in individuals that were unknown. This, in turn, limits the exchange networks that a person interacts in and negates the positive benefits of formal network structures.

As mentioned, a negative of such enclosed circles of trust and acceptance is that social capital can be limiting, and issues such as social exclusion come to the fore. However, a social mechanism of identification serves as a dampening tool in some situations to close the gap of social distance. Many individuals described ways within which this can be achieved through communication and interaction, where the parties try to identify commonalities, such as mutual friends and acquaintances. Deni, a self-employed undeclared handyman, explained:

“It always seems to happen ‘oh which school did you go to?’ or ‘where are   
 you from?’ or something similar. When you find some common ground it   
 is almost like reassurance. Like what you would call a background check   
 or something. Sometimes it is even quite exciting that their mum came   
 from the exact same village in Slavonija [region of Croatia] as your wife or   
 that they have a house on the same part of Brac [an island in Croatia]   
 where your grandma is from.”

This results in positive feelings between the individuals, but also has symbolic implications of pride in individuals by demonstrating how well connected they are.

However, although broadening the scope of social capital is positive, it also has negative elements. These include restricted freedom to barter and make decisions, nepotism, lack of civic participation and exclusion. Some individuals, for example, stated that it becomes difficult to carry out business or do things fairly, because “someone always knows someone” and they feel obligated to reciprocate. Sara, a university student carrying out tutoring on an undeclared basis, described the need to conform to the norms:

“It is difficult because everyone wants a favour and someone is always someone’s family friend who has done a favour for you at some point, or   
 comes from the same village as you. Then you get a bad reputation for not   
 doing a favour for a ‘friend’ so you have to give in”

Two different themes arose as explanations for this need to reciprocate. One refers to the already mentioned need to reduce the state of indebtedness, because the person’s “association” has carried out a favour. The other involves a more seemingly rational choice calculation to protect their reputation, or that they may need a favour in the future. However, the latter is not always described in an exploitative manner, but is expressed as a necessity because past experiences have shown that it is difficult to do some things without connections, because of corruption and bureaucratic inefficacy. As such, individuals are not doing this to get ahead, but to get by. This shows that generalised exchange, although positive as a broad concept, can be considered in a utilitarian manner, depending on the resource being exchanged and the true motive behind this.

Furthermore, when there is a lack of trust in government, people often build connections and social capital out of necessity, rather than want. They sometimes engage in activities they do not want to because of the value arising from the created relationship. Although this can be positive when the value is intangible, “I do this because I care”, but when the value is more concrete, “I do this because the future is unstable and I have to make sure to have the right connections when the need arises” the symbolic nature is lost and the utilitarian motives become evident. If such importance is placed on social capital and lack of trust of those who do not form part of a network, then this can lead to nepotism. The reliance on known social networks, also creates closed circles of activity, further restricting activity.

Moreover, this attitude of *identification* and *exclusionism* can be detrimental to individuals who fall beyond the scope of acceptance and fail to integrate through the process of identification described above. Lana, an apartment owner, who is not a native of Split and feels excluded, gives one such example stating that she has “been reported a number of times by the locals”. She feels that this is because she is “not from around here”. Although such actions deter certain individuals from partaking in the undeclared economy and can therefore be seen as positive, the negative implications are also wide reaching. They contribute to an “us and them” attitude that fosters exclusionism and contributes to low trust amongst citizens of Croatia.

Situations in which undeclared work was carried out by individuals unknown to each other, or each other’s networks, were less frequently mentioned. Furthermore, they were more characterised by unrepeatable interactions, rather than multiple or long-term relations. Due to there being a lack of trust, these were normally regulated by simple and direct exchange (quid-pro-quo). Where the work was a service that needed to be completed over a period of time, a system was normally devised, where one part was paid before (as a deposit) to protect the hired individual, and one part after, to protect those who requested the service.

Therefore, four clear themes of regulating mechanisms within undeclared situations arise. These are internalised norms, conformity to norms, reputation, as well as the process of identification. Firstly, in situations where the norms seemed truly internalised, individuals did not seem to justify or explain why the relations are different when the exchange occurs within one’s network. Secondly, there were some situations in which the individual took more time to explain why this occurred. These individuals seemed less accepting of the way in which things occurred, but still conformed to the perceived social norm, as they felt uncomfortable going against the standard. However, this explanation still better conforms to the symbolic explanation, rather than utilitarian, as the individual acted against what was felt to be the most beneficial situation to them. Thirdly, the regulatory mechanism of social capital in the form of reputation, better corresponds to utilitarian perspectives, as individuals evoking such explanations explained their awareness, that actions such as charging lower prices to the right people, are beneficial to them in the long-term because they create valuable connections. Fourthly, the intertwining and complex nature of social capital showed some negative regulatory mechanisms that were exclusionary in nature. These were, however, to some extent relieved through the process of identification, which was perceived as positive by some and negative by others.

**Figure 5.7- Mechanisms that contribute towards regulating undeclared activities**

### 5.4.5.6 Damaging effects of informality norms

Discussions with freelance workers indicated that firstly, some norms that exist in the undeclared realm have a negative impact on those wanting to be fully legitimate. Second, these damaging norms also resulted in constrained opportunities for those operating wholly informally.

Firstly, those self-employed who stated that they obeyed *all* of the laws, rules and regulations, often spoke of the extraordinarily disadvantaged position they put themselves in. Although they often state their inability to compete with prices because of the added costs of being formal, a whole array of other issues seemed to be present. These included bureaucratic impediments and a lack of connections to get things done. The bureaucratic limitations were exasperated in negative impact by participants discussing a need to bend the rules in order to get things done. However, individuals unwilling to cut corners felt they were disadvantaged, compared to those who were willing to do so. Becoming further entangled with red tape was perceived a handicap, as well as being excluded from certain networks and as such, experiencing lower levels of certain type of social capital (in Croatian: veze, connections to get things done). Zlatko, a fully declared self-employed individual detailed the problems he encounters:  
  
 “I am not willing to do him a ‘favour’ in giving him a lower price   
 informally or doing something dodgy, so of course he is not going to help   
 me out when it comes to something normal. Not participating in this cycle   
 of corruption makes things harder, slower and longer, but I have shown it   
 is not impossible to do well fairly, and I think many people appreciate   
 that.”   
  
However, those who engage in such activities do not view them as corrupt in nature, but a way to instil fairness by counteracting the perceived corruption and difficulties presented by the government. Stipe, a small hotel owner, justified this by stating that:

“The government has created so many barriers because of their   
 corruption and unfairness, we have to look out for each other in order to   
 get by.”

This shows how a weak or negative social contract, created by perceived corruption and lack of care of citizens, creates a vacuum even within the formal economy where individuals play by the rules that conform to informal, rather than formal institutional mechanisms.

Another example of the damaging effects of informality norms was that the normalization and extent of undeclared work in certain industries meant that it was hard for businesses to acquire enough expenses to deduct from the business, because so few businesses and individuals were willing to issue receipts. Antea, a business owner, who finds this a particular frustration, summed up the situation:

“Even those who are willing to give you receipts, look at you as   
 though you are crazy when you ask for this and explain ‘you know   
 that it will be cheaper if I do it without a receipt”

The complicated nature of the taxation system, as well as employee’s lack of awareness of it, was a further source of frustration for many business owners. They often argue that individuals are completely unaware of their wages in gross terms and are in most cases purely and only interested in the final amount they receive. This carries with it, important implications for motivation in the workplace, as businesses owners contend that employees think they are not being paid enough because they do not understand the amount that the employer has to give in terms of taxes and contributions.

Therefore, we can see how normalisation of informality can damage those individuals who are aligned with formal institutions and as such, want to work within a wholly declared route. Furthermore, considering that those entrepreneurs or freelancers who are wholly undeclared do not have any consistent employees, it shows the limits imposed on growth. Andre, an undeclared mechanic, explained his situation:

“I cannot take on more jobs because I work on my own, but I cannot grow   
 my business because I cannot put up adverts or hire employees because I   
 will become a target for inspectors that way. It is a price I happily pay for   
 having my freedom, I earn enough and I am happy with this”

Therefore, although they have advantages of flexibility and autonomy, the misalignment of institutions has meant that growth and expansion are compromised. Furthermore, it shows that both undeclared and formal actors are to a certain extent, harmed by institutional incongruence.

## 5.4.6 Connections

The focus of the next section is to outline the findings related to the use of connections. Individuals were asked two different sets of questions, where the first related to the perceived need and importance of using connections to get things done and the second set referred to the acceptability of the use of such connections. With the latter questions, participants were asked to note down how acceptable they find using connections, how acceptable they thought individuals of their identity group find it, as well as how acceptable they think the situation is for an average Croatian citizen. The first question, asking the perception of the importance of connections (veze) regarding employment, schooling and medical care, the majority of participants (65 per cent) stated that they believed it was either very important (31 per cent) or important (32 per cent), whereas 23 per cent thought it was somewhat important and only 14 per cent thought it was not important. The second question, on the other hand, seeks to measure the perceived importance of connections to avoid sanctions for carrying out undeclared work. Yet again, the majority thought connections to be either very important or important 59.3 per cent whereas 17.5 per cent of individuals consider them to not be important. Finally, the participants were asked their opinion of the use of connections for various work permits, concessions and grants. Similar results are gathered here, with 23 per cent of participants considering connections to be very important, 35 per cent considering them to be important, 23 as somewhat important and 19 as not important.

These findings show that, generally, Croatian citizens consider there to be a need to use connections to get by. This could be indicative of high levels of perceived corruption, as well as bureaucracy, and goes hand in hand with there being generally low levels of trust or confidence in the state. No linear relationship was found between trust in government and importance of connections at the individual/participant level. However, this does not necessarily mean that there is no relationship. This is because, when there are generally low levels of trust in government (as were found here), informal institutions form their own rules of operation and one of the mechanisms is the use of connections. Therefore, although a relationship was not found at the individual level, it might be that there was more of a direct effect during the formation of weak social contracts, or failures of the state to meet the citizens’ needs.

Following the examination of the importance of connections, it is useful to consider the tolerance of their use. When asked how acceptable individuals thought it to be for someone to use connections to surpass bureaucratic procedures, 37 per cent thought it was unacceptable (1-3 on the scale), 44 (4-7) per cent thought it somewhat acceptable and 19 per cent considered it to be highly acceptable (8-10). Using connections to circumvent rules regarding contractual obligations such as health and safety was, on the other hand, much less commonly tolerated. In this example, 64 per cent of the respondents did not tolerate such activity, whereas only 36 had at least some tolerance towards it (4-10 on the scale).

***Connections to speed   
up bureaucracy***

***Connections to avoid contractual obligations***

**Figure 5.8- Tolerance of use of connections**

Figure 5.8 shows the perceived tolerance of connections for those within each individual’s identity group, as well as societal norms. It is evident that there was a much tighter congruence of personal norms with identity group norms than to societal norms. However, it can be seen that individuals generally viewed themselves as being less tolerant than others of such activities. This is an interesting finding, because the fact that individuals consider such activity to be acceptable by the general population meant that they viewed it as widely used. This then resulted in the individual being able to justify their own behaviour in the use of connections. Therefore, even though they were not tolerant of the need, if they viewed others as being tolerant, they often saw a need to use connections themselves as “this is how things are done”. The rationale behind this, as discussed in the previous section, is that because the activity is so prevalent, they would be disadvantaged by not participating. Frane, a partially declared restaurant owner, explained:

“In a perfect world I would not do this. But in a perfect world I wouldn’t   
 need to, because no one else would be and the system would be fair”

Here, therefore, one potential solution would be to inform individuals of the general tolerance of such activities being lower than they originally perceived. However, the effects of this would be limited if the corruption that draws out such activities, lies in formal institutions. We can see from the above analysis that many individuals perceive the use of connections to be important in getting things done. Therefore even if not tolerated, connections would be used out of necessity, rather than willingness. This might, then, have a cascading effect, yet again, on the formation of norms.

The perceived need for connections can be an indirect proxy of perceived corruption or red tape. Therefore, a three-item scale of the above-discussed measurements for perceived importance of connections with Chronbach’s Alpha of .872 is created. Running a regression analysis shows that perceived importance of connections could statistically significantly predict tolerance in the use of connections to circumvent bureaucracy, F(1,295)=701.833, p<.0005. The perceived importance of connections accounted for 70 per cent of the explained variability. This indicates that if an individual thinks it important to have connections to get by (i.e. because of corruption or red type), then they are more likely to view this behaviour as acceptable. This indicates that use of connections is not necessarily seen as corrupt behaviour because it is used as a necessary mechanism that has arisen, due to the persistence of corruption or red tape. Presumably, if all saw the system as fair, many would not tolerate the use of connections. However, no linear relationship was found between the perceived importance of connections and the use of connections to avoid contractual obligations. This might be due to the majority of participants representing an employee, rather than an employer perspective.

## 5.4.7 The role of social norms in defining the state of the social contract

### 5.4.7.1 Effect of social norms

This section focuses on the effects of social norms on the state of the social contract and in reducing the state of indebtedness. As all individuals use public services, if only to a certain extent (e.g. roads, infrastructure), it means that the state is providing some resources on their part of the exchange relationship. Individuals who do not pay tax then, are indebted for not providing reciprocation. This section, therefore, deals with the justifications for not engaging in their part of the social contract, or other ways in which individuals reduce this indebtedness. In discussing the state of the social contract, it was evident that the individual felt they did not need to reciprocate if there was a breach of contract or its general state was weak. However, it was also found that social norms also play a part, and do so in three different ways. Firstly, it is not necessary for the individuals to have experienced a dissatisfaction with the state themselves, if they have witnessed in some way, another individual’s breach in contract. Second, a perceived breach of contract on a societal level, rather than individual or personal, can weaken the state of the contract. Third, the perceived social of acceptability of informality contributed towards reducing the state of the indebtedness and as such, alienates the individual in their relationship with the state.

Some evidence of transferring the effects of another individual’s breach in contract to that of their own was found. For example, one individual mentioned that the tax authorities constantly check on their neighbour, even though they were fully formal was unfair and as such, it impacted on their own perception of the government. Furthermore, other more general examples were given, where other people’s opinions of the government were referred to as justifications for reducing the state of indebtedness. Karla, a teacher that also moonlights as a tutor and has a lack of trust in the state, gave an example of her friend being “treated so badly for receiving a small amount of benefits”. She also added that “you always hear stories of the way government treats people unfairly”. Therefore, even though an individual might not have personally experienced dissatisfaction in the social contract, they draw upon experiences of other individuals to reduce their state of indebtedness. Furthermore, an individual can perceive actions of the government that influence the societal level, rather than directly at the individual or interactional level, to be breaching the social contract. For example, individuals often described government as not looking after certain segments of the population adequately. Commonly mentioned here are the retired, students, the unemployed and single parents. Therefore, (not) looking after vulnerable groups, can be seen as a breach of expectations of what the government should be doing in the eyes of its citizens.

Surprisingly, actions taken by the government to tackle undeclared work, have in some cases contributed towards breaching the social contract. Although this was not a view amongst all participants, the following quotes display examples of where it was an issue:

“Some people are using undeclared work as a last resort to feed their children and the fact that the government is wasting money on seeking   
 out the grey economy, shows how wrong their priorities are”   
 (Ivana: retired)

“Why not just punish work in general? Everyone who works or is trying to   
 work should be punished at the start, because that doesn’t fit the   
 government’s vision”

(Andre: undeclared mechanic)

Therefore, the perception that government is punishing those trying to make a living creates negative feelings towards government. Individuals perceive there to be incongruence between what needs to be the government’s priorities and their priorities. Although the government may focus on undeclared work, some individuals who prioritise other issues do not see this as positive. Such evidence can be to display the need for greater communication and dialogue between the government and its citizens. The government needs to be more aware of the citizens’ perspectives and perceptions, as well as communicate the full rationale behind their actions.

The final justification for conducting work on an undeclared basis refers to divulgence of responsibility, due to prevalence or tolerance of such activity. Individuals reduce their state of indebtedness through justifying that their share of taxes does not make much of a difference because “it is just a small amount”, “everyone else evades so it does not make a difference” or “it isn’t really up to me, it is just how things are done”. This shows that the perception of the prevalence and acceptance of undeclared work, contributes towards reducing the state of indebtedness an individual feels for engaging in the undeclared sphere. How the perception of social norms develop, will be discussed in the following section.

### 5.4.7.2 Generalised reciprocity

Although generalised reciprocity is interconnected with social norms, it is useful to separate it in discussions, because it involves active engagement, rather than rationalisation to reduce the state of indebtedness. Generalised reciprocity refers to a ‘moral norm of reciprocity which defines certain actions and obligations as repayments for benefits received’ (Gouldner, 1960:170) and goes beyond individual self-interest. As such, it is considered as a silver lining or comforting prospect of evading taxes. As part of an individual’s conceptualisation of the social contract, generalised reciprocity served as a tool to reduce a vertical state of indebtedness (with the state) through horizontal means. This was achieved by carrying out work for family, friends, neighbours and the disadvantaged, that was either free or represented by payments in kind or token monetary amounts. The undeclared economy, in this sense, not only serves as a platform for resistance to formal institutions, but also as a tool to reduce the consequent negative effects. If we view payment of taxes in its idealist form of large scale generalized exchange, then opting out from this system has negative effects on society. Therefore, in such instances, the vertical reciprocity, which should serve as a tool to distribute the resources amongst citizens fairly, is replaced by direct horizontal reciprocity.

Furthermore, individuals who were retired, carried out undeclared work, but often gave money to their children or grandchildren, and as such did not feel indebted to the government. The same was the case with parents moonlighting informally and using the money to support their children through university. This was also not uncommon, even once the children had families of their own, especially those with young children. Indebtedness was not felt for a number of reasons. Firstly, the monetary value was not directly for the person carrying out undeclared work and as such, they felt it was more justified to try and pass on a higher amount to their children or grandchildren. Second, the need to carry out such work creates a negative perception of the government in what they do for their citizens, which relates to the view described in the previous section. The use of generalised reciprocity in such a way seems rational in the light of high levels of perceived corruption. Conceptualising generalised reciprocity at the vertical level, citizens with higher incomes, in theory, do not mind paying more for the benefit of the society as a whole. However, in the case of high levels of perceived corruption, paying taxes is not necessarily viewed as contributing to society. As such, the sense of indebtedness is not felt towards the state, but towards society. Although these should be conceptualised as one, the presence of unfairness creates a distinct segregation of the two, where it makes sense that indebtedness towards society is felt at a deeper level, due to lack of trust in government. As such, this is reduced by contributing through carrying out free, or badly paid work, to help out other members (usually known) of society. Although this might not have catastrophic effects if done to a certain extent, and could conversely be positive, it leaves gaps in resources used for provision of public goods and services.

# 

# 5.5 Predicting engagement in undeclared work

## 5.5.1 Testing the model

A logistic regression was performed to test a model explaining engagement in undeclared work. The aim was to ascertain the effects of trust in government (both at constitutional and current socio-economic level), personal norms, perceived likelihood of detection, procedural justice and distributive justice in the likelihood that an individual engages in the undeclared economy. A dummy variable for undeclared economy participation was created. The logistic regression model was statistically significant, χ 2(6)=112.509, p<.0005.

### Table 5.5- Regression table

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Variables in the Equation** | | | | | | | | | |
|  | | B | S.E. | Wald | df | Sig. | Exp(B) | 95% C.I.for EXP(B) | |
| Lower | Upper |
|  | Personal Norms | .039 | .015 | 6.773 | 1 | .009 | 1.040 | 1.010 | 1.072 |
| Procedural Justice | .117 | .064 | 3.300 | 1 | .069 | 1.124 | .991 | 1.275 |
| Distributive Justice | -.007 | .026 | .069 | 1 | .793 | .993 | .943 | 1.046 |
| UDW discovery | -.767 | .263 | 8.507 | 1 | .004 | .464 | .277 | .778 |
| Trust govt overall | .049 | .073 | .454 | 1 | .500 | 1.051 | .910 | 1.213 |
| Trust govt current | -.574 | .100 | 33.219 | 1 | .000 | .564 | .464 | .685 |
| Constant | 1.632 | .825 | 3.913 | 1 | .048 | 5.113 |  |  |

The model explained 45 per cent (Nagelkerke R2) of the variance in engagement within the undeclared economy and correctly classified 77 per cent of cases. The sensitivity level was 81 per cent, whereas specificity was 75. Three from the six variables were statistically significant: personal norms, current politico-economic trust in the government, and likelihood of undeclared work discovery. As was theorised, a higher tolerance of undeclared work increased the likelihood of engaging in the undeclared realm. On the other hand, higher levels of trust in government and perceptions of retributive justice (probability of discovery of informality) decrease the likelihood of carrying out undeclared activities.

**Figure 5.9- Factors influencing engagement in the undeclared economy**

However, it is important to note that factors such as personal norms and trust in government, are theorised to influence the extent an individual is *willing* to engage in the undeclared realm. As such, this does not encompass individuals who undertake undeclared work as a result of exclusion from the formal economy, rather than exit. Some descriptive statistics help to shed further light on this situation. Those who chose to exit from the undeclared economy, have a mean total personal norms score of 26. On the other hand, those engaged in the undeclared realm involuntarily (as a result of an employer request or inability to find a formal job), have a mean total score of 18, indicating lower levels of tolerance towards undeclared work. However, this relationship was not significant. Furthermore, personal norms can only predict engagement in the undeclared economy, to the extent that they conform to other factors such as opportunity and need that are not tested for in the survey section. This is because, as aforementioned, a person engaging fully and exclusively in the formal economy, may still have tolerance of undeclared activities.

From the findings we can see that although trust in the government at the current socio-economic level has a significant impact on the decision of which economy to engage with, procedural and distributive justice do not. This shows that trust in the state, at a broader level, in the current setting, is more important. This is not to say, however, that elements of procedural and distributive justice have not, over the years, contributed to the formation of trust as a whole. Corruption is likely to be the mediating variable, which is not measured in this questionnaire, but undermines any positive opinions on elements of procedural, distributive and retributive justice. This might have been more reflected in the procedural justice results, had the questions been more aligned with opinions of procedural justice at a broader scale, rather than the tax office itself. Furthermore, from the insignificance of distributive justice, we can see that individuals do not base their opinion upon a calculation of the balance of what is received, compared to how much is given, as previously discussed in the vertical relations section. In countries where overall confidence and trust in government is relatively high, procedural and distributive justice might play a bigger role to determine engagement in the undeclared economy.

Another interesting finding is that, as mentioned, trust in government at the current socio-economic level, carries some significant effects, whereas constitutional trust does not. This is different to the findings by other studies, as Torgler et al. (2007), for example, find that both measures of trust have a statistically significant positive effect on tax morale in Switzerland. This is interesting, because both measures of trust were fairly low in Croatia, with constitutional being slightly higher. Intriguingly, a linear relationship between the two is not observed, showing diversity in opinion between them. As mentioned, Levin and Satarov (2000) explain the judicial weaknesses in post-communist societies. In newly independent countries such as Croatia, this is likely to be a magnified problem. It might be the case that individual’s expectations of judicial developments as a new country, were efficiently managed. As such, although confidence is low, because expectations were managed, there is no breach of contract or direct effect on the decision-making process. Alternatively, it might be, that the state at the current socio-economic level is easier to characterise in the minds of citizens, and blame is easier to assign. Further yet, it might merely be an issue of a sampling error. This is not something that was explored in the interviews, because there was an expectation that trust at both levels would be a significant factor. This finding, therefore, warrants further research.

Furthermore, we can see that retributive justice also has a significant effect. However, because of the way this question was framed, it could be interpreted differently. Essentially, it asks the participants how likely they think a person carrying out an activity is likely to be caught by the government. Rather than being perceived as retributive justice, therefore, it can be construed as the level of risk an individual calculates to be associated with working informally. Therefore, rather than a fairness perception, the effect becomes a calculative decision, where they might chose to engage in the undeclared economy if they believe the risk to be low, or to remain formal because they believe the government is likely to detect such activity. Excluding this variable, therefore allows us to estimate the percentage of variance explained by the developed framework.   
χ 2(5)=103.285, p<.0005

According to this, the framework explains approximately 42 per cent of variance (Nagelkerke R2). This shows the massive effect the vertical relationship with the state and norms can have on the decision making process, as well as the prevalence of undeclared work within a country.

## 5.5.2 Other determinants of undeclared work participation

It was initially theorised that acceptance of undeclared work was a major determinant of engagement in the undeclared economy. It was, however, found that in reality, the situation is more complex, and many individuals accepting of undeclared work, do not engage in the undeclared economy and some not accepting of it, do so. The qualitative aspect of the study revealed the importance of opportunity, as well as risk aversion.

5.5.2.1 Opportunity

Although individuals with more accepting personal norms of undeclared work were more likely to engage in the undeclared economy, this was not always a given rule. Some individuals with a high personal acceptance of undeclared work, were engaged in the formal economy. As Milica, a customer assistant, explained:

“I was lucky that I got a job here [international chain], but not everyone   
 can get such a job and it is not for everyone. I get security and it is a   
 steady job, but everything is very formalised. If you do something wrong   
 you get an email, rather than an informal chat and so on. Some people do   
 not like this style of working and if you need more autonomy, the big   
 shops are not for you. Declared jobs are limited also, sometimes you just   
 have to take what comes up. ”

5.5.2.1 Risk aversion

Risk aversion was an overpowering factor in the formalisation decision-making process. Those whose personal norms were accepting of undeclared work and had the opportunity to engage within the undeclared economy, seemed to be more likely to forgo this opportunity if they were risk averse. Zlatko, a fully declared individual, explained:

“I pay everything I need to, I think I am probably the only one around   
 here that does, but then I know that if inspection is coming or someone   
 gets angry at me for a silly reason and reports me, or if anything happens  
 …at least everything in order and there is nothing they can pick me up on.   
 I can sleep at night, without having to worry about what will happen   
 tomorrow. ”

However, it is important to note that a very small number of people consider engaging in the undeclared economy to be a high-risk endeavour. Referring to the quantitative findings of risk, it was shown that the majority of the survey participants (61) considered the risk to be fairly small. However, if someone is not willing to take any risk, even a very small chance of being detected can act as a deterrent. In few instances where risk averse individuals engaged in the undeclared economy, the overpowering factor was that of necessity where they had a lack of other opportunities.

Personal norms

Opportunity

Risk aversion

Necessity

**Figure 5.10- Factors affecting engagement in undeclared work**

## 

## 5.5.3 Social control of undeclared work

The following section deals with the cyclical effects caused by the development of norms that foster negative attitudes towards the state. Although individuals who have high tolerance of undeclared work do not always engage in the undeclared economy, they still indirectly contribute to its development. This is because these individuals may be more likely to use undeclared services or purchase undeclared goods, and because they are not contributing towards social control of the phenomenon. If undeclared work was largely unacceptable, those who conform to social norms would be likely to internalise such norms, but utilitarian individuals would also be deterred from such activity in certain cases, because a damaging reputation could lead to exclusion from social groups and connections, as well as less work. This therefore does not occur when there is social tolerance within certain groups.

Discussing whether they would report informality, many noted that it would depend on the type of work that was carried out as well as the reasons for doing it. By all in this category, it was agreed that if the work was done to get by or out of necessity, they would never report it. Milica described a situation where she would consider reporting undeclared activity:

“..but when it is a guy with 3 yachts and clearly not doing it out of   
 necessity, I probably would.”

This lenience towards necessity-driven undeclared work was a common theme and seemed to be generally tolerated, whereas the more wealthy groups were sometimes considered as more greedy for evading taxation. This was also reflected in how those who considered themselves to be wealthier, framed their own undeclared work situation in interviews. More time was spent justifying the action. These justifications ranged from explanations of using the additional money to secure a future for their children, to an unpredictable economic situation and the need to save for the turbulent future. A strong distinction was made between tolerance of undeclared work carried out for necessity/ community building and work carried out for personal gain.

However, procedural justice and corruption were also recurring themes with individuals failing to see the point in reporting such activity. The two main reasons given, were those of inefficiency and the government not being able to do anything about such a large volume of undeclared work, as well as corruption of either inspectors or those higher up who would aid in resolving or hiding the issue.

“Although in such a case [the 3 yacht example given above] it is probably   
 more pointless, because this guy knows all of the right people for it to not   
 matter”.  
 (Milica: waged employee)

This lack of trust in government, further strengthen the norms that support and normalise undeclared activity. Individuals often stated, that even though they are not accepting of undeclared work, they do not believe that anything would be done if the incidents were reported. Individuals do not feel they can make a difference and therefore do not report the activity, which further contributes to the normalisation of undeclared work. If there is a lack in the reporting of such activity, individuals are more likely to perceive that the chances of getting caught are small.

# 

# 5.6 Use of informality as a people management tool

Interesting qualitative findings arose regarding the use of informality and its mechanisms as a people management tool. This can be seen in a number of different ways. Firstly, the perceived benefits and savings made from not declaring all work are sometimes, or at least partially, used as monetary rewards to motivate employees. Second, undeclared loans and advances are used to change the nature of the relationship from utilitarian to symbolic and therefore have higher expectations of employees. Third, the involvement of social and family networks, on an undeclared basis, also changes the nature of the relationship.

Considering the use of rewards, individuals willing to engage with the undeclared economy, explain that they bypassed the issue of complaints about low pay (outlined above), by paying envelope wages to their employees. A small business owner, Andjela, expresses how she amplifies the positive effect of this, by combining it with clear communication as to why she chooses to do this. In order to maintain the business, she has a capped amount of how much she can afford to pay, and the employees can choose whether they have it fully declared and receive a smaller amount or have part in cash and have a higher wage overall. She says that this acts well as a motivational tool on two levels. Firstly, the employees are more satisfied because they are getting paid more. Second, the employees are given a choice and therefore feel more involved in the decision-making process. With such motivations underlying the use of envelope wages within firms, it shows that informality can be used as a Human Resource Management or workplace management mechanism. Considering the latter justification particularly, it can be conceptualised as increasing autonomy and the decision-making power of employees, which can have powerful effects on motivation, Nguyen et al. (2003) for example show that perceived job autonomy has highly significant effects on various job satisfaction domains, such as pay and job security.

Such a use of envelope wages shows that the undeclared economy is employed as a mechanism for workplace management. Whereas envelope wages mainly serve to motivate employees through monetary value, as well as involvement, there were other mechanisms that did so by reducing the social distance (Sahlins, 1965) and changing the nature and content of the exchange to be more symbolic (social), rather than monetary (economic). These included undeclared loans, bonuses (undeclared) and undeclared advances in pay. A particularly interesting example is that of undeclared loans given to employees by business owners. From the employer perspective, this is a favour to the employee that goes beyond the contractual or standard duties of the employer. As such, it is a favour for the employee who is then expected to reciprocate by going above and beyond their standard duties for the business or the employer. For the employee, off-the-books (OTB) loans, serve as a rational alternative to overly bureaucratic or inaccessible formal market loans, and are therefore explained by the legalist approach to informality. The loans are quicker to obtain and are often given interest-free. However, the resulting effect and motives from employers can better be explained within the social exchange framework.

Evoking the concept of relational rents (Dyer and Singh, 1998), Hunt (2013) shows a similar occurrence in his findings, where owners bind their employees through the seeming appearance of equality, but with the motive of the operationalisation of paternalism and peonage. However, through the lens of such studies, the use of OTB loans is presented as a mechanism to exercise labour control (Santiago and Thorbecke, 1988; Hunt, 2013) and is seen as utilitarian in nature. Although this is true to a certain extent, the current study shows a more positive side in which, employers use the mechanism as a tool to create a social relationship or a positive social contract. The use of the undeclared loan is not an isolated mechanism used to exercise control over the employee, but is instead, one aspect in the building of a social exchange relationship, represented by mutual reciprocity. Frane, a restaurant owner, explained, that “if you do a favour for [your employee], they then owe you”. This shows the utilitarian and calculative nature in use of tools such as undeclared loans within social exchange. Andjela, on the other hand, stated that “it is a good opportunity to show your employee that you care about them” and that “it creates mutual trust” indicating an element of symbolic explanation, more suitably interpreted by anthropological/sociological explanations of exchange. Undeclared loans thus serve only as a first step in building a relationship based on social, rather than economic exchange. The resulting social contract helps foster commitment and motivation amongst employees.

Another example of such a mechanism was given when extra help was needed, or the work needed to be subcontracted outside of the firm in question. This work would normally be carried out on an undeclared basis, where the exchange was not of a dyadic nature and can therefore be better explained by the anthropological/sociological explanations of SET. In such situations an individual would use the networks of their current employees to find the new or temporary employee. Therefore, the “contents” of exchange move beyond that of the monetary value traded between the employer and the new/temporary employee. The relationship is represented diagrammatically in Figure 5.11.

1

Employer

New Employee

Current Employee

2

3

4

5

1- money paid for carrying the work out  
2-carrying out the work   
3- favour in hiring a family member  
4- commitment   
5-theorised reciprocity

**Figure 5.11- Network relationship**

Where 1 and 2 represent a fairly simple monetised exchanged between the employer and new employee, the relations are also regulated by the relationship between the two family members (5). Andjela, a business owner, explains a situation whereby she hired a new temporary employee by a recommendation of a current employee. She perceived there to be a significant advantage in using such networks to hire employees:

“I know that he [new temporary employee] would do a good job because   
 he comes recommended by a trusted employee. They are family, so he   
 would not do a bad job to embarrass his cousin.”

This shows the extension of trust from one individual to their personal connection. Due to the information gathered from the employer, the employee perspective is absent. However, it can be theorised that there is a reciprocal relationship (5: new employee and current employee) between the family members. The trust from this relationship aids in regulating the relationship between the two parties that have no previous relations, and therefore have had no opportunity to build trust (1-2: employer and new employee). Nonetheless, the indirect trust is important, especially because the work is carried out informally. The employer has to trust that the new employee will carry the job out well, whereas the new employee has to trust that they will be paid, even though there is no formal contract in place to stipulate this. Parts 3 and 4 on the diagram show the effect that the process denoted by 1-2 on the diagram has on the relationship between the existing employee and employer. The hiring of an employee’s family member, changes the nature of the relationship to more social, rather than strictly monetised. This is because it is seen as a favour carried out for the employee in hiring their family member. The employee is in return appreciative of this, and more likely to go above and beyond the standard working duties for their employer. Andjela, business owner, added her view on the benefits of extending the exchange relationship with employees:

“Sometimes it just strengthens the relationship that is already there with   
 the employee, because I am doing something to help out their friends or   
 family, but it can also form a new bond with an employee I see potential in. It is probably not something that is done in big firms, but here [a small business] we [employer and employee] depend on each other, so trust and helping each other out is crucial.”

Furthermore, as the employee perspective was not explored within this context, it is theorised that this is then balanced, due to the reciprocity exchanged between the family members themselves (5), whether directly in a dyadic relationship or through other members of their network (generalised exchange). However, it is also important to note that there are times where hiring a family member can have the opposite effect, leaving the employer, rather than the employee indebted in reciprocity. Robert, a construction company owner, had an example of such a situation. Similarly to the previous situation a current employee’s recommendation of family was used for work. However, it is evident from the tone of the discussion that the nature of the exchange was different:

“I was in a bind because the company I hired did not deliver and I needed   
 the design for my customers. One of my employees’ brothers was very   
 good with graphics and he called him up there and then and he produced   
 something brilliant over-night. He charged me next to nothing as well,   
 wouldn’t accept more. I was so grateful. ”

Although the same mechanism is used here, the intent of the employer was different and therefore the “resources” exchanged carry different meanings. Whereas in the example that Andjela provided it is the employer that is carrying out a favour, this is not the case with Robert where the employer feels as though the employee carried out the favour. The differences in the two examples exemplify that, depending on the context and need, pushing the boundaries of dyadic relations can work, both in the favour of the employer or the employee. Furthermore, this also shows the contextual importance of the exchange and nature of the relationship being dependent on situational factors.

This section, therefore, demonstrates the use of informality as a mechanism in regulating work relations. It is shown how employers can use informality to their advantage to create a relationship that surpasses monetary value and fosters commitment on behalf of the employee. Furthermore, it is illustrated how often such relations cannot be understood from a dyadic perspective. This thesis therefore advocates that, especially in the context of countries, where trust in government is low and citizens have to rely on their own mechanisms, research is extended to include a multi-foci perspective that encompasses multiple parties to exchange.

Figure 5.12- Diagrammatical representation of the decision-making process

Elites and Role Models

Construction of social contract

Personal Norms

Identity Group Norms

Societal Norms

Conflict

Trust

Government Representatives

The State

Risk Aversion

Opportunity & Necessity

Media

Communication and Observation

# 5.7 European Union and socialism

Given the importance of context, it is necessary to look at people’s perceptions of the past, the present and opinions of the future. A transition country, in more than one sense, Croatia provides us with an unusual context of study. At the point of the data collection, the European Union was the future for Croatia, whereas socialism was the past. Therefore opinions about the two were sought.

Although at the time of the survey, Croatia had not officially joined the EU, the decision to join had already been made. It seems as though many people were not hopeful about the future in the context of the European Union. Whereas 38 per cent of participants were optimistic about joining the EU, 13 per cent were unsure and the majority (49 per cent) were not optimistic. With the majority of participants not optimistic of joining the EU, it shows that expectations were not managed, to the extent that the citizens trust that this would be a positive influence on the economy and lives of citizens. However, although not in the majority, it is important to note that, managing expectations about the positive outcome of joining the EU are important to prevent the expectations of the contract being broken or violated.

A number of questions were asked to gauge the opinions of the current situation, compared with socialist times. Those too young to experience these times, were told that if they had no opinion, they could miss out these questions. However, opinions on the questions were often still given, as the participants formed a perception of the socialist era from discussions with parents, colleagues and friends, as well as from education. The results, overall, show vast pessimism and disappointment with the current situation across all generations, including those not old enough to have experienced the socialist times; 75 per cent of people believe that trust in government is lower now, than during the communist era, 18 per cent think that it is about the same. As such, these are not necessarily indicative of a truly worse situation, but might be better explained by broken social contracts from expectations, that the situation would be improved. Furthermore, 77 per cent of participants think that trust amongst citizens is lower now and 81 per cent that citizens help each other less now than during socialist times.

When discussing undeclared work, 65 per cent of participants state that it has increased, 4 per cent think that it has decreased and 11 per cent that it is fairly similar. A further 20 per cent believe that the quantity of undeclared work has stayed the same but the type has changed. Two explanations arise from this, with many people arguing that those participating in undeclared activities today, do so out of necessity and to get by. Firstly, the perception of undeclared work in socialist time, as conveyed by those who think that it differs in nature to today’s manifestation, is that of gaining additional income to improve their standard of living. In this sense it takes the form of moonlighting, rather than having a main contribution to the budget. Ivana, a retired individual, believes it is the type of undeclared work that has changed, stated the following:

“Contrary to socialist times where undeclared work was done for some   
 extra cash for holidays and nice things, today it is necessary for survival.   
 No one would work undeclared, unless they were ‘forced’ to do so.”

Such a portrayal of the undeclared economy paints a picture of honest workers trying to make a living and was favoured by many of those falling within this 20 per cent category. A sense of community and positive society, but economic hardship and lack of government help was often described. Second, and although in the minority, another theme was recognised when describing the differences between the two eras. This took the form of a view that considers today’s society as one lacking responsibility. Individuals pertaining to this view, described undeclared work on the same level as criminal work, with Zlatko, a self-employed individual, explained the situation as follows:

“We should start with ourselves before judging others. Some people   
 blame politicians and corruption, excusing their own dodgy activities [….]   
 Those people should be ashamed of themselves”

Therefore, it is shown that although some participants are optimistic about joining the EU, these are not the feelings of the majority. On the other hand, it was felt by many, that the socialist period was stronger in terms of trust in government, as well as other issues.

# 5.8 Issues with policy design

## 5.8.1 Introduction

As aforementioned, the policy options to tackle undeclared work, vary from direct to indirect controls. Where direct controls focus on deterrents such as improved detection and increased penalties, as well as incentives for both businesses and individuals, indirect controls emphasise reducing the asymmetry between formal and informal institutions. Although, in practice, many policy interventions focus on deterrence, there has been recent recognition that incentives are just as important. More recently, advocates of the institutional perspective have argued that, in order to improve tax morale, emphasis should be placed on indirect controls (Williams, 2014a, 2014b).

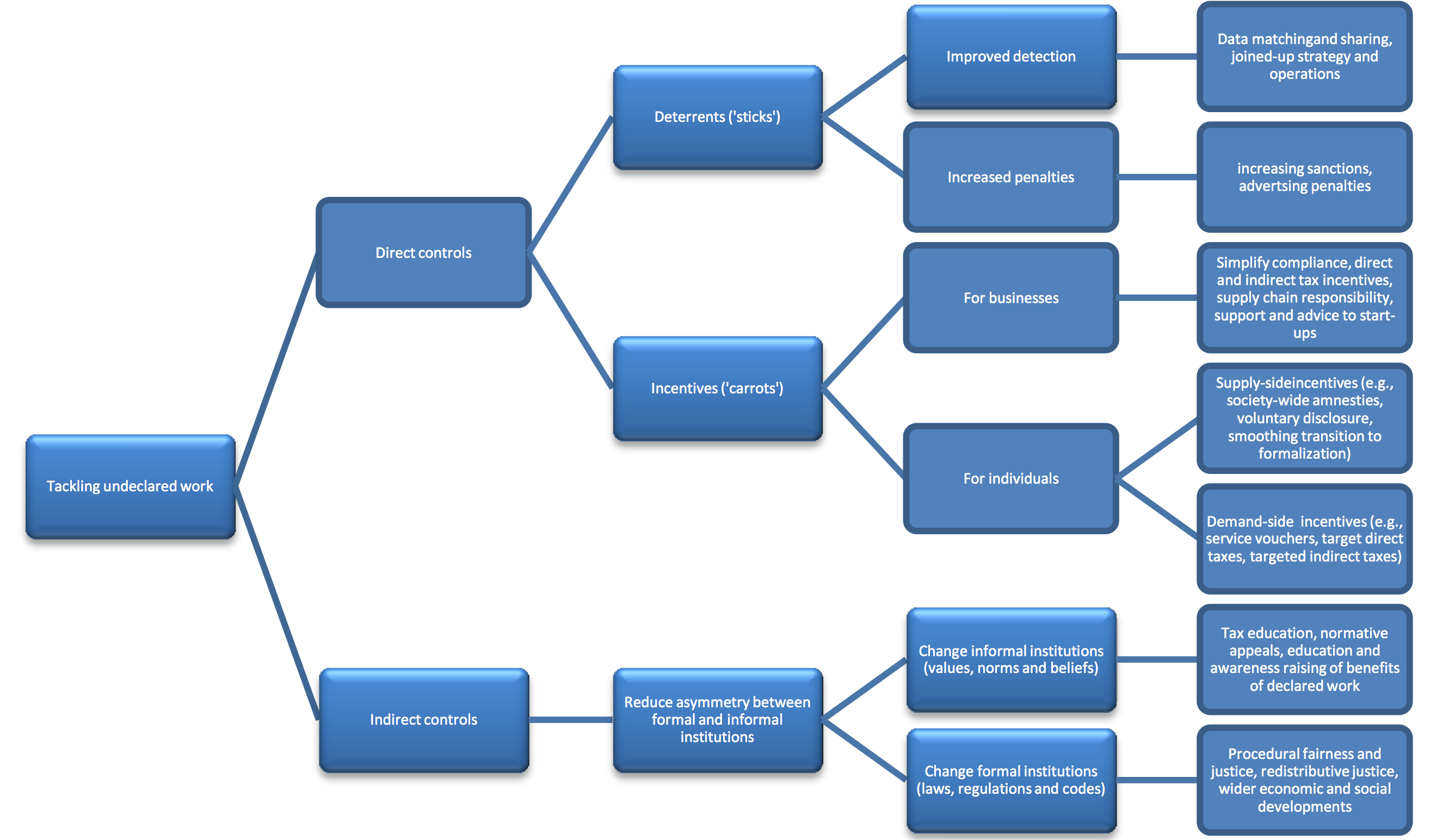


Figure 5.13- A typology of policy measures for tackling undeclared work. Source: Williams (2014a)

The aim of policy interventions in this context is to influence the decision-making process of individuals and collectives. Therefore, in order to evaluate whether a policy is suitable, factors that influence this decision-making process need to be considered, as well as the effect of this policy on these factors. The Findings Chapter also highlights the importance to consider the complex interplay between the factors themselves. Considering the above-mentioned framework (Figure 5.11) in such a manner brings to light some structural issues. The high levels of undeclared work and extent of the weakness of the social contract in Croatia, suggests that it will be difficult to apply such a model to tackle the undeclared economy. The institutions and norms are not as well established in the infrastructure to support, implement and enforce those policies as they are in developed countries. The following section focuses on evaluating each aspect of the model, using the relevant findings of the current study.   
  
5.8.2 Direct controls

The emphasis given to cost benefit analysis in the decision-making process (of whether to operate on a declared or undeclared basis) gives evidence of a utilitarian perspective. As part of this, an individual weighs up all the costs, as well as all the benefits of the two options and chooses the optimal route, be it the formal or the undeclared. Evidence shows that, in Croatia, some individuals see little benefit to engage in the formal economy because they do not view it as any more secure or dependable than the undeclared (full details outlined in Chapter 5). Combined with the low levels of perceived danger of being found out to be engaging in the undeclared economy, many seriously entertain the decision of being undeclared. Therefore, a clear policy strategy here, might be to increase the benefits of operating formally, whilst increasing the costs of operating informally, particularly increasing the presence of inspection to tackle the low perception of detection probability. However, it is important to note that the cost-benefit analysis is also influenced by a variety of other dynamics. It was found that many individuals are influenced by symbolic factors such as trust (both vertical and horizontal) and social norms and therefore it is necessary to evaluate the implications of these on the above mentioned policy options.

### 5.8.2.1 Deterrence

Deterrence has often been a dominant policy choice in Croatia (Baric and Williams, 2013). The level of corruption is particularly important in this example. For simplicity sake, increased penalties for those carrying out work informally are a useful example of a deterrence policy. However, this might not have the desired effect in Croatia because of the levels of corruption and might instead foster further bribing of government officials. In fact, the bigger the penalty, the more worthwhile it is for the individual to offer a bribe. Social norms then also play a role in the decision-making process, rendering such activity as acceptable or unacceptable. If the activity is socially unacceptable, the individual might be persuaded against it because this means they are more likely to feel guilty or ashamed, as well as more likely to suffer undesired social consequences, such as a damaged reputation. As in Croatia there is general support for some undeclared activity, especially for those engaging with it in order to get by, this is another factor that contributes towards social acceptability of informality.

During the qualitative leg of the research, an interesting issue arose, indicating that large differences were found between how people discussed public officials such as inspectors. This shows a lack of standardisation with how issues are dealt with realistically. However, it was also interesting that if the inspectors were viewed positively, they were separated from the “central government” and individuals seemed more willing to cooperate with them on “local issues” but still had negative perceptions of government as a whole and had no problem in not declaring their earnings fully as was evident with the example of Andjela, the partially declared business owner. When the inspectors were viewed negatively, on the other hand, they were considered as one entity together with the “central government”. Stipe, a small hotel owner that is tolerant of undeclared work, painted a hyperbolic but relevant picture of what happens on occasions where the inspectors are viewed negatively:

“It’s as though they want us to fail on every account - they just want the money really. Last time they near enough fined us for stuff like the waiters wearing the wrong apron or the toilet paper colour being slightly off”

Such individuals seemed completely demoralised and had a very negative social contract, often expressing wishes to work on a fully undeclared basis. An example of this was Andre, a self-employed mechanic who stated that working on a declared basis was “too much hassle” and that now he works completely off the books as this way he “avoids all of the complications”.

These inconsistencies exemplify the need for training and consistency of inspectors, before policies such as improved detection can have the fully desired effect. These are the individuals who deal with citizens on a more regular basis and therefore substantially effect the development of trust in formal institutions and in turn the social contract. Unless this is rectified, policies aiming to improve detection of undeclared work issues might therefore have a detrimental effect on the social contract. However, this does not undermine the need to have a sophisticated deterrence policy plan as part of an overall strategy, but instead points to potential problems that might arise in the current setting.

Whereas both the utilitarian (cost-benefit) and social (moral and norm related) aspects of the decision-making process are embedded within many individuals, there are some individuals whose decisions are largely led by the utility maximising principle. Although focusing on deterrence might have the desired effects to target those individuals, they still only represent a proportion of the population. In fact, there was evidence of social control working the opposite to the desired direction, where an individual’s personal norms were not accepting of undeclared work, but they engaged in the undeclared economy because this is the way that such type of work is carried out.

### 5.8.2.2 Incentives

During the follow-up interviews stage, current approaches to tackle undeclared work in Croatia were mentioned to entrepreneurs, and the knowledge, as well as opinion of the participants was sought. Due to the lack of trust in government, the incentives placed to encourage formalisation do not seem to always have the desired effect and instead, people find ways to make them work to their personal advantage and the state’s disadvantage. Whilst discussing incentives to hire young workers, Robert, an owner of a construction company explained his negative perceptions, as well as experiences of the government, before detailing his opinion of incentive schemes:

“they normally have them for a year or so, which enables me to hire the   
worker for the required amount of time. Works well for both of us, but then it is better that they go back to undeclared work because it’s just not worth it. It is just a government scheme because they are trying to get you in the short-term so that they can rip you off in the long-term.”

This explicates the negative effects of a weak social contract on citizen buy-in to certain policies. Measures such as the one described above are designed to support employers and employees, but are not seen as such because of the low trust in formal institutions, and therefore allow for some citizen’s to avoid using them for fear of being caught in a trap, or some to take a step further and exploit them for personal benefit.

Turning to curative measures, there are a number that might have an extremely positive effect in Croatia. However, others such as tax amnesties for formalising an undeclared business, seem to be having the opposite of the desired effect and might actually be diminishing tax morale of those who have been conducting business on a declared basis. Zlatko, a self-employed declared worker, who stated full compliance to tax, rules and procedures, explained feeling “like a fool” because those “creating unfair competition for [him] have been forgiven for all of their wrongdoings”. As such, he stated that he feels as though he is “being punished for being good”. This therefore shows that, although curative measures might incentivise some to formalise, tax amnesties can have a detrimental effect on tax morale because of the questionable justice background.

Furthermore, those entrepreneurs, self-employed individuals and business owners who stated that they obeyed all of the laws, rules and regulations, almost always spoke of the extraordinarily disadvantaged position they put themselves in. Some cited unfair competition, whilst others talked of unfairly high taxes that they had to pay. A large number also stated that they found it hard to total their deductions (expenses to be deducted from total revenue) because so much work was being done on an undeclared basis, it was difficult to obtain some receipts for the purpose of deductions. The issues outlined with direct measures have important implications with regards policy design, which will be further discussed in the following chapter.

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# 5.9 Conclusions

This chapter has reported the quantitative and qualitative findings. The first section has outlined the extent and nature of undeclared work in Split. Here it has been shown that undeclared work is heterogeneous in nature, and that about 39 per cent of individuals engage with the undeclared economy from the supply side, whether exclusively or partially. The widespread nature of envelope wages is also shown, with about 13 per cent of employees having received envelope wages within the past 12 months. This shows that informality is extensive in Croatia and deeply embedded within the working lives of many citizens.   
 The section outlining the vertical relationship between citizens and the state has shown the damaged social contract experienced by many surveyed citizens. The lack of perceived justice and trust in the state and its actions are evident. However, it is also shown that there is great difficulty to conceptualise the relationship with the state, as there are different parties involved (e.g. the state as a whole, state officials, the tax office). The discussion of the horizontal relations between citizens shows the widespread acceptance of undeclared work, as well as the impact of societal norms on personal tolerance. The qualitative data adds to the knowledge of the formation, conflict, as well as changes in social norms. Within this, the cyclical nature of low tax morale effects arises as an important theme, because even though some individuals do not necessarily engage in the undeclared economy, their tolerance towards such activities has perpetuating effects regarding social approval. The theorisation of the undeclared economy being regulated by informal institutions is shown by mechanisms such as social capital and reputation. Furthermore, other mechanisms falling beyond the scope of utilitarian interpretations are shown to regulate informality. These include symbolic meanings of social capital, as well as generalised reciprocity. Although there are many positive elements to these, the findings also show some adverse aspects. These include a lack of trust of unknown individuals, as well as damaging norms to those not conforming to certain roles of informality. The qualitative discussion therefore illustrates the informal institutions that arise, when the regulatory mechanisms provided by the government, fail in the eyes of the country’s citizens. From this, regression models explaining the tolerance, as well as engagement of undeclared work are outlined. It is shown that perceived identity group norms, as well as societal norms to a lesser extent; explain a substantially significant variation in personal tolerance of undeclared activities. Furthermore, it is shown that trust in government (at the current socio-political level), personal acceptance of undeclared work and perceived likelihood of undeclared detection by government, explain a significant amount of variance of engagement in the undeclared economy. These carry important implications that will be discussed in the next chapter.

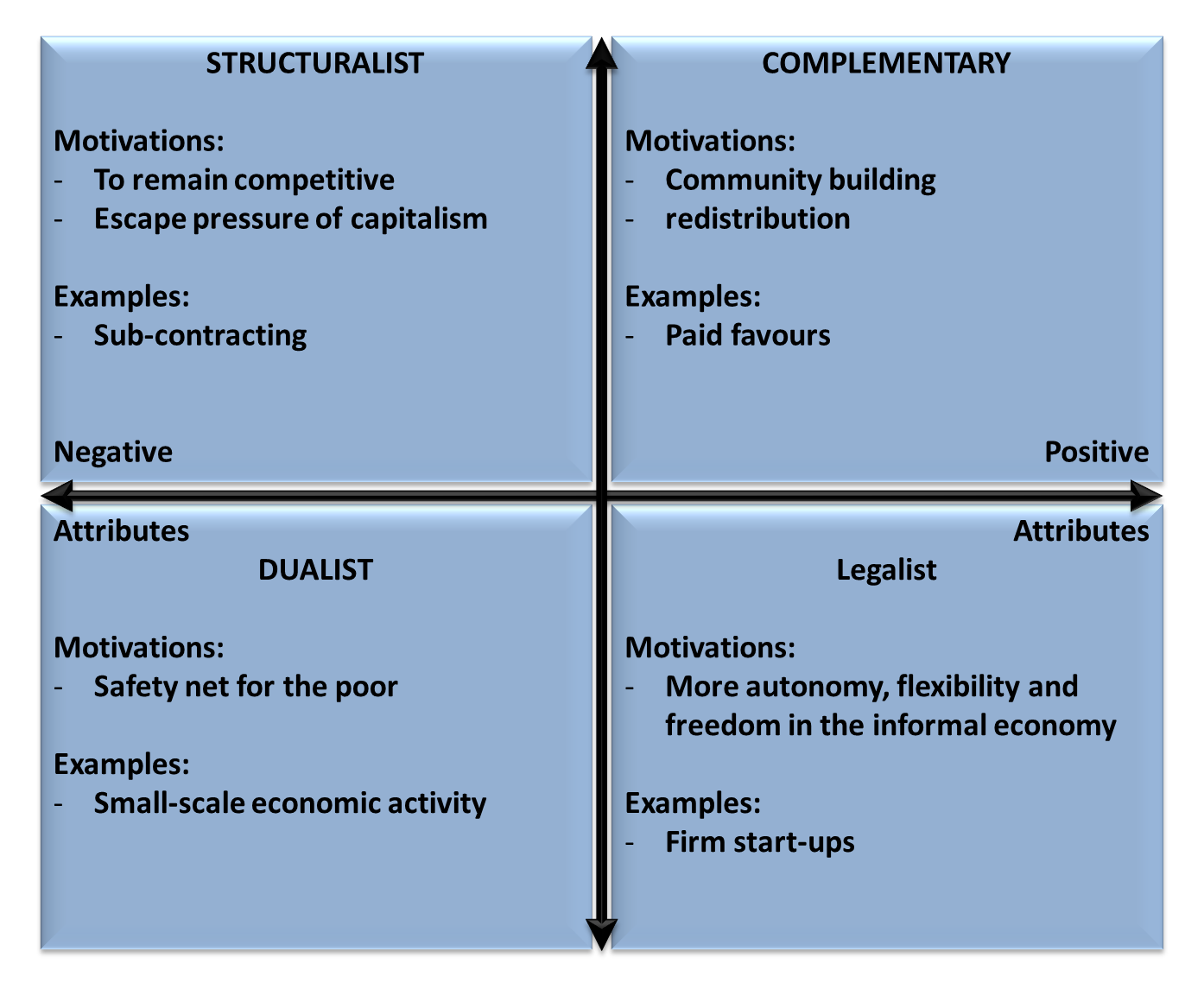
The quantitative study provides a clearer idea of the nature and extent of informality, as well as the usefulness of the developed framework. The qualitative aspect, however, provides greater depth and richness to the quantitative explanations, but also brings to light some new and interesting findings. In this sense, these findings were also inductive in nature. The new discoveries are in the conceptual advances of the manifestation and causes of undeclared work, and should therefore be utilised to expand the framework of its development.

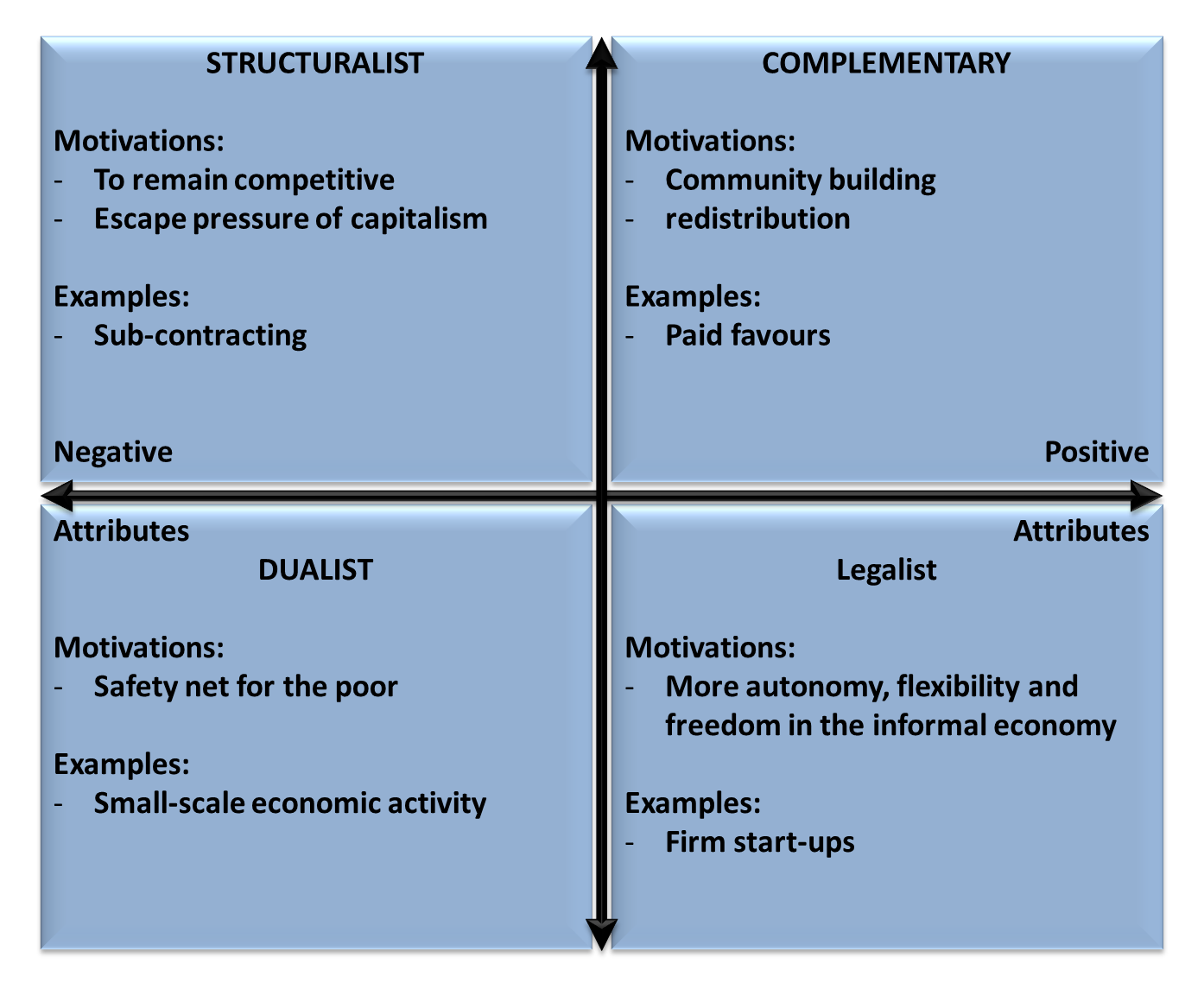
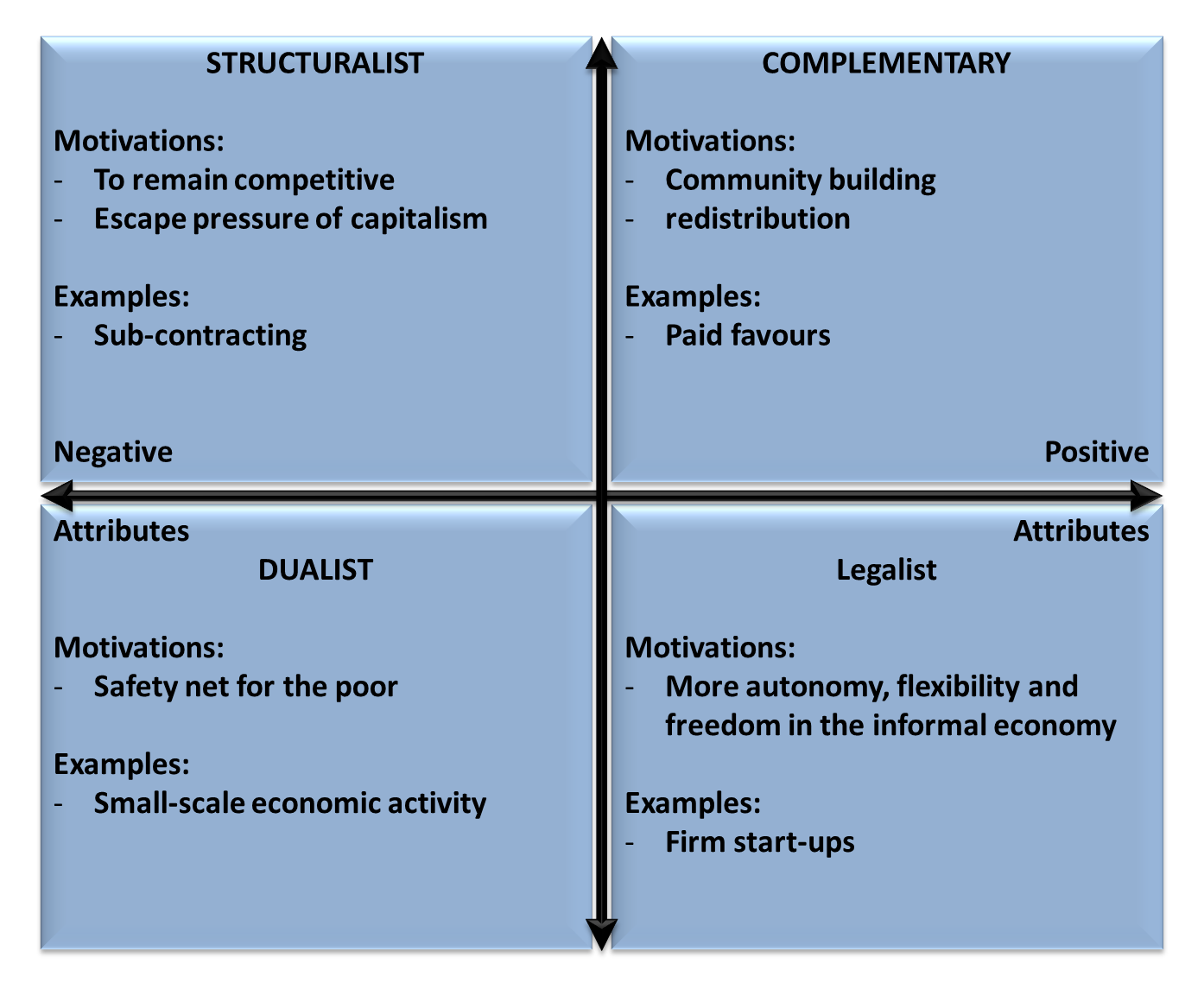
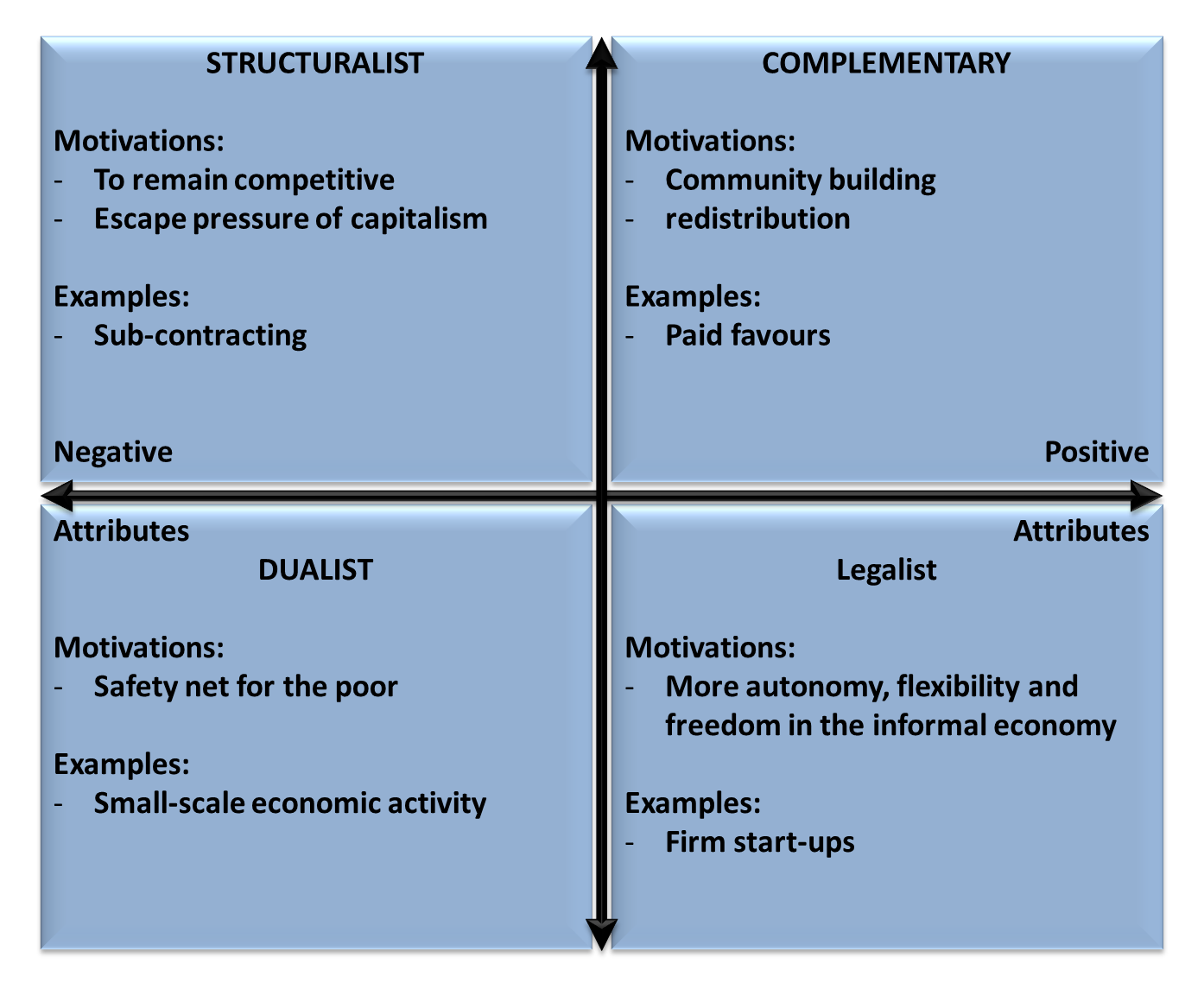
Chapter 6: Discussion and Policy Implications

Having reported the empirical findings in the last chapter, this chapter now discusses the implications of these findings. Firstly, the competing theoretical explanations are evaluated, second, the usefulness of the new social exchange theory framework is considered, and third and finally, the implications for policy evaluated. Following this, the contribution of the thesis is outlined, the need for further research discussed and overall conclusions drawn.

# 6.1 Evaluating the dominant theoretical perspectives

This section evaluates the validity of the competing theoretical frameworks discussed in the Literature Review Chapter as ways to explain the nature and prevalence of undeclared work in Croatia (see Figure 6.1).





**DUALIST**

**STRUCTURALIST**

Figure 6.1 – Perspectives of undeclared work

## 6.1.1 Dualist

From the lens of the dualist school of thought (residue theory), undeclared work is viewed as a set of survival activities conducted by the low skilled and the unemployed (Hart, 1973; Sethuraman, 1976; Tokman, 1978). Dualists point to the lack of formal employment opportunities as the main driver of undeclared work, and therefore advocate the creation of new jobs as a viable solution to combat this phenomenon (Hart, 1973). A certain proportion of the undeclared economy in Split, Croatia, can be explained from this perspective. This is because 7 per cent of those working on an undeclared basis reported doing so because of a lack of declared opportunities or inability to find a declared job. Therefore, for these individuals, undeclared work serves as a survival practice. It is nonetheless clear that, due to a large proportion of the undeclared work being unaccounted for by dualist explanations, this perspective cannot offer a full explanation of the existence of the undeclared economy in the region.

Proponents of the dualist theory also, to a large extent, consider undeclared work to be a leftover from an earlier mode of consumption and production. In this sense, its materialisation is considered to be an indication of under-development. The high level of undeclared work and normalisation of such activities in Split, dispute the explanation of undeclared work as a residue. However, due to a lack of studies carried out in Croatia, it is difficult to conclude whether it might be the case that the currently high level of undeclared activity is a residue of a still bigger undeclared economy from previous years. It might, on the one hand, be argued that the undeclared economy was much larger during the socialist period and that the current manifestation is merely a remainder of this. Moreover, this view does not seem to correspond to the perception of the citizens, as 65 per cent of respondents state that undeclared work has increased, whereas 20 per cent believe the quantity has remained the same but has changed in nature and 11 per cent believe the extent and type have stayed more or less the same. Only 4 per cent of the respondents expressed the opinion that undeclared activity has reduced. However, this is not necessarily a good indication, as being retrospective and opinion based, it might not be a true reflection of the actual levels of undeclared work. On the other hand, the fact that undeclared work is considered to be so prevalent, and even to a certain extent condoned by society, shows the permanent nature of its state, therefore, to an extent, disproving certain elements of the dualist theory.

The difficulty of comparability with previous evidence on the nature and extent of undeclared work makes it difficult to reach a firm conclusion on the relevance of the dualist theory in the context of Split or any specific type of undeclared work. Despite this, it seems clear that undeclared work is a permanent phenomenon in Croatia, and due to its deep embeddedness within the society, it will persist in its existence for the foreseeable future.

## 6.1.2 Structuralist

There is an element of overlap between the dualist and structuralist (alternative) view, making it difficult to categorise certain characteristics as belonging to one, but not the other. This is because both view undeclared activity as being ridden with negative characteristics. Much like the structuralists, dualist advocates view the undeclared sphere as composed of the marginalised population. However, rather than a lack of development, it is the nature of the capitalist society that accounts for growth of the undeclared economy.

Although advocates of the structuralist school acknowledge a relationship between the two economies, they argue that the undeclared is a by-product of the declared (Moser, 1978). In this sense, the manifestation of undeclared work is normally seen to result from competition of large formal firms, trying to reduce their expenditures, by using small-scale undeclared firms and self-employed individuals. It is therefore depicted by exploitation, that being undeclared is forced upon the workers by the larger decision-makers. Evidence from the findings disputes this to an extent, in that *many* individuals chose to work on an undeclared basis, in order to save money or to avoid bureaucratic regulations. Furthermore, reasons such as “it is normal to conduct this type of work on an undeclared basis” were given, which shows the ingrained nature of the work. Nonetheless, the fact that some individuals engaged in undeclared work, but were not accepting of it (personal norms), shows that they did so against their own will, therefore providing some support for the structuralist theory. Furthermore, some individuals (5 per cent, N: 6) answered that they worked without declaring their jobs, because their employer did not want to register them. 5 of these employees were those receiving envelope wages who would prefer their work to be wholly declared, whereas the other was a participant who engaged in undeclared moonlighting as a second job. Presuming that this is a choice enforced by the employers to save on costs and remain competitive, the explanation of this proportion of undeclared work conforms to the alternative view. Examples of this include cleaners hired by large companies on an undeclared basis. Therefore, the total number of participants who are engaged in the undeclared economy involuntarily as a result of exclusion, whether fully or to a certain extent, is 14 (11.9 per cent). To further analyse the relevance of this theory, it is useful to look at the characteristics of those who conform to exclusion theories. Those engaging in the undeclared economy involuntarily are composed of waged employees (N:6), the unemployed (N:4), the retired (N:2) and students (N:3). There is no significant difference found in exit or exclusion from the formal economy, by gender or industry.

The findings show that whereas participation varies and can be both a result of exit from the formal economy, as well as exclusion, exit seems to better explain the manifestation of undeclared work in Croatia. The structuralist or by-product theory is more applicable to explain manifestations of undeclared work amongst waged employees and those who are unemployed. It is therefore likely that it is the employers trying to decrease costs by not registering their employees or not declaring their full wage, so as to decrease taxes and contributions. However, an alternative or supplementary explanation was the finding that the extra income served as an additional reward or motivational tool, without the cost associated with higher income. It therefore also benefits the employee, because they are not just being paid the minimum wage. Nonetheless, it is likely that in such situations the reasoning is communicated, and therefore, those employees that stated who are happy with such a situation, therefore conform to the exit interpretation. As the structuralist theory fails to adequately explain the manifestation of self-employed undeclared work, the legalist theory is examined next.

However, it is important to point out, that a limitation might be that it is possible that the findings of the study are underestimating the proportion of those that participate in the undeclared economy as a result of exclusion. Although this is unlikely it might occur due to the question being susceptible to a social desirability bias because individuals do not want to state that they have a lack of choice in their decision-making.

## 6.1.3 Legalist

In the legalist or alternative view, undeclared work is an alternative to formal work and as such, is seen to possess positive characteristics that promote growth and development. In itself, undeclared activity is a direct consequence of administrative and financial burdens imposed by the state (de Soto, 1989), and is thus, a ‘popular resistance to an unfair and overly intrusive state’ (Rakowski, 1994:506). The manifestations of this interpretation are small-scale entrepreneurs who choose the undeclared as an alternative to the declared. Accordingly, advocates of the legalist interpretation see the solution in a reduction of the state’s intervention with business regulations (Gërxhani, 2004).

This view is evidently applicable in certain representations of undeclared work in Croatia. The reasoning becomes evident, especially in the case of self-employed undeclared workers. The Croatian Bureau of Statistics (2007: notes on methodology) defines self-employed individuals as ‘employers who run an enterprise and employ one or more employees, as well as own-account workers who have no employees’. Self-employed workers represent 16 per cent (N:49) of the surveyed population. However, this figure includes those working fully on an undeclared basis, as only 13 per cent reported their official employment status to be self-employed, with the rest being unemployed. This is approximately in line with, albeit slightly below, the national average, where the composition of self-employed persons lies at 17 per cent of the total employed population (Figure 6.2) (Croatian Bureau of Statistics, 2013).

**Figure 6.2- Persons in employment, by status in employment, 2013 Source: Croatian Bureau of Statistics**

In the surveyed population, therefore, there are 9 wholly undeclared self-employed individuals. These did not have any employees on a consistent basis but did occasionally hire other individuals for help on an undeclared basis. Only 3 self-employed individuals stated that they fully report their activities. The remaining 37 are engaged in both economies. Of those choosing to exit the formal economy, either wholly or partly, there are no individuals in this sample who do so, due to exclusion. Therefore, because willing engagement in the undeclared realm explains the activity of all of the self-employed workers who work (at least to an extent) on an undeclared basis, the legalist approach is particularly sufficient to explain this particular employment category. The stifling nature of the declared economy is said to be in direct contrast with the flexible and independent nature of the undeclared, which is further characterised by ease of entry (Gerxhani, 2004). As such, workers choose to engage in the undeclared economy to gain autonomy. In support of this, reasons, such as being too small to bear the costs of formalisation, or a wish for freedom, were explained by participants.

From the 9 wholly undeclared self-employed individuals, 3 have never been employed on a formal basis, whereas the other 6 chose to exit the declared realm in favour of the undeclared. Positive aspects of the undeclared realm are emphasised in the argument that it is more dynamic in terms of its operations, and therefore those engaging within it need to possess the same quality.

Working on an undeclared basis, either fully or to a certain extent, gives individuals more flexibility and allows them to avoid some of the bureaucratic rules and regulations imposed by the state. The general view held, was that connections were needed, in order to be successful in the formal realm. The majority of those who started a business (49 per cent) believe that connections were only somewhat important to start a business. However, 46 per cent believe that connections are important to keep a business going, whereas 41 per cent think that they are very important.

In order to evaluate the legalist perspective, the above mentioned data, providing reasons for engaging in the undeclared economy could be further analysed. To provide this insight, participants were asked their opinions on why other people conduct undeclared work. This data, represented in Figure 6.3, allows an overall impression to be understood, therefore providing a more holistic view of undeclared motives.

**Figure 6.3 – Reasons for participating in the undeclared realm**

It is clear that a weak social contract, represented by a negative opinion of the government, is taken to be the single most explanatory reason (17 per cent) behind the development of the undeclared economy. However, taking into consideration two factors which conform to the legalist view, bureaucracy/red tape (9) and high taxes/social contributions (14), there is clear evidence of a legalist perspective. This shows the view that superfluous state involvement, through enforcement of high taxes and red tape is popular amongst citizens of Croatia. In fact, this accounts for over 20 per cent of responses. This, to an extent, conforms to de Soto’s (1989) claim that the concern lies, not in the undeclared aspect, but rather with state intervention and control over the market.

However, it is important to note that, although literature conforming to the legalist view, mainly focuses on opportunity-driven undeclared self-employment, there are situations when salaried individuals also choose to work on an undeclared basis, given the opportunity. Conducting a deeper analysis of those conforming to the exit interpretation of undeclared work, we can better understand such manifestations. According to the findings, as theorised, the biggest proportion of voluntary unregistered workers is taken up by the self-employed (35 per cent). However, substantial parts are also made up of waged employees (29 per cent), the unemployed (14 per cent), of whom some are freelance workers as already described, and students (a further 14 per cent). Furthermore, a small proportion of those choosing to exit from the formal economy, at least to some extent, are taken up by the retired (6 per cent) and homemakers (2 per cent). It was explained in the previous chapter that, the reasons behind this exit vary and are substantially explained by taxes being perceived as too high and overall pay being better, if carried out on an undeclared basis. However, flexibility was also an important factor for groups such as homemakers and students, therefore indicating that the legalist approach is an appropriate explanation.

Therefore, it is shown that the legalist view represents a large proportion of undeclared work in Croatia, whether from the perspective of the self-employed or other employment groups. However, considering the findings that are outlined in the previous chapter, it can be concluded that it does not fully explain the intricacies of such work or the motives behind each decision-making process.

## 6.1.4 Complementary theory

The final perspective considered here, and most recent in terms of its inclusion in the dominant framework, views the two economies as mutually dependent and structurally interdependent (Williams, 2007). The description of the intertwined nature of the declared and undeclared leads to the conclusion, that those benefitting from the undeclared economy are also those benefitting from the declared. Support for this is found, as those who are formally employed, but also engaged in some way in the supply of undeclared work, constituted 28 per cent of the survey population, and 34 per cent corresponded to those earning wages in some way (excluding those with no earnings and receiving only a pension or welfare payments). This clearly indicates that those engaging in the declared realm, are also benefiting from undeclared work. As such, these are best explained from the position of the complementary perspective, as it is argued that declared and undeclared activity rises and falls in tandem, rather than counter-cyclically.

The manifestation of the type of work where individuals benefit from both realms, can mostly be split into the categories of partially declared self-employed workers, moonlighters and occasional work carried out for friends and family. The latter of the three is rarely monetised, but sometimes includes small token amounts. Furthermore, considering that many individuals carried out reduced rate or free work for friends and family provides explanatory powers to this theory.

## 6.1.5 Conclusion

The results clearly point to the diverse nature of the conditions under which undeclared work occurs in Croatia. This is reflected by elements of each theory, to a certain extent, being applicable in the researched area.   
It was explained that the majority of undeclared workers in Split, Croatia seem to engage in the undeclared economy voluntarily. The analysis therefore shows that, although a large composition of this “exit” group consists of self-employed workers, waged employees, as well as the unemployed; students, the retired and homemakers also engage in the undeclared economy willingly.

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# 6.2 Moving beyond the categorical approach: considering the findings from a social exchange perspective

Although it is useful to consider the above framework of undeclared work, the findings outlined in Chapter 5 show a need to move beyond this in order to capture the full picture of the manifestation of undeclared work in Split, Croatia. Therefore, the focus of the following section considers the usefulness of the newly conceptualised framework for studying undeclared work.

## 6.2.1 Addressing the usefulness of social exchange theory

The second part of Chapter 2 focused on developing the underpinning framework for studying undeclared work. Within this, it was advocated that the social exchange theory framework should be conceptualised to encompass multiple perspectives. Given that utilitarian perspectives dominate the manner in which SET is used as a framework in current works, it has been argued that to broaden the scope, symbolic interpretations should be considered. This is in line with academics who argue that sociological interpretations of exchange need to be incorporated into SET developments (Collett, 2011; Zafirovski, 2005). In light of this, a new framework has been developed that encompasses both utilitarian and anthropological/sociological aspects, whilst being moulded to fit the phenomenon of undeclared work. The social contract (vertical relationship) between the state and its citizens is formulated so as to include utilitarian aspects such as goods and services received, as well as more symbolic elements such as procedural justice. Furthermore, the incorporation of social norms (horizontal relations) allows for a more contextual understanding of the decision making process.

The results of the surveys and interviews provide empirical evidence to support the need for a multi-level approach. The use of the SET framework enriches the understanding of the decision-making process and the nuances within it (Figure 5.15 in previous chapter). This exemplifies a more complex decision-making process than those previously reflected in mainstream literature. Placing the emphasis on the *process,* rather than merely the outcome, also brings many interesting conclusions and new insights. Considering that the developed framework explained 42 per cent of variance of the decision to participate in the declared or undeclared economy shows the applicability and usefulness of the framework in understanding undeclared work within the context of Croatia. Furthermore, the unearthing of complexities such as use of undeclared activity as a management tool shows the depth that can be added with the use of the SET theory in an undeclared work context. It is the incorporation of the utilitarian view together with the anthropological perspective that has enabled this usefulness. As can be seen throughout the findings chapter, elements of both perspectives are needed to gain a more holistic understanding of the phenomenon being investigated. The usefulness of this is evident in the depth of explanation of the phenomena being research. For example, when discussing undeclared loans given to employees, the same activity was better explained by the utilitarian perspective in one situation and the anthropological/sociological in another. One participant’s (Andjela) description of the activity better fitted the anthropological/sociological perspectives as it was symbolic in nature and the participant focused on showing her employees that she cares, whereas another such activity was more akin to interpretations of the utilitarian perspective as it involved a calculated decision to carry out the activity in order to make their employee feel indebted towards them (Frane). Another example lies with motives to participate in the undeclared realm. Just one perspective, utilitarian or anthropological/sociological, would not be able to explain the wide variety and complexity of motives involved in making this decision. Whereas in some situations individuals conducted a cost benefit analysis in considering the merits of both realms of work, others merely stated that there was “no particular” reason for engaging with undeclared work. The former clearly conforms to the utilitarian perspective as it is based on rational choice, whereas the latter shows the deeply embedded nature of such activities and is better understood through anthropological/sociological schools of thought.

The use of the social exchange theory framework has contributed towards unearthing factors that affect the decision making process of participating in the undeclared realm. It has done this through a deeper understanding of the role played by the vertical (social contract) and horizontal (personal and social norms) relations. The findings give a better understanding of the formation of the social contract and factors that affect its state, as well as the elements of the social contract that affect tolerance of undeclared work. The complicated nature of trust is emphasised. Within this, it is indicated that there are numerous levels of the state that influence the decision making process, and it is noted where improvements need to be made. It is also shown that it is important to manage the expectations of the citizens to be realistic, rather than overly optimistic, so as to avoid future perceived breach of social contract. Moreover, the use of the SET framework in its current conceptualisation has enabled a better understanding of the formation of social norms that contribute towards tolerance of undeclared work. In particular, the powerful effect of norms related to an individuals identity group (e.g. occupation) has been unearthed as a crucial factor. Furthermore, interesting inductive findings, about regulation of undeclared work as well as use of informality about as a people management tool, give a better understanding of how activities in the undeclared realm are conducted and ways in which they are used.

A number of important developments have been made, and findings unearthed, that enable the conceptualised framework to better explain the complex decision making process of engaging in the undeclared economy. The introduction of multi-foci relations was embedded with the survey in looking at different elements of trust in the state. However, it was also further developed in the qualitative interviews showing clearly the different levels within government that influence the formation of the social contract. Moreover, the incorporation of horizontal relations and the influence of social groups and norms has further enabled movement away from simple dyadic relations and has therefore contributed towards developing SET as a framework. This has, in part, allowed the unearthing of the complexity of undeclared economy engagement, in finding the cyclical nature of exchange processes. Furthermore, depth is added by showing that the nature of the relationship, along the utilitarian to symbolic continuum, can change over time or be altered with certain occurrences. These developments will now be explored in more detail.

### 6.2.1.1 Multi-foci exchange relations

As was discussed in Chapter 2, much research presents a simplistic relationship of two parties involved in an exchange. The current findings show that this is not a valid representation of the social contract because the relationship between the two parties (the state and the citizen) is formed on a number of levels beyond the parties themselves. For example, some complexities arise, as there is evidence that individuals make distinctions between the state as an entity and state representatives as individuals. This helps to unearth more depth in the decision making process, of whether to operate on a declared or undeclared basis, as it provides a better understanding of how the social contract develops and what influences trust in the state. This is important because, as it was shown, trust is an important determinant in the decision-making process.

As expected, it is shown that the actions of the government, as perceived by its citizens, have an impact on how the state is viewed. However, it is also shown that it is not so simple to decide who the social contract is held with in this relationship, and evidence shows the need for a multi-foci lens is needed to fully understand its formation and implications. Although scant previous research was found on this, parallel findings have been discovered in the formation of the social contract in the organisational context. This might help to shed some light on the situation. Schein (1965) argued that one approach is to personify the organisation in the sense that the employees attribute the organisation human motivation, characteristics and behaviour, so that the actions by agents of the organisation are viewed as actions of the organisation itself. The same conceptualisation can be applied to the social contract, with the state being personified. However, Bligh and Carsten’s (2005) argument that the focus on “the organisation” as the chief contractual representative may be misleading, also applies to that of the state. It becomes especially difficult, when there are inconsistencies between the messages different agents communicate to the public. Consequently, as Guest and Conway (2004) argue for the organisational social contract, it is unclear who undertakes the responsibility for contract negotiation, intervention and maintenance. Therefore, it becomes important to highlight the difficulties in managing public expectations and in turn, contract breach and violation, which can have detrimental effects on tax morale. This emphasises the significance of consistent communication across different state agents. Furthermore, it also points to a need to have a coherently designed policy, not only for those targeting undeclared work, but on a broad level also.

Furthermore, this research showed that the participants had clear views and expectations of Croatia’s EU membership, whether positive or negative. This indicates further complexity in the conceptualisation of the social contract, and shows how early the stages of the development of social contract occur. This has important implications for Croatia regarding the expectations of citizens but also for future candidate countries. It also helps to shed light on exchange relationships generally, showing the complex nature of forming and starting relations. Although research on this is scant, it is paralleled in management literature, which shows that the development of a psychological contract can occur, even in the pre-employment stages (Robinson and Rousseau, 1994).

### 6.2.1.2 Moving beyond dyadic relations: the influence of social groups and norms

Much social exchange research focuses on dyadic exchanges, leaving out the potential impact of third parties on exchange outcomes (Collett, 2011). This thesis shows that the social contract is also influenced by horizontal relationships, therefore indicating that the social contract exchange does not occur in a vacuum, but that there are influences by other parties also. Other than influence by the state generally, local authorities, well-known individual government figures, and individual government representatives, the state of the contract were also shown to be influenced by the media and discussions with others. The social contract involves the state contributing goods and services to citizens, as well being fair and just in their decisions. The contribution of the citizen is in the form of tax payments and greater general conformity to formal rules and regulations. However, it is shown that the contribution of the citizen is not based merely on the state of the social contract, but is also influenced by social rules and norms. It was observation of others’ behaviour, discussion and communication regarding such behaviour, the media and the elites that shaped the perception of these social rules and norms. This shows the complexity of the exchange relationship and the decision-making processes. It also shows that exchange relations are affected by other parties and factors. In turn, it suggests that social exchange relations are deeply embedded in context and the importance to look into the influence of social groups and norms as a part of the investigation.

### 6.2.1.3 Cyclical nature of exchange processes

The final two research questions seek to examine the impact of both the social contract and personal and social norms, on the decision-making process to become declared. The full extent of this is described in the previous chapter, but it is important to note the significance of the cyclical process that occurs. It was theorised that both the social contract and the various norms, will have an effect on the decision to declare their work. However, the two categories were conceptualised as separate factors that affect the decision-making process, with the state of the social contract affecting personal and social norms. However, as it is explained above, social norms have an impact on the state of the social contract. Perceived breach is able to occur in the absence of actual breach (Robinson, 1995) and with personally and socially constructed expectations, this can have detrimental effects, creating a multiplier effect that is difficult to break out of. Once a breach has occurred, particularly one that breaks the relationship, it becomes very difficult to manage expectations. As shown in the previous chapter, this has negative effects, because the worldview of the individual can change to a pessimistic perception, where even positive actions are viewed in a negative manner. This shows that when the nature of the relationship changes, so does the individual’s view of the actions of the state. Thus, actions that would be viewed as positive in a strong social contract are viewed as being driven by ulterior motives in a broken one. Given that such issues are widely communicated, personal norms very quickly become social, therefore perpetuating the negative social contract, which in turn affects norms yet again. This makes it very difficult to change the perception of formal institutions and improve the social contract.

### 6.2.1.4 Regulation of undeclared activities

The findings provide clear justification for the rejection of Castells and Portes definition of the undeclared economy as ‘unregulated by the institutions of society, in a legal and social environment in which similar activities are regulated’ (Castells and Portes 1989:2). It was found that a number of mechanisms serve to regulate officially undeclared relations. These can be explained by utilitarian interpretations, such as reputation and customer retention, as well as symbolic elucidations, such as symbolic benefits of social capital, norm of reciprocity and generalized exchange. However, it was found that work carried out due to necessity and exclusion, rather than exit, is not effectively regulated by social mechanisms, and should therefore be treated differently.

### 6.2.1.5 Changing nature of relationship: the shift from utilitarian to symbolic

While investigating the nature of work relationships, it was found that there was a large variety on the continuum between utilitarian and anthropological/sociological exchanges. Whereas the former are characterised by clear rules and economic exchange, the latter are more complex and involve symbolic exchange. The finding that aspects of undeclared work are used as mechanisms for people management, can also serve as an example of a shift in exchange relations. As part of this, employers offer envelope wages to employees, to provide higher pay and are thus better motivated, but also as involvement strategies, so that they can make decisions about their own work. Furthermore, employers give employees undeclared advances, loans, bonuses and hire family members to engage with the workers on a more social level, pushing the relationship along the social-monetary continuum. This, arguably, has the effect of creating commitment and engagement of employees through the relationship, rather than the job itself. This occurs through changing the nature of the relationship between the two parties, from utilitarian to symbolic. Due to this, the exchange is characterised by different norms and rules, resulting in more complex interactions and moving beyond quid-pro-quo exchanges. Furthermore, it is important to view the relationship as a continuum, rather than as purely utilitarian or symbolic in nature. With the example above, it is clear that the exchange is no longer exclusively calculative and simple, but it is also not merely symbolic in nature. As such, the exchange is still economic in nature but with an interpersonal element. The example therefore lies somewhere between the two contrasting perspectives, which should be viewed as a spectrum, rather than mutually exclusive categories. As this theme was based on an exploratory finding, it would be interesting to conduct a study, focusing on such concepts to gain more depth, as well as to investigate the issues from both the employer and employee perspective.

### 6.2.1.6 The usefulness of the currently conceptualised framework in policy design

It is clear from the discussion that the use of SET has been useful in the theoretical contribution of undeclared work. It has done this by unearthing factors that contribute towards development of tolerance of undeclared work as well as engagement in the undeclared realm. However, social exchange theory, as well as being used to investigate the phenomenon of undeclared work, is also used in this chapter to frame the relevant policy options. It is therefore important to consider the usefulness of the theory in doing this. Considering the policy options available (Chapter 3), the use of indirect methods is inherently based more on anthropological/sociological interpretations of social exchange theory, whereas direct methods are better explained by utilitarian theories. However, as is argued throughout the rest of the thesis, emphasis should be placed on integrating both the utilitarian and anthropological/sociological interpretations. This should be done within each of the categories when designing policies to create a more holistic approach.

Considering the policy aspects of the improvement of formal institutions and strengthening of the social contract, the rational choice perspective of social exchange theory relates to undeclared work, where the maximine principle is accepted. Such trust is likely to increase through efficient and adequate delivery and provision of goods and services. From an anthropological/sociological perspective, on the other hand, trust is more likely to increase from fairness and caring of citizen welfare. Due to the particularly weak perceptions of the latter aspect of the social contract, the citizens have no trust in the government to redistribute resources to those in need. As shown in the findings, this is due to the lack of trust and a redirection of generalised reciprocity. Although individuals sometimes use undeclared work for friends and family for token payments to rationalise the engagement in the undeclared sphere, there are positive effects for citizens. Policy design must, as such, be prudently designed and implemented so as to not diminish such feelings and actions of generalised reciprocity, but rather redirect them towards the social contract. Arguably, however, it might not be desirable for all reciprocity to go through the vertical channel, as fostering direct relations on a horizontal level can have other benefits, such as increased community spirit and in turn trust amongst citizens. Furthermore, as drawn from the implications from Latane and Darlye’s (1969) argument, the optimal group size is small for non-monetary value work, and larger for commodity exchange. Therefore, undeclared activity creates a good setting for work carried out with the motive to help friends and neighbours. On the other hand, it seems to be constricting to those entrepreneurial in nature (capturing the self-employed), as networks of exchange are in many cases constrained to informal channels and word of mouth. However, this does not seem to be a direct consequence of informality, but rather a lack of trust in unknown individuals and formal civic participation.

Considering the targeting of informal institutions, the utilitarian and anthropological/sociological perspectives are embedded by targeting the change of norms and attitudes through a combination of rational choice reasoning, as well as generalised exchange-based justifications. The former is done through advocating clear and strategic reasons for engaging with the formal economy that seek to tip the balance. Exemplifying the broader benefits of taxes for society, on the other hand, incorporates the latter. Using social exchange theory as an underpinning framework in the development of policies, allows for the approach to be better tailored, given the findings of the current study.

As will be shown, the use of both anthropological/sociological and utilitarian justifications of social exchange theory in the recommendations of measures, show the applicability of the theory, not only to understand phenomena such as undeclared work, but also to design practical policies. As in reality most individuals’ behaviour is explained by a combination of utilitarian and anthropological/sociological perspectives, both sets of measures should be used to change formal and informal institutions. This enables policy makers to concretely address the different motives and perspectives of engaging in the undeclared realm. Overall, the merging of the different perspectives aids to create a more comprehensive picture of undeclared work in its context, giving empirical support to such a conceptualisation. As Coyle-Shapiro and Conway (2004) emphasise the empirical needs as an issue of SET and its theoretical ambiguities, the current thesis contributes by adding evidence of important aspects of the theory in the context of undeclared work.

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# 6.3 Policy implications

## 6.3.1 Introduction

This section serves to extend the discussion of the findings to consider the policy implications. Links are, therefore, made to the literature on policy design (outlined in Chapter 3), whilst the recommendations for Croatia are outlined. It is important to take the concerns outlined in Chapter 5 into consideration when designing policies to tackle undeclared work. A number of issues point to potential problems that might affect the feasibility of measures in Croatia. These are outlined in Table 6.1. Furthermore, the transformational period of Croatia means that policies have to be carefully designed before implementation.

**Table 6.1 - Issues with policy approaches**

|  |  |
| --- | --- |
| POLICY APPROACH | SUMMARY OF PROBLEM |
| Deterrence | Deeply embedded norms of undeclared work and informality, as well as large extent of its engagement, make deterrence policies costly. Other issues also lower its effectiveness: -corruption (increasing penalties only increases the incentive to bribe government officials/inspectors)  -negative engagement with the public and lack of standardisation mean that deterrence policies might push individuals further into the shadows to avoid any detection |
| Incentives | Low citizen buy-in creates a danger of these incentives being ignored (due to citizens not perceiving the government as effective or trustworthy); being misused (due to citizens feeling as though they do not get what they deserve and they should even the playing field in some way) |
| Changing informal institutions | Difficult, due to such deeply rooted norms of informality, as well as negative opinions of government effectiveness and fairness. The low buy-in of government actions is likely to dampen the positive effect of relevant campaigns. |
| Changing formal institutions | Key priority due to: -low levels of trust in government -weak perception of procedural, distributive and retributive justice |

As is evident, the current use of direct policy approaches (deterrence and incentives) and reliance on rational actor underpinnings, is likely to have a limited effect in Croatia. This is largely because of a widespread negative social contract between the government and its citizens that causes low tax morale. The resulting effect of this negative contract is a substantial mismatch between formal and informal institutions. Bridging this gap should be a key priority to tackle undeclared work, because without doing so, the tax morale in Croatia will remain low. As the social norms that surround acceptance of undeclared work and negative perceptions of the government are so deeply rooted in society, changing informal institutions will be difficult before a change in formal institutions surfaces. This makes changes to formal institutions a key priority. In accordance with this, Figure 6.7 presents a hierarchy of needs for Croatia, developed using the typology of policy measures to tackle undeclared work (Williams, 2014). This framework is presented as a more appropriate tool for transition countries, along with those that have weak social contracts or high levels of perceived corruption.

Figure 6.7- Hierarchy of needs for Croatia

As the discussion of the findings pointed to a problem with using direct measures and changing norms, it is evident that in Croatia it is not sufficient to use a combination of policies to achieve a best outcome. Instead, the individual policies have to be formed as part of a larger plan, where priorities are placed, as is detailed in the hierarchy of needs. The following section, therefore, outlines some policy options that can be adopted to change formal and informal institutions.

## 6.3.2 Improving vertical relations: Changing formal institutions

Improving vertical relations by changing formal institutions is the first step to create a more positive social contract between the citizens and the state. From the anthropological/sociological perspective of social exchange theory, and the evidence of a damaged or non-existent social contract between the citizens of Croatia and the state, focus on improving formal institutions should lie with improving the relationship and focusing on aspects such justice and fairness. From the rational choice perspective on the other hand, emphasis should be placed on more tangible resources. This would therefore involve improving goods and services, reducing taxes, as well as improving the ease of registration for businesses and eliminating bureaucratic barriers. Due to particularly low levels of trust in government, emphasis is placed on the anthropological/sociological aspects. However, it is important to note that it is also important to have a satisfactory level of tangible resources.

#### 6.3.2.1 Increasing transparency

The findings of this research indicate that, it is not merely the authorities that deal with tax or undeclared work that influence the decision-making process. Therefore, the recommendation is that, before focusing specifically on undeclared work, improvements should be made at a broader level. One of the main findings was the impact of the low perceived procedural justice on the social contract and therefore tax morale. There was a general feel of a lack of justice, fairness and presence of corruption. It should be noted that, in Croatia, a number of steps have been taken to combat corruption. These have centred on detecting and identifying such activities (European Commission, 2014). The problem is, however, that there have been problems at a judicial level with those being unpunished or receiving short sentences (ibid). Furthermore, there is a lack of focus on prevention of corruption (European Commission, 2014c). It is necessary for Croatia to take further steps to tackle corruption. However, it is also imperative to increase transparency of processes to allow the public to see what is happening.

There are a number of good practice policies that can be implemented to achieve better transparency. Hypothecation is one example that can particularly useful to improve perceived procedural justice, because it involves assigning tax revenue to a specific end and clarifies where the money taken from the citizens is spent. Taking these initial steps to strengthen and elucidate links between revenue and expenditure while increasing transparency of tax policy making, would send a positive message to the citizens of Croatia. This would help to improve the relationship, as it would allow citizens a better view of where their contributions are spent, rather than going towards a ‘black hole’ (Doetinchem, 2010: 1). Although one example of this is already used with the Croatian healthcare system (Voncina et al., 2012) there is a need to have greater transparency.

Other policies, such as tax reforms, can also be used to simplify processes and increase transparency. Turkey is a good example of such reforms used to create new jobs (Eurofound, 2013). As such, it also corresponds with the aim of broader economic and social developments (see section 6.2.2.4). To remove formalisation barriers, the Turkish government implemented a series of tax reforms from 2006 onwards. These included the reduction of statutory corporate tax rates and introduced a tax-free minimum allowance, amongst others. The reforms have, since, resulted in the creation of many additional formal jobs (Eurofound, 2013).

#### 6.3.2.2 Improving administrative capabilities and processes

However, for such policies that seek to improve procedural justice through transparency to be successful, it is important to have good administrative capabilities. Since its independence, Croatia has been subject to many structural, administrative and legislative alterations that further hamper the state’s performance. This is also likely to cause confusion and uncertainty amongst the citizens. A key aim should therefore be to have carefully planned, structured and implemented changes. This will create greater consistency and clarity with citizens having a better chance of being up to date with changes. Improving the capabilities of administrative processes will create a foundation that would enable improvements in legislation and policy creation.

Moreover, the increased complexity arising from frequent alterations and changes has implications on public officials, meaning that they have to conduct state business in new and different ways (OECD, 2000). The qualitative findings show that interaction with government representatives and public officials, affected the overall perception of the state of the social contract. Furthermore, it was shown that there were inconsistencies and mixed messages. This is a key priority, because this interaction is the most direct contact with the state, and is as such, a critical influence in the formation of the social contract. One possible recommendation is standardisation of procedures and training for public officials, to create consistency in practices and the way citizens are dealt with. This is of vast importance, as the interaction between public servants and citizens is the most direct contact received with the state, and shown to be a key influence in the formation of opinions of the state.

#### 6.3.2.3 Coordinating undeclared work related actions

Once these broader changes are made, the state can begin to make improvements to coordinate departments and actions related to undeclared work. This is particularly important, as this is an area defined by poor coordination between various government bodies, with no particular agency bearing the responsibility for undeclared work (Baric and Williams, 2013). For actions and policies to be more successful, processes and outcomes should be coordinated in a more planned and strategic manner, enabling the system to be viewed as fair. It is difficult for Croatia to achieve this without having an overarching plan or department or body to take responsibility. Improvements in strategic operations can be made to include the formation of inter-ministerial committees or a coordinating entity with hierarchical structures. An example of locally based cooperation lies with the UK, where Joint Shadow Economy Teams were established in 2000 (Williams, 2009) carrying out joint inspections, showing that these can be conducted without specific legislative frameworks. According to the OECD (2005) using tools such as discussion forums are vital in promoting coordination between departments. It is argued that:

‘Through commitment, involvement and greater accountability, government departments can become fully fledged partners’ (OECD, 2005: 166)

#### 6.3.2.4 Broader economic and social developments

However, given some of the findings, too much focus on undeclared work might damage tax morale further, as citizens believe the government concentrates on collecting money, rather than using it in appropriate ways. The finding that reinforces this indicates that, often individuals perceived the government’s actions as not being carried out in the best interest of citizens’. These generally included, broad examples of policy and actions of the government and examples of certain groups being unprotected, such as single mothers or the retired. Shifting the focus towards positive social improvements might improve the state of the social contract. This finding is also mirrored in literature, where the argument that striving to achieve broader economic and social developments, can help create a high commitment culture (Vanderseypen et al., 2013; Williams, 2014). Such types of policies have a two-fold rationale, as they indirectly change informal institutions as well as the direct change of formal institutions. This is because the positive engagements to create jobs, along with policies that protect the vulnerable may have the effect to improve the social contract, through improving the perception of the state in the eyes of the citizens. In Croatia, the elderly and those with lower education levels are materially deprived and consequently particularly vulnerable (Eurofound, 2014) and should therefore be targeted.

#### 6.3.2.5 Improving dialogue with citizens

As well as taking the steps to improve procedural, distributive and retributive justice, Croatia must also pursue wider economic and social development aims. Furthermore, as the expectations held by citizens are highly important to maintain a positive social contract, it is important that the government improves the dialogue with its citizens, increasing communication through a variety of mediums. Considering the literature that surrounds breach of social or psychological contract, this communication is indeed very important. Here it is useful to again borrow from management literature. It is supposed that if the contract is breached, but the belief is that the employer had no opportunities to fulfil their obligations, due to external factors, then the employee has less intent to react to this breach (Chao et al. 2011). The message that can be drawn from this is that it is necessary for the government to be honest in the messages it sends to the citizens. If there are certain promises or expectations that have not been met, these need to also be communicated and explained. In this way, citizens are better informed, but also feel more involved in the future of their country.

Moreover, it is recommended that more research seeks to unearth the expectations of the different groups of citizens in Croatia. Understanding what such expectations are, and how they form, will result in better management of them. A good example of starting a dialogue with a particular type of medium is the provision of advisory services on employment issues, which was undertaken in Italy. During this project, emphasis was placed with unregistered entrepreneurs wishing to go through the formalisation process (Bàculo and Gaudino, 2009). Although it took some time to get started, citizens eventually saw it as positive. The figures portray the success of the project in that over one thousand undeclared entrepreneurs were advised and over three thousand new entrants assisted in their business startup. Although such a project would be costly for Croatia to implement, the long-term benefits are substantial. Such steps taken by the state, act as positive signs of a government that wants to help its citizens, thus improving the perceived relationship.

To bring more activity to the declared realm, it would be useful to carry out further research to understand the undeclared economy in the current context as well as building profiles of those that comply and those who do not, to better understand their motives. Further yet, this allows the state to better engage in the conversations that serve to construct social norms. It is argued in this thesis that the decision making process is affected by the perspective of the individual rather than the objective truth. Therefore, once the relevant institutional changes have been made, it is also important to align these changes with the perspective of the public. With this aim, policy measures, such as campaigns providing information and promoting compliance, tax compliance appeals and tax knowledge improvement, will be useful (Williams and Renooy, 2009; Williams, 2014).

#### 6.3.2.6 Conclusions

Improving formal institutions and, in turn, increasing trust in the government, can have very positive effects. Ayres and Braithwaite (1992), for example, argue that there is a positive relationship between government confidence and acceptance of public policy. Increasing the state of indebtedness, whilst increasing trust, should be combined with tackling the mechanisms that people use to reduce their state of indebtedness, whilst engaging in the undeclared economy. These include generalised reciprocity, personal justifications and externalisation/internalisation of social norms. With actions such as those outlined, the government starts to regain the trust of its citizens, and alongside doing so should pursue measures, such as those that seek to change both informal institutions and incentive measures.

## 6.3.3 Changing horizontal relations/informal institutions

By improving formal institutions, the government is indirectly changing informal institutions because, if successful, the perception of the social contract is altered in a more positive manner and can therefore have an affect on the norms that arise. Although clear steps can be taken to improve formal institutions, the difficulty lies in these steps being perceived as positive. As mentioned, it was found that once a contract has been breached, often, even positive developments are viewed in a negative light, resulting in difficulties to change social norms. Furthermore, as Castro and Batel (2008) discuss, there are many problems with encouraging new or differing norms and practices. Therefore, as is the focus of this section, it is important to also directly target informal institutions.

#### 6.3.3.1 Campaigns

As tax morale was found to be low, it is important to exemplify the importance of paying taxes. This is an increasingly common policy option with a number of countries seeking to do this by clarifying the link between tax contributions paid and the benefits (goods and services) received for this. Such an approach has foundations in the anthropological/sociological interpretation of social exchange theory, as it appeals to norms. A useful example of such an attempt is the Estonian “Unpaid Taxes Will Leave a Mark” campaign. As part of this, buses in Estonia carried photos of rescue service workers stating: “Should we take the trolley bus to an emergency call-out? This can happen if you do not pay your taxes” (Nurmela, 2013). Such an approach is desirable in Croatia to encourage the citizens to think about the significance of taxes. However, there are also limitations to such approaches. If the citizens of Croatia currently believe that the goods and services provided are not of a good standard, then such campaigns are likely to have only a limited effect. If, on the other hand, the campaigns are timed when governments are already making improvements, and tailored to exemplify these improvements, the positive effect is likely to be higher. Pointing to other potential barriers Thurman et al. (1984) discuss denial of responsibility with adverse effects of undeclared activity. Their argument is that those engaging with undeclared activities view their role as minor, without having an effect on collective issues. If this is the case, it reduces the effectiveness of the campaign. Nonetheless, using such campaigns, in combination with normative appeals, may reduce the denial of responsibility. If the campaign included realistic details of undeclared work, individuals would gain a more realistic view and would be less likely to view their own activity as minor. Furthermore, the findings also show that personal norms and tolerance of undeclared work was much lower than both perceived identity group norms and societal norms. As such, it would be useful to show citizens that although there is some level of tolerance towards certain undeclared activities, this is not as widespread as considered. Moreover, it was found that individuals are much more likely to identify with norms of their reference group, than that of society in general or an average Croatian citizen. In light of this, the design of campaigns and appeals should be tailored to this effect. As it was shown that the majority of individuals best identify with their profession group, this is where the focus should lie.

The use of media and campaigns can also be designed from a rational choice perspective of social exchange theory. This would involve designing an individual level campaign that focused on raising awareness about the positive features of declared work, and the negatives of undeclared work. This would therefore appeal to someone undertaking a decision process, based on rational choice, rather than those considering issues such as procedural justice. Advantages of such a design lie with providing concrete and personal benefits of declaring one’s activities. Taking the example of Estonia again (Nurmela and Lill, 2009), focus can be placed on negative aspects of the undeclared economy, such as uncertainty, lack of insurance, social protection and lower pensions. It should also be noted that the two forms of campaigning are not mutually exclusive, due to their reliance on the same tools, such as TV advertising and posters. As such, it is encouraged that they are applied in tandem. The use of media is generally important, because it was a factor that was found to influence the formation of perception of norms. Furthermore, because it was found that the elites and role models impact on the perception of social norms, good examples should be drawn and appeals made in such a way.

6.3.3.2 Education

As norms are developed through a process of socialisation, education can be used as a tool to strengthen the norms that are positively related to the strength of a social contract and tax morality. This can take the form of taxpayer education to improve tax knowledge (Eriksen and Fallan, 1996). Saad (2014) argues that a significant proportion of evasion is unintended and is due to a lack of knowledge or understanding of one’s obligations. Education has the potential to reinforce and strengthen those norms that are related to tax compliance (Mazar and Ariely, 2006). It therefore, makes education especially important, to align the values and norms of citizens to those in formal institutions (Williams, 2014). Furthermore, the student generation often referred to teachers carrying out undeclared work as justification of its social acceptance. Therefore, teachers might be considered as role models in such situations. This indicates that teachers and the education system more generally, may play a large role in the shaping of social norms. Therefore, using this medium to not only educate the youth about the tax system, but also instil a sense of tax morality through emphasising the importance of contribution, might prove fruitful. This can involve using the education system to ‘reinforce the concept of fairness of the tax system among taxpayers; and develop programs that enhance and appeal to a taxpayer’s moral conscience and reinforce social cohesion.’ (Trivedi, Shehata & Lynn, 2003: 175). Moreover, as teachers act as role models, training and development, as well as incentives to declare extra earnings, might be helpful in the quest to change social norms.

However, it is important to further stress, that timing of implementing campaigns is crucial. This is because it is necessary that changes to formal institutions be made before such campaigns are used. Employing the use of the campaigns before citizens begin to notice any changes in the effectiveness of the state, will merely result in further negative comments towards the state and no improvement in the perception of the social contract. As the majority of the interviewed individuals readily provided examples of inadequacies of the state, advertising the state in a positive manner, might merely seem like a ploy to “trick more money out of the citizens” via propaganda methods, or as something that has to be done to check an “EU box”, both of which were given as opinions of some of the current policy measures employed. The focus on the negative is not an unusual finding, as it is generally shown that individuals are more inclined to react strongly to negative occurrences, whilst often the positive ones are ignored (Baumeister et al., 2001). In terms of the psychological contract, it is also found from management literature, that employees have strong reactions to breach, whilst the fulfilment of promises and expectations does not always result in positive behaviours (Conway et al., 2011). It is therefore important to implement genuine improvements and to show willingness to carry this on in the long-term. It is also important that no unrealistic promises are made, as this can further result in damage to the social contract. Changing the perceptions of the public is a long-term goal and cannot be achieved quickly, but is crucial in instrumentally fostering more declared activity. Furthermore, campaigns work on the basis of affecting an individual’s attitude towards paying taxes, but the findings include a discussion as to ways in which a negative social contract affected the behaviour but not the attitude of the participant. This provides a further rationale to firstly target a change in formal institutions to capture such individuals.

## 6.3.4 Conclusion

The discussion of policy implications shows the need to address the low tax morale in Croatia. For this to be achieved, focus should be placed on improving formal and informal institutions because the employment of direct controls is ridden with difficulties, while institutional asymmetry is substantial. In the case of Split, Croatia institutional asymmetry explained 42.4 per cent of variance in engagement in the undeclared economy, and as such, presents a strong rationale for this focus. A summary of the suggested policies is included in Table 6.2.

**Table 6.2- Suggested policies for Croatia**

|  |  |
| --- | --- |
| Improving Formal Institutions | Improving Informal Institutions |
| -Improving procedural justice: increasing transparency | -Campaign: linking taxes to goods and services |
| -Improving administrative capabilities, training for public officials and standardisation of procedures | -Campaign: advantages of declared and disadvantages of undeclared work |
| -Coordinating departments and actions related to undeclared work | -Broader use of media: drawing on elites and role models |
| - Broader economic and social developments | -Education |
| -Improving dialogue with citizens |  |

# 6.4 Contributions

This thesis makes several theoretical and practical contributions. Firstly, a new theoretical framework to study undeclared work is put forward that allows a deeper understanding of decision-making processes. The newly developed model takes into consideration many social and contextual issues. In doing this, it steps away from broad categorisation of individuals, and instead, focuses on factors such as personal norms, social norms, the relationship with the government and opportunity. Interesting issues of trust, social cohesion and social control arise from studying the phenomenon from such a perspective. These developments further our knowledge of the phenomenon of undeclared work.

This thesis not only applies social exchange theory to understanding undeclared work, but in doing so, seeks to advance SET itself. It does so by creating a more integrated approach to understand social exchange than is currently the case. With regard SET, Coyle-Shapiro and Conway (2004) argue that social exchange theory is ridden with theoretical ambiguities and empirical needs. As the framework is theoretically underdeveloped, it leads to a narrow employment of methods and further stunting of the theory (Cropanzano and Mitchell, 2005). The current study, therefore, seeks to take a step towards filling this gap. In light of this, it shows an empirically supported need and importance to incorporate varying perspectives to encapsulate a depth of understanding. It is clear from the findings, that if only the utilitarian or the anthropological/sociological perspective was employed, only one part of the decision-making process would be understood, and therefore, depth of understanding would be lost. Furthermore, as can be seen in the discussion of the framework in section 6.2, this thesis shows a need to address the complexities associated with social exchange relationships, and as such, move beyond dyadic relations, embed the influence of social norms, as well as recognise the cyclical nature of exchange processes.

This thesis also makes a contribution by providing much needed new empirical research on the undeclared economy in Croatia. This enables a better understanding of the nature and extent of undeclared work within its context, therefore facilitating a tailored policy design. The contribution of policy implications is two-fold. In one respect, the thesis makes practical contributions by drawing on the findings and discussion, to create empirically grounded policy recommendations. On the other hand, it also helps to contextualise the different possibilities, showing the need to prioritise and focus policy options, rather than merely using a combination of the different approaches. The policies are tailored to the current situation in Croatia, but there are also implications for countries in a similar situation. The design of the measures is therefore useful for many countries neighbouring Croatia that suffer from a weak relationship between the state and its citizens, as well as normalisation of undeclared activities.

# 6.5 Further research

The current thesis raises important questions and provides some answers to the influence of the social contract, formal institutions, social norms and social interactions. Alongside making the above outlined contributions, it also points to the significance of some issues that have been scantly explored.

The findings of this study suggest that undeclared work in Croatia is more prevalent than predicted by some estimations, particularly those of the Eurobarometer. In light of this, it should be given more attention in research, to better understand a phenomenon that is so present in the lives of Croatian citizens. Moreover, more attention should be given from a policy design perspective. In order to do this in an informed manner, however, more research is needed to fully understand the extent to which different parties influence the state of the social contract, and therefore the development of tax morality. The current research identifies parties, such as the state, as an overall entity, individual politicians, government officials, as well as local councils. Particularly in the context of small countries, it reveals the elites as a potentially important contributor to the development of tax morale, which has not been previously investigated and in turn warrants further research. Taking this further is important, because it can aid in policy design to tackle undeclared work, but also beyond this phenomenon. This line of research can help to develop better understanding with issues such as civic engagement and social cohesion.

As trust in government seems to explain a substantial variance in interaction with the undeclared economy, it is important to undertake further studies that seek to better unearth the range of factors that influence the development of trust or mistrust in formal institutions. In their paper on corruption, trust and the undeclared economy in transition countries, Wallace and Latcheva (2006) find that the subjective evaluation of the level of corruption, in comparison to the socialist era, explains 6.4 per cent of total variance in trust in political institutions. This is even stronger for Croatia, explaining 11.1 per cent of variance and is particularly relevant considering the aforementioned problems with levels of corruption. As this data is, however, collected from 1998 there is a need to gain a more updated view as, well as one that casts a wider net, to better consider other factors that contribute towards the variance. A limitation of the current study is that it only directly explored corruption on a qualitative level and not a quantitative, and therefore no conclusions can be made as to the extent of its effect on the formation trust in the government. Therefore, as already mentioned, such factors need to be incorporated into the quantitative survey design, so that more information of their representativeness can be gained.

From a social exchange perspective, the informality of operating in the undeclared work sphere, often promotes a better platform for the development of positive connections and reciprocal long-term relations, rather than short-term, purely monetised ones. The "formalising" of such activities might diminish the social aspect and therefore create undesirable consequences of weakening satisfaction. Therefore, more research, focusing on *social* exchange and the semiotics, rather than economics of undeclared work should be carried out. The aim of such research would be to gain a better insight of how the transition to formality can be made, without sacrificing valuable social ties and benefits.

This thesis unearths the use of informality as a management mechanism and therefore adds to a small body of literature focusing on off-the-books loans. Previous research (e.g. Hunt, 2013) finds the occurrence of this to be motivated by the operationalization of paternalism and peonage and therefore be best explained by the utilitarian social exchange perspective. However, the current thesis unearths symbolic and trust related elements to such activities therefore providing a new perspective. However, there are many limitations, due to the findings being inductive in nature. Nonetheless, it presents an interesting view of the use of undeclared activity as a labour management mechanism. Further research, therefore, is called for, to examine its nature and extent in different contexts. Moreover, it would be interesting to inspect the use of undeclared loans from the perspective of the employee.

Finally, it can be argued that there is a need to explore further how social contracts, personal norms and social norms develop. This is necessary to better understand how to mediate outcomes of acceptance of, and engagement in, the undeclared work realm. Although some changes in these phenomena were noted in this thesis, these are retrospective in nature. The current thesis is limited in its findings with regard changes of social norms because, although in-depth interviews are carried out, it seeks to investigate the issues in the context within which they occur, placing the point of analysis in development of social norms as they are currently. However, some indication of changes is given and this is a crucial point of interest for research, as it shows the changes that can occur during transitional periods, as well as over short periods of time. As Croatia is still in a transitional period, albeit now of a different type, it can be argued that this is the ideal situation for directing and influencing the development of norms. The given example of acceptance of smuggling, shows the effect changes in the environment have on social norms, but further research would be useful, to better understand how state interventions can be used to bring about such change. This in turn, advocates for more longitudinal studies to be carried out to investigate such phenomena.

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**QUESTIONNAIRE**

**1. Approximately how many years have you lived in this part of town?**

**2. How many years have you lived at this address?**

**3. Age:**

|  |  |
| --- | --- |
|  | **Under 18** |
|  | **18-25** |
|  | **26-35** |
|  | **36-45** |
|  | **46-55** |
|  | **56-65** |
|  | **Over 65** |

**4. Gender:**

|  |  |
| --- | --- |
|  | **Male** |
|  | **Female** |

**5. Employment status:**

|  |  |
| --- | --- |
|  | **Employed- full time** |
|  | **Employed- part time** |
|  | **Self-employed** |
|  | **Unemployed** |
|  | **Home maker** |
|  | **Retired** |
|  | **Student** |
|  | **Disabled** |
|  | **Other** |

**Occupation:**

**Employment History:**

|  |  |
| --- | --- |
|  | **Never in formal employment** |
|  | **Mostly not in formal employment** |
|  | **Mostly in formal employment** |
|  | **Always in formal employment** |

Undeclared work/Unregistered work/Work in the grey economy: work which is legal by nature (and as such does not encompass illegal acts such as drug trafficking or prostitution) but is not either wholly or partially declared to the relevant authorities (social security and tax offices).

1. **What do you think is approximately the share of the population is Croatia that works without declaring their income, or a part of it, to tax or social security institutions?**

**Less than 1%** **1% to 5%** **5% to 10%** **10% to 20%** **20% to 30%** **30% to 40%** **40% to 50%** **More than 50%**

1. **According to your opinion, which of the following are most likely to carry out undeclared work? Which is the second most likely?**

**Unemployed****Self employed (no employees)****Self employed (with employees)****Full-time employees****Part-time employees****Students****Illegal immigrants****The retired****Others**

1. **What do you think are the main reasons for carrying out undeclared work?**

**Bureaucracy/red tape to carry out a regular economic activity is too complicated** **Lack of control by authorities****Sanctions are too weak****In some sectors or regions there is no valid alternative** **The wages in formal businesses are too low** **There is a lack of regular jobs on the labour market** **The state does not do anything for the people, so why should they pay taxes**  **Nobody would purchase such goods or services at normal market rates** **Taxes and/or social contribution payments are too high****Other \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**Demand**

There is evidence to show that part of the population to some extent accept "undeclared work" – i.e. activities which circumvent declaration to tax authorities or social security institutions, and where the person who acquires the good or service is aware of this. Usually both parties – the doer and the recipient – profit from this mainly since they do not pay VAT, income tax or social security contributions.

**9. In the last 12 months have you acquired any services or goods for which you had reason to believe that they were embodied in undeclared work?**

**Yes   
 No   
 Don’t know**

**10. What kind of goods or services coming from undeclared activities did you acquire? Would you please shortly characterize each of these services or goods? Please indicate the most important three ones in terms of value. - First most important one.**  
**11. Who did you buy this good or service from?**

**Friends/colleagues/acquaintances**

**Family**

**Neighbours**

**Other private individuals**

**Firms or businesses**

**Other**

**12. Why did you buy this work on an undeclared basis?**

**Lower price**

**Faster service**

**Better quality**

**In order to help someone who needs the money**

**As a favour amongst friends/relatives/colleagues** **Good/service is not hardly available on the regular market**

**Supply**

Sometimes employers prefer to pay all or part of the regular salary or the remuneration for extra work or overtime hours cash-in-hand and without declaring it to tax or social security authorities.

**13. In the previous 12 months, has your employer paid you all or part of your income in such a way?**

**Yes**

**No**

**Don’t know**

**14. If so, was this remuneration for regular work, for overtime hours, or for both?**

**Regular work**

**Overtime or extra work**

**Both**

**15. What is the approximate percentage share of your gross yearly income (from your main job) that you receive in such a way** **Are you happy with this arrangement or would you prefer to have your total gross salary being declared?**

**Happy with this****Would prefer fully-declared****It depends:**

**Undeclared Work**

**16. Please state three types of undeclared work that you carried out the most in the past year:**

1.

2.

3.

*For the following questions, please bear in mind the undeclared work that you carried out most commonly.*

**17. In the past 12 months, how often did you carry out such work on a undeclared basis:**

**Just once**

**Occasionally**

**Often**

**18. In the past 12 months, how many weeks did you do this work in:**

**19. In those weeks when you undertook this work how many hours in a week did you spend doing so?**

**20. Who did you mainly carry this work out for?**

**Friends/colleagues/acquaintances**

**Family**

**Neighbours**

**Other private individuals**

**Firms**

**Other**

**21. How were you paid for this work?**

**Mainly money**

**Mainly in kind**

**Both approximately equally**

-**If cash**, **approximately how much do you receive for an hour of this type   
 of work?**

**-If payment in kind or both, how much do you think you would received if this work was paid fully in cash?**

**Why did you accept payment in kind?**

**Difficult to obtain this good or service on the regular market**

**The quality is lower or service less fast on the regular market**

**To avoid taxes**

**To help someone who is in need of money**

**This was the only means of payment offered**

**This is a usual way of payment when such work is carried out amongst friends, neighbours and relatives**

**Who did you carry this work out for?**

**Friends/colleagues/acquaintances**

**Family**

**Neighbours**

**Other private individuals**

**Firms or businesses**

**Other**

**22. Why did you carry this work out on an undeclared basis?**

**The recipient or employer requested it to be undeclared**

**It is too complicated to declare this work due to paperwork**

**Could not find declared work**

**The pay is better if undeclared**

**It is of benefit for both parties**

**The tax is too high**

**More flexibility if the work is not reported**

**It is normal to carry out this type of work on an undeclared basis**

**The government does not do anything for me so why should I pay taxes**

**23. Other than financial differences, did you experience any consequences for carrying the work out on an undeclared basis?**

**Higher risk of accident**

**Lack of insurance against accident at work**

**Harder working conditions compared to formal work**

**Higher risk of losing the job**

**Other**

**24. How important is undeclared work for your budget?**

**Very important****Important****Not important****No undeclared work**

**25. Have you ever experienced any difficulties from the state due to undeclared work?**

**Yes****No**

**26 What contributes the most to your household budget?**

**Regular work**

**Undeclared work**

**Own production**

**Favours from friends and family**

**Welfare benefits**

**Pension**

**27. Who would you likely turn to in times of financial crisis?**

**Family**

**Friends**

**The government**

**Social partner institutions**

**The Church**

**Other :**

**28. When you are no longer able to work, what do you expect to rely on for your income?**

**State pension**

**Children**

**Family**

**Private insurance**

**Savings**

**I do not know**

**Other:**

**Connections**

**29. How important are connections for getting things done in various sectors in Croatia? (school, employment, healthcare etc)?**

Very important Important Somewhat important Not important

**30. How useful do you think connections are for avoiding sanctions for undeclared work?**

Very important Important Somewhat important Not important

**31. How important do you think connections are for various work permits, concessions and grants?**

Very important  Important Somewhat important Not important

**Questions for self-employed/entrepreneurs:**

**32. How important were connections for setting up your business? (permits, registration, avoiding bureaucracy etc)**  
Very important Important Somewhat important Not important

**33. How important are connections in conducting your business now that you are set up?**   
Very important Important Somewhat important Not important

**Norms**

**34. Please indicate the extent to which you agree with the following statements** (1=completely disagree 12=completely agree)

* **I am proud being Croatian**

1 2 3 4 5 6 7 8 9 10 11 12

* **Being Croatian is important to me**

1 2 3 4 5 6 7 8 9 10 11 12

* **I feel a moral obligation for following the rules and regulations set by the state**

1 2 3 4 5 6 7 8 9 10 11 12

* **I feel a moral obligation to other citizens of Croatia (respecting social norms etc)**

1 2 3 4 5 6 7 8 9 10 11 12

**35. Each individual belongs to a number of social groups [explanation]. Please note with which group you feel you most identify with in terms of working norms and taxation issues:**

**Profession**

**Class**

**Regional**

**National**

**Social**

**Religion**

**Gender**

**Generation**

**Neighbourhood**

**Other**

**36. For the following set of statements:**

**A** Please mark with **A** how acceptable you find the situation  
**B** Please mark with **B** how acceptable you consider the situation to be with the **reference** **group** you chose above **C** Please mark with **C** how acceptable you think this situation is to an average Croatian citizen

Where 1=Completely unacceptable a 10=Completely acceptable

**1 Someone receives welfare payments without entitlement**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|  |  |  |  |  |  |  |  |  |  |

**2 Someone uses public transport without a valid ticket**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|  |  |  |  |  |  |  |  |  |  |

**3 An individual hires another individual for help in the house and they do not declare this work**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|  |  |  |  |  |  |  |  |  |  |

**4 An individual hires a firm and the work is not declared**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|  |  |  |  |  |  |  |  |  |  |

**5 A firm hires an individual and the work is not declared**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|  |  |  |  |  |  |  |  |  |  |

**6 A firm employs another firm and the work is not declared**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|  |  |  |  |  |  |  |  |  |  |

**7 A person does not, either wholly or partially, declare their earnings**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|  |  |  |  |  |  |  |  |  |  |

**8 Someone uses connections to speed up the process of bureaucracy**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|  |  |  |  |  |  |  |  |  |  |

**9 Someone uses connections to partially or fully avoid contractual or legal obligations such as health and safety at work.**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|  |  |  |  |  |  |  |  |  |  |

**Relationship with the government**

**37.   
Please note the level of confidence you have in the legal system**1=no confidence and 12=absolute confidence

1 2 3 4 5 6 7 8 9 10 11 12

**38.  
Please note the level of trust and confidence you have in the government in your capital and your parliament**  
1=no confidence and 12=absolute confidence

1 2 3 4 5 6 7 8 9 10 11 12

**39. Please note the extent to which you agree or disagree with each of the following statements.**(where 1=Completely Disagree se a 12=Completely Agree)

* **The tax office’s decisions are fair**

1 2 3 4 5 6 7 8 9 10 11 12

* **The rules and approaches applied by the tax office treat all taxpayers equally**

1 2 3 4 5 6 7 8 9 10 11 12

* **The tax office’s decisions reflect mainly its own stakes**

1 2 3 4 5 6 7 8 9 10 11 12

* **The tax office’s decisions are mainly based on facts and not on opinions**

1 2 3 4 5 6 7 8 9 10 11 12

* **Changes or adaptations will be applied in case the decisions made by the tax office are found to be wrong or bad**

1 2 3 4 5 6 7 8 9 10 11 12

* **Compared to the tax I pay, I receive too few public provisions**

1 2 3 4 5 6 7 8 9 10 11 12

* **Some groups in society profit more from the tax system than I do**

1 2 3 4 5 6 7 8 9 10 11 12

* **It is unfair that some people have to pay less taxes than me but at the same time, take advantage of all sorts of provisions**

1 2 3 4 5 6 7 8 9 10 11 12

* **I think I have to pay too much tax**

1 2 3 4 5 6 7 8 9 10 11 12

* **I think the Croatian tax system is fair**

1 2 3 4 5 6 7 8 9 10 11 12

**40. Do you know where you could turn to for free help or advice in terms of tax obligations or for setting up a business?**

**Yes**

**No**

**41. Those working on an undeclared basis risk the tax or social security institutions finding out about this. What do you think is the level of risk for being detected in Croatia?**

**Very high**  **Fairly high**  **Fairly small**  **Very small**

**42. In your opinion, what sanction is normally to be expected if an individual is discovered to be carrying out work without declaring it to the authorities**

**Normal tax or social security contributions due, but no fine**

**Normal tax or social security contributions due, plus a fine**

**Prison**

**Don’t know**

**Other**

**European Union**

**43. Are you optimistic with regards the situation in Croatia improving due to entering the EU?**

**Yes**

**No**

**44. Do you think undeclared work will:**

**Decrease**

**Increase**

**Stay the same**

**Socialist Era**

**45. Compared to the socialist/communist era do you think…**

* **That trust in the government is**

**Higher**

**Lower**

**Fairly similar**

* **That trust amongst citizens is**

**Higher**

**Lower**

**Fairly similar**

* **That citizens help each other out**

**More**

**Less**

**A similar amount**

* **That undeclared work has**

**Increased**

**Decreased**

**Stayed fairly similar**

**Stayed fairly similar but changed in type**

* **That economic stability is**

**Better**

**Worse**

**Fairly similar**

* **Taking into consideration all factors (social, financial, economic etc) do you think the situation is better**

**Now**

**During the socialist era**

**Final Questions**

**46. Which sector are you currently employed in?**

**47. Please state the approximate proportion of undeclared work to your monthly income:**

     %

**48. Please state your approximate monthly income (gross)**

**Under 2,000 kuna**

**2,000-4,000 kuna**

**4,000-6,000 kuna**

**6,000-8,000 kuna**

**Over 8,000 kuna**

Information Sheet

The Informal Economy in Croatia: A Social Exchange Perspective

Dear Interviewee,

You are being invited to take part in a research project. Before you decide it is important for you to understand why the research is being done and what it will involve. Please take time to read the following information carefully and discuss it with others if you wish. Ask us if there is anything that is not clear or if you would like more information. Take time to decide whether or not you wish to take part. Thank you for reading this.

The survey is carried out by the PhD candidate Marijana Baric at the University of Sheffield Management School within the bounds of her thesis. The expected end of the research is September, 2013.

The aims of the project are:

- To measure the nature and extent of undeclared work in Split, Croatia

-To evaluate opinions and attitudes towards participation in undeclared work

- To examine the influence of personal and social norms on the decision to formalise

-To examine the impact of the social exchange relationship between the government and citizens on the decision to formalise

- To evaluate the relevant policy recommendations based on the findings

For the selection of respondents a probability sampling method is used. That is, a number of sampling points will be drawn with probability proportional to population size (for total coverage of the country) and to population density and the distribution of the resident population in terms of metropolitan, urban and rural areas. In each of the selected sampling units, a starting address will be then drawn at random. Further addresses (every nth address) will be subsequently selected by standard “random route” procedures from the initial address. In each household, meanwhile, the respondent will be drawn at random (following the “closest birthday rule”). The projected number of respondents recruited is 200.

It is up to you to decide whether or not to take part. If you do decide to take part you will be given this information sheet to keep (and be asked to sign a consent form) and you can still withdraw at any time without it affecting any benefits that you are entitled to in any way. You do not have to give a reason.

The interview will take you 1-2 hours. You will be asked to respond to the open as well as closed-ended questions listed in the questionnaire. The questionnaire consists of the following sections of sections such as your background (including closed-ended questions concerning general information such as sex, age, work status), the supply and demand of undeclared work, personal attitudes and social norms towards undeclared work, the perception of the government and their fiscal policies. You might also be asked to take part in a follow-up survey dealing with more in-depth questions about motives for operating in the informal economy.

If for any reason you have a complaint regarding your participation in the research, you can contact the Supervisor of the project:

*Colin C Williams*

*Professor of Public Policy*

*School of Management*

*University of Sheffield*

*9 Mappin Street*

*Sheffield S1 4DT*

*E-mail: C.C.Williams@sheffield.ac.uk*

Should you feel your complaint has not been handled to your satisfaction you can contact the University’s Registrar and Secretary:

*Registrar and Secretary's Office*

*Firth Court*

*Western Bank*

*Sheffield, S10 2TN*

All the information that we collect about you during the course of the research will be kept strictly confidential. You will not be able to be identified in any reports or publications.

The results of the research are likely to be published in 2013, you will be able to obtain a copy of publication from Marijana Baric. You can find contact information below.

This project has been ethically approved via Management School ethics review procedure.

Contact for further information:

*Marijana Baric*

*PhD Student*

*School of Management*

*University of Sheffield*

*9 Mappin Street*

*Sheffield S1 4DT*

*E-mail: m.baric@sheffield.ac.uk*

Thank you for taking part in the project!

**Participant Consent Form**

|  |
| --- |
| Title of Research Project: **The Informal Economy in Croatia: A Social Exchange Perspective**  Name of Researcher: **Marijana Baric**  Participant Identification Number for this project: Please initial box   1. I confirm that I have read and understand the information sheet dated explaining the above research project and I have had the opportunity to ask questions about the project. 2. I understand that my participation is voluntary and that I am free to withdraw at any time without giving any reason and without there being any negative consequences. In addition, should I not wish to answer any particular question or questions, I am free to decline. 3. I understand that my responses will be kept strictly confidential (only if true). I give permission for members of the research team to have access to my anonymised responses. I understand that my name will not be linked with the research materials, and I will not be identified or identifiable in the report or reports that result from the research. 4. I agree for the data collected from me to be used in future research 5. I agree to take part in the above research project.   \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  Name of Participant Date Signature  (*or legal representative*)  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  Name of person taking consent Date Signature  (*if different from lead researcher*)  *To be signed and dated in presence of the participant*  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  Lead Researcher Date Signature  *To be signed and dated in presence of the participant*  Copies:  *Once this has been signed by all parties the participant should receive a copy of the signed and dated participant consent form, the letter/pre-written script/information sheet and any other written information provided to the participants. A copy of the signed and dated consent form should be placed in the project’s main record (e.g. a site file), which must be kept in a secure location.* |