

## 6.1. The prevalence of envelope wages and the fear of unemployment

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There are different types of undeclared work. A worker can be (a) employed by an unregistered business, (b) employed illegally by a registered business, (c) employed legally by a registered business and receive one part of their wage declared to the tax authorities and the other part as an undeclared envelope wage. If a worker is not employed by the company although effectively works there and receives his/her payment against a VAT invoice issued by another company (typically his/her own) then this is considered a variant of case (b) or (c).

This chapter explores whether the crisis has had an impact on the prevalence of envelope wages and it also looks at the relationship between previous unemployment experience and workers' willingness to accept envelope wage payments. First, the potential effects of the crisis will be discussed, then the data for the analysis, and finally the main findings will be presented.

In terms of undeclared work, registered businesses could have responded to demand and supply shocks associated with the crisis or unrelated government shocks (such as the increase of the minimum wage, statutory pay increases etc.) in a number of ways: 1) they laid off some of their workforce and "re-employed" them illegally, 2) increased the share of envelope wage payments within the workers' pay package, or 3) they increased the proportion of undeclared workers against declared workers, in extreme cases they froze hiring legally and only took on undeclared workers who were then paid envelope wages. All three adjustment strategies lead to the increase of envelope wage payment both in terms of prevalence and amount.

On the contrary, it might also be argued that the crisis and government measures had a negative impact not only on companies that register their employees but on the undeclared labour market as well. Demand for the products of businesses employing undeclared workers also *declined* despite their relative advantage in terms of labour cost compared to their competitors that employ registered workers

(to a greater extent). Furthermore the decline in the share of undeclared work might also be associated with *sectoral* factors: due to the decline in consumption (particularly consumer services characterised by high under-reporting) and its stagnating at a lower level than before the crisis, or the collapse of the construction industry in Hungary, companies that relied more heavily on undeclared work might have been more likely to leave the market or reduce the number of their (undeclared) workers.

However, another possibility is that the flat income tax introduced in 2011 might have created incentives for declared as opposed to undeclared work for both employers and – particularly higher-paid – employees through the reduction of the tax wedge and no changes in the probability of inspection. These potential effects could have reduced the prevalence and extent of envelope wage payments.

The sum of the various effects can only be established with empirical analysis using multiple data sources. This chapter presents the relevant findings of two surveys that can provide useful information for further economic analysis. The first survey took place in 2008 and the second in the spring of 2012, both using a sample of 1,000 adults from the general population aged between 18 and 60 years.<sup>\*</sup> Data was representative and homogeneous in terms of gender, age groups and type of settlement in both surveys.

Results suggest that at least 14.6% of 18–60 year olds received envelope wage payments at least once in the previous two years in 2008, while the same figure was 14.4% in 2012 – therefore the situation has not changed over the past four years. The survey also asked those who received part or all of their pay as an envelope wage to estimate the share of their last such pay within their total net earnings. Again, there were no considerable changes compared to the situation before the crisis: 29 per cent said that they received less than a quarter of their net earn-

<sup>\*</sup> For the questionnaires and main characteristics of the surveys see link in the on-line version.

ings as an envelope wage payment, 17 per cent said less than half, eight per cent said no more than three quarters, three per cent said more than that but not their total pay, and 44 per cent stated that they received their total pay as an envelope wage.

There were various changes in the relationship between the prevalence of envelope wage and the characteristics of workers over the past four years; however the direction and strength of correlations often remained the same. For example, receiving envelope wage payments was more common among men (18–19%) than women (11%) both in 2008 and 2012.

Similarly, the willingness to accept envelope wage payments was consistently associated with previous unemployment experience. While 9 per cent of respondents who had never been unemployed received envelope wage payment in 2008 and 2012, 22 per cent of those who had experienced unemployment before said that they had received envelope wage payments within the previous two years.

With regards to other factors, there were some changes. In 2008 envelope wages were significantly more prevalent among workers in Budapest (19%) than those in the countryside (14%); by 2012 the situation changed and they became less prevalent in Budapest (12%) and increased somewhat among those living in the countryside (15%). There were similar changes in the age groups of workers: while in 2008 envelope wages were more common in the age group under 30 (21%) and 30–44 (16%) (their prevalence being 9% above 45), in 2012 the prevalence of envelope wages was high only among young people (20%) and in the other two age groups it was 13%.

Looking at the characteristics of people who take up undeclared work in the 2008 survey, it emerges that envelope wage payment was particularly common in a clearly defined group of workers (those avoiding poverty) – see *Fazekas et al. (2012)*. This group is characterised by not having any assets apart from the property where they live, have a low level of education, work in semi-skilled or vocational jobs and often they or one of their family members has already experienced unemployment. People in this group move between a) legal employment with fully declared pay, (b) undeclared work and (c) unemployment. This highlights the link between unemployment and the prevalence of envelope wages. It can be assumed that the acceptance of undeclared or mixed pay is heavily influenced by the risk of unemployment. If there is such risk or it is higher, then the worker is more likely to accept envelope wage payments as well. The risk of unemployment was measured by asking the question “have you ever been unemployed since you first started working?” and the number of months in work during the previous year. The analysis of this relationship on the pooled database of 2008–2012 shows a correlation in the expected direction between past unemployment and receiving envelope wage payments (the probability of this is 2.7–3.2 times higher). The same result is obtained if gender, education, type of settlement and age are included in the analysis as control variables.\*\*

\*\* For detailed results see link in the on-line version.

## 6.2. Minimum wage or minimum tax?

MIRCO TONIN

What is the interaction between minimum wage legislation and the underreporting of earnings? *Tonin (2011)* looks at this issue by investigating the massive minimum wage increase that took place in Hungary in 2001, when the statutory monthly minimum wage was increased from 25,500 HUF (98 EUR or 90 USD using the average exchange rate for 2000) to 40,000 HUF (156 EUR or 140 USD using the average exchange rate for 2001).

The basic idea is that the minimum wage can have an impact on compliance, as it usually represents the smallest possible amount that has to be declared to be in the official economy. The impact is similar when declaring a sub-minimum amount is permissible, but attracts higher scrutiny by the tax authority (*Tonin, 2013a*).

In an environment in which firms and workers can collude to report to the fiscal authorities an