

## SHADOW ECONOMY AND UNDECLARED WORK

The shadow economy **includes those economic activities and the income derived thereof that circumvent or avoid government regulation or taxation**. A large share of the shadow economy is undeclared work which refers to the wages that workers and business do not declare to avoid taxes or labour market regulation. The rest is represented by business underreporting income to avoid taxation.<sup>1</sup>

### 1. Key statistic indicators

The fact that undeclared work is not observed or registered, and it may be defined differently in national legislation, makes it **difficult to obtain reliable estimates** of how widespread it is across Member States. At EU level, undeclared work is defined as "*any paid activities that are lawful as regards their nature but not declared to public authorities, taking into account differences in the regulatory system of Member States*".<sup>2</sup> Assessing the extent and features of undeclared work is indispensable in order to put in place appropriate policy measures.

There are **no aggregated data on undeclared work at EU level**. Different methods exist to approach and measure undeclared work and there have been several attempts to measure the phenomenon. As stated in the COM (2007)628: "*Undeclared work can be measured both directly and indirectly. Indirect methods are based on the comparison of macroeconomic aggregates (such as national accounts, electricity consumption, cash transactions). Indirect (especially monetary) methods often over-estimate the level of undeclared work and say little about its socio-economic characteristics. Direct methods, on the contrary, are based on statistical surveys and have advantages in terms of comparability and detail, but tend to under-report the extent of undeclared work.*"

**Caution has to be taken when using indirect methods as there is wide agreement among experts that they over-estimate undeclared work and measure the whole shadow economy**. Data on the size of the shadow economy (as presented in the first column of Table 1 in the Annex) are based on indirect methods and include undeclared work and underreporting of income. Although the methodology faces strong criticism and should not be taken as producing uncontested values, the results have the advantage of coming from the consistent application of a methodology across Member States and over time allowing for a basis for identifying trends in the phenomenon. According to this methodology, Bulgaria, Romania, Lithuania, Estonia, Latvia, Cyprus, Malta and Greece are estimated to have the highest levels of shadow economy, with levels ranging from 25% in Greece to 31.9% in Bulgaria in 2012.

The **results of available estimates differ a lot depending on the methodology used**, and e.g. in the case of Estonia it varies from 4% (estimate of the national Statistical Office) to around 28% (in Schneider 2012). Therefore the results of the work should be viewed against the policy settings in Member States that could set more or less favourable conditions for the shadow economy. The report "Tax Reforms in EU Member States 2012", published by the European Commission, states that the **available results only provide an indication of the extent of the problem and the development over time, so that the levels should not be taken as an absolute measure of the phenomenon**<sup>3</sup>.

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<sup>1</sup> Schneider (2011), The Shadow Economy in Europe 2011.

<sup>2</sup> COM(2007) 628

<sup>3</sup> See page 74 (section 5.3.1) in European Commission (2012), Tax reforms in EU Member States, Taxation Paper 34 and European Economy 6/2012 ([http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/gen\\_info/economic\\_analysis/tax\\_papers/taxation\\_paper\\_34\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_34_en.pdf), [http://ec.europa.eu/economy\\_finance/publications/european\\_economy/2012/ee-2012-6\\_en.htm](http://ec.europa.eu/economy_finance/publications/european_economy/2012/ee-2012-6_en.htm)).

Based on a different method and a different definition, the World Bank's research on informal workers<sup>4</sup> suggests a decline in the total informal economy, the latter including depended work without a contract, informal self-employment and unpaid family work. According to this research, countries of Southern Europe are estimated to have the highest levels of total informal economy, with levels ranging from 18.8% in Spain to 53% in Cyprus. In addition Ireland, UK, Poland and Austria have high levels of informal economy with 33.0%, 21.7%, 21.6% and 19.7% respectively.

**Direct survey based methods of measurement have advantages in terms of comparability and detail, but tend to under-report the extent of undeclared work.**

Another important source is the European Employment Observatory, which collected national data in 2004 and 2007 for the share of undeclared work. The data is collected using different source in different Member States<sup>5</sup> and, therefore, the reported national data for undeclared work are **not fully comparable across countries**. However, they provide a useful alternative. The divergences between indicators stress the need for cautious assessment. The data for undeclared work points to a great deal of heterogeneity with estimates ranging from 2% to 30%. The estimated size of undeclared work is usually significantly lower in the reported national data compared to alternative measures of the shadow economy.

According to the Special Eurobarometer on undeclared work<sup>6</sup> which was based on interviews with EU citizens, the total share of citizens who said they performed undeclared work was 5% in 2007, but variations existed among countries. The European Commission launched a new Eurobarometer survey on undeclared work in 2013. The comparability of the questionnaire with the Eurobarometer 2007 will allow comparison of the trends observed since the onset of the crisis.

## **2. Assessment of the main challenges in the Member States**

Shadow economic activity and undeclared work have negative implications which affect macro-economic objectives as well as quality and productivity of work and social cohesion. From a macroeconomic perspective, they **decrease tax revenues** (income tax and VAT) and undermine the financing of social security systems. From a microeconomic perspective, undeclared work tends to **distort fair competition** among firms, paving the way for social dumping inhibiting the creation of regular employment with full social protection. It also causes **productive inefficiencies**, as informal businesses typically avoid access to formal services and inputs (e.g. credit) and do not grow.

A number of factors have contributed to concerns over a growing scope for undeclared work:

- the growing demand for household and care services as a result of socio-demographic changes, possibly in combination with working time reduction;
- the trend towards smaller and less hierarchical working relationships with more flexible pay systems or time accounting;
- self-employment (including false self-employment) and sub-contracting and, more generally, flexible contracts and on-call work, when they are misused for non-declaration of part of the revenue;
- the growing ease of setting up cross-border groupings of enterprises, which require efficient international cooperation between monitoring and enforcement bodies and/or systems.

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<sup>4</sup> WB's research working paper 5912 on "Informal Workers across Europe": Michails Hazans, December 2011; for measurement issues see section 2.1 and tables 1 and 2.

<sup>5</sup> Depending on availability, these figures are based on micro surveys, labour-force survey studies, macro studies or other available information.

<sup>6</sup> [http://ec.europa.eu/public\\_opinion/archives/ebs/ebs\\_284\\_en.pdf](http://ec.europa.eu/public_opinion/archives/ebs/ebs_284_en.pdf)

The situation of the economy also plays a crucial role in people's decision to work in the shadow economy. In a booming economy, people have a lot of opportunities to earn a good salary in the official economy. This is not the case in an economy during a recession; when more people might try to compensate their income losses through additional shadow economy activities.

The transformation of undeclared work (UDW) into formal work is an important issue for the current employment policy of the European Commission, and represents an important step towards job creation and the fulfilment of the employment targets of the Europe 2020 strategy. In order to catalyse progress towards the employment target<sup>7</sup>, the Commission adopted the Flagship Initiative "An agenda for new skills and jobs"<sup>8</sup>, where the promotion of job creation is a key action. In this context the move from informal or undeclared work to regular employment was highlighted.

The Employment Package<sup>9</sup>, adopted in April 2012, carries forward the actions presented in the abovementioned EU 2020 flagship initiative. In the communication "Towards a job-rich recovery" the Commission stresses that employment policies help to create conditions favourable to job creation and that transformation of informal or undeclared work into regular employment could have a positive impact on labour demand

The European Commission also promotes other initiatives which are related directly or indirectly with undeclared work, such as on taxation and anti-fraud policy or on immigration policy (notably Directive 2009/52/EC on sanctions for employers of illegally staying third country migrants, the posting directive)<sup>10</sup>. The 2013 AGS recommend that tax compliance should be improved through systematic action to reduce the shadow economy, combat tax evasion and ensure greater efficiency of tax administration.

### 3. Horizontal issues

Preventing and deterring undeclared work are primarily tasks of the Member States. To tackle undeclared work, Member States apply a series of measures, including a mix of preventive and detection/deterrence measures targeted at the reduction of the attractiveness of undeclared work, administrative reform and simplification and strengthening the surveillance and sanction mechanisms. In 2012 EUROFOUND presented an overview of the policy approaches and measures that have been implemented in the EU Member States (EU27) and Norway to tackle undeclared work since the beginning of the recession in 2008<sup>11</sup>.

However, currently there is no coherent approach on EU level to prevent and deter undeclared work and tax fraud. To these ends the Commission has launched several initiatives. First, in December 2012, The European Commission has adopted an Action Plan<sup>12</sup> setting out over 30 measures to combat tax fraud and tax evasion now and in the future. It includes concrete steps to help protect Member States' tax revenues against aggressive tax planning, tax havens and unfair competition. The priorities now are for Member States to make the necessary improvements to their national tax administrations and systems, to make full use of the existing European toolbox and to agree on new rules and instruments

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<sup>7</sup> 75% of 20-64 year olds in employment by 2020

<sup>8</sup> Communication from the Commission "An agenda for new skills and jobs: A European contribution towards full employment" COM 2010(682) of 23 November 2010

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010DC0682:EN:NOT>

<sup>9</sup> Communication from the Commission "Towards a job-rich recovery COM (2012)173 of 18 April 2012

<http://ec.europa.eu/social/main.jsp?langId=en&catId=101&newsId=1270&furtherNews=yes>

<sup>10</sup> The adoption of the legal instrument establishing a European platform to fight undeclared work is foreseen in the CWP 2013 (2nd Semester 2013).

<sup>11</sup> EUROFOUND (2012), EU MS and Norway fact sheets on estimates and approaches to measure undeclared work.

<sup>12</sup> Communication from the Commission "An Action Plan to strengthen the fight against tax fraud and tax evasion", COM(2012)722,

[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/tax\\_fraud\\_evasion/com\\_2012\\_722\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/com_2012_722_en.pdf)

where relevant. Second, in line with its 2012 Employment Package<sup>13</sup> it has also launched in 2013 an initiative on enhancing EU cooperation in the prevention and deterrence of undeclared work with the aim of enhancing cooperation at EU level between all enforcement bodies, such as labour inspectorates, social security, tax and migration authorities, whose aim is to track, prevent and sanction undeclared work. Finally, The Commission is ready to provide targeted support and technical assistance to any Member State that needs it to strengthen its tax system against evasion, and improve tax collection. In Greece, for example, the Task Force for Greece, together with experts from Member States, is actively engaged in helping build a more robust tax system to deliver quality revenues, and positive results are already beginning to emerge.

Measures that can reduce the size of the shadow economy include the following<sup>14</sup>:

- Reducing the financial attractiveness of undeclared work through better design of tax and benefit systems, and stricter controls in the social protection system with regard to the performing of undeclared work:
  - ensuring adequate levels of income support, recognition of the link between rights and contributions, by controls on welfare beneficiaries and adequate financial sanctions for tax and social security fraud;
  - monitoring areas such as (i) the impact of taxation on overtime work, (ii) the respect of minimum wages or wages set by collective agreements and their possible role as levels of reference for envelope wages, (iii) tax distortions between the status of employee and self-employed, and (iv) the reduction of fiscal burden on low skilled jobs (v) perceived fairness of the tax system.
- Administrative reform and simplification should be targeted to reducing the cost of compliance with regulations:
  - further improvement of labour law and administrative systems to better cope with short-term needs and shortages in the labour market;
  - improving national strategies on (joint) inspections;
  - sector-specific approaches to transform undeclared work into regular work (especially in hotels and restaurants, agriculture, home services);
  - enforcement of the Community *acquis* on the free movement of workers;
  - further exploiting the possibilities of e-government, on-line registration and exchange of information between administrative databases;
  - The use of electronic payments for purchases over a certain threshold could be made mandatory.
- Strengthening the surveillance and sanction mechanisms will have to rely on the involvement of labour inspectorates, tax offices and social partners:
  - exemptions from the practice of written labour contracts should be limited to the minimum;
  - sector-specific solutions to control and regularise undeclared work with the involvement of the social partners;
  - cooperation between the various bodies in charge of tax, labour, and immigration, as well as on the enforcement of legislation and sanctions.

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<sup>13</sup> COM(2012)173

<sup>14</sup> For a discussion of measures to combat the shadow economy see Jensen and Woehlbier (2012), Improving tax governance in EU Member States: Criteria for successful policies, European Economy, Occasional Papers 114.

- Higher penalties for undeclared work could have a deterrent effect
- Legislation can be enforced at national level aimed to consider the purchase of undeclared work as a criminal activity.
- Trans-national cooperation between Member States :
  - enhancing cooperation at EU level between enforcement bodies, such as labour inspectorates, social security, tax and migration authorities;
  - sharing best practices, identifying common principles, promoting exchanges of staff and joint training, facilitating joint controls and improving the knowledge and measurement of the phenomenon of undeclared work.
- Awareness raising activities:
  - increasing awareness among the public on the risks and costs to society linked to undeclared work, particularly as far as sanctions are concerned; social partners have a key role to play in this respect;
  - informing citizens about the positive effects of full payment of taxes and informing them about the insurance nature of social security contributions

**ANNEX**

**Table 1: Estimated size of the shadow economy and undeclared work in the EU**

<b>Country</b>	<b>Size of shadow economy (in % of GDP), 2012<sup>1</sup></b>	<b>Undeclared work (share of GDP or employment), 1995-2006<sup>2</sup></b>	<b>Country data or estimations<sup>3</sup></b>	<b>World Bank research<sup>4</sup> (% of extended labour force)</b>
Austria	7.6	2	No data	19.7
Belgium	16.8	6-10	No data	10.5
Bulgaria	31.9	22-30	20% of GDP (2011)	13.2
Cyprus	25.6	4.2	19.1% (2012)	53.0
Czech Republic	16.0	9-10	No data	12.5
Denmark	13.4	3	No data	11.5
Estonia	28.2	7-8	8% (2011)	9.8
Finland	13.3	4.2	No data	11.2
France	10.8	4-6.5	No data	10.3
Germany	13.3	7	No data	11.9
Greece	24.0	25	36.3% (2012)	46.7
Hungary	22.5	15-20	16-17% (2006)	9.4
Ireland	12.7	NA	No data	33.0
Italy	21.6	12	12.1% (2011)	22.4
Latvia	26.1	18	No data	8.0
Lithuania	28.5	16-18	No data	6.4
Luxembourg	8.2	NA	No data	No data
Malta	25.3	25	No data	No data
Netherlands	9.5	2	No data	12.6
Poland	24.4	12-15	4.6% (2010)	21.6
Portugal	19.4	5		22.4
Romania	29.1	16-21	31.4% (RO Trade Unions)	11.8
Slovakia	15.5	13-15	No data	12.2
Slovenia	23.6	17	No data	14.1
Spain	19.2	12	17% (2011)	18.8
Sweden	14.3	5	No data	8.2
United Kingdom	10.1	2	No data	21.7
EU-27 (weighted average)	14.9	7.2	No data	No data
EA-17 (weighted average)	15.0	8	No data	No data

*Source: 1: Schneider, F. (2012), "Size and development of the Shadow Economy from 2003 to 2012: some new facts", 2: European Commission (2004, 2007), European Employment Observatory Review, Spring 2004 and Spring 2007, 3: EUROFOUND (2012), EU MS and Norway fact sheets on estimates and approaches to measure undeclared work. 4: WB's research working paper 5912 on "Informal Workers across Europe": Michails Hazans, December 2011*

**Note:** The size and development of the shadow economy is calculated with the MIMIC estimation procedure. The currency demand approach was used for Austria, Germany and Poland. Averages are GDP-weighted. For undeclared work, national data is collected by European Employment Observatory (EEO), Spring Review 2004 and 2007 (figures for Belgium, Italy and Lithuania are based on the articles on undeclared work from national EEO correspondents).

## Lessons learnt from Mutual Learning on Tackling undeclared work

As part of the Mutual Learning Programme under the European Employment Strategy (MLP), the European Commission and the Czech Ministry of Labour and social Inclusion organized a Peer Review in October 2012 in Prague on "Tackling undeclared work: developing an effective system for inspection and prevention".

The mutual learning highlighted the following phenomena associated with the diffusion of undeclared work<sup>15</sup>:

- Overall public perception and understanding have a strong influence on the level of UW.
- Whilst the nature of UW varies from one country to the other, there is a general negative perception that "undeclared work pays".
- Sectors that commonly make use of UW are those with high labour demand, particularly for low-skilled workers, and marginal value-added activities (construction, care services, agriculture, transport, wholesale/retail trade, personal services and seasonal work).
- At company level, micro, small and family-run businesses seem particularly susceptible due to their tight financial margins.
- At the individual level, young people, students, women and pensioners are at a greater risk of working illegally

The mutual learning activity also put forward a number of measures to address this challenge to be understood in terms of a process, from prevention and deterrence, through to detection, negotiation and finally action:

- Political willingness to tackle UW is paramount. Without it, the capacity and credibility of any measure can be severely undermined.
- A clear and robust legal framework is needed that clearly defines UW, gives authority to inspectorates and helps to enforce penalties.
- The role of labour inspectorates is central to monitor, control and penalise UW.
- There is a need for a strong cooperation between the different state authorities, and labour market actors.
- A balanced combination of activation measures, monitoring and sanctions can be effective in dissuading or preventing individuals from engaging in UW.
- National authorities will have to encourage a legal and economic incentives' framework to make 'declared work pay' in order to engage employers and individuals in the fight against undeclared work.

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<sup>15</sup> All host and peer country papers, executive summaries, and presentations prepared for the Peer Reviews have been published on the Mutual Learning Programme website [http://www.mutual-learning-employment.net/index.php?mact=PeerReviews,cntnt01,detail,0&cntnt01template=display\\_by\\_year&cntnt01year=2012&cntnt01orderby=start\\_date%20DESC&cntnt01returnid=59&cntnt01item\\_id=96&cntnt01returnid=59](http://www.mutual-learning-employment.net/index.php?mact=PeerReviews,cntnt01,detail,0&cntnt01template=display_by_year&cntnt01year=2012&cntnt01orderby=start_date%20DESC&cntnt01returnid=59&cntnt01item_id=96&cntnt01returnid=59)

### **Case studies on tackling undeclared work**

In a recent report EUROFOUND presented an overview of the policy approaches and measures that have been implemented in the 27 EU Member States (EU27) and Norway to tackle undeclared work since the beginning of the recession in 2008. It shows that while a 'deterrence approach', which seeks to increase the actual or perceived likelihood of detection and penalties, remains the dominant approach, many countries have begun to take more 'enabling' measures; some of these innovative policy measures could be transferable to other countries. A second key finding is that a strong correlation appears to exist between wider austerity measures being pursued and the size and growth of the undeclared economy.

A 'knowledge bank' of case studies on how to tackle undeclared work is available online in the Eurofound web page:

<http://www.eurofound.europa.eu/areas/labourmarket/tackling/search.php>

This 'knowledge bank' represents an important first step in producing a comprehensive learning hub, where social partners can pool and share knowledge, review evaluations of policy initiatives and explore their feasibility and transferability to other sectors and areas. A total of 100 initiatives are described, showing the different approaches, the potential effectiveness of the specific policy measures and their transferability capacity.

### **Joint management project between the Commission and the ILO**

A joint management project started with the ILO on "Labour Inspection strategies for combatting undeclared work in Europe" (covering ES, IT, FR, IE, BE, RO, NL). Its purpose is to consider the role that national labour inspection systems in the EU have as part of strategic policy response to undeclared work. In addition to country studies and a comparative study, a set of guidelines on labour inspection and undeclared work will be prepared by Mid-September 2013.