



Mutual Learning Programme

DG Employment, Social Affairs and Inclusion

Peer Country Comments Paper – Cyprus

Seeking elusive chains of employment in the underground economy

**Peer Review on “Control and prevention of undeclared
work in complex chains of economic activity”**

Slovakia, 4-5 May 2021

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April 2021



EUROPEAN COMMISSION

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This document has received financial support from the European Union Programme for Employment and Social Innovation "EaSI" (2014-2020). For further information please consult:
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1 Introduction

This paper has been prepared for the Peer Review on "Control and prevention of undeclared work in complex chains of economic activity" within the framework of the Mutual Learning Programme. It provides a comparative assessment of the policy example of the host country (Slovakia) and the situation in the Republic of Cyprus (Cyprus). For information on the host country, see Holubová and Kahancová (2021).

2 Situation in the peer country

Cyprus experienced a mild contraction during the International Crisis of 2009 and a severe one during the Cyprus Crisis (2012-2014). It rebounded in 2015 and continued to enjoy substantial GDP growth during 2016-2019. This improvement of economic activity came to an end during the Covid-19 pandemic, when real GDP growth in 2020 was -5.1%. The incidence of Covid-19 continues to mute economic activity.

Two papers provide estimates of the 'shadow economy' in Cyprus. Andreou, C. et al (2019, p.2) define it as ... "market-based activities that are hidden from the authorities, and therefore are neither taxed nor included in national statistics". They use quarterly time series of the growth in the consumption of electricity and the associated GDP, relative to the actual official GDP, to deduce the size of the shadow economy. Their average estimate of the shadow economy for the period 1995-2018 is in the range of 11-18% of GDP. Using the currency demand approach, their estimate over the same period is in the range of 25-34% of GDP. Andreou, E. et al (2020) use household surveys for 2009 to estimate "income under-reporting in the shadow economy" by comparing the food consumption patterns of paid workers (who are assumed not to underreport their income) and the self-employed (who are assumed to do so). They estimate the underreporting of income by the self-employed to be in the region of 40%, which may be in the region of 8% of GDP. The large categories of undeclared work participants are thought to be (Member State Factsheets on Undeclared Work, Cyprus, p. 29) illegal immigrants and refugee claimants, who are not supposed to work for six months, the self-employed who do not report or who underreport earnings, and paid workers in undeclared jobs for which no income taxes and social contributions are made.

It is not clear what the implications of these measurements may be for letterbox companies, platforms, temporary agency work (TAW), and complex employment chains. They may capture underreporting because they do not rely on direct measurements in the four forms of employment. All methods approximate undeclared work through how the income from these activities modifies the transactions and consumption of the individuals involved. No reliable estimates of employment in the four forms are available.¹

Third-country workers are not initially involved in undeclared work because their entry into Cyprus is tightly controlled. Some do enter illegally or may break their contracts and disappear into the labour market. Table 1 shows their legal numbers in 2008, 2016, and 2019; also, by gender and the main (over 1000 individuals in 2008) NACE categories where they are employed. The largest category is women in domestic work, the care of children, and the elderly (category T). Their total number fell with the Cyprus Crisis in 2016, but rebounded to 35 000 (15 600 men and 19 400 women) in 2019, or 10.6% of the total Cypriot employment (this is 15.5% for EU citizens). The impact of the COVID-19 recession on undeclared work in Cyprus is difficult to evaluate; particularly as many programmes which were adopted to support employment during

¹ Christofides (2021) reviews available evidence on the size of platforms in Cyprus. As a percent of GDP, this is likely to be a low single-digit number. Official information on self-employment, those holding second jobs, and precarious employment (categories likely to exist in complex employment chains) suggests that low numbers are involved. Self in total employment declined from 21.7% in 2005 to 11.2% in 2019.

the pandemic may have generated paid leisure which may have been devoted to undeclared work.

Table 1. Employment by nationality, economic activity, and sex (NACE Rev. 2, 15+, in 1000s)

	2008			2016			2019		
	Total	M	F	Total	M	F	Total	M	F
Total	382.9	212.2	170.6	363.1	188.4	174.6	416.5	221.2	195.2
Cypriots	318.2	184.2	134.0	292.6	155.7	136.9	330.2	179.1	151.2
EU nationals	34.9	18.7	16.2	44.5	23.7	20.8	51.2	26.6	24.7
Non-EU nationals:	29.8	9.3	20.4	26.0	9.1	16.9	35.0	15.6	19.4
A Agriculture, Forestry and Fishing	1.5	1.4	0.1	2.4	2.4	0.1	1.5	1.2	0.3
C Manufacturing	1.1	0.9	0.2	0.4	0.2	0.1	1.4	1.2	0.2
F Construction	4.2	4.0	0.1	2.6	2.5	0.1	5.6	5.4	0.2
G Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles	2.2	0.7	1.5	1.7	0.9	0.9	1.9	1.4	0.5
I Accommodation and Food Service Activities	1.0	0.5	0.5	1.3	0.4	0.9	3.3	1.6	1.7
T Activities of Households	16.2	0.3	15.9	11.8	0.2	11.6	14.2	0.7	13.5

Source: CYSTAT, updated May 4, 2020, abridged from Christofides (2021, Table 7).

3 National policies and measures

3.1 Overarching issues

As the quote from Eurofound (2018) notes,² the legal underpinnings of employment in the EU have not coped with the complexities in long chains of employment. These issues include:

- (i) the concepts of 'employee' as well as the definition of 'self-employment' and the notion of 'dependence' on the employer,
- (ii) the legislation/regulations that go with the status of 'employee' and the 'self-employed',
- (iii) the situation with EU and third country workers,
- (iv) the extent to which the employer has fulfilled the obligation to advise authorities of a new employment, and
- (v) whether compulsory contributions to social security, health and the income tax authorities are made.

² " For the time being, none of the EU Member States has clear regulations specifying the employment status of platform workers. As a result, workers fall back on the existing regulatory framework and adopt one of the employment statuses it recognises. Typically, a distinction is made between employees and self-employed workers."

As far as the first point is concerned, the concepts of 'employee' and of the 'self-employed' are not clearly distinguished in Cyprus. 'Employer dependence' is used in some jurisdictions to distinguish between employees and the self-employed. It concerns whether and to what extent a worker relies on a *sole* employer for his/her income and whether the employer has a direct supervisory role in the execution of the worker's duties. As Stavrou (2009) notes,³ self-employment is of legal consequence as it relates to the payment of social security, and health contributions. Different contribution rates are required for employees and the self-employed. But it is also of consequence for how labour income is declared and taxes are paid to the government (as separate forms exist for employees and the self-employed).

In Cyprus, there has not been much discussion and codification of how employees and the self-employed are to be defined and distinguished. By contrast, Slovakia has made this distinction clearer (Host Country Paper, footnote 8). However, it is not obvious how underreporting by the self-employed is regarded in Slovakia: "A key aspect in defining (and proving) illicit work and illicit employment is the performance of dependent work" (Member State Factsheets on Undeclared Work, p. 151). Does this suggest that underreporting by a self-employed individual who is not dependent on a sole employer is legal in terms of labour legislation? Is it not an offence under the provisions of income tax legislation? A clarification to this question is sought in section 5.

Regarding the second point above, the concept of an 'employee' is covered by the labour code; issues such as wages (including minimum wages), hours of work, holiday entitlements, work safety, notice of layoff and compensation, and unemployment insurance are also regulated. A proportional treatment is legally assured for those on part-time or temporary contracts.⁴ By contrast, the 'self-employed' are thought of as employers and employees, making higher social security and health contributions, and not being eligible for workplace accident or unemployment insurance in order to avoid moral hazard, i.e. a situation where social insurance causes insufficient effort to avoid a work accident or to secure additional work, actions which may be entirely at the discretion of the self-employed person acting in the capacity of 'employer'.

The income tax authorities are instrumental in determining and treating the nature of labour income as either (a) income from paid work as an employee, or (b) as income from self-employment. For *employees*, their income taxes, social security, and National Health System ('GESY') contributions must be collected at source and be transferred to the authorities directly, along with the employer's share of the contributions. Employees receive their labour income net of these three payments. On the other hand, the *self-employed* have an income imputed according to their profession, and contributions levied on it. Their (claimed) actual income is used for income tax purposes. Regardless of the employment status, net income (actual minus contributions) is taxed, if it is above EUR 19 500, at increasing marginal rates between 20% and 35%.

It is widely believed that self-employed trades people and professionals underreport their income. They engage in legal activities which, however, may be part of the world

³ "there is a legislative gap in relation to [...] the concept of employee. [...] Labour legislation as a whole refers exclusively to employees but without expressed reference to paid employment and does not cover the self-employed. The concept of self-employed [...] is encountered only in the area of insurance where the [...] Law [...] makes a clear distinction between paid employees and self-employed persons as the two categories of compulsorily insured people. As far as the extent and nature of economically dependent work are concerned, to date no relevant studies or research have been carried out. [...] the most common form of economically dependent work is [...] bogus self-employment. No statistical data are available."

⁴ The Ministry of Labour, Welfare and Social Insurance (MLWSI) has posted information on temporary and part-time employment arrangements – see the References. The Law Concerning *Work on Fixed Terms* (Prohibition of Discrimination) of 2003 covers contracts with length based on objective and verifiable factors (e.g. calendar time and completion of task). There is no limit on the number of successive contracts but, after thirty months of continuous employment, the contract is converted to one of indefinite duration. *Part-time work* is regulated through the Law Concerning Part-Time Work (Prohibition of Discrimination) of 2002, amended in 2007. These laws aim to encourage alternative forms of employment and to discourage discrimination against them. See Christofides (2016).

of undeclared work if they are not fully reported. Of course, for income tax purposes, this is an offence. Until the tax year 2020, individuals with income below EUR 19 500 did not have to file a personal tax return, a provision which gave the self-employed an opening for underreporting. The obligation to file is in the process of being made stricter for the tax year 2020.

On the third point, non-Cypriot EU citizens are treated as if they were Cypriots in terms of all the above issues. The arrival and employment of third country workers is for fixed terms, it is governed by separate processes and legislation, and is tightly monitored by the government. The aim of monitoring is to avoid abuses of the workers, while at the same time ensuring that the worker returns home once the contract expires and does not disappear into the Cyprus labour market illegally. Of course, cases of failing to achieve both objectives are bound to exist.

Regarding the fourth point, when a new employee is hired, employers in both Cyprus and Slovakia are required to notify the authorities, though country details may differ.

As for the fifth point, in Cyprus, social security and NHS (GESY) contributions are made by both employers and employees. Employers must remit their own contributions and, in addition, they must withhold and remit the contributions of their employees along with the appropriate income tax on the expected earnings of their employees.

The terms of letter-box companies, platforms, and complex employment chains are not spelled out in Cypriot legislation. Legislation on temporary agency work (TAW) does exist⁵ and may cover some problems that could arise in complex employment chains.

3.2 Detailed questions raised in the template⁶

The questions/issues posed in the template are grouped under the headings below. It must be remembered that platforms, complex chains of employment, letterbox companies and TAW are relatively new phenomena in Cyprus – see Christofides (2021) for Cyprus and Eurofound (2018) for the EU. As a result, clear and definite answers cannot be given to many of the questions posed in the template.

Employment versus provision of business services

As discussed in section 3.1, the concept of self-employment has not been of specific legal concern, except in as much as the provisions of social security/health and income tax filing differ from those for employees. As noted by Stavrou (2009), this opens up the possibility of 'bogus self-employment', functioning as an 'employee' but claiming 'self-employment' for tax and contribution purposes. This may be advantageous to employees and employers. Unlike Slovakia, which has codified the distinction between the two forms of employment, this has not been set in law; it is instead handled pragmatically in Cyprus by the authorities that collect contributions and income taxes.

Inspections, appeals, inspection/violation records, procedures followed

The 2017 Law Regarding the Establishment and Organization of a Central Labour Inspectorate makes the Inspectorate responsible for the enforcement of thirty extant pieces of legislation. Before the establishment of the Inspectorate, these were under the remit of three separate Departments in MLWSI. This legislation includes the control of undeclared work, the enforcement of the minimum wage, hours of work, and the operation of TAW. The Inspectorate cooperates with several government units, as needed.

The procedure for inspections follows two main routes:

⁵ Law N. 174/2012 and regulations 517/2012 cover Temporary Agency Work, where employment is secured through an intermediating agency. There is a maximum initial term of employment of 4 months with renewals not to exceed a further 8 months.

⁶ This section draws on material supplied by Andis Apostolou of MLWSI.

- A hotline has been operating since 2010 and information or complaints can be filed by employers or employees. More than 60% of inspections are triggered by contacts from this hotline.
- Programmed inspections are organised according to an annual plan, particularly for employers who were found in violation of any law during previous years.

More than 6 000 inspections and about 1000 fines are imposed every year, and information concerning several laws is collected at each inspection. The Inspectorate is responsible for keeping a Registry where certain information is filed (name of company, number of employees, violations, fines, etc.). This Registry is kept with no time limit for internal use, but it is also made available to committee meetings involving social partner organisations. Unlike Slovakia, where some pushback from employers has occurred, at this stage of the new system this has not happened in Cyprus to any significant extent.

Co-responsibilities in complex chains and letterbox companies

There has been no specific information regarding complex chains or letterbox companies provided to the Inspectorate. As a result, these cases are handled as any other usual cases: information is sought from the employer in Cyprus and the inspection process proceeds according to the provisions of the relevant legislation.

Supervision and undeclared work

An important priority of the Inspectorate is to tackle undeclared work but not specifically illegal workers (12% in 2020, down from 26% in 2009). An annual programme of inspections is approved by the Minister. Sectors where high percentages of undeclared work are thought to exist are targeted for monthly inspection. Legislation regarding undeclared work and the protection of wages has reversed the burden of proof to the employer facilitating convictions.

In cases where undeclared work is involved, the law provides for an administrative fine of EUR 500 per month for every employee who is found not to have been registered in social insurance services. This is levied for seven months, amounting to EUR 3 500 per person. In addition, in cases where a Court decision for undeclared work has been reached, the employer is excluded from public contracts for three years. This exclusion exists in Slovakia too.

Regarding the third-country nationals, a special permit is required from the Department of Labour in MLWSI; the Inspectorate is responsible for ensuring compliance.

4 Considerations for future policies and initiatives

Cypriot tax arrangements provided a window for possible abuse by the self-employed because, until the tax year of 2020, it was not necessary to file an income tax form for incomes below EUR 19 500. This personal exemption is above the average salary and a credible income for many professions. This is not easy for employees because their employer must issue them with annual Certificates of Earnings, withhold, and remit income tax and other contributions to the authorities. Filing for taxes regardless of income will be compulsory from 2020, though further details are being worked out.

The possibility of undeclared work becomes especially likely when employees work in long chains of command which blur their responsibilities and sources of income. Bogus employment can then be a tempting alternative for workers. This raises the issue of the determination of the employment, social security, health care, and tax status of an individual. The codification of the employment status could help discourage bogus employment.

The establishment of the Inspectorate in 2017 is an important step forward in Cyprus. The Inspectorate took over the enforcement of a number of laws dealing with labour market issues and has improved the efficiency of supervision and control. It has also

improved knowledge about undeclared work and has discouraged it through the application of fines, and frequent inspections. This has been a high priority for all social partners.

Complex employment chains are a relatively new phenomenon in Cyprus and, it seems, in Slovakia too. A clear codification of the employee/self-employed status and closer co-operation of national authorities could provide a better appreciation of these chains.

5 Questions

- Is it necessary to file a tax return regardless of the level of income earned and the personal exemption in Slovakia?
- Are the self-employed in Slovakia thought to be engaging in undeclared work through underreporting? How would underreporting be treated by the income tax authorities? If established, would it not be an offence?
- How are long chains of employment recorded and treated in Slovakia?

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Annex 1 Summary table

The main points covered by the paper are summarised below.

Situation in the peer country

- Recent estimates of the value of undeclared work relative to GDP exist from different methods: Based on the consumption of electricity it is 11-18%; on currency demand it is 25-34%; and on food consumption of the self-employed (who underreport incomes) relative to that of employees (who are assumed to declare income fully) it may be about 8%.
- These wide and differing estimates underscore the difficulty of measuring undeclared work.
- Large numbers of other EU and third country nationals work in Cyprus legally (15.5% and 10.6% of Cypriot employment respectively). These are not likely to be the source of undeclared work in Cyprus.
- Participants in undeclared work may be illegal workers, self-employed who underreport, and undeclared paid workers; there are no official figures for these groups.

National policies and measures

- Legislation is in place for part-time, temporary work, and TAW, but not specifically for platforms and complex employment chains.
- There is no codification of the definition of self-employment, the employee status, and the role of dependence on a single employer in Cyprus. This may facilitate the operation of complex employment chains and bogus employment.
- Self-employment had, until now, offered a number of advantages in regard to tax avoidance. These will be restricted when, from tax year 2020, all individuals regardless of income must file for taxes. Clarifications on exemptions are pending.
- The system of registering new employees and withholding funds to cover income taxes and contributions is in place and works, except in the cases of undeclared work.

Considerations for future policies and initiatives

- Illegal employment has become a difficult issue because of the porous nature of the border with the north and the large number of refugee claimants.
- Underreporting by the self-employed could be tackled more effectively by codification of this status.
- A better appreciation of the architecture of employment chains requires supra-national cooperation; this could help locate individuals along with their physical, tax, social security and income tax residence.
- The establishment of Inspectorate has been an important development; its reach and ability to cover complex employment chains would be enhanced through international cooperation.

Questions

- Is it necessary to file a tax return regardless of the level of income earned and the personal exemption in Slovakia?
- Are the self-employed in Slovakia thought to be engaging in undeclared work through underreporting? How would underreporting be treated by the income tax authorities? If established, would it not be an offence?
- How are long chains of employment recorded and treated in Slovakia?

Annex 2 Example of relevant practice

Name of the practice:	Law Regarding the Establishment and Organization of a Central Labour Inspectorate
Year of implementation:	2017
Coordinating authority:	Ministry of Labour, Welfare and Social Insurance (MLWSI)
Objectives:	Brings the responsibility of overseeing the provisions of some thirty pieces of legislation, previously the remit of three different departments in the MLWSI, under the roof of the Inspectorate.
Main activities:	Planning and execution of systematic labour inspections, particularly in sectors where undeclared work is more likely to exist. The focus is not specifically on illegal workers. Follow-up on information left on a confidential line by employers and employees regarding undeclared work violations. No separate procedures for platforms and long chains of command exist as of yet. A law about Temporary Agency Work is in place, overseen by the MLWSI. The Inspectorate collaborates with several government units to carry out its responsibilities.
Results so far:	About 6 000 inspections are conducted and approximately 1 000 fines are levied annually. Records of the outcomes of these are kept internally and are made available to meetings involving the social partners. Fines may be imposed and offending firms may (in the case of judicial decisions) be banned from bidding for public contracts for three years.



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