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Dissecting the illicit practice of wage underreporting: some evidence from Croatia

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ABSTRACT

Even though quasi-formal employment has become an integral part of European labour markets, not much is known about the functioning of this ingenious tax evasion scheme. To start to fill this gap, this paper elaborates the most important findings from qualitative interviews with 30 quasi-formal workers and 9 representatives of relevant institutions in Croatia. Among other important issues, this in-depth study, conducted during 2015 and 2016, aimed to explore the strategies that employers apply to ensure their workers' collaboration, as well as the schemes through which they extract cash for the unreported portion of the wage. The study revealed that not only can this practice subsist independently from undeclared work, but in certain circumstances it can even rely on cash flows that are fully visible to the authorities. Furthermore, we show that many quasi-formal workers are actually happy with their employment due to the mistaken belief that they earn more money this way. In addition to its theoretical significance, this paper also provides valuable practical information that could assist the authorities in their fight against this phenomenon.

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1. Introduction

Despite substantial efforts by the academic community and international institutions, there are still many aspects of taxpayers' behaviour that are not sufficiently understood. In fact, those eager to outsmart the state are constantly finding new strategies to do so (Fanusie & Robinson, 2018; Marian, 2013; Round et al., 2008). Novel forms of tax evasion have been regularly emerging, thus impeding the endeavours of the authorities to increase compliance rates.

This paper is dedicated to quasi-formal employment, which is one of the most recently described of such strategies (Elek et al., 2011; Hazans, 2005; Sedlenieks, 2003; Williams & Horodnic, 2015). Also known under the names of 'under-declared employment' and 'wage underreporting', this illicit practice assumes a verbal

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agreement between an employer and their formally registered employee that only one part of the remuneration for a given job will be reported to the state institutions (OECD, 2008; Williams & Padmore, 2013b). Hence, alongside the officially declared wage, the worker receives an additional (untaxed) cash-in-hand payment¹.

Due to their devastating effect on the budget revenues of EU member states, the European Commission has recently started actively seeking efficient policy remedies for these illegitimate wage arrangements (see European Commission, 2018; Mineva & Stefanov, 2018; Williams, 2018). The fight against the phenomenon is, however, hampered by limited knowledge about the rationales and behaviour of participants (especially workers) and the exact functioning of the fraud in practice. Not only does the payment of envelope wages on a regular basis require constant inflows of cash, but it also assumes the unconditional compliance of both parties (i.e. an employer and employee) with the unwritten agreement. Yet no study so far has evaluated these two central pillars of wage underreporting, which is precisely the gap this paper aims to fill.

This will be done by presenting the most important findings from a qualitative study of 30 quasi-formal workers and 9 representatives of relevant institutions in Croatia. With 8% of employees receiving one part of their wages through unofficial means of payment, this South-Eastern European country is at the top of the EU list when it comes to the pervasiveness of quasi-formal employment (European Commission, 2014). Another interesting peculiarity of the newest EU member state, which made it highly suitable for this study, relates to the ubiquity of the phenomenon. That is to say, no occupational and social group has been spared from such arrangements: alongside 12% of manual workers and 13% of individuals holding service jobs, some 11% of highly educated professionals and almost 9% of managers in Croatia are also receiving more remuneration than stated in their work contracts (Francic & Williams, 2014).

The paper is structured as follows: in the next section we first give a brief summary of the existing studies and further elaborate on how this particular one will contribute to the literature. After a detailed description of the methodological approach and fieldwork conducted, Section 4 presents a typology of quasi-formal jobs based on the exact function of envelope wages. Section 5 then provides an overview of the most common schemes that employers use to acquire cash for envelope wages. Concluding remarks and suggestions for a more effective fight against wage underreporting are given in the last part of the paper.

2. Nature and causes of quasi-formal employment: a literature review

It is estimated that some 11.6 million dependent employees in the EU actually receive higher salaries than reported to the authorities (Williams, 2013), which clearly shows that this illicit tax evasion scheme has already become a constituent part of labour markets around Europe. Informal cash supplements to official wages are particularly prevalent in micro and small companies, with young individuals being the most common recipients (Kedir et al., 2011; Meriküll & Staehr, 2010; Williams & Padmore, 2013b). Although no profession seems to be immune to this type of dishonest behaviour, studies have shown that low-skilled workers are somewhat more likely to hold quasi-formal jobs (Williams & Padmore, 2013a). Likewise, underreporting of wages

was found to be more prevalent in certain segments of the economy, such as construction, agriculture, retail and the hospitality sector (European Commission, 2007).

Just like other tax evasion strategies, quasi-formal employment is also more widespread in post-socialist countries (European Commission, 2007, 2014). Besides a weak culture of voluntary compliance inherited from the socialist period, scholars also emphasise high tax burden, reduced flexibility of labour markets and weak enforcement bodies as the central reasons for employers in new democracies resorting to this practice (Abbott & Wallace, 2009; Baric et al., 2016; Gërxhani, 2004; Torgler, 2004; Woolfson, 2007).

However, things are not so clear when it comes to the factors influencing the behaviour of workers in this respect. In fact, until recently, quasi-formal employment was perceived as being strictly confined to individuals who cannot find legitimate jobs. Given that this type of work provides at least some level of social protection, such workers were believed to choose wage underreporting rather than fully undeclared work² or remaining unemployed (Hazans, 2005; Woolfson, 2007). In line with this, quasi-formal workers were commonly depicted as a highly vulnerable group of individuals who are regularly exploited and oppressed by their employers (Hazans, 2005; Round et al., 2008).

However, this perception has started to change with some recent studies revealing that many workers are actually willing participants in this fraud. For instance, the representative survey of informal practices in the Balkan region conducted in 2015 showed that one in three quasi-formal workers was highly satisfied with their position (Fracic & Williams, 2017; Williams & Bezeredi, 2017; Yang & Williams, 2017). As a matter of fact, some 30% of envelope wage earners in this part of Europe personally initiated such an arrangement.

Yet, this state of affairs seems also to hold true in many other European countries. Indeed, every third quasi-formal employee surveyed within the 2007 Special Eurobarometer survey on undeclared work in the EU was happy with their employment, which equalled the portion of those who would have preferred full declaration (European Commission, 2007)³. There seems to exist a close link between one's satisfaction and the exact purpose of cash supplements, as individuals receiving envelope wages strictly for overtime and/or extra work were by far the most likely to approve this arrangement. On the other hand, employees whose informal payments compensated both regular and overtime work were commonly highly displeased with their employment (European Commission, 2007). However, no study so far has investigated how the function of cash payments within quasi-formal employment exactly shapes the willingness of workers to comply with this verbal agreement with their employer.

This research article seeks to fill precisely this gap. Not only can insight into the various tactics that employers apply to ensure the collaboration of their personnel enhance the so far very limited knowledge about the role of workers in sustaining this practice, but it can also help in explaining why certain categories of individuals and jobs are more prone to this particular tax evasion scheme. To further elucidate the economic and functional aspects of this phenomenon, in the rest of the paper we also discuss the most common cash extraction strategies. Before moving to these matters, however, it is essential to provide details on the fieldwork and data analysis.

3. Methodology and fieldwork details

The qualitative study was conducted during 2015 and 2016 in Zagreb, the capital of Croatia⁴. Workers were recruited following the snowball sampling procedure, whereby the diversity of the sample was secured by finding different initial informants. The total number of participants in this stage was not predetermined as the idea was to keep finding and interviewing workers until reaching the saturation point (i.e. up to the moment when information and knowledge gathered started to repeat).

The final sample of workers comprised 16 women and 14 men. All age groups were represented, with the youngest participant being 23 years of age and the oldest one being 64 years old. Likewise, a range of different occupations were included: besides a substantial number of low-skilled individuals (such as construction workers, cooks, gardeners, waiters and goldsmiths), the sample also included a group of managers and other high-income earners (e.g. dentists, construction engineers, lawyers, architects, mathematicians and graphic designers). Finally, there was a non-negligible number of workers earning average salaries, such as accountants, secretaries, salespeople, dental technicians, commercial travellers, teachers, etc. It is also important to stress that all interviewed individuals were employed in the business sector of the economy.

The main emphasis during the interviews with workers was on their motivations to accept (or initiate) underreporting of wages, as well as on attitudes towards their own position and this type of employment in general. To further explore the complex mechanisms behind this practice, workers were also asked about the process of negotiation between them and their employers which led to wage underreporting. A particular emphasis was on the different payment options offered by the business owners, which are the focus of this paper. In addition, individuals holding managerial positions and those who were employed in the financial department of the company were also asked about the strategies for generating cash for envelope wages. Interviews were semi-structured, allowing a discussion of these key issues with every single participant while at the same time permitting them to develop the topics and potentially unravel new aspects of the phenomenon.

To obtain as comprehensive an insight into the practice as possible, the second phase of the fieldwork involved representatives of labour unions, employers' associations and enforcement bodies. The idea was not only to discuss all the vital information and data they possess but also to compare the viewpoints of these contrasting groups. Purposive sampling was applied in this case, as the intention was to cover the most relevant institutions in this respect. The choice of state bodies was straightforward, given that the fight against quasi-formal employment in Croatia is the joint responsibility of The Ministry of Labour and Pension System, the Tax Administration and the Labour Inspectorate⁵. Trade unions were represented by individuals from the Independent Trade Unions of Croatia, Union of Autonomous Trade Unions of Croatia and Trade Union of the Construction Industry of Croatia. The employers' side of the story was set out by the representatives of the Croatian Employers' Association, Croatian Chamber of the Economy and the Construction Employers' Association.

Each of these nine institutions was contacted directly by phone or e-mail and asked to recommend an individual who could provide valuable information on the topic. All participants from this stage of the study were highly ranked in their organisations and were, therefore, able to provide an exhaustive account of this illegitimate scheme. Given the variety of institutions involved, interviews for this phase of the study were unstructured (i.e. only wider thematic areas were prepared for each interview).

Participants in both waves of the study were requested to sign the Consent Form before starting any discussion. Permission for voice recording was also sought so as to speed up the process. In the small number of cases when consent for recording had not been granted, the researcher took notes during the conversation. Finally, the anonymity of all participants was secured by rendering their personal details non-identifiable. After finalising the whole process, the transcripts were systematised using the qualitative data analysis tool NVivo and analysed following the thematic approach.

4. Typology of quasi-formal jobs based on the function of envelope wages

The most important notion grasped from the interviews with quasi-formal workers relates to a firm association between their overall take-home pay and their readiness to comply with the agreement with the employer. In fact, when asked to comment on their current position and future prospects, most study participants went on to scrutinise their job strictly through the prism of net monthly earnings. This was commonly done by comparing personal take-home pay with those of fellow citizens holding similar jobs, as well as with the average income from waged employment in Croatia. Even though some other factors also exerted influence in this respect⁶, higher income generally entailed a greater level of satisfaction.

Being aware of this, some employers in Croatia opt to offer performance-related salaries. This section explains in which situations this can happen, as well as for which groups of workers and jobs such variable take-home pay can occur. While doing so, we will also discuss various traps hidden behind each payment strategy.

4.1. Share of employee's profit-making accomplishment paid in cash

Quasi-formal employment seems to be particularly appealing to employers who can draw a clear (and quantifiable) line between the efforts of their employees and the total revenue of the company. To ensure maximum engagement of an individual worker, some business owners thus offer to pay in cash an agreed share of the business income resulting directly from the personal achievement of the worker. In line with this, it is not hard to understand why wage underreporting is so widespread in retail and wholesale jobs.

In principle, this specific form of quasi-formal employment provides tangible short-term benefits for both parties involved. The very nature of the arrangement guarantees greater potential profit for business owners, whereby only a small part of

it will be shared with their staff. Labour suppliers, on the other hand, are motivated to invest more time and energy in their work as this will automatically entail higher take-home pay. It is hence not surprising that interviewed individuals working under this particular scheme expressed a much greater level of satisfaction with their employment compared to the rest of the sample.

The mere fact that their dedication was being acknowledged and adequately rewarded was enough for such workers to withstand all the issues encountered during the course of employment (e.g. disputes with fellow employees, limited duration of the contract, problems with obtaining loans, etc.):

It is much better this way because the system stimulates you to work harder. I earn more this way. If I were completely declared, I could work much more than now and get the same wage.

(Financial intermediary, 28)

Nevertheless, there are circumstances in which a worker would not share these standpoints. Problems can, for instance, occur in industries with inherent seasonal variations given that take-home pay can appear insufficient during certain periods of the year. Additionally, the enthusiasm of workers towards variable earnings seems also to be strongly associated with the situation in their private life:

I indeed saw some benefits of a variable wage in my previous company where I had been receiving a share of the income from my sales in cash. However, even though I was able to earn quite a lot at those times, there were some unstable parts of the year when I was getting only the declared wage. This was because you could not earn any extra money in certain months as there were no sales at all. Now I always earn a fixed amount regardless of the sales, which is certainly better when you have a family.

(Sales manager, 38)

It is thus not hard to conclude that quasi-formal employment with envelope wages subject to personal achievement is most frequent among the youngest labour cohort. Besides a greater eagerness to test their limits and higher inclination towards risky behaviour compared to more experienced individuals, most new entrants to the labour market are unmarried at the moment they start working. This not only gives them more flexibility in time and work management but also greater tolerance towards unsteady income. As admitted by many interviewees, things changed dramatically after they got married and became parents since control over income and time suddenly became a priority.

Yet, despite being recognised as the most advantageous form of quasi-formal employment by the majority of study participants, this specific arrangement also entails the greatest number of potential problems. The most important of them is certainly the considerable risk of employers failing to fulfil their part of the financial deal, which is not surprising having in mind that variable take-home pay complicates labour cost management. This issue is especially emphasised in arrangements in which envelope wages are linked to the volume of trade during the course of a month, rather than to the revenue from paid invoices. Nonetheless, even more severe complications can arise when employers misjudge the capability of their workers or set excessively high cash premiums:

The boss probably underestimated the amount of money I could earn this way. I mean, he realised that he had to give me quite a lot. Still, if he had left my share at 10% of sales, I would have had more incentive. I would have been motivated to sell more and to work more. Of course, he would also have earned more – so this is a closed circle.

(Commercial traveller, 29)

In such circumstances, employers commonly either stop paying envelope wages or request redefining the terms of payment. Both scenarios regularly lead to a series of conflictual situations which eventually result in the worker quitting their job due to the destroyed trust between the stakeholders.

4.2. Per-hour payments

Yet another resourceful tactic to ensure the collaboration of workers is to tie their take-home pay to the quantity of working hours completed. That is to say, instead of negotiating on the size of the monthly wage, employers can suggest a fixed net payment for a single hour of the worker's effort. This scheme again implies variable take-home pay, which in this particular case is calculated as the product of the price per hour and the total number of hours worked during a month. This payment strategy appears to be highly popular among employers whose business activities show a seasonal character and/or require excellent time management, which in turn explains why wage underreporting is pervasive in the construction sector and agriculture.

Besides determining the exact per-hour payment, the two parties also need to agree on the amount that will be declared to the authorities. This is actually the point where the central advantage of this payment scheme from the perspective of business owners comes to the fore. Namely, upon being convinced that they are in control of their own monthly earnings, workers generally tend to pay less attention to the quantity reported to the authorities. This therefore opens the prospects for employers to offer quite a low official wage. As reasoned by one quasi-formal worker belonging to this particular group, who was in fact declared on the minimum wage but did not see any problem in this:

If I work every day, I can easily earn some HRK 6,500-6,700. Once my wage even reached HRK 7,000, but for that you really must work like a dog. But I make the decisions about my take-home pay myself. On the other hand, we usually need to spend some two to three days on each building and therefore it is also much better for the boss if I stay longer every day as in that way we can finish the job earlier. As a result, the company can arrange more contracts with buyers.

(Construction worker, 25)

Moreover, alongside motivating their workers to invest additional efforts in busy periods, this scheme also protects employers from negative balances during times of low demand. Since their overall off-season wages are much lower (and often there are no cash supplements at all), a significant part of the adverse effect and risks arising from the cyclic nature of the business actually falls on the workers. Regardless of this, most individuals working under this particular arrangement expressed a high level of contentment with their position, first and foremost owing to the mistaken belief of being fully in charge of their own earnings. Given their limited ability to foresee all

the pitfalls in this scheme, on the one hand, and a greater inclination towards risk on the other, one should not be surprised to hear that inexperienced individuals are the most common recipients of per-hour payments.

Despite sharing many features, there is one noteworthy difference between these two types of quasi-formal employment with variable payments. While an employer can easily track the accomplishments of a quasi-formal worker receiving a part of their sales in cash (i.e. by examining invoices), this is not so easy in the case of per-hour payments. The latter scheme essentially requires either the continuous presence of the business owner at the workplace (or at least their representatives) or an extraordinary trust between the two stakeholders. Otherwise, the worker could easily fabricate their records on the working hours. Yet, even the presence of the employer would not entirely resolve this issue, as the productivity of an individual does not necessarily go in line with the exact duration of their work. Since quasi-formal employment based on per-hour payments provides a clear incentive for lazy personnel to outsmart their employers, it appears to be feasible only in situations where there is a high level of mutual respect:

The boss trusts me. If I submit a record with 300 working hours at the end of a month, he knows that I really have worked that much. The thing is that we have known each other for some ten years. I always keep the records of my working hours on my own and I never cheat. But all the others who come to the company – you can frequently hear them saying: ‘Sit a bit, rest for a while, have a coffee and just write down as if you had worked’. They are cheats. This is why he always gives them fixed wages.

(Construction worker, 25)

4.3. Fixed net payment

An evident linkage between business revenues and the performance of workers is an essential, but certainly not the only, condition that has to be fulfilled for variable payments to take place. In fact, there are two additional features of every single job that also play an important role for business owners in this respect.

The first of them is the ease of substitution, i.e. the simplicity of finding an alternative worker if the current one declines the employment offer or quits their job. Obviously, this has a lot to do with unemployment rates in a particular sector and within specific occupations. If there is an army of unemployed workers with suitable skills, employers would prefer a ‘take it or leave it’ strategy owing to a high probability of encountering individual(s) ready to accept any offer just to escape poverty:

Employers are looking for a person that will accept all the terms. Since there is a huge army of the unemployed, they know they will eventually find someone. All in all, 99% of the people straightforwardly agree to work on a quasi-formal basis. It is an unwritten rule that only the minimum goes into the bank account, and all that is to be arranged is the amount which would be paid in cash.

(Head waiter, 40)

However, there is yet another important aspect of each job to consider, which is the ease of adaptation for new personnel. Many jobs commonly require training for a worker or at least a certain adjustment period, which makes staff replacement fairly

expensive. The supremacy of employers is somewhat reduced in such circumstances, which not only motivates many of them to offer more generous envelope wages, but also to refrain from violating the rights of workers by any means:

No, no, this is not an option. If this happens, then GOODBYE, NO MORE; GOOD NIGHT, I AM LEAVING. He clearly knows that I have the 'know-how' in this company. All the products he sells were made by me.

(Goldsmith, 50)

In any case, if neither of these two factors is relevant for a particular job, then wage underreporting with fixed take-home pay will almost certainly take place. Unlike the previous two types, quasi-formal employment with fixed payments provides no financial motivation for the worker. For this reason, such individuals appear to be slightly more thorough in assessing the pros and cons of their employment. However, even in this case, the evaluation is heavily based on the financial aspects of one's employment, while other important issues are often left aside. Most study participants belonging to this group were repeatedly drawing a line between their take-home pay and that from comparable, but fully declared jobs. Individuals who were persuaded that they were actually benefiting in this way commonly expressed contentment with their position:

Yes, this was quite a good wage. I know many waiters who earn up to HRK 3,500. And what is more, these people have more responsibilities than I had, such as annual revenue accounting, etc. They work like dogs and have nothing, just some pathetic little tips. [...] I really cannot complain as I was really happy with my earnings. I have many friends working as waiters and when I hear their stories I must say my job was excellent.

(Waiter, 31)

Conversely, those believing that fellow citizens with completely legitimate work contracts earn more were usually highly dissatisfied with their position. Only individuals who were certain that wage underreporting exerted no influence on the size of their take-home pay went on to consider other essential factors. The attitudes and viewpoints of this particular subgroup were hardest to anticipate as their reasoning was strongly imbued with subjectivity.

4.4. Occasional quasi-formal employment and other atypical forms of supplementary payments

Some cases encountered during the fieldwork involved employers applying a combination of fixed and variable cash payments. In addition to 'monthly envelopes' covering the undeclared part of an agreed take-home pay, every now and then (e.g. on a quarterly basis) those workers were also receiving cash remuneration for all overtime work during that period. Besides facilitating labour cost management for employers, this mixed approach also made it quite easy for workers to relate their efforts to their income. It is hence not surprising that research participants from this group were generally more satisfied with their employment than individuals receiving income for both regular and overtime work in a single envelope.

Although most often used for motivational purposes, variable take-home payments can also be an efficient solution for unforeseen fluctuations in business activities. Explicitly, many employers faced with a short deadline and/or temporary increase in demand for their products or services are not eager to hire new workers, as this would entail severance payments and various procedural problems once the demand returns to the average level. They thus rather opt to increase the workload of existing personnel and pay this additional effort in cash. Such workers can be best described as 'sporadically quasi-formal' given that they receive informal supplements to a regular wage on an occasional basis.

However, an opposite scenario can also happen in situations where the nature of the activities in question gives rise to periods of breaks in business. This not only relates to the construction sector and agriculture (which have modest or non-existent activities during winter) but also to many other professions susceptible to seasonal disruptions. Typical examples are activities related to culture, sports, teaching and tutoring, which all experience reduced demand during summer. To address the issue of limited revenues during these specific parts of the year, some employers choose to reduce envelope wages during the rest of the year. The money saved in this way is then used to pay the official part of the wage in the course of the business break. Obviously, the amounts deducted are conditional upon the income of the company during the peak period, which causes constant variability of envelope wages. Not surprisingly, the interviewed workers from this group expressed complete dissatisfaction with their employment. This was not only because of the inability to predict their income but also due to the exploitative nature of this approach. They are essentially paid only for one part of the year while working for free during leaner times.

Occasional envelope wage payments can also occur in companies wishing to reward their workers. This is most frequently related to holiday allowances, 13th wage, various bonuses and even lunch allowances. As they are aware that workers will most likely perceive these payments as acts of generosity, some employers decide to give them in cash so as to avoid paying taxes (when taxable) and/or avoid various administrative requirements. As one would expect, most study participants belonging to this group of quasi-formal workers expressed absolute contentment with their employment.

However, sporadic undeclared payments can occur even in situations when workers are entitled to cash supplements for every single month. To understand when and why this usually happens, one must be familiar with different schemes through which employers obtain enough cash for envelope wages. The next section, therefore, gives an overview of various cash extraction methods which take place in Croatia.

Before commencing, it ought to be stressed that the idea is not to offer an exhaustive account of all existing strategies, nor to make any assumptions about the pervasiveness of those described. Given the non-random nature of the sample, the following section should be perceived only as a foundational step in our endeavours to understand this so far unresearched aspect of wage underreporting.

5. An overview of cash extraction strategies

So far quasi-formal employment has been widely perceived as a by-product of undeclared work, i.e. a clever solution for employers willing to reuse the cash

generated through informal transactions for yet another round of tax evasion (Eurofound, 2008, 2013). However, the qualitative study conducted revealed that this tax evasion scheme is more sophisticated than previously believed, as there exist many alternative ways to obtain money for envelope wages. In fact, some of these strategies actually assume reporting the transaction to the authorities and sometimes even payment of a certain (but much smaller) amount of taxes.

Judging from the experience of study participants, various frauds relating to travel costs seem to be highly popular among Croatian employers for this purpose. As explained by a number of interviewees, the two parties can, for instance, agree that the worker will change their official address of residence so as to seemingly increase the distance between their home and the workplace. Most commonly this is the address of their parents, relatives or friends, and in rare cases is associated with their own real estate. Obviously, such a change results in them being entitled to larger amounts of money for travel costs⁷. Yet, since the worker, in reality, continues to live at the previous (closer) location, no additional expenses actually occur for them. Neither employers nor workers in Croatia are obliged to pay any taxes on this particular item, which provides a clear incentive to underreport the actual wage by the amount of money extracted in this way. This strategy shows that the label 'envelope wages' can sometimes be quite misleading, as in this specific case the unreported part of the wage is in fact paid through a bank transaction.

Nevertheless, this is not the only manipulation of travel costs facilitating quasi-formal employment. An alternative option is to reimburse expenses for bogus business trips, which can be done either by falsifying travel documents or by submitting those occurring during private journeys. Even though it is typically associated with occasional quasi-formal employment, in certain circumstances this scheme can be sufficiently lucrative to enable payments of envelope wages on a regular basis. Indeed, business trip reimbursement commonly includes daily allowances which increase the total amount of money extracted in this way. Although they are often aware that this type of fraud is taking place, there is not much the authorities can do to prevent it:

The company can easily fabricate a trip to Osijek and recompense the accompanying cost. The question is how we can prove there was no business trip at all? This is really hard. You see... a travel warrant exists, a business relationship with the company in Osijek exists and the income from that relationship is realised... So, how can we say: 'This thing never happened?' I mean, we can ask the company in Osijek, but they will confirm it.

(Representative of the Tax Administration)

It is important to stress that bogus travel costs do not necessarily need to pertain to the person ultimately receiving the money. One interviewed quasi-formal worker, for instance, explained how all employees in her company were actively involved in this sort of deception despite only some of them receiving envelope wages. Faced with severe financial problems during the global economic crisis, the owner and workers in certain sections of the company agreed to start underreporting wages so as to avoid dismissals. The remaining workers then spontaneously decided to show solidarity with their colleagues and employer by helping in cash extraction. Individuals whose job position involved business travelling had thus been regularly bringing receipts for petrol and tolls from their private journeys, as well as from

those of their family members. After the finance department reimbursed them, these individuals withdrew the cash and returned it to the company. This money was later used for the envelope wages of co-workers.

In fact, this is not the only scheme in which income reported by one individual eventually ends up in the hands of someone else. Another inventive strategy of this type involves hiring ‘phantom employees’. Those are mostly students, although other individuals entitled to various deductions of taxes and social security contributions are also eligible. Phantom employees, in reality, do not perform any work, and in most cases they are appointed to jobs which do not require a physical presence on the work premises during standard working hours. The tasks written in their contract are actually conducted by regular employees of the company, which makes it extremely hard for the authorities to disclose the fraud:

I think they could not prove this was happening in practice given that all the tasks stated in the student contract were completely justifiable. [...] Students only had to take the contract from the student service and bring it to the company to be signed. After the end of the month, they were supposed to give us the cash deducting a 10% fee.

(Director, 67)

Although this strategy commonly entails certain liabilities regarding taxes and social security contributions, alongside the payment of an agreed fee to the phantom employee, many employers find it attractive owing to a tangible reduction in labour costs. However, this is not where their ingenuity ends, as there are other options for paying envelope wages while not hiding the transaction from the authorities. For instance, sometimes they can opt to pay their workers for fictitious goods and services if this can be justified based on the supplementary employment and/or hobbies of the latter. One of the study participants, for instance, described how his being a musician actually simplified the whole process of wage underreporting for both parties. Upon realising that the worker had a music band, his employer suggested payment of envelope wages in the form of reimbursement for a counterfeit gig. Every now and then the employer would just increase the final payment to the restaurant in which he had a business dinner so as to pay for the gig that actually never happened in reality. The owner of the restaurant later transfers this money to the bank account of the band, and the process ends with the worker receiving the amount which corresponds to the sum of his envelope wages since the last such fraud:

This is really straightforward. All my employer needs is evidence of his presence in the restaurant on that particular day. Fortunately, he has such events every third day. Nobody can prove that the gig did not happen as there is indeed an invoice from the restaurant confirming business expenditures.

(Manager, 28)

This story explains how workers entitled to monthly envelope wages can in reality be receiving them on a sporadic basis. On the other hand, although constant recurrence of this deception could easily raise suspicions, it would be extremely hard for the authorities to verify it, since everything is commonly settled after the event.

In fact, the limited ability of the authorities to monitor the provision of services resulted in yet another creative cash generation strategy. As explained by several

research participants holding positions in finance departments and management, in Croatia there exists a well-developed network of firms which provide assistance in this respect through fictitious services. The company wishing to extract cash for envelope wages would just pay for a non-existent service, only to receive most of this money back from the payee (with the deduction of a fee):

This is simply a certain mind-set. They basically think that this is the best way to run a company. We [people in the finance department] were expected to do all sorts of dodgy things. Whoever was not ready to cooperate had to move on.

(Head of finance, 62)

Finally, there are two additional options serving as last resorts in situations where the abovementioned strategies are unavailable or insufficient in a given moment. According to the experience of the workers interviewed, some business owners in Croatia choose to misuse the otherwise legitimate possibility of taking personal loans from their own company whenever faced with a shortage of cash for envelope wages⁸. In more extreme cases, there is also an option to use the withdrawal of profit for this purpose. Although both these scenarios entail some financial expenditure (i.e. payment of interest in the first case and payment of corporate taxes in the second), many employers seem to find them quite appealing as long as such costs are exceeded by the savings from wage underreporting. This is understandable given that the alternative would be a failure to pay envelope wages, which can have quite a detrimental effect on the psychological contract between the two parties.

6. Conclusion

The issue of quasi-formal employment has been high on political agendas around Europe for the last several years, which is not surprising given the detrimental effect of this illicit practice on public budget revenues. Still, the efforts of the authorities to deter business owners and workers from wage underreporting have been hampered by the limited understanding of the stakeholders' rationales for their participation and the exact functioning of the fraud in practice.

To start filling the gap, this paper elaborated the most important findings from a qualitative study of 30 quasi-formal workers and 9 representatives of relevant institutions in Croatia. As shown, wage underreporting can exist independently from undeclared work due to many alternative options for generating money for envelope wages. In fact, some of these methods even involve the (mis)reporting of this transaction to the authorities. On the whole, employers seem to find any payment option appealing as long as it reduces their liabilities towards the public budget and provided that it would not be easy for the authorities to detect the deceit.

To further elucidate the supporting pillars of this resourceful tax evasion strategy, we also discussed situations in which employers decide to offer fluctuating envelope wages. Most commonly this is done by granting workers a certain share of revenues resulting from their own sales or production achievement. Alternatively, the two parties can set the per-hour wage, whereby the worker receives in cash the difference between the total income earned in this way and the agreed official wage.

Both scenarios essentially trap workers into the delusion that they are in absolute control of their earnings, which explains why the majority of such individuals are happy with their position. However, they commonly fail to realise that employers are actually the only true winners of this arrangement. Besides being an efficient strategy to reduce labour costs during good periods, variable take-home pay also enables employers to shift part of the negative effect during business downturns to their quasi-formal employees.

Alongside advancing our knowledge about this rather under-researched phenomenon, the present study is also intended to make a considerable practical contribution. This primarily relates to the cognition that repression, which is by far the most common option for tackling standard forms of tax evasion in the EU, might not be the best approach in the case of quasi-formal employment. Even if they have a suspicion that wage underreporting is taking place, the authorities cannot provide incontrovertible evidence for this in many situations. For this reason, reducing the attractiveness of quasi-formal employment for workers seems to be a more viable policy response.

This, however, is not going to be an easy task in Croatia, given that workers mainly care about their take-home pay, while the rest of the gross wage is perceived by many as money thrown in the garbage bin. The key initial step in the fight against this phenomenon would, therefore, be to give citizens the sense that they receive enough in return for the taxes paid and social security contributions. This primarily requires establishing a clear link between one's current liabilities towards the pension and healthcare systems and future income and services received from them. Yet, positive trends in the culture of voluntary tax compliance will be difficult without significant structural changes aiming to increase the efficiency of public administration and the overall trust in ruling elites.

In addition to this, it is also essential to evaluate the pros and cons of giving privileged tax treatment to different groups of workers and expenditures. Even in cases where such exemptions are completely justifiable, it is necessary to establish better controlling mechanisms so as to reduce the possibilities for employers to misuse them.

It should, however, be stressed that this paper is by no means an attempt to give a representative overview of quasi-formal employment in Europe and beyond. Although the findings elaborated here are expected to have broader resonance beyond the Croatian case, it would be overly optimistic to expect that the identical state of affairs is to be found in any other country. This first and foremost relates to the strategies by employers to extract cash for envelope wages, as these are strongly dependent upon the labour and tax regulation of a particular country. If this study thus motivates similar research on the phenomenon in other countries, then it will have fulfilled one of its broader aims.

Notes

1. Commonly referred to as 'envelope wages', these informal payments usually represent part of the remuneration for regular work, although they can also serve strictly as compensation for overtime hours or even cover both overtime and (part of) regular work (Meriküll & Staehr, 2010; Williams & Horodnic, 2015; Williams & Padmore, 2013a).

2. Throughout this paper the term undeclared work will denote ‘any paid activities that are lawful as regards their nature but not declared to the public authorities’ (European Commission, 1998, p. 4).
3. The remaining individuals were either indifferent or did not provide a definite answer.
4. According to existing studies, four out of ten quasi-formal individuals in Croatia are working in Zagreb (Fracic & Williams, 2014), which explains why this largest and most developed city was chosen for the fieldwork. This specific study was part of a large-scale EU project evaluating the nature, drivers and prevalence of illegitimate economic practices in South-Eastern Europe.
5. The Labour Inspectorate operated as a separate unit at the time of the fieldwork. As of 1 April 2019, it has become part of the newly established State Inspectorate.
6. Overall lack of trust in institutions was actually something that all interviewees with a positive attitude towards quasi-formal employment had in common. Besides complaining about an inefficient state apparatus, low transparency in public spending, pervasive public sector corruption and weak rule of law, many participants also expressed concerns about the long-term sustainability of the pension system and the quality of healthcare services received. In line with this, the phrase ‘money thrown into the garbage bin’ was frequently heard during the fieldwork in the context of interviewees’ personal contribution to the public purse.
7. Employers in Croatia are not obliged (unless proscribed by collective agreement or other context-specific acts) to remunerate the cost of transport to and from the workplace. However, if they decide to do so, these payments are then exempt from taxation (Official Gazette, 2017).
8. Instead of repaying the loan from their own pocket, the owner will later utilise cash extracted through one of the previously described methods for this purpose.

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