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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE
EUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE AND THE COMMITTEE OF THE REGIONS**

Stepping up the fight against undeclared work

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1. INTRODUCTION

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*". This definition¹ links undeclared work with tax and/or social security fraud and covers diverse activities ranging from informal household services to clandestine work by illegal residents, but excludes criminal activities. Undeclared work is a complex phenomenon influenced by a wide range of economic, social, institutional and cultural factors, but it is generally recognised that undeclared work tends to obstruct growth-oriented economic, budgetary and social policies.

Both employers (and consumers) and employees (and self-employed) may engage in undeclared work because of the potential gain — compared to the risk of being sanctioned — in avoiding taxes and social security contributions, social rights (minimum wage, employment protection legislation, leave entitlements) and the cost of complying with regulation (registration requirements, health and safety regulations). To the extent that undeclared work competes with and even crowds out activities which comply with regulations, it is the main source of social dumping. In the case of undeclared work performed by individuals who are receiving benefits compensating their inactivity, there is also a dimension of social fraud.

Undeclared work was already analysed in the Commission's 1998 Communication, which presented a review of its causes and impacts, and highlighted a few policy experiences. The Communication prepared the ground for an EU-wide policy debate on undeclared work, which culminated in the adoption of the common policy approach set out in the Employment Guidelines 2003-2005². These Guidelines advocated a balanced mix of prevention (notably through well adapted tax-benefit and administrative regulations) and awareness raising, sanctions and law enforcement. Such a policy mix was further articulated in the Council resolution of 29 October 2003 on transforming undeclared work into regular employment³, which also called for action by the social partners. Furthermore, the Communication was one of the elements inspiring the experiment launched in 2000 allowing for the reduction of VAT on specified labour intensive services⁴.

Against the background of the continued significance of the informal economy and the perceived growth in certain sectors (construction) and forms of work, concerns may be raised

¹ COM 98(219)

² OJ L197 of 5.8.2003 (specific guideline n° 9 on undeclared work).

³ OJ C 260/1 of 29.10.2003.

⁴ Directive 1999/85/EC, OJ L277, 28.10.1999 allowing Member States to reduce VAT on specified labour intensive services, such as renovation of private dwellings, hairdressing, window-cleaning, domestic care services and small repairs. This experiment was prolonged until 31.12.2010 by Directive 2006/18/EC, OJ L51, 22.2.2006, p.12.

as to the level of sustained political attention given to undeclared work. This Communication aims therefore to underline the policy relevance of undeclared work by taking stock of the actions undertaken in the Member States, and by illustrating the scope for mutual learning about successful practices. The analysis is also supported by new evidence from a harmonised survey developed in order to shed more light on the characteristics of and motives for undeclared work.

2. POLICY RELEVANCE OF REDUCING UNDECLARED WORK

The successful implementation of policies which aim at transforming informal work into formal forms of employment will contribute to the achievement of the main goals of the renewed Lisbon Strategy for growth and jobs.

Undeclared work has negative implications which affect all three pillars of the Lisbon strategy and in particular the over-arching objectives of the European Employment Strategy (full employment, quality and productivity at work and social cohesion). From a macroeconomic perspective, it decreases tax revenues and undermines 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. It also causes productive inefficiencies, as informal businesses typically avoid access to formal services and inputs (e.g. credit) and prefer to stay small.

The recent Green Paper on Labour Law⁵ identified undeclared work as the main contributing factor to social dumping and thus as one of the key issues for the modernisation of labour law in the EU. Moreover, undeclared work tends to be associated with poor working conditions for individuals and subsequent risks to workers' health, low prospects for career progress and insufficient social protection coverage. In this context, EU social partners have envisaged a joint analysis of undeclared work in the framework of their 2006–2008 work programme⁶. The subsequent consultation on the Green Paper⁷ revealed strong support from administrations for increased administrative cooperation at EU level and for wider exchange of information and good practice, whereas social partners and other stakeholders confirmed the policy priorities laid down in the 2003 Council resolution. Notably the trade unions favoured a better legal framework and enforcement at European level, in order to combat cross-border social fraud.

There is growing consensus on the cost of undeclared work to social security systems: not only is their financial basis weakened by the loss of revenue, but also public trust and credibility in these systems is undermined. Indeed, undeclared workers can often be entitled to unemployment, inactivity, or family benefit, but at the same time forego all the benefits of working with a formal contract, such as earnings-related pensions, training, the perspective of progressing in pay and status, and risk being persistently employed only in undeclared activities. Reforms of social protection systems can provide strong incentives to declare work, as highlighted in the 2006 Synthesis report on Adequate and Sustainable pensions⁸.

⁵ Modernising labour law to meet the challenges of the 21st century, COM (2006) 708 of 22nd November 2006.

⁶ Work Programme of the European Social Partners 2006 – 2008.

⁷ Outcome of the Public Consultation on the Commission's Green Paper "Modernising labour law to meet the challenges of the 21st century" (COM(2007)xxx).

⁸ SEC(2006)304.2

The problem of a segmented labour market, where large groups of workers are trapped in activities with inadequate protection, is also increasingly recognised. Undeclared work represents an extreme case of labour market segmentation⁹.

The possibility of finding undeclared work is a key pull factor encouraging illegal immigration. For illegal residents, who tend to fall outside the social security system, undeclared work is often offered under conditions which are socially unacceptable and in breach of health and safety regulations. On 16 May 2007 the Commission proposed a directive providing for sanctions against employers of illegally staying third-country nationals¹⁰.

3. EVIDENCE ON UNDECLARED WORK

A. Drivers of undeclared work

There is concern over a growing scope for undeclared work in view of the following factors:

- 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.

B. Statistical evidence at EU level

Measurement problems

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. But assessing the extent and features of undeclared work is indispensable in order to put in place appropriate policy measures.

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. A thorough understanding of the extent of undeclared work and its causes therefore requires combining

⁹ "Towards common principles of flexicurity", COM(2007)359 of 27.6.2007.

¹⁰ See COM(2007)249 of 16.05.2007.

both methods. Moreover, there is a wealth of administrative information, which is not systematically exploited and could be used to complement findings from direct and indirect analyses (e.g. statistics from inspections).

National estimates

The best available estimates so far, based on indirect methods, of the overall level of undeclared work in the Member States were collected through a study carried out for the Commission in 2004¹¹. The extent and characteristics of undeclared work appeared to differ widely in the Member States, with highs of 20% of GDP or more in some southern and eastern European countries. A recent stocktaking by experts of the European Employment Observatory network¹² indicates that undeclared work is still on the rise in several Member States¹³, whilst in a number of new Member States strong job creation in recent years and the emergence of labour market shortages, has led to a decline of the phenomenon.

C. Characteristics and forms of undeclared work according to Eurobarometer

Further to the 2004 study, in the second quarter 2007 a survey on undeclared work using direct methods, was carried out in the EU27 as a special Eurobarometer survey (N° 284). It focused on public opinions on undeclared work, the demand and supply side, the reasons for engaging in undeclared work, and the socio-economic characteristics of producers and consumers.

In view of the sensitivity of the subject, the pilot nature of the survey, and the low number of respondents who report involvement in undeclared work, results should be interpreted with great care. In particular, the quantitative results are likely to provide only a lower bound of the actual values. As the Eurobarometer survey is based on an established sample, it could not provide reliable evidence on the situation of illegally staying third-country nationals or citizens from the new Member States facing temporary restrictions on free movement. However, results indicate for example:

- the existence of a large market for undeclared work throughout the EU, especially in household services;
- that avoidance of taxes and administrative burdens (notably in the case of atypical work, e.g. seasonal activities) are the main drivers, less so necessity;
- the importance of envelope wages¹⁴, especially in the construction sector;
- the prevalence among students, self employed and unemployed;
- the low awareness of sanctions in case of detection.

¹¹ "Undeclared Work in an Enlarged Union"; May 2004, http://ec.europa.eu/employment_social/incentive_measures/activities_en.htm.

¹² www.eu-employment-observatory.net.

¹³ Abstraction is made of the effects of recent regularization campaigns of illegally staying third-country nationals in IT, ES and PT.

¹⁴ I.e. the share of total wages which is paid cash-in-hand and undeclared.

4. POLICIES TO REDUCE UNDECLARED WORK

In view of the complexity and heterogeneity of undeclared work, there is no simple solution to combating it. A balanced policy approach consisting of measures to curb or prevent its occurrence and their enforcement, involving the social partners, is needed. Such an approach was set out in the 2003 Council resolution on transforming undeclared work into regular employment, which called for

- reducing the financial attractiveness of undeclared work stemming from the design of tax and benefit systems, and the permissiveness of the social protection system with regard to the performing of undeclared work;
- administrative reform and simplification, with a view to reducing the cost of compliance with regulations;
- strengthening the surveillance and sanction mechanisms, with the involvement of labour inspectorates, tax offices and social partners;
- trans-national cooperation between Member States, and
- awareness raising activities.

The main policy developments, in the areas mentioned above, are discussed below and are illustrated with examples of innovative practices¹⁵ introduced in the Member States.

A. Financial attractiveness of undeclared work

The available evidence confirms that the perceived level, design and implementation of different kinds of taxation (notably labour income tax and social security contributions) are important drivers of undeclared work. However, other factors also play a role, including, for example, people's confidence in fiscal and social protection systems.

In this respect, most Member States have improved the financial incentives for regular work, notably by increasing the tax-free base for labour income and through appropriate setting of minimum wages, either through legislation or collective agreements. Statistics confirm the general but slow reduction of the tax burden on low paid labour. In the EU, the total tax wedge on labour decreased by around 1.2 percentage points on average between 2000 and 2005¹⁶. However, with the average gross level staying around 40%, these reductions may still be unconvincing when given the option of undeclared work (notably in combination with benefits). Moreover, the effect of these reductions may be negated in the case of overtime work, which is subject to significantly higher taxation in many Member States.

Significant increases in minimum wages have been introduced, especially in the new Member States. These were usually set in a cautious way (at less than half of the average wage) so as

¹⁵ The examples do not reflect an order of preference, nor are the country references exhaustive. A more extensive list of innovative practices is presented at the European Employment Observatory website (www.eu-employment-observatory.net) and in the documentation presented at an international conference on undeclared work and tax evasion, held in Brussels on 21-22 June 2007 (http://socialsecurity.fgov.be/european_congress/).

¹⁶ See Eurostat, Structural Indicators, tax wedge on low wage earners.

to avoid the destruction of regular jobs and substitution by undeclared work. Moreover, in many new Member States where the practice of envelope wages is widespread, higher minimum wages reduce the margin for negotiating such “envelopes”.

Work-related and minimum welfare benefits should be set in a way to allow decent living conditions, while keeping regular work financially more attractive than undeclared work in combination with benefits. Stricter controls of benefit recipients have been introduced in most Member States.

The important share of self-employment in some Member States points to possible distortions between the tax and social security regimes for employees and the self-employed, stemming from lower corporate tax rates compared to labour income taxation and different treatment of self-employed and employees in the social security systems. The introduction of a single flat tax rate in SK and EE could be seen as an attempt to remove such distortions.

Some policy lessons:

- from the perspective of undeclared work the balance of incentives and disincentives in social security systems can be improved by 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;
- points to watch include (i) the taxation of overtime, (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 taxation on low productivity jobs.

B. Administrative reform and simplification

Together with labour taxation, the administrative burden, notably for atypical and seasonal work, appears to be the strongest driver of undeclared work. In some extreme cases, the combination of low productivity with administrative and/or tax burdens renders certain activities not economically viable in the formal economy.

Simplified systems for the registration of workers were introduced in EL (for family workers), FR (seasonal workers in agriculture, hotels and restaurants), NL (for house cleaning) and DE ("mini-jobs") with considerable job creation. In ES, where regional comparisons reveal a correlation between the incidence of temporary contracts and undeclared work, the Social Partner agreement concluded in 2005, aiming at reducing temporary employment, may be regarded as a promising step towards the regularisation of undeclared work as well.

Service vouchers and facilities to perform regular domestic services were introduced in BE, AT, and ES, whereas they were scaled down in DK in 2001. Often there was a significant positive impact on job creation, but the results in budgetary terms are mixed.

To the extent that undeclared work may occur in conjunction with the evasion of indirect taxes, some Member States have taken up the possibility offered by Directive 1999/85/EC to reduce VAT on specified labour intensive services. There is limited evidence of the employment creating effect of a single reduction of VAT. For building renovation and maintenance, several Member States (e.g. FI, SE, IT) opted for a deduction from the tax base of the consumer as a more effective instrument.

Upon accession of 10 new Member States on 1 May 2004, the UK, IE and SE opened their labour markets for workers from these new Member States, whereas others applied transitional arrangements to workers from 8 of them.

In its report on the functioning of transitional arrangements set out in the 2003 Accession Treaty, the Commission stated that restrictions on labour market access may exacerbate resort to undeclared work.¹⁷

Since 1 May 2006, other EU-15 Member States (FI, ES, PT, EL, IT, NL and soon LU) have fully lifted their restrictions, while others have simplified theirs, in a context of tightening labour markets. Recently, DE and AT have announced liberalising access for skilled specialists. On 1 January 2007, ten EU-25 Member States (CZ, EE, CY, LV, LT, PL, SI, SK, FI and SE) have liberalised access of Bulgarian and Romanian workers to their labour markets under national law.

Some policy lessons:

- there is scope for further improvement of labour law and administrative systems in order to better cope with short-term needs and shortages in the labour market;
- there is wide scope for sector-specific approaches to transform undeclared work into regular work (especially in hotels and restaurants, agriculture, home services);
- the Community *acquis* on the free movement of workers should be generally enforced and facilitated (notably through EURES);
- the possibilities of e-government, on-line registration and exchange of information between administrative databases should be further exploited.

C. Surveillance and sanctions

The Commission's Green Paper on Labour Law¹⁸ highlighted a need for more effective cooperation at national level between different government agencies, such as labour inspectorates, social security and tax authorities, and stated that "improvements in the resources and expertise of these law enforcement authorities, and in their cooperation with partners, can contribute to reductions in the incentives to undeclared work".

New laws and Action Plans aimed at better detecting undeclared work have been enacted in several Member States (DE, FI, FR, IT, SK etc.). In many cases, the definition of undeclared work has been updated to reflect developments in the labour market (agency work, subcontracting etc.) and criteria have been adopted to detect false self-employment.

The improvement of the monitoring and control capacity of social security organisms, labour inspectorates and trade unions has become a priority in many Member States. Inter-ministerial

¹⁷ COM(2006)48 final of 8.2.2006 concerning the period 1 May 2004-30 April 2006. A further report is due before the end of the second phase on 30 April 2009, respectively the end of the first phase on 31 December 2008 in the case of Bulgaria and Romania.

¹⁸ COM(2006)708 previously mentioned

coordination structures have been set up in FR, BE, IE and IT. Interfaces between the relevant databases have been established (e.g. in PT).

The obligation for employers to register workers from the first day of employment has been generalised. Also the potential users of undeclared work have been made liable in DE (obligation since 2004 for households to keep invoices on construction and maintenance services) and in AT (obligation of up-to-the minute accounting on a cash basis in the hotels and restaurants).

Social Partner agreements have been concluded in many countries, notably in the construction sector (DE, FI, IT). In IT, the Budget Law states that in 2007 the Ministry of Labour, in cooperation with the social partners, will introduce a normative system to estimate actual numbers of hours worked ("indici di congruità").

Sanctions for employers of illegally staying third-country nationals have been introduced (e.g. FI, DE, NL, UK), and, in many cases, strengthened, including through bans on public procurement. In this context, the Commission has recently proposed a directive to ensure that all Member States introduce and enforce similar sanctions against employers of illegally staying third-country nationals as part of a comprehensive EU migration policy.¹⁹

Some policy lessons:

- Compulsory registration of workers is a pre-requisite for detecting undeclared work. Exemptions from the practice of written labour contracts should be limited to the minimum;
- There is considerable scope for sector-specific solutions to control and regularise undeclared work with the involvement of the social partners;
- The success of policies to combat undeclared work depends on the cooperation between the various bodies in charge of tax, labour, and immigration, as well as on the enforcement of legislation and sanctions.

D. Cross-border cooperation within the EU

Bilateral cooperation agreements have been concluded in the context of Directive 96/71 on the posting of workers between, among others, FR, BE and DE, and a few others are envisaged (between IT, ES, PL and CZ). Moreover, a group of Member States have set up cooperation with a view to promote and exchange expertise on a wider undeclared work related policy agenda²⁰.

The Commission has concluded that administrative cooperation among Member States should be improved, in particular in the field of posted workers²¹. In this context, the Commission plans to adopt a Recommendation aimed at reinforcing such cooperation through the use of the Internal Market Information System, as well as a Decision setting up a high level

¹⁹ See COM(2007)249 of 16 May 2007.

²⁰ ENUW (European Network on Undeclared Work) established between public partners of five Member States (DE, FR, IT, BE and RO) and coordinated by the Italian Ministry of Labour.

²¹ COM(2007) 304 Final of 13th June 2007 on the posting of workers in the framework of the provision of services.

Committee. This Committee should support and assist the Member States in identifying and exchanging good practices as regards control and enforcement of legislation for posted workers.

Moreover, the 2006 Commission proposal for a Regulation of the European Parliament and of the Council laying down the procedure for implementing Regulation 883/2004 concerning the coordination of social security schemes (which will replace Regulation 1408/71 as soon as the implementing regulation is adopted) also contains provisions strengthening the cooperation between social security institutions of the Member States.

Policy lesson:

- The institutional framework for controlling cross-border movements of workers needs continuing adaptation to the growing pace and complexity of cross-border business.

E. Awareness

Several successful awareness campaigns have been conducted (e.g. Danish "fair play" campaign). In the new Member States, they were often on a large scale and focused on specific issues like envelope wages (e.g. "Work Contract Works" in LV).

Policy lessons:

- There is scope for increasing awareness among the public on the risks linked to undeclared work, particularly as far as sanctions are concerned (see Eurobarometer results); social partners have a key role to play in this respect;
- It is important to inform citizens about the positive effects of full payment of taxes and about the insurance nature of social security contributions.

5. CONCLUSIONS AND FOLLOW UP

There are no convincing signs that undeclared work has noticeably decreased in recent years. Undeclared work remains a financially attractive option, especially in combination with VAT fraud and the possibilities to operate on a wider EU scale. Piecemeal policy actions have been taken across Member States, but there is an apparent lack of evaluation of results and pooling of expertise. It is time for Member States to step up their efforts in the fight against undeclared work.

- Despite some progress (labour taxation for the low paid), more needs to be done, taking into account national circumstances, in order to further reduce labour taxation, by improving the quality of public finances, notably the efficiency of public expenditure and taxation systems, by reducing non-wage labour costs, and by shifting the tax burden to alternative sources of revenue²². There is also scope

²² See the Integrated Guidelines N° 2, 3, 5 and 22. The Employment Guidelines contained earlier references to shifting the tax burden on labour towards indirect or environmental taxation (see e.g. the 2001 edition). See also the Green Paper on market-based instruments for environment and related

for reducing the administrative complexities in tax and benefit systems, which may constitute incentives for undeclared work, notably for the self-employed and small companies;

- The Commission considers the transitional arrangements limiting the mobility of workers from the new Member States as a factor hampering the recourse to declared work, hence may exacerbate the practice of undeclared work, while the current labour market developments create enhanced opportunities for regular work. In this context, the Commission calls on the Member States, who are responsible for these arrangements, to review them as soon as possible, or in any event, at the end of the second phase on 30 April 2009 in the case of EU-8, and at the end of the first phase on 31 December 2008 in the case of Bulgaria and Romania;
- Member States are invited to give due attention to undeclared work when deciding on the pathways they intend to follow in implementing the common principles of flexicurity.
- The Commission calls on the social partners to agree on concrete initiatives in the field of undeclared work in the context of their joint work programmes, at the European cross-industry, sectoral and national levels;
- Effective surveillance and enforcement are important components of a comprehensive policy approach. In this context the Commission recalls its legislative proposal on sanctions for employers of illegally staying third-country nationals.
- The Commission will investigate the feasibility of establishing a European platform for cooperation between labour inspectorates, and other relevant monitoring and enforcement bodies.
- To enable the monitoring of progress in transforming undeclared work into regular work, Member States should explore with the Commission the most suitable methodology for quantifying the existence of undeclared work. A study will be undertaken to this end under the PROGRESS programme in 2008.
- The Commission will treat undeclared work as a priority in its Mutual Learning programme. Stakeholders will have the opportunity, under the PROGRESS programme, to submit proposals for information campaigns, survey and evaluation activities, and initiatives to exchange information on good practices.

policy purposes, COM(2007)140 of 28.3.2007, and the Communication "European Values in the Globalised World", COM(2005)525 of 03.11.2005.