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"What we pay in the shadow: Minimum wage hike and labor tax evasion"

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This paper studies the employment effect of a minimum wage hike in Latvia in 2014. As in many post-soviet countries, the Latvian labor market is characterized by a high prevalence of envelope wages, i.e., an additional wage component paid in cash to employees and not declared to fiscal authorities. Using a combination of administrative and survey data, we propose a methodology to detect firms likely to evade using machine learning techniques. We then examine firms' employment response to the minimum wage hike conditional on tax compliance. Firms engaged in labor tax evasion are insensitive to the minimum wage shock, unlike compliant firms. Our results suggest that increasing minimum wage can push tax-evading firms to convert part of the envelope into legal wage, but this comes at the cost of a negative employment effect on compliant firms.

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