

# Cash wage payments in transition economies: Consequences of envelope wages

## Reducing under-reporting of salaries requires institutional changes

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### ELEVATOR PITCH

In transition economies, a significant number of companies reduce their tax and social contributions by paying their staff an official salary, described in a registered formal employment agreement, and an extra, undeclared “envelope wage,” via a verbal unwritten agreement. The consequences include a loss of government income and a lack of fair play for lawful companies. For employees, accepting under-reported wages reduces their access to credit and their social protections. Addressing this issue will help increase the quality of working conditions, strengthen trade unions, and reduce unfair competition.

### KEY FINDINGS

#### Pros

- + Paying envelope wages might preserve employment.
- + Employees can receive higher wages if tax and social insurance contributions are not fully deducted.
- + Envelope wages can contribute to company survival, functioning as a buffer that allows for downward wage mobility, thereby protecting the company and its employees against negative demand shocks.
- + Reducing institutional asymmetry between formal and informal mechanisms might reduce the salary under-reporting practice.

#### Cons

- Envelope wages undermine the state’s ability to control the quality of working conditions; they weaken trade unions and collective bargaining power.
- Such arrangements result in lost public revenues.
- Under-reporting wages adds pressure on legitimate businesses to evade regulatory compliance due to unfair competition.
- By accepting envelope wages, employees reduce their entitlement to credit, pensions, and social protection, and allow employers to impose additional conditions in the future.

### AUTHOR’S MAIN MESSAGE

The phenomenon of salary under-reporting is a result of an illegal verbal arrangement between employers and employees. This agreement nullifies the formal written contract regarding the conditions of employment. A common feature is the payment of illegal cash, or “envelope wages,” which are not recorded by formal institutions (i.e. tax, pension, or credit authorities). Policymakers can address this problem in a number of ways, including educational or punitive measures, or by modernizing government processes; however, the bringing of formal and informal institutions into closer alignment—though no simple task—may represent the most effective method to reduce salary under-reporting.

