

## **Factsheet on Undeclared Work – ESTONIA**

### **1.1 Nature and Estimated Scale of Undeclared Work**

#### **1.1.1 Definition of undeclared work**

In principle, there is no official (positive) definition of undeclared work. The legislation stipulates rights and obligations regarding work and services and in-directly designates practices whereby workers, employees, service providers, employers avoid employment law, labour market regulations, tax and social security regulations and contributions.

In principle the same latent definition is followed by different institutions. However, while the labour law enforcement institution, i.e. Estonian Labour Inspectorate, focuses on regulation of labour market; tax and social security contribution collection and administration institutions, Estonian Tax and Customs Board focus on tax law.

#### **1.1.2 Characteristics of undeclared work**

The main features that link to undeclared work are working without a formal binding employment contract, envelope wages, and partially undeclared work in the form of replacing employment contracts with providing services via self-employment or a company. The last category points to dependent or false self-employment; 'para-subordinate workers' in contrast to genuine, real self-employment or entrepreneurship. It is motivated by differences in taxation of labour and services in Estonia. It results in undeclared work where a portion of the employee's salary from a formal employer (usually the minimum salary) is paid officially while the remaining salary is paid as business income to benefit from significantly lower tax contribution.

Following the poll of Estonian Chamber of Commerce in 2016 (336 respondents) the three main incentives for undeclared work within employers were<sup>1</sup>:

- a) High taxation rate (57.3%), personal income tax is 20%; social tax is 33% of gross earnings; unemployment insurance premium is 1.6% of gross earnings<sup>2</sup>) and corporate income (only distribution of profits are subject to income tax at the rate of 20 % of the amount of taxable payment.
- b) Cost saving and competitive advantage (42.7%), in sectors with very tight competition, like construction and food sector, envelope wages are more common. This might be enforced by institutional settings. For instance, public procurement procedures give advantage to the lowest price, which leads construction companies to make public offers under the market price, i.e. already assuming that part of the payroll will be left undeclared. Envelope wages and labour tax avoidance are seen as significant competitive advantage, because it allows them to offer the cheapest price and therefore create win-win situations for buyers and sellers.

From employees perspective the reasoning of undeclared work is as following:

- a) Income concealment (37.5%), individuals are motivated to hide their real income to take up benefits and tax credits for people in employment, or might be interested in undeclared income in case they are obliged to pay for child support and they intend to avoid these obligations;
- b) Higher salary (9.5%), non-payment of taxes is seen as an easy way to increase personal or business income;
- c) Loss of unemployment benefits (4.5%).

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<sup>1</sup> [https://www.emta.ee/sites/default/files/kontaktid-ja-ametist/uudised-pressiinfo/pressimaterjalid/30\\_11\\_2016\\_umbrikupalkade\\_tulemused\\_koda\\_mta\\_v.pdf](https://www.emta.ee/sites/default/files/kontaktid-ja-ametist/uudised-pressiinfo/pressimaterjalid/30_11_2016_umbrikupalkade_tulemused_koda_mta_v.pdf)

<sup>2</sup> <https://www.emta.ee/eng/private-client/declaration-income/tax-rates>

According to the Estonian Chamber of Commerce 2017 poll, the sectors where 'envelope wages' are most prevalent are construction, transport, HORECA, retailing, and industry. Also, most of the incidences are reported in small enterprises with up to 19 employees<sup>3</sup>.

Meriküll and Staehr (2010)<sup>4</sup> have estimated that firm-related characteristics, such as sectoral activity, firm size and employment changes, are important determinants of unreported employment in Estonia as well as in other Baltic states. According to the authors, many of the recipients of envelope wages may have few alternatives to accepting unreported employment. This indicates that individuals are often forced to accept fully or partly undeclared work, i.e. the situation is involuntary. Regular analysis of the undeclared economy by the Estonian Institute of Economic Research has indicated that about a half (37% in 2016) of people receiving undeclared salaries are not satisfied with this while just below half (47%) are satisfied with it<sup>5</sup>. In comparison with 2015 unsatisfied rate grew significantly, most of them (66%) are younger generations (aged 18-29). The same research indicates that the share of people satisfied with undeclared work is unequally divided in the society, i.e. geared towards older generations (aged 72), in rural areas and towards lower educated. However, the general attitudes among the working population are rather unsupportive of undeclared salaries as 62% of all working people do not favour payment of undeclared salaries in 2016. About 42% of undeclared wage receivers are afraid of losing their job in case they refuse undeclared work. However, the share is 49% among those who are not satisfied with receiving undeclared salaries, indicating that it is a forced choice for a considerable share of people receiving undeclared salaries.

### **1.1.3 Estimated scale of undeclared work**

The Estonian Tax and Customs Board have estimated based on administrative data that in first quarter of 2017 the share of undeclared work was under 4.59% of workers<sup>6</sup>. Also, the Estonian Institute of Economic Research has estimated based on cross-sectional survey that the share of 'envelope wages' in 2016 has remained at between 7% and 10%. In 2016 the estimated tax loss from envelope wages was round EUR 109 million, which in comparison with 2015 was 32.7% (50 million) less. Compared to the last year the number of employees that received envelope wages decreased by 1,821 to 34,297.

Williams and Horodnic (2015)<sup>7</sup> have estimated (using Eurobarometer 2013 survey data) that 5% of employees are paid envelope wages, that the median percentage of gross

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<sup>3</sup> [http://www.emta.ee/sites/default/files/kontaktid-ja-ametist/uudised-pressiinfo/pressimaterjalid/22.05.2017\\_pressikonverents.pdf](http://www.emta.ee/sites/default/files/kontaktid-ja-ametist/uudised-pressiinfo/pressimaterjalid/22.05.2017_pressikonverents.pdf)

<sup>4</sup> Meriküll, Jaanika, and Karsten Staehr. 2010. 'Unreported Employment and Envelope Wages in Mid-Transition: Comparing Developments and Causes in the Baltic Countries', *Comparative Economic Studies* 52 (4): 637–70. doi:10.1057/ces.2010.17.

<sup>5</sup> Estonian Institute of Economic Research 2016. *Varimajandus Eestis 2016* (elanike hinnangute alusel). Tallinn, 2016 (title in English: *Shadow Economy in Estonia 2016*). Internet:

[https://www.mkm.ee/sites/default/files/varimajandus\\_eestis\\_2014\\_elanike\\_hinnangute\\_alusel\\_.pdf](https://www.mkm.ee/sites/default/files/varimajandus_eestis_2014_elanike_hinnangute_alusel_.pdf)

<sup>6</sup> [http://www.emta.ee/sites/default/files/kontaktid-ja-ametist/uudised-pressiinfo/pressimaterjalid/22.05.2017\\_pressikonverents.pdf](http://www.emta.ee/sites/default/files/kontaktid-ja-ametist/uudised-pressiinfo/pressimaterjalid/22.05.2017_pressikonverents.pdf)

<sup>7</sup> Williams, C. C., and I. A. Horodnic. 2015. 'Evaluating the Prevalence of the Undeclared Economy in Central and Eastern Europe: An Institutional Asymmetry Perspective', *European Journal of Industrial Relations* 21 (4): 389–406. doi:10.1177/0143831X14568835.

salary paid as envelope wages is 40% and the tax morality index<sup>8</sup> is 2.82, which is the average for CEE countries and indicates that attitudes towards non-compliance behaviours are generally unaccepting.

Also, Paulus (2015)<sup>9</sup> have estimated (using income survey data linked with tax records at the individual level) that about 12% of wages and salaries in total are under-reported, and that people in the bottom and the top part of the earnings distribution evade much more.

## **1.2 Institutional Framework**

### **1.2.1 Responsibilities for addressing undeclared work**

Addressing undeclared work is the focus of two main institutions in Estonia: the Estonian Labour Inspectorate, and the Estonian Tax and Customs Board. The former focuses on making employment rights effective, including tackling undeclared work; the latter is responsible for collecting tax revenues. Additionally, administrators of social and unemployment insurance could have a role in identifying and tackling undeclared work. The eligibility criteria of these benefits are related to factual declared employment and payment of taxes, thus during the application cases of undeclared work could emerge and information could be used by the Labour Inspectorate or the Tax and Customs Board to enforce the legislation.

### **1.2.2 Characteristics of the responsible organisations**

**The Estonian Labour Inspectorate** is a government agency working under the authority of the Ministry of Social Affairs. The main tasks of the Inspectorate are implementation of work environment policy, national supervision of requirements of legal acts regulating health and safety at work and labour relations in the work environment, notification of the general public, employees and employers about hazards in the work environment, and resolution of individual labour disputes at an extra-judicial labour dispute resolution body. In the Inspectorate, the Supervision Department is responsible for making employment rights effective and supervision of requirements of legal acts regulating labour relations and the working environment. About 52 labour inspectors are working in this department.

The area of activity of the **Estonian Tax and Customs Board** includes administration of state revenues, implementation of national taxation and customs policies and protection of society and legal economic activities. The Board has a directing function and exercises state supervision and applies enforcement powers of the state on the basis and to the extent prescribed by tax legislation. The Board is accountable to the Minister of Finance who directs and coordinates its activities and exercises supervisory control over it. Departments of the Board are: 1) Administration Department; 2) Legal Department; 3) Audit Department; 4) Tax Department; 5) Personnel Department; 6) Internal Control Department; 7) Intelligence Department; 8) Service Department; 9)

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<sup>8</sup> In the analysis, to identify the level of population tax morale, Eurobarometer survey data were analysed, In the survey, six attitudinal questions were asked regarding how people rate the acceptability of various types of shadow work on a 10-point Likert scale (where 1 means absolutely unacceptable and 10 means absolutely acceptable). The index for each nation is calculated using the mean score across these six attitudinal questions. It is important to keep in mind that all scores are closer to 1 (totally unacceptable toward non-compliance behaviours) than 10 (attitudes reflecting total acceptance of non-compliance). Even for those, who receive envelope wages in CEE countries, the median score is 3.83.

<sup>9</sup> Paulus, Alari. 2015. 'Tax Evasion and Measurement Error: An Econometric Analysis of Survey Data Linked with Tax Records', ISER Working Paper Series 2015-10. Institute for Social and Economic Research. <https://ideas.repec.org/p/ese/iserwp/2015-10.html>.

Customs Department; 10) Revenue Department; 11) Investigation Department. The Board has its central office in the capital Tallinn, and regional offices across Estonia.

### **1.2.3 Cooperation and collaboration between authorities and cross-border authorities**

The main cooperation model/tool on undeclared work is the 'Employment register'. Since 1 July 2014, all people who are employed or who are working on a voluntary basis in Estonia must be registered by employers in the new employment register.

On the one hand, the register should reduce undeclared work and increase tax revenue by requiring registration of employees before the actual employment starts, and by making the supervision by taxation officials easier. On the other hand, the purpose of the register is also to increase the amount of electronically gathered data for administrative decisions and to ease the data exchange between different state institutions. The employment register is also the basis for determining the employment related social guarantees (health insurance, pension, and unemployment insurance premiums) and for supervision over the fulfilment of the employment related obligations. The database is used by:

- The Estonian Tax and Customs Board for monitoring the tax liabilities of taxable persons;
- The Labour Inspectorate for making entries into the register on the basis of the decision of the labour dispute committees;
- The Estonian Unemployment Insurance Fund for verification of employment status and registration of persons as unemployed or moving back into work, and for granting unemployment allowances and other unemployment insurance benefits;
- The Estonian Social Insurance Board for verification of employment status and granting different benefits;
- The Estonian Health Insurance Fund for verification of employment status and granting health insurance benefits; and
- The Police and Border Guard Board for exercising supervisory control over the working conditions of foreigners.

Also, every worker can check the system to make sure that the employer has registered them correctly, payments are declared and all taxes are paid. The register data is available for all public bodies requiring employment related information. The objective of the implementation of this system is to avoid multiple submission, collection and processing of the data and to reduce the administrative burden of the employers as well as of the public agencies.

Additionally, the Labour Inspectorate and the Estonian Tax and Customs Board cooperate by sharing case-by-case information on establishments and employers that are suspected of infringing employment and tax law. Also, the Labour Inspectorate and the Police and Border Guard cooperate by carrying out joint inspections based on a cooperation agreement and plan for detection of illegal employment and cases of labour exploitation (e.g. trafficking).

Cooperation with other Member States is mostly based on data sharing. The Estonian Tax and Customs Board shares data with other tax authorities based on the council directive 2011/16/EU and council regulation 904/2010/EC on administrative cooperation in the field of direct taxation. There are also number of bilateral agreements<sup>10</sup> for the avoidance of fiscal evasion with respect to taxes on income and capital. These regulations stipulate both automatic exchange of information and also case by case exchange of information on possible employment relations and tax obligations.

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<sup>10</sup> See internet: <http://www.emta.ee/eng/business-client/income-expenses-supply-profits/international-agreements/conventions-avoidance-double>

Additionally, the Labour Inspectorate cooperates with other member state authorities in case the undeclared work is related to posting of workers in the framework of the provision of services as stipulated in the Directive 96/71/EC. In these cases, the Inspectorate shares the available administrative data or additionally carries out inspection to gather evidence.

### **1.3 Policy Focus and Measures**

#### **1.3.1 Policy approach**

Different policy measures tackle undeclared work, including increasing commitment via awareness-raising and information campaigns to inform workers about the risks, and deterrence approaches that detect and punish non-compliance. Since 2017 a greater effort is being directed to encouraging people and businesses to work legitimately or to help those already participating in undeclared work to legitimise their activities.

#### **1.3.2 Measures to tackle undeclared work**

**Enabling compliance - fostering commitment via awareness rising.** The Estonian Tax and Customs Board have launched a campaign website<sup>11</sup> to inform workers and employers about 'envelope wages' and undeclared work. The key message is that these practices are illegal, introduce unhealthy competition and paralyse Estonia's development and the good functioning of society as a whole. In regard to information sharing, the website includes a calculator that estimates loss of income in cases of social risks like unemployment, parental leave, and sickness absence. Also, there are complementary channels of communication, including radio, to raise the awareness.

**Deterrence - improving detection.** Since 1 July 2014, employers are obliged to register their employees in the employment register, which gathers information about employments. All businesses who provide work are required to register the persons employed by them in the register irrespective of the form or the length of the contract. In addition, data on people working on a voluntary basis must also be recorded in the employment register. Hence, all people doing some kind of work must be registered. The employment must be registered at the moment the employee starts working in order to avoid the 'first day of employment' excuses. The termination of employment must be registered within 10 calendar days. Registration is possible via The Board's website, via personnel management programmes of a company or agency or by visiting the bureau of the Estonian Tax and Customs Board in person. It is also possible to use a simplified procedure for first registration by telephone or text message, although it must be supplemented within seven calendar days to be complete. If the employer does not register the start or the end of employment as required, the tax authority may claim penalty payment of maximum EUR 3,200.

Both the Labour Inspectorate and the Tax and Customs Board have carried out targeted control of enterprises for tax avoidance and undeclared work. The activities include inspection visits to company and work sites as well as notification letters. The objective is to prevent the infringement of tax laws and raise law-abiding behaviour among tax payers, thus instead of burdening employers and administrators with offence procedures in the first instance they are given the opportunity to revise their business activities and change them in accordance to the law. In these letters, the companies are asked to revise their accounting and tax related information and give feedback to the tax authority on the results of their business activities. The notification letters give companies a certain time to improve their tax behaviour. In those companies who do not improve their tax behaviour or cannot give satisfactory reasons to the results of their business activities, a control of tax payments and accounting are initiated.

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<sup>11</sup> See internet: <http://www2.emta.ee/palk/>

In the competence of the Labour Inspectorate is to find out whether employees have been notified of working conditions in writing (i.e. amount of salary, taxes, description of duties, working time etc.) if not, the inspector has a right to make an injunction or start a misdemeanour proceedings. If the inspector suspects that the employer has not paid taxes on behalf of the employee or have not registered his/her employees, the inspector provides that information to Tax and Customs Board.

### 1.3.3 Closer cooperation with Social Partners

Estonia's Tax and Customs Board newly adopted strategy for 2017 – 2020 foresees measures for taxpayers awareness raising including deeper cooperation with all social and cross-industry partners on all tax matters.

#### Bogus Self-Employed

- Counselling, analysis of companies with potential risk, first contact by phone, following subsequent counselling activities including correspondence and meetings with companies;
- Cooperation with Estonian Auditor's Association and formation of a working group;

#### Estonian Association of Construction Entrepreneurs

Cooperation for elaborating new provisions to the Public Procurement Act, according to which when submitting a tender, supplier should provide evidence of its six-month wages, if they are not 70% of sectors average, the organizer of tender is obliged to ask for an explanation and can eliminate such supplier from procurement.

#### Estonian Association of Security Entrepreneurs

In order to combat envelope salaries, undeclared work and underestimated bids in public procurement, the members of the association gave their agreement on disclosure of their detailed tax data, which is used to ensure fair competition and could serve as a starting point for concluding collective agreements in the area of Security services. In cooperation with Tax and Customs Board, members formed a working group, which is dedicated to sectoral analysis, counselling and prevention of possible labour risks.

### 1.3.4 Good practice

There are no policy evaluations on interventions for tackling undeclared work. However, the **Employment Register** would be considered good practice on the grounds that it is a new/innovative measure in the Estonian policy mix that is expected to increase compliance with the labour and taxation regulations. Overall, the employment register has been well accepted by employers and employees (both the Estonian Trade Union Confederation ([EAKL](#)) and the Estonian Employers' Confederation ([ETTK](#)) welcomed the register). It is much easier for employers to register their employees and for the taxation officials to perform supervision, compared to the previous system. State institutions have now more information without the need to require additional documents from persons, hence the register reduces administrative burden.

Since the implementation of the register as of July 2014 up to June 2015, tax revenue has increased around EUR 11.8 million and the number of persons that received declared income increased by 21,000 persons.

However, there are doubts whether the declared wages are correct, as they are mostly around national minimum wage. Hence, it is assumed that full undeclared work and wages is being replaced by partial undeclared wages. Moreover, on construction sites, people have been registered as 'volunteers' who do not seem credible and show that some employers still try to find ways to cheat the system. Although these 'volunteers'

account for only around 0.2% of all employees, the taxation officials consider it as a serious problem.

### **1.3.5 Challenges and barriers**

According to the study, Shadow Economy in Estonia 2016<sup>12</sup>, 42% of those not satisfied with receiving envelope wages self-reported that they would have lost their job if not doing so. It follows that job and employment security are a crucial push factor of envelope wages and undeclared work. According to the same study, 13% of workers report that they are not against envelope wages and 25% do not have an opinion whether they are in favour of or against these practices. The main reasons for supporting envelope wages are too costly tax burden for employees (67% of those in favour), it is an option for higher income (64% of those in favour) and too costly tax burden for employers (64% of those in favour). These self-reported considerations show that there is a considerable share of undeclared work cases that could be prevented by raising legal awareness and legal certainty.

As discussed above, the institutional factor of partial undeclared work is that the taxation of labour and capital is not proportional, favouring the latter. The incentives in the system motivate to provide services for another company as a juridical person through the person's own private limited company instead of arranging an employment contract. Both parties win from the situation, because if the worker would have an employment contract, then the employer would have to declare and pay social tax (33% of gross wage) and unemployment insurance premiums (0.8% of gross wage) on the remuneration. Since one company provides services to another company, employment taxes need not be paid and the entire remuneration is paid directly to the private limited company. The owner of the private limited company can then decide how much they would pay for themselves as salary and how much they would take out as dividends. In sum, this motivates partially undeclared where a portion of the workers income is received without paying all the taxes.

However, institutional factors could not explain the whole situation as labour market conditions and the economic situation also influence workers' and companies' preferences and behaviour. Prevalence of undeclared work tends to increase during the recession and reduction in labour demand.

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<sup>12</sup> Estonian Institute of Economic Research 2016, op. cit.