

WORKSHOP

DILEMMAS OF ENTERPRISES LEAVING THE HIDDEN ECONOMY

Case study: messenger services providers in Budapest, 2006–2008*

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Abstract: Some of the enterprises providing messenger services in Budapest have radically decreased their involvement in the hidden economy in the summer of 2006 which provides a unique opportunity to study the combined effect of two specific government measures: increasing the expected costs of hidden economic activities and tax amnesty. Furthermore, it could be explored how the two initiatives interact with the crucial variables defining involvement in the hidden economy and which additional impacts for the whole market emanate from the legalization of a small number of market players. Through interviews with CEOs of major companies on the market and a few of their employees, the study focuses on the following: from which motivations, according to what conditions and based on which strategies did the enterprises change their tax paying behavior? Furthermore, the success and downsides of such strategies were examined. According to the results, the key ingredients for changing the involvement in the hidden economy are: the moral costs of the CEO stemming from illegal taxpaying practices (tax morale) and the subjective appraisal of costs and benefits of operating in the hidden economy. Nevertheless, these factors can only lead to alterations in the degree of tax evasion if the financial situation, market position of the enterprise, and its relation towards customers and employees can provide a solid basis for covering the additional costs of fulfilling all legal obligations. These factors, in turn, determine the slices of the extra costs each involved actor has to bear. The main findings

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suggest, firstly, that governments can successfully fight the hidden economy by decreasing the administrative burden of enterprises, clear communication of regulatory intentions, and lowering the expected net benefits of involvement in the hidden economy. Secondly, improving the public opinion on government and tax morale both motivate economic actors to reveal their hidden economic activity. Lastly, tax amnesties entail relatively low long-run costs in an economic environment where tax compliance is not the prevalent norm. However, these factors can only lead to a permanently lower size of the hidden economy if they are able to motivate a sufficiently high proportion of economic actors of a given market to leave the hidden economy.

Keywords: hidden economy, tax evasion, tax amnesty, legalization, messenger services providers

INTRODUCTION

In most of the developed world hidden economy and its negative consequences cause serious problems, that is why this subject has raised more and more attention in recent decades (Tanzi 1982; Feige 1979, 1989). Although the concept of hidden economy covers an extremely heterogeneous group of phenomena which involves different social groups and economic actors with various motivations, (Pfau-Effinger 2002, 2008; Renooy et al. 2004); taking all the evidences into consideration, we can say that it has rather harmful impacts. From the point of view of the employee, working in the hidden economy violates legality, jeopardizes compliance with security requirements at work, and causes problems with having entitlement for pension and health care (Evans et al. 2004; *ILO* 2002). On the company level, it becomes an obstacle of development and expansion (e.g. access to credit markets), decreases the chances to enforce contracts, and distorts competition between legal and semi-legal enterprises (Renooy et al. 2004; Schneider and Enste 2002). On the societal level, it decreases government revenues, and in general, it weakens the rule of law (Williams 2004; Renooy et al. 2004).

Realizing the significance of these problems led to the extensive analysis of government tools fighting hidden economy as well as to the development of new tools to do so (Devos 2004). Up until now, the steps taken to regularize the hidden economy are typically based on threatening – the strength of threat is measured by the product of the penalty and the probability of being penalized (Williams et al. 2008; Devos 2004).

At the same time, based on experiments and empirical surveys on the micro level, many authors argue that the rational calculation approach contradicts the mechanisms defining tax-paying behavior, for example, many people pay their taxes even if they are not punished for not doing so (Cummings et al. 2005; Alm et al. 1992, 2004, 2006). The academic literature also highlights the fact that, as hidden economy is a complex category, it is impossible to manage it only by one sort of action (Bird and Wallace 2004). Considering this, many OECD countries now use measures influencing the rational calculation and the social, attitudinal background of the hidden economy simultaneously. However, there is a paucity of information on the mechanisms of these

government interventions on the micro level, so public policy is based on limited evidence in many cases.

The following case study aims to advance our understanding of public policies which strive to regularize the hidden economy by studying the effect of two simultaneous public measures¹: (1) increasing the expected punishment for participating in the hidden economy: stricter control and more effective legal background for investigating pretended subcontracting²; and, parallel to this, (2) proclaiming tax amnesty: tax authorities pardoned tax evasion committed through pretended subcontracts and unregistered employment if the enterprise registered its former semi- or illegal employment practices (XCI. Law of 2003).³

The market of messenger services providers gives us an outstanding opportunity to study the effect of these two public interventions on the operation of hidden economy and the exit from it. The leader of this market – from now on we will call it company A – decided to completely regularize its business in the summer of 2006, which was a definite break with its own and the typical practices of the market. This decision mainly derives from the above mentioned two public interventions as we are going to show it below. The exit from the hidden economy by messenger company A had different effects on competitors, customers, and employees which turned the so far stabilized semi-legal conditions upside down. Furthermore, the Hungarian economy can be looked at from a wider perspective: one of its representative segments can be studied which is highly involved in the hidden economy. This is warranted by the fact that the instant messenger services market of Budapest is served only by small and medium size domestic businesses (Semjén et al. 2009a; Krekó and Kiss 2007).

The case study research design utilized here provides an opportunity for the deeper understanding of the analyzed market, the particular events, and the detailed exploration of causalities. This is aided by the fact that the market is very heterogeneous regarding company size, efficiency, profitability, technology used, and tax paying behavior some of which dynamically changed during the study period. Moreover, the uniqueness of the service – parcel delivery on the same day, and mail delivery mainly within the borders of Budapest – greatly reduces competition from substitute services, so the operation of the market can be studied more or less separately from the adjacent markets.

The following key research questions are explored throughout the study:

1) What are the reasons for enterprises leaving the hidden economy? What role does regulation (greater expected cost of tax evasion and tax amnesty), the company's market position, the moral cost of tax evasion, and the experiences from previous employment play in this decision?

1 The comprehensive list of public policies aiming at the reduction of hidden economy can be found also in the following studies: Lackó et al. 2009 and Williams et al. 2008.

2 The key idea behind this form of tax evasion is that by employing regular employees as subcontractors the employer as well as the employee/subcontractor can evade a large amount of tax payment as VAT on subcontracting is a much smaller burden than the combined amount of social security and personal income tax.

3 http://www.magyarorszag.hu/allampolgar/ugyek/munka/munszerz20050805/szinleltmunkasz20080123.html/u_gyleirasjogi.

- 2) Under what condition is it possible to leave the hidden economy?
- 3) What typical strategies do enterprises pursue when they are leaving the hidden economy?
- 4) How successful or unsuccessful are these strategies? What are the problems they cannot handle?

Beyond these questions, we are going to discuss from a broader perspective the dynamics and the functioning of the Hungarian hidden economy and the spillover effects of the legalization of a small number of companies on the wider business environment.

Throughout this article we use the phrase 'hidden economy' for economic activities whose products and services are legal, but the process of production or sale entails some violation of law. This definition is practically identical with the irregular sector definition of Thomas (1992) and Semjén and Tóth (2004). However, the phrase hidden economy employed here does not involve the informal production of households or illegal economic activity by nature (e.g. human trafficking).

In the analysis, while being open for the identification of new factors, we largely rely on the literature discussing the impacts of public interventions (see above) and on scholars exploring the factors shaping the participation in hidden economy. Based on these authors, we focus on the following factors: 1) individual judgment on the cost-benefit ratio of taking part in the hidden economy (e.g. effective tax rate, the possibility of being caught, expected fine) (*World Bank* 2008; Renooy et al. 2004; Mateman and Renooy 2001); 2) the flexibility and predictability of the regulatory environment (Renooy et al, 2004; Mateman and Renooy 2001); 3) profit prospects and the role of economic development (Williams and Windebank 2001; Semjén and Tóth 2009); 4) attitudes towards the government and tax authorities (Cummings et al 2005; Renooy et al. 2004); 5) the moral costs of tax evasion and hidden employment (*World Bank* 2008; Renooy et al. 2004); 6) the solidarity and information conveying role of social networks (Pfau and Effinger 2002). The goal here is to provide more details on each of these factors when discussing the results as well as comparing the findings with the contentions of the literature.

In answering the research questions, we rely on semi-structured interviews with the CEOs of those two companies which decided on complete regularization (A and B enterprises), the CEOs of two companies that only slightly or not at all changed their tax paying behavior (call them C and D companies), and two employees of company A. This entails that we managed to gather data from 3 out of 4 companies with the highest turnover, moreover, from a smaller, but dynamic company too.

The article is structured as the following: first, the general features of messenger services providers in Budapest are highlighted emphasizing those elements that remained the same between the summer of 2006 and February 2008. Second, the decision of company A and the underlying factors are analyzed. Third, we study the competitors' different strategies in light of the changing tax paying behavior of company A; and finally, the key findings are summarized.

AN OVERVIEW OF THE MESSENGER SERVICES PROVIDER MARKET IN BUDAPEST, 2006–2008

In 2006, the combined revenues of messenger companies in Budapest were about 2.3 billion HUF, which reached 2.4 billion in 2007. During the analyzed period, the combined market share of the 5 biggest companies is a bit over 50 per cent; on the other hand, the 12 biggest enterprises comprise only 70 per cent of the market. The remaining 30 per cent is divided among businesses employing only a few people (LORA 2005b; interviews with the CEOs of messenger companies). Thanks to this market structure, price competition is very strong in the market though many bigger and older companies managed to differentiate their services based on quality, punctuality, and reliability; this way they softened the edge of competition. Nevertheless, long-term business relations are typical between the messenger companies and their customers which further advances stability on the market, especially for the bigger companies providing better quality services. Aggressive campaigns occur sometimes, i.e. attempts to seize the customers of the others; however, these are rather exceptions as most competitors abide the unwritten rules of the market and respect the solidarity of the subculture (messenger providers and their employees developed a distinct cultural identity in Budapest which is characterized by an environmentally conscious approach, anti-motorist sentiments, and vibrant civic activity).

Table 1. The Size of the Messenger Services Providers Market in Budapest, 2004–2007 (thousand HUF)

Year	The total returns of messenger companies
2004	2 036 388
2005	2 144 286
2006	2 384 004
2007	2 425 992

Source: LORA 2005a, 2007.

Most of the enterprises use the same technology: a mixture of cyclists, motorcyclists and car drivers, however, there are huge differences in their distribution and work organization (managing the couriers' daily work). Differences in technology do not lead to large profit differences; furthermore, the capital-labor ratio varies only in a narrow range. According to the interviewees, the most frequent way to reduce costs and thus to get a better place in the price competition is to reduce labor costs. It can be achieved by the more effective use of the given technology (e.g. faster parcel delivery, organizing biker and driver couriers in a better way) or by illegally "saving" on taxes imposed on labor, but this latter one is restricted by the expected cost of being caught.⁴

4 Couriers change their workplaces dynamically enough to prevent large differences in salaries to arise on the market.

“That is why it is [i.e. the economic activity of messenger companies] a borderline: we have to find the position where we can pass the APEH (the Hungarian Internal Revenue Service) audit and we can pay enough for the employees simultaneously.” (the CEO of one of the messenger companies)

The biggest companies on the market employ 140–160 people; however, most of the enterprises have 10–15 employees.

Bike couriers do not have to have any qualification to fill their position; accordingly, they typically have vocational or technical school education. However, being a courier is a very stressful work physically, accidents are frequent, so 40–60 per cent of the couriers typically leave the profession after 1 or 2 months. A courier employed illegally or registered only for a part of his or her salary, with an average performance, earns a net sum of 170–180 thousand HUF⁵ (in almost all companies the salary is based on the number of delivered parcels) (These figures reflect the salaries of early 2008). On the other hand, those couriers registered for their full salary earn net 30–40 thousand HUF less with the same performance. The work of motorcyclist and driver couriers is much less burdensome, of course, they have to have a driving license, but apart from this, they do not need any other qualification to do their job. The average salary is net 150–200 thousand HUF when only a part of it is registered, and similarly to the previous case, net 30–40 thousand less if they are entirely legally employed.

Before August 2006, there was not a single enterprise in the market which operated entirely legally and registered salaries in accordance with reality. Based on the interviews, it is a likely relationship that the bigger companies which provide better quality services reported the higher proportion of the salaries, while most of the smallest companies almost totally hid them.⁶

“Tax evasion is common in smaller companies. They are forced to “reduce their costs”: they do not pay taxes.” (the CEO of one of the messenger companies)

“[...] for market leaders, the number of registered workers is high and the number of subcontractors is low. For smaller businesses, it is the opposite. And I suppose that at the smallest ones it is typical not to have the employees registered at all, so complete tax evasion.” (the CEO of one of the messenger companies)

Practically all the techniques for hiding wages fully or partly which were revealed by former Hungarian studies can be found on this market (Semjén et al. 2009a, 2009b); we have found only a few new techniques. This phenomenon was interpreted in the following way by one of the interviewees:

5 As a benchmark the average gross monthly wage in the Hungarian private sector in 2007 amounted to 110 thousand HUF, way below what an average courier could earn (semi-legally) as net salary without any specific qualification.

6 The validity of this statement is slightly weakened by the fact that the smallest analyzed business (with 11 employees) is among the most legally operating companies in the market. However, it is rather an exemption and can be led back to the moral attitude of the owners; according to all interviewees, it is common that the size of the company and tax fraud is in inverse proportion, furthermore, the opinions mentioned are also in harmony with the theoretical conceptions.

“There is no such a particularity which wouldn't be known to anyone: ‘there are platitude solutions’, those who know how cost production⁷ works know what I am talking about.” (the CEO of one of the messenger companies)

Techniques used more frequently are the following ones:

1) It is typical of the bigger companies that they employ bike couriers by making their employment appear as a subcontract. Furthermore, they have a few employees registered – typically supervisors (dispatchers) or the administrative staff – but only for the minimum wage or slightly above that, and in addition they receive the same amount unofficially (‘envelope wages’). This method is greatly restricted in bigger companies as their customers mostly require an invoice, so they hardly dispose the necessary unreported money needed for the unregistered payments.

2) The companies employing drivers and motorcyclist couriers with higher production costs (e.g. capital, petrol) use mostly the method of “cost production”. These enterprises report higher costs than the reality and they pay a part of the unreal cost as salary without having it registered. Besides, the employees are either subcontractors or on the minimum wage. Some of the companies with lower operational costs evade taxation by similar methods, despite the fact that it shows a much less credible cost structure for tax authorities, and buying fictive invoices is an extra cost.

“You cannot play tricks by hiding your revenue – due to transfers and invoices. So the main goal is to increase costs. We do not necessarily create real expenditures, we are cross-invoicing.” (the CEO of one of the messenger companies)

3) There are workplaces where employees are registered for four hours a day instead of the eight hours they actually work; in addition, they also work as subcontractors.

4) There are enterprises which operate entirely illegally; however, we did not manage to discern from where they get the unregistered money for the illegal payments. Based on the experiences of the other companies, they possibly get money through service without a receipt or an invoice, or over-reporting their costs.

After the moratorium concerning pretended subcontracting expired, enterprises started to use new methods to circumvent the more stringent regulation, these are the following:

1) Some enterprises cooperate to make their subcontracts appear as real ones. The essence of this method is that the partner enterprises employ each other's couriers on paper, in this way a subcontractor works for more companies thus appears as a real enterprise providing services to several costumers. Of course, every courier works only for his or her own company in reality.

⁷ The expression ‘cost production’ (‘kölséggyártás’ or ‘kölségelés’ in Hungarian) refers to the frequently used technique of creating invoices which do not represent any factual cost to the enterprise, but which can be used to over-report costs thus decrease reported profit. This results in lower corporate income tax.

2) An interviewed enterprise uses a variant of the previous method: they buy out a competitor, merge the dispatcher centre and administrative functions, but the couriers continue to give invoices to the different “subsidiaries” in turns.

3) The couriers organize themselves into Ltds or LPs and invoice their only customer: the messenger company.

4) The same owners found a new company every second year with a different name and site, besides, they serve the same customers. Consequently, they do not have any of their employees registered; sometimes they even break verbal agreements on wages or do not pay at all the unregistered salary.

“I was said to be registered, but I went to the APEH to check it and I was not. It was really embarrassing.” (a bike courier)

By choosing creative company names, they can even partially preserve the brand name appealing for customers.⁸

The extent of these methods and generally of tax evasion can be easily studied by the market operator’s balance sheet figures, as the capital–labor ratio of the used production technology diverges only on a narrow scale from company to company. If we take the entirely legal A and B enterprises as benchmarks, in both companies the proportion of labor costs is 65–75 per cent compared to total annual revenues, then we get a stunning picture of the market: based on the figures of 2006, there is not a single company, apart from the above mentioned two, where the proportion of labor costs would be more than 25 per cent, the most frequent proportion is between 6 and 10 per cent⁹. Taken these estimated numbers, we can assume that the enterprises of the market operating in the hidden economy officially paid 200 million HUF in total to the tax authorities, whereas their real labor cost amounted to 1,300 million HUF. So messenger companies operating in hidden economy hid a labor cost of approximately 1,200 million HUF in 2006¹⁰.

Nevertheless, the interviewees’ definite opinion was that the market is consolidating; there are less and less entirely illegal enterprises. It can not be completely explained by the amended tax paying behavior of company A; the other key explanatory factor appears to be the decreasing demand for the services of the unstable, unreliable companies and the more successful model of companies providing better quality services and thus operating in the legal economy.

LEAVING THE HIDDEN ECONOMY – COMPANY A

Messenger company A is the market leader in Budapest, its net revenue in 2007 was 450 million HUF, which had showed a continuous growth in previous years; in

⁸ We will not show the particular example due to anonymity.

⁹ We cannot publish exact figures and names of companies due to the anonymity of this case study.

¹⁰ To this estimation, we assumed that revenues and labor costs of these companies would not change in case of registering employees for their full salary. We assumed a 65% average labor cost to revenues ratio in case of an entirely legal operation, moreover, we also assumed the salaries reported by the enterprises operating in the hidden economy to be 10% of their total revenues, by implication we have given a lower bound estimation of hidden salaries.

2007 they employed 145–150 people on average, of which 20 worked in the office (dispatchers, administrators) and the others were couriers. The company provides its services in the medium high price category emphasizing the quality of service (flexibility, speed, customer care) (LORA 2005b, interview with the CEO of messenger services provider A). They created an alternative capitalist, social entrepreneur image in the wider population and customers; some elements of this are: they operate a used battery collection system for customers for free and employ people dropped out of work therapy.

In August 2006 messenger company A had all of its employees registered for their real salary; these had been either on minimum wage so far (e.g. dispatchers) or had been employed through a subcontract (as in case of the couriers).

Motivations and Conditions

Based on the interviews with one of the CEOs, leaving the hidden economy can be traced back to the following reasons in the case of messenger services provider A:

- 1) The CEOs' moral and psychological costs derived from tax evasion;
- 2) The high expected cost of being caught whose subjective evaluation and factual value both had risen before August 2006¹¹;
- 3) The expiry of the moratorium concerning pretended subcontracting (XCI law of 2003).¹²

These claims apply specifically to messenger services provider A, however, later we are going to extend the validity of these to the other operators of the market too; and we are also going to study the question of generalizability.

These results confirm the observations of the literature which state that better tax moral of employers and employees and their more negative appraisal of tax evasion decrease the participation in the hidden economy (Cummings et al. 2005; Renooy et al. 2004; Mateman and Renooy 2001). Moreover, if operators on the market consider the expected costs of tax evasion as higher the involvement in the hidden economy decreases (*World Bank* 2008; Renooy et al. 2004).

However, the above mentioned incentives would not have been enough for "regularization"; the following preconditions made it possible for this enterprise to remain profitable while fulfilling all its legal obligations:

- 1) Stable market position based on firm competitive advantage and long-term business relation with customers based on trust¹³;

11 "[...] no matter how little the chance of an audit is in the following 5 years, in the case we are caught the sanction is that subcontracts are reclassified as employment contracts [...], and we have to pay the previously unpaid taxes. Besides, due to a new regulation, the managing director has criminal liability." (the CEO of messenger company A, interview 1)

12 http://www.magyarorszag.hu/allampolgar/ugyek/munka/munszerz20050805/szinleltmunkasz20080123.html/u_gyleirasjogi.

- 2) Product differentiation based on quality and image¹⁴, which decreased the price elasticity of demand;
- 3) High profit and a wider margin for cost reduction;
- 4) The loyalty and trust of employees towards the company.

These four factors helped messenger services provider A to remain profitable and stable even after August 2006, however, it is not evident to what degree the particular factors contributed to this. We can only explore this question by showing the key differences in the market position and behavior of the other companies.

Both stable market position and the higher profitability imply that economic prosperity contributes to the reduction of hidden economy. Although this relationship is far from being automatic other factors are also necessary. Our result sheds new light on the relationship between economic development and hidden economy which extends the arguments around it (Williams and Windebank 2001; Semjén and Tóth 2009).

Strategies Used and their Outcomes

The key to the successful “regularization” was that the company managed to share the extra costs deriving from paying the full tax burden among customers, employees, and the enterprise. This was possible as the company had established trust relationships with them in previous years. The proportion of extra cost falling on each stakeholder group was defined by their tolerance to bear the extra costs (e.g. the customers’ price-sensitivity or the couriers’ wage-sensitivity) as well as by the requirement of the company remaining profitable. Beyond this, the “whitening” of messenger company A would have been much easier if they could persuade all the major competitors to follow their example; this way they could have reduced their competitive disadvantage coming from legalization.

Customers. Before the “regularization”, the likely reaction of customers was assessed with the highest uncertainty. A price increase of 30 per cent¹⁵ could have covered all the extra costs if the quantity of orders would not have decreased too much. However, the CEOs did not dare to risk such a price increase particularly because most of the competitors did not follow the example of messenger company A in August 2006. So they increased prices by 20 per cent which was a drastic rise compared to the usual increases of previous years when prices had been increased according to the consumer price index (i.e. less than 10%). As a consequence of this price increase the

13 *"We had credit and all our customers believed that we were rising our prices because of the introduction of entirely legal employment and that it was not a scam."* (extract from the 1st interview with messenger services provider A)

14 *"Basically, we could increase our prices because of our image. The competitors thought the price increase was impossible; however, our alternative capitalist, social entrepreneur image was a great advantage. We had credit."* (the CEO of messenger company A, interview 1)

15 It draws the attention to the fact that if a large number of companies compensate their extra costs deriving from exit from the hidden economy by increasing their prices higher inflation on the macro level will arise.

quantity of orders declined by 10 per cent in the first few months of implementation; however, in the next half year they managed to reach the original demand level; and altogether only one, very price-sensitive customer left the company.

“Increasing prices by 20 per cent was very hard [...] and we were not sure at all whether we can make customers accept it, we were afraid that the company would go bankrupt.” (the CEO of messenger company A, interview 1)

They informed every customer by mail in which they explained the reasons for the price increase in details thus as a matter of fact they made a campaign out of this move:

“[...] (the messenger services provider) is going to have its employees registered for their full salaries with paid holidays, pension, and sick pay in case of an accident. If you call us, you pay only for the freight; you do not have to pay also the taxes instead of us. Your parcel is also in better hands if the courier can take a rest and feels secure.” (excerpt from the campaign text)

The outcome of this campaign was very positive; many customers expressed their support per mail. According to the CEO of messenger company A, trust was the key component: people believed that the price increase was necessary for legal employment.

Employees: As it was not possible to pass on all the extra costs to the customers; the company had to reduce the salary of its employees. However, this move faced an external constraint: the employees were willing to accept only a certain difference between their net salaries and the net salaries paid by competitors in spite of the advantages not explicitly appearing in the net sum (e.g. social security entitlement, sick leave, paid holidays). This difference can be thought of as the cash equivalent of all benefits emanating from legal employment.

This difference in net salaries had been thought to be 10 per cent in advance by the CEOs; however, they had to carry out a 15–20 per cent salary cut to keep the company profitable. What is more, the best couriers were affected above average: their net salaries were reduced by 25–30 per cent due to progressive taxation. As a consequence, the former performance pay system working according to a linear logic (the courier had received a fixed per cent of the fare) was inverted in the case of the best couriers. The above entails that, with similar performance, the couriers' net salary was reduced by approximately 30–40 thousand HUF compared to the net salaries at the competitors.

Before, couriers and employees had not been disturbed by the fact that they had been employed semi-legally, yet, lower salaries¹⁶ due to the regularization made many of them leave the company. Employees left the enterprise mostly from the best category of the couriers, but following the transition after legalization, the fluctuation of employees decreased considerably. There were couriers who came to messenger

16 Net salaries remained well under the sum couriers could earn at the competitors, even after a correction by tax free vouchers (these are tax exempted under the then applicable tax law of Hungary).

services provider A just because they knew they would be employed legally there. It seems to be possible that the net 15–20 per cent difference in salaries is compensated by the advantages of legal employment among those who did not leave messenger company A and also for those who joined the company after the period following “regularization”.

Business results of the undertaking. As the price increase and the salary cut combined were not enough to offset the extra costs deriving from “regularization”, messenger services provider A was inflicted by a significant decrease of profit. In the 4–5 months following August 2006, the enterprise either had zero profit or it made a loss though this situation improved a lot in the later months. The CEOs were surprised by the steep decline in profit. The primary reason was that they had not been able to anticipate the extra costs, for example, they had not planned the labor costs of public holidays that they had to pay. As they got to know the precise cost figures, they had to renegotiate the salaries with the employees.

“There were months when the company was loss-making. Then we changed the commission of the couriers, but they understood and accepted it because they felt to be compensated by receiving salary during public holidays, too.”
(the CEO of messenger company A, interview 2)

These draw our attention to that the complexity of labor law and the difficulty of learning it jeopardized the exit from hidden economy and increased the costs of transition. As a consequence, we suggest that simplifying the regulatory environment and making more easily accessible information on the regulatory framework would aid companies and individuals in leaving the hidden economy thus they would decrease hidden economy on the medium to long run. These findings are confirmed by a number of international comparative studies (*IBRD and World Bank* 2008, 2009; Renooy et al. 2004; Mateman and Renooy 2001).

Competitors. Right from the beginning, the CEOs of messenger services provider A tried to persuade their competitors to follow them in legalization, it was partly due to a commitment and partly because they wanted to ease the burden of competition on their enterprise. This is why they organized a meeting in the summer of 2006, where all major competitors were present. Here, only 3 or 4 of them showed inclination to “whitening”, yet, the majority did not see the reason for a drastic change, and even among the 3 or 4 enterprises only one (messenger services provider B) legalized entirely its operation; the others only partly changed their tax paying behavior (we are discussing these strategies and the motivations behind them below).

With the legalization of two operators of the market and all other companies’ remaining in the hidden economy, a significant distortion of competition came into force at the expense of the entirely legally operating companies. At the same time, the formerly very well working cooperation among competitors and their mutual support for each other in tax evasion which has been revealed by several studies in other sectors became unstable and debated (Semjén et al. 2009a, 2009b). A sign of this is that the legally operating enterprises started to collect information on the illegal activities of

their competitors and that messenger services provider A was anonymously reported against at the police which had been completely unprecedented on this market before.

“[...] we had ‘plan Bs’ too, for example, that we would report the competitors to the police, as we know the weak points relatively well. We have not done it so far, but we are prepared to do so if our enterprise suffered a significant competitive disadvantage. We know all information about the competitors. However, we would like not to do so [...]” (excerpt from the interview with the CEO of messenger services provider A)

The problems and success of “regularization”. Due to the effective communication with stakeholders, the more or less proper planning, and the enterprise’s stable market position the legalization of messenger services provider A is considered as successful in the sense that the company is profitable and after the turbulent changes of the transition the relations with customers and employees settled down.

Despite all these, we can identify a few problems that made the transition more difficult and carry a risk for the future.

1) The complication, inflexibility, and the high costs of complying with labor and tax regulations made the planning of legalization very difficult¹⁷ (e.g. the order of paying the salaries) as well as preserving the company’s effectiveness after “regularization” (e.g. performance pay) a challenge.

2) The unfair competition between the entirely legally and semi-legally operating enterprises and the tension deriving from it make the stability of the present setup questionable which is very well illustrated by the previously unprecedented anonymous accusations against competitors at the police and by the further consideration given to this by the parties.

THE REACTION OF THE OTHER OPERATORS OF THE MARKET

In the following, we are discussing the relevance of factors motivating and allowing for the “regularization” of messenger services provider A in the case of its competitors. Furthermore, we are identifying new explanatory factors, particularly with regard to the impact of the altered taxpaying behavior of messenger company A on competitors.

We encountered all the forms of altered tax paying behavior on the messenger services market of Budapest since August 2006: messenger services provider B legalized its activities entirely, two significant companies decided for a partial “whitening”, whereas, many companies did not change their behavior at all besides increasing prices and making bigger profits – thus behaving as free riders.

¹⁷ *“Before [legalizations] 50 per cent of the price paid by the customer was given to the employee in return for an invoice, and we did not have anything else to do regarding employment. After the announcement of ‘whitening’ we had to figure out salaries as 70 per cent of our revenues goes to covering labor costs. We made many mistakes by not knowing the relevant laws [...] Earlier – partly because of bad experiences – we thought that entirely legal employment was impossible, as the price increase needed for this would ruin the company.”* (extract from the 1st interview with the CEO of messenger services provider A)

On the alternative Way to complete Legalization – Messenger Services Provider B

Messenger services provider B is the only company on the market which entirely legalized its operations similarly to messenger company A. Earlier, apart from invoicing as subcontractors, the employees were also registered on minimum wage here; and they earned between net 150 to 200 thousand HUF per month, however, they did not have paid holidays or sick pay. This enterprise had a turnover of 36 million HUF in 2007, and employed 12 people, so it is significantly smaller than messenger company A.

Motivations and Conditions. Messenger services provider B left the hidden economy independently from messenger services provider A, however, only for slightly different reasons. These reasons were the following:

- 1) The CEOs' moral and psychological costs derived from tax evasion;
- 2) The high expected cost of being caught which was signified by the anonymous report against messenger company B at the APEH¹⁸;
- 3) The expiry of the moratorium concerning pretended subcontracting (XCI law of 2003).¹⁹

What slightly differentiated the two cases, i.e. messenger company A and B, and largely defined the strategies used by messenger services provider B was rather the preconditions of "regularization" (e.g. market position, business size, and profitability) and thus the room for maneuver in terms of legalization strategies. The preconditions were the following in the case of messenger services provider B:

- 1) Stable market position based on firm competitive advantage and long-term business relation with customers based on trust;
- 2) A wider margin for cost reduction;
- 3) The loyalty and trust of employees towards the company.

Based on these, it seems that a unique image and strong product differentiation are not necessary conditions. On the other hand, the trust of customers and employees and 'reserves' in the financial performance of the enterprise – the possibility of cost or profit reduction – are indispensable to cover the extra costs deriving from complying with legal obligations.

Strategies used and their outcomes. As messenger company B provides less differentiated products than messenger company A it is not surprising that it could only install a much smaller price increase – 8–12 per cent – which only slightly exceeded the yearly inflation rate. As a consequence of this, none of the permanent customers left the company, and the drop-out of occasional customers increased only slightly.

18 "An accusation was the direct cause, and then came the expiry of the moratorium. But if it hadn't come, we would have made the change anyways." (excerpt from the interview with the CEO of messenger services provider B)

19 http://www.magyarorszag.hu/allampolgar/ugyek/munka/munszerz20050805/szinleltmunkasz20080123.html/u_gyleirasjogi.

Thus, the arising extra costs (labor costs rose from 40 per cent to 67 per cent as measured against the company's net revenues) had to be divided mainly among the enterprise and the employees. However, again the reduction of the couriers' salary was constrained by their acceptance of salary differentials given their loyalty and the advantages coming from legal employment. Messenger services provider B could carry out a salary cut similar to messenger services provider A, which amounted to an average of 30–40 thousand HUF per employee per month. Because of this, 2 workers out of the then 14 left the company, but since then the fluctuation has significantly decreased here too, according to the CEO, for the following reasons:

"Now that they are employees, they are not going away. [...] People are applying for a job not for a little money. People are coming now who want a job. [...] There is not so much fluctuation due to administrative reasons: It is not feasible to fill in so many papers. On the one hand it is good for the company on the other hand it is bad."

"Friendships had a considerable effect: there were some people who wanted to go, but owing to emotional reasons they stayed. Specifically, there are three persons here who love this place and that's the reason why they haven't left." (excerpt from the interview with the CEO of the messenger services provider B)

It is the apparent experience that the messengers hardly understood those advantages arising from their legal employment which they received less directly, like social security entitlement or pension contributions.

Nevertheless, as not all of the arising extra costs could be passed on to buyers and employees, the company had to bear the main burden. It resulted in a considerable drop in profitability and in a drastic decrease of production costs. The latter was achieved by giving up the central office, moving the dispatcher center into one of the owners' flat, and reducing the number of employees.

"We should have said to our customers: we would be not only more expensive, but also worse as less people would get more work to do." (excerpt from the interview with the CEO of the messenger services provider B)

The competitors made the situation of messenger services provider B particularly trouble as they kept on evading taxation thus they could keep their prices low. Notwithstanding, the CEOs of company B did not denounce them even though they had sufficient information to do so.

"It might happen that once I become so despondent that I will go to the APEH and tell them that I will be killed by tax evading rivals. I hope the employees will notice little by little that it is not Gyurcsány [the Hungarian prime minister then] who steals from them, but they steal from each other 10–20 thousand forints [HUF]." (excerpt from the interview with the CEO of messenger services provider B)

PARTIAL OR MINOR CHANGES IN TAX PAYING BEHAVIOR

The four enterprises of which we could collect sufficient amount of data²⁰ and which have changed their tax paying behavior at least to a minor degree since August 2006 are the large or medium-size operators of the market with 100–350 million HUF net revenue in 2007. Their average yearly number of employees was between 60–140 people in 2007, they typically have growth plans, and their position in the market is stable.

Motivations and conditions. The differences in the tax evasion behavior of these four companies as well as the differences between their and the messenger services provider A and B's behavior can be traced back to the following motivations:

1) Differing evaluations of moral and psychological costs regarding tax evasion which are connected to the negative opinion on the state and to the conviction that this situation is not likely to improve²¹.

2) The subjective judgment of expected costs of being caught, as all the tax evading entrepreneurs were certain²² that they could not be punished by APEH as it had no evidence against them²³.

3) The different subjective judgment on the net benefits of participating in the hidden economy: tax evading enterprises typically underestimated the customers and employees' profit loss deriving from illegal operations and overestimated the benefits of the money deriving from tax evasion compared to legally operating enterprises²⁴.

20 We made interviews with the CEOs of two companies and we got detailed and reliable indirect information about two others. From the two visited companies, one "whitened" its operation partially and in addition, it increased the prices, the other entirely kept its former tax evasion techniques and did not change its prices. From the two other companies, one decided for partial "regularization", but in spite of increasing prices, it reduced the salaries, and changed its production technology; while the other one increased its prices but did not change its tax paying behavior.

21 All the interviewees had a negative opinion on the state, its effectiveness and level of corruption, however, those company CEOs which changed their tax paying behavior believed in improvements and that the state might be able to reform itself.

22 We could not check the truth of these statements, however, the fact that many CEOs from different industries claimed something very similar, as captured by Semjén et al. 2009a, 2009b, is quite telling.

23 "Denunciation would not hurt us. If there is an APEH audit, we just pass it. Only that operator can be caught which works entirely illegally. We work in such a way that the pieces fit well together." (quote from an interview with a company CEO)

24 "It would be no use sitting down with the 24 year old couriers and telling them that how good is for you to pay taxes properly because then you will have a good pension, your kids can live in a better country, and there will be roads etcetera, you know, fair play. They would laugh at me and say that the life expectancy is only 62 years for Hungary and the retirement age is 65, so what am I talking about? Where will they be in 40 something years? Therefore they do not care about their pension at all"– "This will happen until taxes are not paid on this market: more money for the owner, more money for the courier. Couriers in their twenties do not care about their pension."– "At messenger services provider A the couriers were complaining a lot, their net salaries were cut back from 150 thousand to 90 thousand. From the point of view of the company it is a story of absolute success, but for the couriers it is not at all. Our couriers told us that they hoped not to be registered for their full salary as they had heard how the couriers of messenger services provider A had sucked." (quotes from interviews with company CEOs)

The following are closely connected to these three factors.

1) Enterprises judged the importance of the moratorium's expiry and the changing regulations in different ways – those which changed only slightly the quantity of taxes paid reacted only by changing their tax evasion methods.

2) The interviewed CEOs judged the move of messenger services provider A differently; those enterprises which did not decide for “regularization” did not believe that messenger services provider A operates on an entirely legal basis and even the changes believed to have occurred were attributed to certain particular factors not applicable for other companies (e.g. the company A's eco-image).

3) All of those companies which carried on operating in the hidden economy thought that it was not possible to stay profitable and keep the employees and the customers while complying with all the regulations. Nevertheless, it is possible that this argument served as self-justification for the CEOs which attempted to underpin their behavior; thus the direction of causation around this argument is not clear.

“It is impossible to remain profitable with entirely legal employment. If someone abides every rule he has to give such a low salary to the colleagues by which he cannot make them stay at the company. It is a classic borderline: if someone does not have his or her employees registered, he or she can give the courier more salary, and he or she can offer lower prices to the customers this way.” (excerpt from an interview with one of the company CEOs)

Comparing the situation of the entirely legal enterprises to the ones operating in the hidden economy, it becomes clear that the above defined conditions are not sufficient in themselves to change the tax paying behavior: all the companies have a stable position in the market, close links to their employees and the customers. It draws attention again to the finding that the relationship between economic prosperity and hidden economy is not evident in itself; it is only worth being discussed together with other factors. (Williams and Windebank 2001). Furthermore, the different subjective judgments on the benefits and expected costs of participating in the hidden economy as well as the moral costs of tax evasion are all related to the exit from the hidden economy in a way which is expected based on the academic literature (*World Bank* 2008; Cummings et al. 2005; Renooy et al. 2004; Mateman and Renooy 2001).

Strategies used and their outcomes. As the four enterprises looked at in this section changed their tax paying behavior only slightly or not at all, it was not necessary to work out complex strategies for the implementation of “regularization”. However, in those two cases where partial changes occurred, enterprises used different strategies to cover their extra costs. In one of the cases, they simply increased the prices: during this process the 20 per cent price increase of messenger company A was the benchmark; they carried out a slightly smaller price increase (15 per cent), but they had not informed the customers about the reasons explicitly. Taking everything into consideration, we can call this strategy successful, as the number of orders decreased only slightly and it was offset by higher prices. In the other case, the enterprise reduced the salary of its employees to the new net salary level of messenger company A and B; besides, it entirely changed from the formerly used company cars and motorbikes to

the own vehicles of couriers. However, they still do not comply with all the legal obligations; for example, there is no sick pay or paid holiday.

CONCLUSIONS

Throughout the study, in accordance with the literature, we explored those motivations that defined the interviewed enterprises' involvement in the hidden economy and the exit from it: the company CEOs had different moral judgments on tax evasion, the benefits deriving from tax evasion and its expected costs, furthermore, they had a different opinion on the feasibility of completely legal operation and the entailed difficulties. As a consequence, they hid their economic activity to different degrees; the law makers' intention (i.e. to decrease the hidden economy) was realized in different ways in each particular case. It became clear that the real or perceived market position of the enterprises limited the CEOs' room for maneuver regarding the legalization of the company. The strategies deriving from these are unique in the sense that they reflect the financial situation of the given enterprise and its relations to its customers and employees. On the other hand, they are also general as they build on typical dilemmas and considerations.

We explored what proportion of the extra costs deriving from complying with regulations the companies pass on to their employees and customers or absorb by themselves. This also drew the attention to the possibility that due to the complete regularization of an economy the actual output level declines thanks to higher prices and less flexible employment forms. Furthermore, the reduction of demand and the complexities of the regulatory environment made the financial situation of messenger services provider A unstable for months following the move to legalize its business activities even though it had had a stable market position and had been generally successful. Presumably, there are many companies in the hidden economy whose regularization would lead to a bankruptcy of the company. During the assessment of public policies which aim to legalize the economy it is essential to take this possible impact into consideration.

As we could only conduct interviews with the largest operators of the market, or at least we could collect reliable information on them, we can consider our findings as valid and reliable for the whole market. However, the smaller, possibly less legally operating companies remained outside of the sample thus it is possible that this market segment operates somewhat differently.

It also turned out, that the companies remaining in the hidden economy made an extra profit out of the market leader's "regularization": they also increased their prices, but they typically did not channel this extra revenue into paying more taxes thus evading less taxation. This apparently has caused some tension on the market. Therefore, the key question is still open as to how the future will change, how stable the situation is which had evolved by February 2008. It seems to be possible that the tension will grow between the entirely legal enterprises and those which operate in the hidden economy due to the unfair conditions of competition. So it would not be surprising if the taxpaying behavior of enterprises changed significantly in the near future – either because of the accusations and audits or fear deriving from these.

It is worth placing the results of this case study in a more general context. Taking the findings of scholarly work analyzing the forms and mechanisms of hidden economy in Hungary (Semjén et al. 2009a, 2009b; Semjén and Tóth 2004) into consideration, it does not seem to be possible that the abrupt and complete exit from the hidden economy would be typical or that this step is likely to occur in the case of other markets. Furthermore, it is still not clear how successful such an “abrupt” and drastic legalization is on the longer term (5–10 years).

The motivations, conditions, and strategies explored in the study and the relationships among them are in accordance with the results of earlier studies, yet, our findings further specify and enrich them.

On the other hand, light was also shed at relationships which were only slightly analyzed before or which were considered as different in the Hungarian literature.

1) Our results slightly diverge from earlier findings regarding the impacts of the subjective judgment of the government on participation in the hidden economy (Renooy et al 2004; Mateman–Renooy 2001). Based on the interviews of our case study it turned out that although the state was thought to be mainly wasteful, inefficient, and corrupt the expectations of the CEOs of those companies which achieved partial or complete “regularization” were more positive about the prospective behavior of the state. They hoped that the present adverse situation will change in the near future. However, as we could not analyze the opinions on the government in the period before “regularization”, we cannot be sure whether it is not only the actors’ self-justifying story.

2) The impact of the imposed labor and tax fines on the taxpaying behavior of enterprises was judged to be controversial in earlier studies because in many cases the tax-evading behavior not, only the employed methods changed (Semjén et al. 2009a, 2009b). On the other hand, in the case of the messenger services providers of Budapest the imposed fine strongly motivated their legalization, in two cases it was the definite cause (see, for example, messenger company B). Moreover, it seems to be likely that information on a serious fine made other, formerly not fined companies reconsider their taxpaying behavior. It is an open question why the change in taxpaying behavior due to imposed fines and strict control does not occur in certain industries (e.g. building industry) while it does in others.

3) In order to achieve the “regularization” of an entire market, it is probably necessary to reach a critical mass beyond which all other operators of the market adjust themselves to the new norms (Szabó et al. 2009). It becomes evident from our study that the “regularization” of one or two dominant operators of a market is not enough for the short term – within 1 or 2 years – legalization of the whole market, but the earlier stable relationships developed among companies operating in the hidden economy can quickly become unstable and strained if some key enterprises “leave the circle”.

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