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## **THE INFORMAL ECONOMY AND POVERTY: EVIDENCE AND POLICY REVIEW**

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This review explores the relationship between the informal economy and poverty so as to understand whether the informal economy helps those who are poor to escape their poverty and how to address the informal economy in anti-poverty strategies.

In particular, the report:

- reviews the existing evidence on the size of the informal economy, who participates in and benefits from informal work as well as what type of work they do and why;
- evaluates the range of policy options for dealing with the informal economy;
- identifies best practice policy measures from other advanced economies that enable people in poverty to move from informal into formal work; and
- reveals the need for changes in broader work and welfare systems so as to prevent people in poverty having to turn to the informal economy in order to make ends meet.

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## EXECUTIVE SUMMARY

To understand whether the informal economy helps those who are poor to escape their poverty, this report reviews the evidence on the size of the informal economy, who participates in and benefits from informal work as well as what type of work they do and why. It then evaluates how the informal economy might be tackled in a way that helps people who are poor to escape their poverty.

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### **Poverty and the informal economy: the evidence-base**

Reviewing the evidence on the relationship between poverty and the informal economy in the UK, this report reveals that although those in poverty are more likely to participate in the informal economy, their wage rates and total income from informal work are lower than for other groups, meaning that the informal economy reinforces their marginalised position.

One recent estimate suggests that the UK informal economy is equivalent to 10 per cent of GDP, thus constituting an economy of £150 billion (Schneider and Williams, 2013). From the limited and somewhat dated evidence available, it appears that although people in poorer populations are more likely to engage in informal work, they benefit less from the informal economy, meaning that the informal economy reinforces, rather than reduces, the inequalities produced by the formal economy. For example, a survey of Southampton and Sheffield found that 40 per cent of households in lower-income neighbourhoods undertook informal work in the previous 12 months but only 18 per cent of households in affluent neighbourhoods. However, lower-income neighbourhoods, the mean annual household income for households working informally was £115 compared with £2,420 for households in higher-income populations (Williams and Windebank, 2001).

Similarly, a 2007 Eurobarometer survey finds that the unemployed in the UK only undertake a small proportion (6 per cent) of all informal work (despite being 8 per cent of the surveyed population) and earn 28 per cent less per hour (£11.84) than the formally employed (£16.42) from their informal work. The unemployed therefore earn just over 1 per cent of the population's total earnings from informal work. Meanwhile, those in formal jobs receive 97 per cent of the total income earned from informal work, earning both more per hour and having higher annual informal incomes (European Commission, 2007b). The outcome is that the informal economy reinforces the marginalisation of people living in poverty.

Examining the types of informal work conducted, the 2007 Eurobarometer survey reveals that 29 per cent is waged employment, 11 per cent is self-employment and 60 per cent is 'paid favours' conducted for close social relations. Informal work in lower-income populations is more likely to take the form of paid favours for close social relations. When they conduct informal waged work and informal self-employment, it is often low-paid and frequently conducted out of 'need, not greed', in the absence of alternative means of support and livelihood (European Commission, 2007b). Whatever the type of informal work conducted and whatever the reasons are for doing so, however, this activity results in unfair

competition for legitimate businesses, does not allow customers any legal recourse if a poor job is done and is fraudulent activity involving tax evasion and/or benefit fraud (i.e., ‘working whilst claiming’) causing a loss of revenue for the state, which has knock-on effects on attempts to create social cohesion and leads to a loss of regulatory control over the quality of jobs and services provided in the economy.

### **What is to be done about the informal economy?**

Four possible policy options exist for dealing with the informal economy: do nothing; eradicate the informal economy; de-regulate the formal economy; or facilitate the formalisation of informal work. Reviewing the implications of each, the finding is that: solely doing nothing would leave those in poverty in their current marginalised position and do nothing to deal with this; solely pursuing its eradication would take away from people in poverty even those small opportunities they can seize to alleviate their plight; solely de-regulating the formal economy would result in a levelling down of work and welfare provision, casting even more into the same plight as those currently living in poverty; and solely facilitating formalisation, although enabling government to achieve its wider objectives of employment creation, enterprise development and social cohesion, would leave governments without any teeth to tackle those refusing to formalise.

The result is that a mixture of these approaches is required. Conventionally, the UK government pursued the eradication of the informal economy by increasing the perceived or actual likelihood of detection and the penalties and sanctions for those caught. However, given that many businesses start-up in the informal economy (Williams and Martinez, 2014) and paid favours are a common tool used by those living in poverty to help each other out (Williams and Windebank, 2001), one hand of government was recognised to be pursuing the elimination of precisely the entrepreneurship and active citizenship that other hands of government were seeking to foster. In recent years, therefore, the UK government’s approach has begun to shift away from eradication and towards facilitating its formalisation. This report supports this policy shift towards formalising informal work but also recognises that other approaches have an additional supporting role to play such as doing nothing in relation to paid favours, eradication when tackling those who refuse to formalise and de-regulation when seeking to make it easier to formalise.

### **How can people in poverty be helped to move from informal into formal work?**

To identify how people living in poverty can be helped to move from informal into formal work, the transferability to the UK of various ‘good practice’ policy measures implemented in other western nations are evaluated. These include initiatives that: enable people to engage in odd-jobs legitimately, such as the mini-jobs scheme in Germany and the Simplified Employment Act 2010 in Hungary; smooth the transition from unemployment to self-employment such as the start-up premium (Gründungszuschuss, GZ) in Germany and formalisation services; and enable types of informal work conducted by people in poverty to be moved from the informal to the formal economy, such as the household work tax deductions schemes in Sweden and Denmark and the service voucher schemes in France and Belgium.

Developing effective methods to transform informal work into formal work, however, is not simply about choosing effective individual policy measures. It is also about putting these policy measures together in various combinations and sequences that are effective. For example, governments might simplify regulatory compliance as well as introduce incentives, such as amnesties, to enable people to move into the formal realm; at the same time, in relation to those who fail to comply, they may implement tougher sanctions for those subsequently caught, while also introducing campaigns to elicit greater commitment amongst the public to tax morality. What combination of measures to use will be determined by the structure of the informal economy. Tackling an informal economy dominated by small-scale paid favours between close social relations for redistributive rationales in the domestic services realm will require different measures to tackling an informal economy where exploitative sweatshop like work exists, such as unlicensed ‘gangmasters’ using illegal immigrant labour in the agricultural sector. An effective mix of measures will thus tackle the specific structure of the informal economy it confronts and directly address the key drivers that elicit such informal behaviour.

In future, in consequence, evaluations will need to be conducted of which combinations of measures ordered in what sequence are most effective in which contexts. Before doing this, however, evaluations will be required of which individual policy measures work and which do not, albeit perhaps in conjunction with other measures. Until this is done, it will not be possible to know what works and what does not in different contexts. These innovative initiatives, however, are mere palliatives. They are necessary but insufficient for tackling poverty and the reasons for people in poverty working in the informal economy.

### **What is the relationship between the informal economy and broader economic and social policies?**

If people in poverty currently reliant on the informal economy as a means of livelihood are to be helped to escape the informal economy, mainstream labour market opportunities and welfare support will also need to be enhanced. Analysing the relationship between the size of the informal economy and broader economic and social policies, using a comparison of the 27 member states of the European Union (EU-27), the finding is that societies with larger informal economies are characterised by lower levels of social protection, less government expenditure on active labour market interventions, lower and less effective social transfer mechanisms and greater inequality. Although these are tentative findings based on simple bivariate correlations and the effect of other contextual factors have not been taken into account, and further research is required, the very tentative conclusion that can be drawn is that there is currently no evidence that ‘austerity’ policy measures of de-regulation and cutting taxation reduce the size of the informal economy (and if anything, they appear to increase its size) and that it is countries pursuing a more ‘interventionist social model’ in the form of greater levels of social protection, government expenditure on active labour market interventions to help vulnerable groups, more effective social transfer mechanisms and more equal societies that have smaller informal economies and the poor therefore presumably less reliant on the informal economy as a means of livelihood and support.

# 1 INTRODUCTION

To understand whether the informal economy helps those who are poor to escape their poverty, this report reviews the limited evidence available on the size of the informal economy in the UK, who participates in and benefits from informal work, what type of work they do and why. This is then followed by an evaluation of how the informal economy can be tackled in a manner that helps people escape their poverty.

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This report is one of several reviews being conducted as part of a four-year JRF programme to produce an evidenced and costed anti-poverty strategy for the UK. The aim of this report is to review the evidence-base on whether the informal economy enables people to escape their poverty and to evaluate what needs to be done about the informal economy. To fulfil this aim, this report has two objectives:

(1) *To analyse the relationship between poverty and the informal economy.* How common is it for those in poverty to participate in the informal economy? Are the poor more likely to engage in the informal economy than relatively affluent groups? Do they receive the same level of rewards from their work in the informal economy? And what type of informal work do those in poverty engage in and why?

(2) *To evaluate in the light of the above findings what can be done about the informal economy.* What are the implications for those in poverty of either: doing nothing about the informal economy; eradicating the informal economy; de-regulating the formal economy; and transforming work in the informal economy into formal work? Are there good practice policy measures from other countries that are transferable to the UK? And what is the relationship between broader social and economic policies and participation in the informal economy?

To fulfil these aims and objectives, the first section reviews the evidence on the relationship between poverty and the informal economy in the UK. To do this, a review is undertaken of what is known about the extent of the UK informal economy, who engages in and who benefits from informal work, what informal work they conduct and why they do so. The second section then explores what is to be done about the informal economy by evaluating the implications for those in poverty of pursuing four possible policy options: doing nothing; eradicating the informal economy; de-regulating the formal economy; and formalising informal work. Weighing up the costs and benefits of each policy and displaying that moving informal work into the formal economy is the only feasible policy option for improving the conditions of those living in poverty and operating in the informal economy, the third section will review

various ‘good practice’ policy measures implemented in other countries to help those in poverty formalise, which might potentially be transferred to the UK policy context. The fourth section will then explore the relationship between broader social and economic policies and the prevalence of, and reliance on, the informal economy.

Before commencing, however, both the informal economy and poverty need to be defined. Reflecting the widespread consensus in both the academic and practitioner literature, the informal economy is here defined as paid activities that are unregistered by, or hidden from, the state for tax, social security and/or labour law purposes but are legal in all other respects (European Commission, 1998, 2007a; OECD, 2012; Renooy et al., 2004; Pfau-Effinger, 2009; Sepulveda and Syrett, 2007; Williams, 2006). If the goods and services involved are illegal (e.g., illicit drugs), or the work is unpaid, these activities are not delineated as the informal economy but rather, part of the ‘criminal’ or ‘unpaid’ economies respectively. There are of course blurred edges, such as when gifts or in-kind labour are exchanged in lieu of money (White, 2009). Here, nevertheless, activities are only deemed to be part of the informal economy if money changes hands between the employer/purchaser and employee/supplier.

The working definition of poverty here adopted, meanwhile, is that it is when a person’s resources are not sufficient to meet minimum needs. Obviously, how people acquire the resources to meet these needs is open to discussion. Although formal employment represents one means of acquiring the resources to help them meet their needs, there are many other ways of accumulating the resources required to do so. In theory, the informal economy might provide one alternative means of accumulating resources to meet needs. Whether this is the case and what can be done about the informal economy is the subject of this report.

## 2 THE INFORMAL ECONOMY AND POVERTY: A REVIEW OF THE EVIDENCE

Reviewing the evidence-base on the relationship between poverty and the informal economy in the UK, this chapter tentatively uncovers that the informal economy does not enable people to escape their poverty. Although people in poverty are more likely to work informally, their pay rates and total income from informal work are lower than for other population groups, meaning that the informal economy reinforces their marginalised position.

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This chapter reviews the available evidence on firstly, the size of the UK informal economy, secondly, who participates in and benefits from the informal economy and third and finally, what type of work they conduct and why.

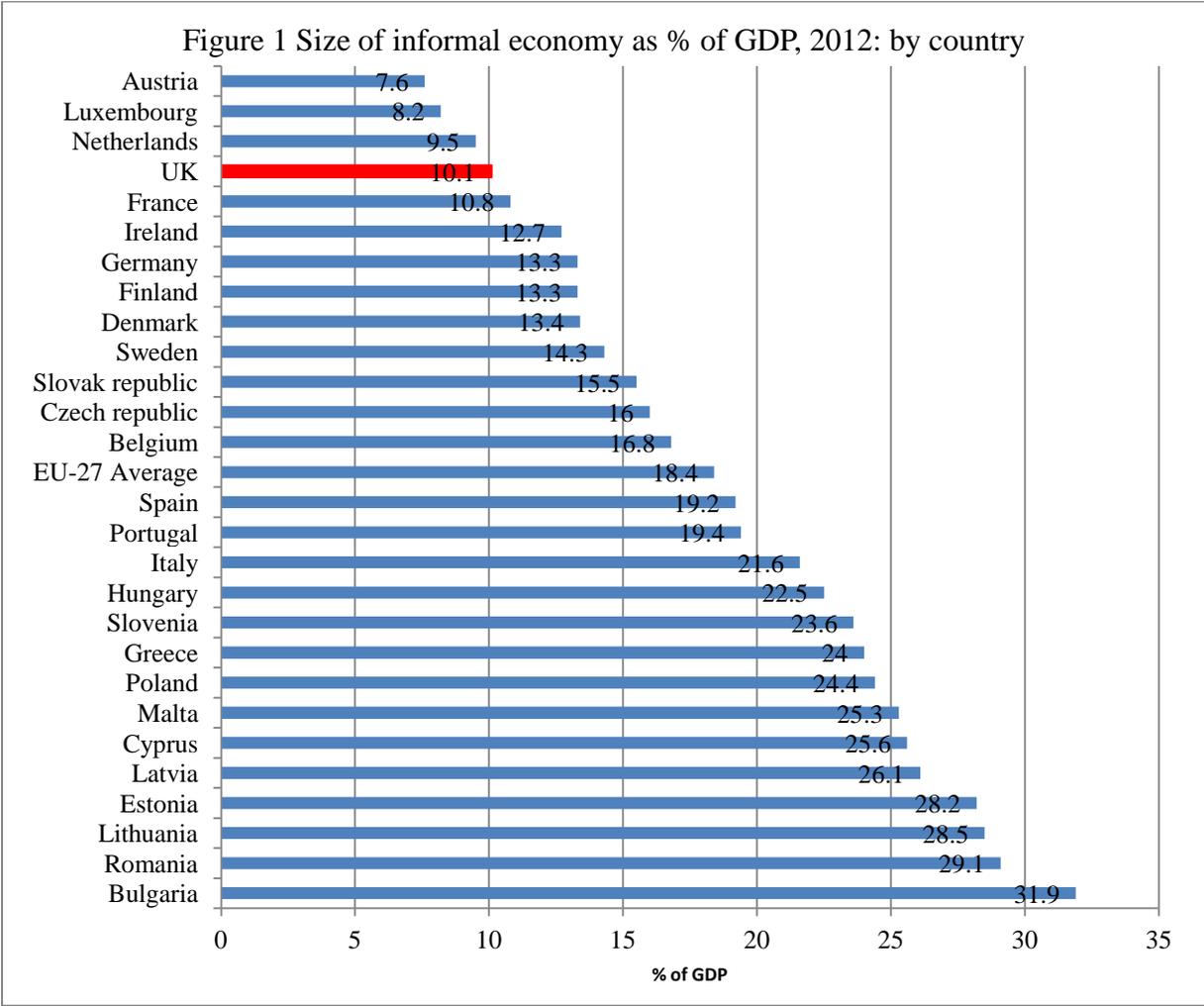
### **Size of the UK informal economy**

Measuring the size of the informal economy in the UK is difficult because this remunerated activity is by definition hidden from view. For this reason, indirect measurement methods are often adopted which measure its size using proxy indicators and/or statistical traces of such work found in data collected for other purposes. These indirect methods range from those using monetary indicators as proxies, such as the currency demand method which takes the use of cash as an indicator of informality, through those using non-monetary indicators, such as discrepancies in the labour supply figures across different surveys, and those using discrepancies between income and expenditure either at the aggregate or household level, to measurement methods using multiple indirect indicators (GHK and Fondazione Brodolini, 2009; Ram and Williams, 2008). However, some claim that although participants hide this work from the authorities, they do not hide it from researchers and will openly discuss this matter with them (MacDonald, 1994; Pahl, 1984; Windebank and Williams, 2010). As such, informal work is directly investigated using qualitative, quantitative or mixed method surveys. These produce lower estimates of its size than indirect methods, leading proponents of indirect methods to suggest that participants do conceal their informal work from researchers. Although one has no way of knowing whether direct surveys produce under-estimates or indirect methods inflated estimates of its size, the consensus across the practitioner and academic communities is to use indirect measurement methods to measure its size and survey methods to evaluate its nature (European Commission, 1998, 2007b; Joassart, 2010; OECD, 2012; Ram and Williams, 2008; Schneider, 2008; Williams, 2006).

Here, therefore, and to report estimates of the magnitude of the informal economy, the most widely used indirect method globally is selected, namely the DYMIMIC (dynamic multiple-indicators multiple-causes) method (for a detailed description of how this method calculates the size of the informal sector, see Schneider, 2005). Rather than rely on one

indicator to measure its size, the advantage of this method is that multiple monetary and non-monetary indicators, related to the money in circulation, level of tax morality and labour supply, are used. Although there are no published criticisms of this method, a problem sometimes voiced is that the detailed methodology is not necessarily as clearly stated (e.g., the assumptions made when using specific indicators and the justifications for the weighting given to each indicator) as many scholars would desire. Nevertheless, the key advantage of using this method here is that data is available not only for the EU-27 (see Schneider et al., 2013) but for 162 countries (Schneider et al., 2010) enabling the UK to be compared with other nations.

Comparing the UK with other European Union member states using this method, Figure 1 displays that in 2012 the size of the UK informal economy was equivalent to 10.1 per cent of GDP. Indeed, as Schneider and Williams (2013) point out, this means that the UK informal economy is a £150 billion per annum economy. Although this might seem large in monetary terms, compared with many East-Central European and Southern European member states, the informal economy in the UK is relatively small as a proportion of total GDP. Indeed, it is smaller than many other Western and Northern European countries. Why this might be the case will be returned to in section 5 of this report.

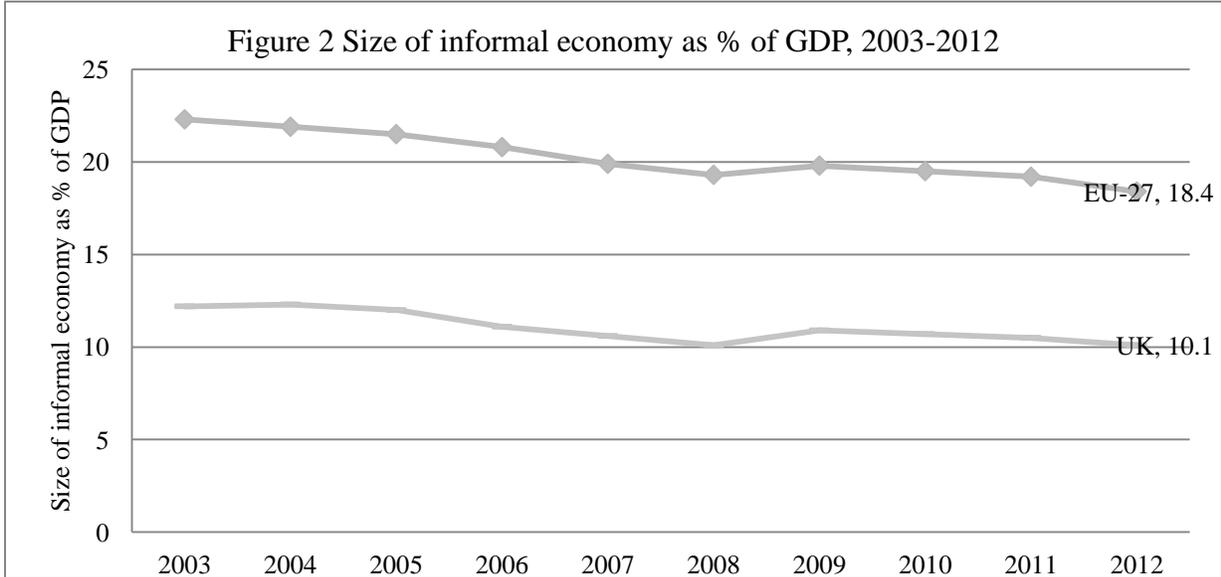


Source: derived from Schneider (2012: Table 1.1)

Indeed, Her Majesty’s Revenue and Customs (HMRC) (2012) have estimated that the hidden economy is composed of some 500,000 ‘ghosts’ (i.e., individuals who receive income from employment or self-employment but are not known to HMRC because they and/or their employers fail to declare their earnings) and 1.5 million ‘moonlighters’ (i.e., individuals who pay tax on their main job, primarily through PAYE, but who fail to declare earnings from a second job or additional income from self-employment). Similarly, the TUC (2008) estimate that there are at least two million vulnerable workers engaged in informal work. No data is currently available on the transitions between formal and informal working of workers and businesses (e.g., whether businesses and employees shift from wholly informal to wholly formal working, and vice versa).

Is the UK informal economy growing or declining in the current period of economic crisis? Two contrasting perspectives exist. One viewpoint is that the informal economy is growing. The rationale is that: firms and households will seek to save on costs in the face of falling profit and income by substituting formal work with informal work, and unemployed workers will be more willing to engage in informal work as a coping practice. The alternative viewpoint is that the informal economy is declining because of: the lower demand for informal labour due to less money being available; traditional sectors where informal work is concentrated (e.g., construction, hotels and restaurants) being harder hit in times of economic crisis, and informal work being substituted by ‘flexible’ and cheaper formal labour, leading to greater in-work poverty.

The finding is that the latter seems to be occurring. As Schneider (2012) finds, and Figure 2 displays, although there was a slight rise in the size of the informal economy between 2008 and 2009, there has been an on-going decline in the size of the informal economy both in the UK and across the European Union as a whole between 2003 and 2012. During the current economic crisis, therefore, the informal economy has been declining, reflecting how it is not a substitute for the formal economy that grows when the formal economy declines, but rather, rises and falls in tandem with the formal economy.



Source: derived from Schneider (2012: Table 1.1)

## Who participates in and benefits from the informal economy?

Two contrasting views prevail regarding the relationship between poverty and the informal economy, namely the marginalisation and reinforcement theses. Here, each is reviewed in turn.

### *Marginalisation thesis*

The ‘marginalisation’ thesis holds that participation in the informal economy is concentrated amongst marginalised populations such as the unemployed and low-income groups, who disproportionately participate in and gain from this realm (Ahmad, 2008; Castree *et al.*, 2004; Gutmann, 1978; Henry, 1982; Katungi *et al.*, 2006; Parker, 1982).

This is a long-standing view. In the early 1980s recession in the UK, Parker (1982: 33) claimed that ‘with high unemployment more and more people are getting caught up in the web of the underground economy’, whilst Robson (1988: 55) asserted that ‘the informal economy is more feasible as an alternative prop to those who are out of work...’. Indeed, so dominant was this marginalisation thesis during the 1970s and 1980s that Pahl (1988: 249) claimed it was ‘in danger of becoming a social scientists’ folk myth’. Despite this warning, it has continued to dominate. As Stauffer (1995: 1) argued in the 1990s, ‘the informal sector can act as an important buffer against unemployment’, whilst Blair and Endres (1994: 288) asserted that ‘The role of the informal sector in providing a source of support for unemployed workers or individuals receiving public assistance is an important function of the unobserved sector’. Indeed, since the turn of the millennium, this assertion has continued to be widely voiced (e.g., Ahmad, 2008; Castree *et al.*, 2004; Davis, 2006; Katungi *et al.*, 2006). The on-going belief, therefore, is that ‘a significant percentage of the officially unemployed are in reality working “off the books”’ (Gutmann, 1978: 26).

### *Reinforcement thesis*

Over the last decade or so, however, there has emerged a reinforcement thesis which argues the inverse, namely that the marginalised, such as the unemployed and lower-income populations, benefit less from the informal economy than those who are employed and higher-income populations and that the informal economy therefore reinforces, rather than reduces, the inequalities produced by the formal economy. To explain this, adherents to this reinforcement perspective commonly cite four reasons:

- the marginalised and poor lack the resources (e.g., car, tools) necessary to engage in a wide range of informal work (Pahl, 1984; Williams, 2004a,b);
- they receive fewer opportunities to engage in informal work (e.g., Komter, 1996; Morris, 1995; Williams, 2006);
- they lack the skills and competencies to conduct better paid informal work (Fortin *et al.*, 1996; Mingione, 1991; Renooy, 1990). If their skills and competencies are inappropriate for finding formal employment, there is no reason to believe that they are appropriate for finding informal work; and
- the unemployed in particular fear being reported to the authorities, not least because claiming welfare benefits illicitly is popularly considered a more serious offence than tax evasion (Cooke, 1997; Williams, 2004a,b).

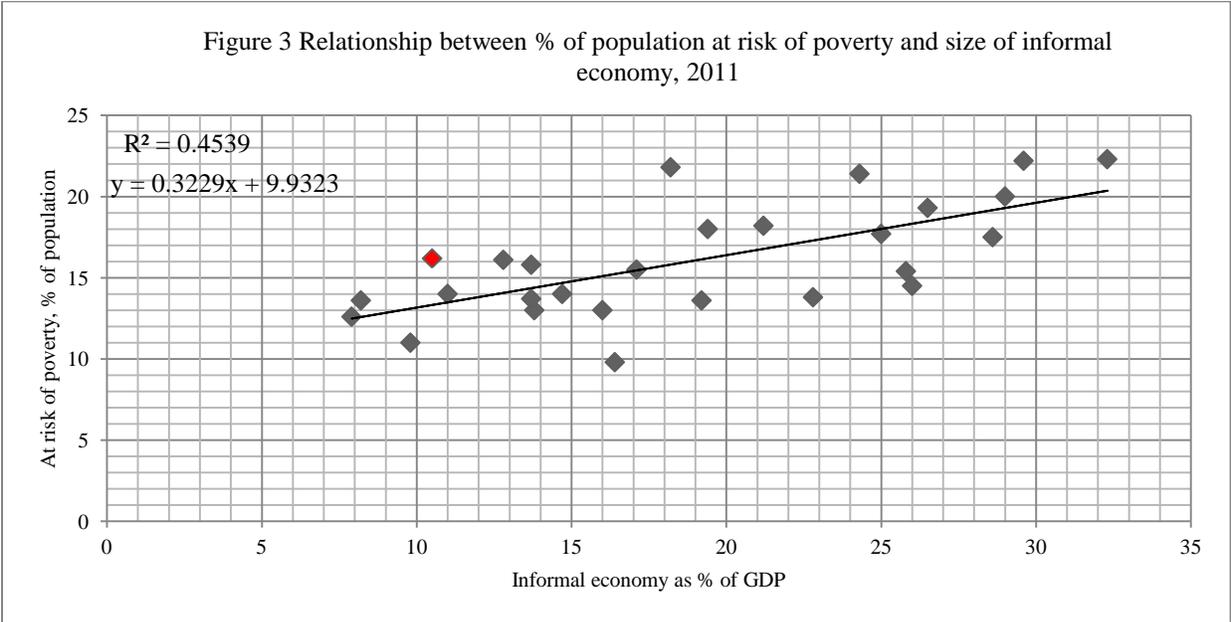
Marginalised populations such as the unemployed therefore possess the free time but fear detection and lack the resources, opportunities and skills necessary to conduct informal work.

Conversely, those in formal jobs and higher-income groups have fewer fears about the authorities, as well as more resources, opportunities and skills to undertake informal work.

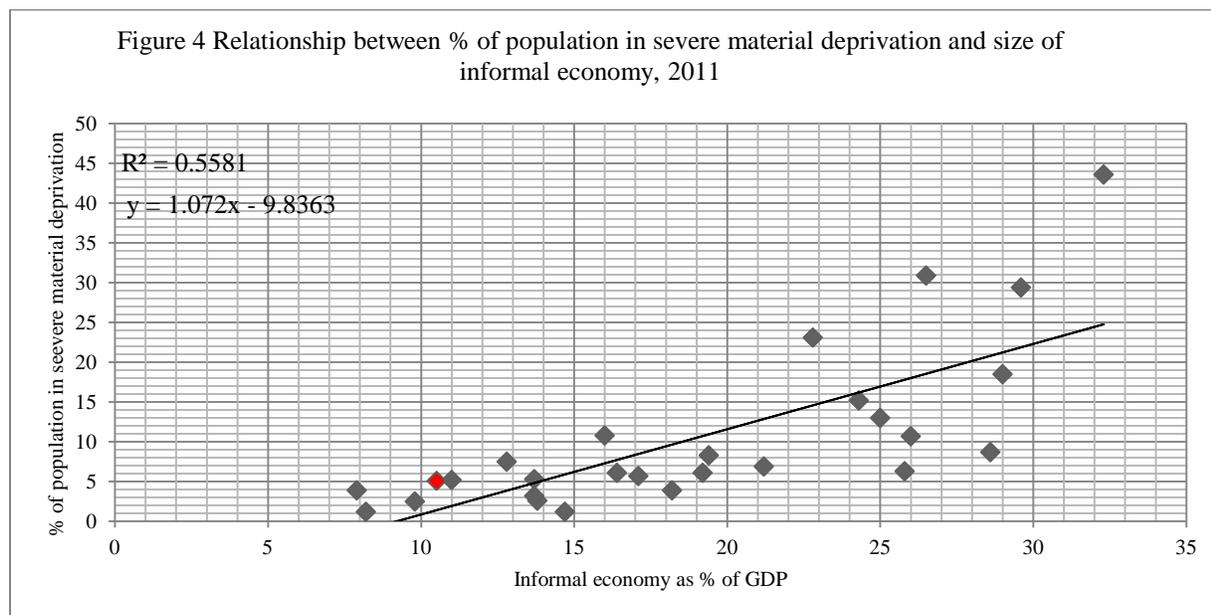
*Evaluating the competing theses*

Reviewing the existing evidence on who participates in the informal economy, marginalised populations are found to be more likely to work in the informal economy than more affluent populations. This is the finding of studies conducted in individual localities such as West Belfast (Leonard, 1994, 1998) and Southampton and Sheffield where it is identified that 40 per cent of households in the lower-income neighbourhoods participated in informal work in the year prior to the survey compared with 18 per cent in the affluent suburbs (Williams and Windebank, 2001), even if affluent populations tend to purchase a greater proportion of informal labour overall (Williams, 2008; Williams and Windebank, 1999, 2001, 2002). Not all lower-income groups, however, engage in greater amounts of informal work. As the 2007 Eurobarometer survey reveals for the UK, although the unemployed were over 8 per cent of the surveyed population, they undertook just 6 per cent of all informal work (European Commission, 2007b).

Nevertheless, there is a significant correlation between poverty and participation in the informal economy. To see this, the 27 EU member states can be compared to explore the relationship between the size of the informal economy and the proportion of the population at risk of poverty, by which is here meant the share of people with an equivalised disposable income (after social transfers) below the at-risk-of-poverty threshold, which is set at 60 per cent of the national median equivalised disposable income after social transfers. As Figure 3 reveals, and using Spearman’s rank correlation coefficient ( $r_s$ ) due to the non-parametric nature of the data, the finding is a strong statistically significant relationship within a 99 per cent confidence interval ( $r_s=0.663^{**}$ ); the greater is the percentage of the population at risk of poverty in a country, the larger is the informal economy.



It is similarly the case when analysing the relationship between the informal economy and severe material deprivation, by which is here meant the inability to afford some items (at least 4 on a list of 9) considered by most people to be desirable or even necessary to lead an adequate life. As Figure 4 reveals, a strong significant association exists between cross-national variations in the level of the informal economy and the level of severe material deprivation ( $r_s=0.823^{**}$ ). The greater is the level of severe material deprivation, the higher is the level of the informal economy.



Turning to who benefits from the informal economy, however, a very different picture emerges. During the late 1990s, supported by the Joseph Rowntree Foundation, face-to-face interviews were conducted with 400 households in higher- and lower-income urban neighbourhoods of Southampton and Sheffield about their supply and use of paid informal work, using a list of 44 common household tasks. One benchmark of the validity of the data collected was that the tasks that households surveyed reported that they received on a paid informal basis in each locality closely aligned with the tasks households in each locality reported that they supplied. The finding was that the residents of the higher-income neighbourhoods were found to be far better remunerated for their informal work than those in lower-income neighbourhoods. Comparing the lower- and higher-income areas, the average amount received for conducting informal work was £90 compared with £1,665 respectively; the average hourly informal wage rate was £3.40 compared with £7.50; and the mean annual household income from paid informal work was £46 compared with £435. For the 40 per cent of households in lower-income neighbourhoods who worked informally, meanwhile, the mean annual household income from such work was £115 compared with £2,420 in the 18 per cent of households who supplied such work in affluent suburbs (Williams and Windebank, 2001). The monetary rewards from paid informal work, therefore, are heavily skewed towards populations in the affluent neighbourhoods. It also reveals that higher-income households (here defined as earning over £250 gross per week) and multiple- and single-earner households conduct a disproportionate share of informal work compared with lower-income and jobless households.

This English Localities Survey, therefore, supports the reinforcement thesis that the informal economy reinforces, rather than reduces, the inequalities produced by the formal economy.

This finding is further reinforced by the 2007 Eurobarometer survey on undeclared work which conducted face-to-face household interviews with over 1,313 UK respondents. Interviewers reported good cooperation with respondents in 90 per cent of interviews. As Table 1 reveals for the UK, the unemployed earn 28 per cent less per hour from informal work (£11.84) than formally employed people who also work informally (£16.42). Indeed, the unemployed earn only 1 per cent of the total income from informal work. Meanwhile, those in formal employment, although 50 per cent of the surveyed population receive 97 per cent of total income from informal work and earn both more per hour and have higher annual informal incomes (European Commission, 2007b).

**Table 1 Extent and nature of participation in informal work: by employment status, UK**

	% engaging in informal work	% of all informal work conducted by:	% of surveyed population	Average total hours	Average hourly informal wage (€)	Mean annual informal income/informal worker (€)	% of total informal income in UK earned by:
All employed	3	64	50	53	19	1035	97
Self-employed	18	38	5	40	23	945	52
Managers	1	6	14	21	26	546	5
Other white collar workers	1	6	10	16	-	-	-
Manual workers	1	15	22	123	9	1109	24
House person	0	0	6	0	0	0	0
Unemployed	2	6	8	12	14	168	1
Retired	<1	3	27	-	26	-	-
Students	7	27	9	53	9	480	18
ALL	2	100	100	53	17	925	100

*Note:* empty cells due to inadequate data available

*Source:* derived from 2007 Eurobarometer survey of undeclared work, n=1,313

Consequently, the marginality thesis and reinforcement thesis are not mutually exclusive. Although marginalised groups disproportionately engage in informal work, they benefit less from the informal economy, meaning that the informal economy reinforces, rather than reduces, the inequalities produced by the formal economy. Informal work therefore leads to a ‘reinforced marginalisation’ of their position. The poor disproportionately engage in informal work but their participation in this realm reinforces their marginalised position, since they earn lower wage rates and total annual informal incomes than relatively affluent populations. They also find that their employability, skills and engagement is not recognised since their work in the informal economy cannot be included on their CV when applying for formal employment.

## **What type of informal work do they conduct and why?**

During the latter half of the twentieth century, a widely-held view was that the informal economy comprised low-paid waged employment conducted under exploitative conditions. Over the past few decades, however, it has been recognised firstly that many conduct informal work on a self-employed basis and secondly, and more recently, that much of this own-account work is conducted by and for close social relations such as kin, friends, neighbours and acquaintances as ‘paid favours’. According to the 2007 Eurobarometer survey, 29 per cent of informal work in the UK is conducted as waged employment, 11 per cent as informal self-employment and 60 per cent as paid favours (European Commission, 2007b). Here, what is known about each form of informal work is reviewed.

### *Waged informal employment*

For many years, the assumption was that the vast majority of informal work was conducted by waged employees. The English Localities Survey conducted in the late 1990s, however, was one of the first studies to reveal that the majority of informal work is conducted on an own-account basis (Williams and Windebank, 2001).

Just because waged work is only a small segment of the informal economy, however, does not mean that it is unimportant. Indeed, marginalised populations are more likely to engage in this form of informal work than more affluent populations and when they do so, it is often low-paid sweatshop-like work conducted for unscrupulous employers, such as under conditions of forced labour (Geddes et al., 2013). In the English Localities Survey conducted in the late 1990s, for example, many instances were identified of informal waged employment conducted by residents of deprived urban neighbourhoods, and in nearly all instances the wage rates were below the national minimum wage (£3.60 at the time). Examples identified included: doing bar work for two weeks for £50; working in a restaurant for £2.00 per hour; working early mornings in a small bakery for £20 per month; working full-time for three weeks in a canteen on a building site for £50; being paid £10 to clean trucks for 3 hours; staffing an ice-cream stall for £2.80 per hour and refurbishing a pub for one week for £100. In 90 per cent of these cases, moreover, it was unemployed people who undertook such work and their sole rationale was that they needed the money. In total, however, this waged work accounted for just 2 per cent of all paid informal work in these lower-income populations (Williams and Windebank, 2001). In the majority of cases, those working as informal employees do so out of necessity in the absence of alternative means of livelihood, whilst the employers do so for the purpose of financial gain (Williams, 2004b).

### *Informal self-employment*

Over the past decade or so, there has been growing recognition that much informal work is conducted on a self-employed basis. Indeed, a view has emerged that the informal economy is one of the main breeding grounds for enterprise creation and a crucible where business start-ups test-trade the viability of their business venture before deciding whether to establish a formal enterprise (Community Links and the Refugee Council, 2011; Copisarow, 2004; Copisarow and Barbour, 2004; Dellot, 2012; Katungi et al., 2006; Llanes and Barbour, 2007; Small Business Council, 2004; Williams, 2006, 2010; Williams et al., 2011, 2012a,b). The result is that the informal economy has been seen as a ‘hidden enterprise culture’ (Williams, 2006). This view has had a major influence on public policy. The conventional deterrence

approach of tax administrations that sought to eradicate the informal sector is now widely believed to result in tax administrations eliminating with one hand of government precisely the entrepreneurship that other hands of governments so desperately wish to nurture (Small Business Council, 2004). The outcome has been that tax administrations across the western world have since the turn of the millennium begun to move away from their conventional approach of eradicating this ‘hidden enterprise culture’ and instead shifted towards an enabling approach that has sought to develop policy measures to facilitate the formalisation of such ventures (Dekker et al, 2010; OECD, 2012; Williams and Nadin, 2012a,b, 2013a,b; Williams and Renooy, 2013).

What, however, is the evidence that in the UK businesses start-up in the informal economy and do so to test-trade the viability of their business? In 2012, a survey was undertaken by YouGov of 595 owners of small businesses in the UK, funded by the Royal Society of the Arts. Some 55 per cent agree that trading in the informal sector is necessary when starting a business and 20 per cent (1 in 5) report that they did so when starting their own business, and for two-thirds (64 per cent), their main reason was to test the viability of the business venture. Examining the 13 per cent of all businesses who start-up in the informal economy to test-trade their venture, multivariate analysis reveals that businesses started by men, with low current annual turnovers and in particular sectors are significantly more likely to do so. Regional variations are not significant (Williams and Martinez, 2014).

More than 1 in 8 business start-ups, therefore, use the informal economy as an incubator (i.e., they operate unregistered and trade informally so as to test-trade the viability of their enterprises). This is a significant minority of all small business start-ups. However, more than double the number of businesses started by men (just over 1 in 6) than by women (just over 1 in 14) test trade in the informal economy. Using multivariate analysis to examine the significance of these findings when controlling for other socio-demographic and firm-level characteristics and regional location, the finding is that men are significantly more likely to not only report having done so with their own business when starting-up but also to have done so in order to test the viability of their business. The reason it is lower for women is because they see their entrepreneurial endeavour more as a ‘hobby’ or ‘side-line’ and not a ‘real business’ than a proper business venture in the initial stages (Williams and Martinez, 2014).

How many people living in poverty seek to start-up enterprises on an informal basis in order to develop means of livelihood? There has recently been a considerable amount of research showing how they do so largely out of need rather than greed, and how they face problems when seeking to formalise their business ventures (Brill, 2012; Dellot, 2013; Llanes and Barbour 2013; Williams et al., 2013). Until now, however, no attempt been made to measure the extent to which those in poverty operate informal enterprises in order to develop means of livelihood. Although a considerable amount of anecdotal evidence exists in the form of case studies of individuals in poverty who develop enterprising activities as a coping practice and means of livelihood (Barbour and Llanes, 2013; Williams et al., 2013), the extent to which those living in poverty engage in such enterprising activity remains unknown.

The English Localities Survey conducted in the late 1990s evaluated the extent to which participants had engaged in enterprising activities and whether this was in the informal economy. As Williams (2008) reports, some 23 per cent of businesses were found to start-up on an unregistered basis trading wholly in the informal economy, akin to the 2012 YouGov survey (Williams and Martinez, 2014). Reporting the results of interviews in higher- and lower-income urban and rural English localities with 91 early-stage entrepreneurs, Williams

(2010) reveals that their preponderance to trade informally is greater in lower-income and rural localities. In affluent urban and rural areas, that is, some 58 per cent and 62 per cent of early-stage entrepreneurs, respectively, trade informally, but 84 per cent and 87 per cent in lower-income urban and rural localities. Despite this greater preponderance to start-up trading informally in lower-income populations, the extent to which lower-income populations engage in enterprising activities remains unknown. This is a major gap that needs to be filled.

### *Paid favours*

One of the major developments regarding the character of the informal economy over the past decade or so has been the recognition that a large proportion of informal work is conducted by and for close social relations such as kin, friends, neighbours, acquaintances and colleagues (Williams and Windebank, 1999). With the advent of market societies, it appears that unpaid community exchanges in the form of reciprocity have become monetised in the form of 'paid favours' (Williams, 2003). However, just because such exchanges have become monetised does not mean that financial gain or profit has become universally imbued in these exchanges. Rather, these paid informal exchanges are frequently conducted either for redistributive motives or to help somebody out who is in need (Williams, 2009). For example, a person may employ their cousin who is unemployed and in need of money to redecorate their living room in order to be able to give them some money so as to avoid any connotation that 'charity' is involved which would result in the cousin refusing to accept the money. Similarly, a plumber or electrician may do some work for an elderly person or somebody 'hard up' known to them who would otherwise be unable to afford to get some necessary repair work done at greatly reduced 'mate's rates' in order to help them out.

The result, and akin to the hidden enterprise culture discussed above, is that any attempt to deter or eradicate such paid favours will result in one hand of government eradicating the active citizenship that other hands of government are seeking to foster. Indeed, examining the scale of paid favours, the finding is that this is not only a significant proportion of all informal work but also that a large proportion of community exchange is now conducted on a paid basis as 'paid favours' (Williams and Windebank, 2001).

Indeed, in the late 1990s English Localities Survey, it was identified that some 16 per cent of all informal work in higher-income districts was conducted for close social relations as paid favours but 68 per cent in lower-income neighbourhoods. Moreover, over half of all community self-help in lower-income urban neighbourhoods is found to have become monetised, meaning that to deter paid favours would be to eradicate the majority of active citizenship in such neighbourhoods (Williams, 2003; Williams and Windebank, 2001).

Recent years have seen a further reinforcement of this finding that a large proportion of all informal work is conducted by and for close social relations as paid favours for redistributive and community-building purposes. The 2007 Eurobarometer survey of informal work for example reveals that 55 per cent of all informal work in the EU-27 is conducted for close social relations as 'paid favours' (Williams and Renooy, 2013) and the 2013 Eurobarometer survey reveals that the proportion of all informal work which is paid favours has further increased during the economic crisis (European Commission, 2013). In the UK in 2007, 60 per cent of all informal work was paid favours. This is not conducted primarily for the purpose of monetary gain. Instead, it is in the majority of cases undertaken for reasons other than financial gain, such as to help others out.

### 3 WHAT IS TO BE DONE ABOUT THE INFORMAL ECONOMY?

Given that the informal economy reinforces the marginalised position of people living in poverty, this chapter reviews the implications of four possible policy approaches towards the informal economy: doing nothing; eradicating the informal economy; de-regulating the formal economy; and moving informal work into the formal economy.

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When weighing up what is to be done about the informal economy, it is first necessary to understand the advantages and disadvantages of the informal economy for those living in poverty both as workers and consumers (see Table 2).

Table 2 Advantages and disadvantages of the informal economy for those living in poverty

<b>Disadvantages</b>	<b>Advantages</b>
<i>For workers:</i>	
Lack of access to credit and financial services, partly due to limited credit history.	A source of income to stay out of poverty.
No entitlement to labour rights such as minimum wage, sick pay, working hours directives or redundancy rights.	Acts as a test-bed for enterprise creation.
Difficulty in expanding a business which cannot be openly advertised.	Flexibility in where, when and how to work (especially important for women who remain responsible for child-care).
May face higher barriers of entry to the formal market on account of an inability to provide employment history to back up their skills.	Reduces barriers to entry into work because the majority of informal work starts with close social relations.
<i>For customers:</i>	
Lack legal recourse if a poor job is done, insurance cover; guarantees in relation to the work conducted, and certainty that health and safety regulations have been followed.	A more affordable product or service can be offered to or asked for by customers if payment is made in cash and no receipts change hands

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*Source:* derived from Llanes and Barbour (2013) and Williams (2006)

Given these advantages and disadvantages of informal work for those living in poverty, there are hypothetically four policy choices. Policy-makers can in theory choose to either: do nothing about the informal economy; eradicate the informal economy; de-regulate the formal economy; or alternatively, move informal work into the formal economy. Here, the implications of pursuing each policy option exclusively are evaluated. This considers only the implications pursuing solely each policy option alone. Later below, we will explore the feasibility and implications of adopting a mixture of these policy approaches.

## **Do nothing**

The rationales for doing nothing about the informal economy are that:

- when the informal economy is relatively small, the revenue-to-cost ratios of reducing the informal economy may be so low that it is just not worthwhile for governments to intervene;
- since the informal economy is a test-bed out of which emerges at least a quarter of new business start-ups (Williams and Martinez, 2014), this sphere should be left alone, and
- because much of the informal economy is composed of paid favours for kin, friends, neighbours and acquaintances which in contemporary market-oriented societies is a main vehicle for active citizenship, the informal economy should be left alone in order that government do not with one hand destroy precisely the active citizenship that with another hand it is so desperately seeking to nurture. These paid favours, furthermore, may often be the initial exchanges out of which people recognise the possibility for creating an entrepreneurial venture and enable them test out their business idea.

For these rationales, doing nothing might be considered viable. The problem, however, is that doing nothing not only leaves those living in poverty in their current marginalised position but also has negative impacts on formal businesses, those working informally, customers and governments.

The negative impacts for those working informally and customers are summarised in Table 2. For legitimate businesses, meanwhile, the informal economy is problematic because it causes: an unfair competitive advantage for informal over formal enterprises (Evans et al, 2006; Grabiner, 2000; Renooy et al, 2004; Williams et al, 2013) resulting in de-regulatory cultures enticing formal firms into a local ‘race to the bottom’ away from regulatory compliance (Grabiner, 2000; Renooy et al, 2004; Williams and Windebank, 1998) and circumstances of ‘hyper-casualisation’ as formal businesses become forced to turn to the informal economy in order to compete (Evans et al, 2006; Gallin, 2001; Mateman and Renooy, 2001; Williams, 2006).

For governments, meanwhile, even if it might be the case that doing nothing is an option if the revenue-to-cost ratios are too low, the rationales for intervention are that the informal economy:

- causes a loss of revenue for the state in terms of non-payment of income tax, national insurance and VAT (Evans et al, 2006; Grabiner, 2000; Williams, 2004b; Williams and Windebank, 1998);

- has knock-on effects on attempts to create social cohesion at a societal level by reducing the money available to governments to pursue social integration and mobility (Williams and Windebank, 1998);
- results in weakened trade union and collective bargaining (Gallin, 2001);
- leads to a loss of regulatory control over the quality of jobs and services provided in the economy (Gallin, 2001); and
- if a significant segment of the population is routinely engaged in such activity, it may well encourage a more casual attitude towards the law more widely (Renooy et al., 2004).

In sum, the negative impacts of solely doing nothing mean that pursuing a laissez-faire approach alone is not a viable option. Nevertheless, even if pursuing solely this policy option is not viable, this does not mean that it cannot be pursued as part of a package of approaches. It may well be the case, for example, that a do nothing approach might be adopted towards small-scale one-off odd-jobs conducted as paid favours to help out others, thus freeing government resources to concentrate on larger-scale tax evasion by businesses. As such, although not applicable to all informal work, such an approach may have a role to play with regard to certain types of informal work in particular populations. On the whole, however, the negative overall implications for all parties of pursuing a laissez-faire approach mean that interventions to deal with the informal economy are required. What form of intervention, therefore, is needed? Three options are available.

## **De-regulate the formal economy**

A first policy option is to de-regulate the formal economy. The logic for this lies in an emergent theoretical position that reads the informal economy to be a result of over-regulation (Becker, 2004; De Soto, 1989 2001; London and Hart, 2004; Nwabuzor, 2005; Small Business Council, 2004). As De Soto (1989: 255) has put it, ‘the real problem is not so much informality as formality’. Seen through this lens, informal workers have become widely depicted as composed largely of own-account workers voluntarily choosing to operate in the informal economy on a self-employed basis and are heralded as heroes who are casting off the shackles of state over-regulation (e.g., Sauvy, 1984; De Soto, 1989). As Nwabuzor (2005: 126) asserts, ‘Informality is a response to burdensome controls, and an attempt to circumvent them’, or as Becker (2004: 10) puts it, ‘informal work arrangements are a rational response by micro-entrepreneurs to over-regulation by government bureaucracies’. Informal workers are thus seen to be only breaking unfair rules and regulations imposed by an excessively intrusive state. Viewed from this perspective, the persistence and growth of the informal economy is a direct result of high taxes, over-regulation and state interference in the free market. Their resultant policy approach is to pursue tax reductions, de-regulation and minimal state intervention.

The desire is therefore to stamp out the informal economy by reducing taxes and state regulations so as to unshackle those in the formal economy from the constraints that force up labour costs and prevent flexibility, and remove the constraints that act as a disincentive to those seeking formal jobs. As Castells and Portes (1989: 13) put it, ‘In an ideal market economy, with no regulation of any kind, the distinction between formal and informal would

lose all meaning since all activities would be performed in the manner we now call informal'. With fewer regulations, the distinction between formal and informal work would thus wither away so that the formal and informal realms would become inseparable since all activities would be performed in the manner now called 'informal', although such activity would be 'formal' since it would no longer be breaking any rules.

However, the problems of pursuing solely this policy option are manifold. As will be shown later in this report, there is little evidence that reducing taxes and de-regulating the formal economy reduces the size of the informal economy. As Gilbert (1994: 616) argues, 'The hope that ... micro-entrepreneurs can go it alone, with a bit of credit and some deregulation, seem to be hopelessly optimistic'. Indeed, even if de-regulation were to lead to a reduction in the amount of so-called formal regulated work and a growth of what is now termed informal work, the outcome would appear to be poorer quality work conditions and a levelling down rather than up of working conditions (Williams, 2006).

Importantly, nevertheless, even if pursuing solely this policy option is not viable, this does not mean that it cannot be pursued as part of a package of approaches. De-regulation, such as in the form of the simplification of compliance, can be a useful tool when seeking to help businesses start-up on a formal basis from the outset. If the regulatory burden is high and complex for businesses, and simpler compliance could be introduced, then de-regulation will have an important role to play in tackling the informal economy in relation to specific problems facing particular types of informality. On its own, however, the de-regulatory approach is not a viable option because it would result in a levelling down rather than up of working conditions.

## **Eradicate the informal economy**

Another option is to eradicate the informal economy. Given the above discussed problems for legitimate and informal businesses, informal workers, customers and governments, it seems at first glance obvious that eradicating the informal economy is an appropriate way forward.

In recent decades, however, numerous problems have been identified with the practicability and desirability of eradicating the informal economy. On the one hand, there is the practical problem of whether it can be achieved as well as how to do it. On the issue of whether it can be achieved, the problem confronting governments is that beyond a certain point, the cost of eradicating the informal economy may well far outweigh the benefits of doing so. There is a point, therefore, beyond which it will prove difficult to proceed so far as eradicating the informal economy is concerned.

On the issue of how its eradication can be achieved, the conventional approach has been to view those operating in the informal economy as 'rational economic actors' who evade compliance because the pay-off is greater than the expected cost of being caught and punished (Allingham and Sandmo, 1972), and to seek to change the cost/benefit ratio confronting actual or likely participants by concentrating on the cost side and increasing the perceived or actual likelihood of detection and the penalties and sanctions for those caught (Grabiner, 2000; Richardson and Sawyer, 2001). This, therefore, is a 'negative reinforcement' approach that seeks to elicit behaviour change using 'sticks' that punish those engaged in 'bad' behaviour. In recent years, however, issues have been raised about the efficiency and effectiveness of this deterrence approach. Although some find that improving detection and/or penalties reduces the informal economy (De Juan *et al.*, 1994; Slemmerod *et al.*, 2001), others identify that the informal economy grows (Bergman and Nevarez, 2006; Murphy, 2005). Indeed, some even conclude that 'it is not sensible to penalize illicit work with intensified controls and higher

finer' (Schneider and Enste, 2002: 192). This is because it can alienate those currently working in the informal economy, decreasing their willingness to comply and amplifying the size of the informal economy by reducing their belief in the fairness of the system, especially if the fines are too high and they are treated in a manner which they do not perceive as fair and just (Murphy, 2005). It is not just the practical issue of whether it is feasible to eradicate the informal economy and how its eradication can in practice be achieved that results in questions being asked about this eradication approach.

Eradication is also perhaps not desirable. If the eradication of the informal economy is pursued, then not only may it prove rather costly for governments, but in doing so, governments will as mentioned above destroy precisely the entrepreneurial endeavour and active citizenship with one hand that with another hand they are seeking to nurture and develop. The resulting challenge for government is to 'join-up' its policies towards the informal economy with its wider policies towards entrepreneurship and active citizenship. There is also perhaps a need to join up its policy towards the informal economy with its wider policies on employment creation and social cohesion. After all, the eradication of the informal economy is a means to achieve ends such as fuller-employment.

Importantly, however, even if pursuing solely this policy option is not viable, it can be pursued as part of a package of approaches. In circumstances where informal workers and informal businesses have been given every opportunity to formalise but have refused to do so, then governments need to be able to punish those who fail to comply. In such circumstances, the tools of an eradication approach such as penalties and sanctions are required to eliminate such endeavour. On its own, however, the eradication approach is not a viable option because it would take away from people in poverty even those small opportunities they can seize to alleviate their plight whilst not putting in place alternative means of livelihood and support to enable them to meet their needs.

## **Move informal work into the formal economy**

A fourth and final policy option, therefore, is to move informal work into the formal economy. Beginning with the potential disadvantages of this approach, a major one is that those starting businesses will be no longer able to undercut the competition and to test-trade in the informal economy when starting up (although the latter issue is not relevant if this approach recognises that many business start-ups are on a journey to formalisation and facilitates them to take this journey), and another major disadvantage is that customers will need to pay the full market price which might mean that the function of the informal economy in providing access to cheaper goods and services will no longer be available. The benefits of moving informal work into the formal economy, however, outweigh the costs of doing so. These benefits can be again related to the various groups of the population with a stake in this matter, namely formal and informal businesses, informal workers, customers and the government.

For legitimate businesses, the benefits of moving informal work into the formal economy are that it: eliminates the unfair competitive advantage for illegitimate businesses over legitimate enterprises (Evans et al, 2006; Grabiner, 2000; Renooy et al., 2004), and enables a 'high road' rather than 'low road' approach to be pursued by businesses whereby they move towards ever greater regulatory standards on corporate social responsibility and conditions of work such as health and safety and labour standards (Grabiner, 2000; Renooy et al., 2004; Williams and Windebank, 1998).

For businesses operating in the informal economy, the key benefits of moving work from the informal economy into the formal economy are that: they can escape pressurisation into exploitative relationships with the formal sphere (Gallin, 2001; Williams and Windebank, 1998); achieve the same levels of legal protection as formal businesses (Castells and Portes, 1989; ILO, 2002a; Williams and Windebank, 1998); and overcome the structural constraints on their development and growth such as gaining access to capital and being able to secure the advice and support available to formal businesses (ILO, 2002).

Individuals working in the informal economy, meanwhile, especially those living in poverty, benefit from shifting their work into the formal economy because they: gain access to health and safety standards in the workplace (Evans et al., 2006; Gallin, 2001; ILO, 2002); enjoy the same employment rights as formal workers, such as annual and other leave, sickness pay, redundancy and training (Evans et al, 2006); are able to gain access to mortgages and credit since their pay is official and recognised by lending institutions (Kempson, 1996; Leonard, 1998; Williams, 2007); benefit from greater job security (Williams, 2001); are unable to get an employer's reference (ILO, 2002); gain access to a range of other legal rights such as the minimum wage, tax credits and the working hours directive (Leonard, 1998; Renooy et al, 2004; Williams and Windebank, 1998); can build-up rights to the state pension and other contributory benefits, and access occupational pension schemes (Gallin, 2001; ILO, 2002); enjoy bargaining rights (ILO, 2002); improve their employability by being able to evidence their engagement in employment; and reduce their constant fear of detection and risk of prosecution (Grabiner, 2000).

For customers using the informal economy, meanwhile, the advantages of moving work from the informal economy into the formal economy are that they: benefit from legal recourse if a poor job is done; have access to insurance cover; enjoy guarantees in relation to the work conducted, and benefit from greater certainty that health and safety regulations have been followed.

Finally, and for governments, the benefits of moving work from the informal economy into the formal economy are that it: improves the revenue for the state in terms of payment of income tax, national insurance and VAT (Evans et al., 2006; Grabiner, 2000; Williams, 2004b; Williams and Windebank, 1998); has beneficial knock-on effects in terms of the ability of the state to create social cohesion at a societal level by increasing the money available to governments to pursue social integration and mobility (Williams and Windebank, 1998); results in improved trade union and collective bargaining (Gallin, 2001); allows the creation of more formal jobs so as to enable societies to increase employment participation rates and to move closer to the goal of full-employment; enables a joining-up of the policy approach towards the informal economy with the policy approaches towards entrepreneurship and active citizenship so that what is pursued with one hand of government is not negated by another hand of government (Dekker et al., 2010; European Commission, 2007a, Renooy *et al.*, 2004; Small Business Council, 2004, Williams, 2006; Williams and Renooy, 2009); leads to an improvement of regulatory control over the quality of jobs and services provided in the economy (Gallin, 2001); and encourages a more positive attitude towards the law more widely (Renooy et al, 2004).

Again, however, and although moving informal work into the formal economy appears to be the most viable of all the policy options, pursuing solely this policy option is perhaps not always viable for all forms of informal work in all contexts. It may be the case, for example, that it would be beneficial to adopt a *laissez-faire* approach towards small-scale piecemeal paid

favours which are conducted to help others out, not least because such endeavour does not seem susceptible to being shifted into the realm of formal employment. In addition, solely providing incentives to help businesses and workers move from the informal into the formal economy without coupling this with an eradication approach for those who fail to do so, would leave governments with no teeth to eradicate those who fail to formalise. Ultimately, therefore, although formalising informal work appears to be the most viable option, doing nothing, eradication and de-regulation are perhaps also required to play supporting subsidiary roles.

## **COMBINING THE POLICY OPTIONS**

In sum, of the four potential policy options, the first option of solely ‘doing nothing’ is unacceptable because it not only does nothing to confront how the informal economy reinforces the marginalisation of those living in poverty but also leaves intact the existing negative impacts on formal businesses (e.g., unfair competition), informal businesses (e.g., the inability to gain access to credit to expand), customers (e.g., no guarantee that health and safety standards have been followed) and governments (e.g., taxes owed are not collected). Secondly, the policy option of solely de-regulating formal work is deemed unacceptable because it results in a levelling down rather than up of working conditions and thirdly, solely eradicating the informal economy is found to be unacceptable because it results in governments repressing through their approach towards the informal economy precisely the active citizenship and entrepreneurship that they otherwise wish to nurture. Although solely transforming informal work into formal work appears to be the most viable policy option if only one approach is chosen, solely facilitating formalisation would still leave governments without any teeth to tackle those refusing to formalise and would still if pursued on its own, lead to shortcomings because doing nothing, eradication and de-regulation might sometimes play useful supporting subsidiary roles.

Ultimately, therefore, and given that these are not mutually exclusive approaches, a mixture of approaches are here advocated that extends the current trajectory being pursued by the UK government. Conventionally, the UK government sought to eradicate the informal economy by increasing the perceived or actual likelihood of detection and the penalties and sanctions for those caught (Williams and Windebank, 2005). Given that many businesses start-up in the informal economy (Williams and Martinez, 2014) and paid favours are a common tool used by those living in poverty to help each other out (Williams and Windebank, 2001), the result was that governments with one hand were eliminating precisely the entrepreneurship and active citizenship that other hands of government were seeking to foster. The result is that in recent years the government has shifted towards an overarching approach that seeks to move informal work into the formal economy, not least so as to achieve its wider objectives of employment creation, enterprise development and social cohesion.

This section has shown that this overarching policy shift towards the goal of shifting informal work into the formal economy is the most viable approach. However, it also shows that the other approaches can also sometimes play an additional supporting role such as doing nothing in relation to paid favours, eradication when tackling those who refuse to formalise and de-regulation when seeking to make it easier to formalise.

## 4 HOW CAN PEOPLE IN POVERTY BE HELPED TO MOVE FROM INFORMAL INTO FORMAL WORK?

To identify how people living in poverty can be helped to move from informal into formal work, this chapter reviews various ‘good practice’ policy measures implemented in other western countries to help those living in poverty formalise their informal work, and the feasibility of transferring these policy measures to the UK policy context.

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Conventionally, informal work was tackled using an eradication approach which sought to increase the perceived or actual probability of detection and the level of penalties so as to discourage participation (Williams and Renooy, 2013). However, the appropriateness of this approach can be questioned for at least three reasons:

- there is growing evidence that increasing the probability of detection and/or penalties often produces the opposite behaviour to that sought, namely greater non-compliance, not least due to the erosion of trust between citizens and the authorities (Torgler, 2011);
- between 2007 and 2013 the proportion of informal work embedded in relations of familial and community solidarity has grown, and much of the rest is composed of self-employed people starting-up and/or trading off-the-books (European Commission, 2013). The result is that if an eradication approach is pursued, one hand of government will be discouraging precisely the active citizenship and enterprise culture that other hands of government are seeking to foster, and
- there is growing recognition that the aim of policy is not simply to eradicate informal work but rather, to transform informal work into formal work in order to meet wider goals such as economic growth, fuller-employment, tackling poverty and social cohesion.

How, therefore, might this be achieved? Table 3 outlines the various policy approaches and the associated measures that can be used to transform informal work into formal work. In the ‘hard’ compliance approach, grounded in the assumption that informal workers and their employers are ‘rational economic actors’ who evade tax, social security and labour law obligations when the pay-off from evading is greater than the expected cost of being caught and punished (Allingham and Sandmo, 1972), the goal is to change the cost/benefit ratio to elicit compliant behaviour. This is achieved either by using deterrence measures to increase the costs of non-compliance (‘sticks’) and/or by making formal

work more beneficial and easier (‘carrots’). These sticks and carrots can be applied both as preventative measures to deter the entry of businesses and people into informal work and as curative measures to shift those in the informal economy into the formal realm. Conventionally, Her Majesty’s Revenue and Customs (HMRC) focused on using deterrents to increase the perceived or actual likelihood of detection and penalties for those caught (Richardson and Sawyer, 2001; Williams, 2008). Put another way, a ‘negative reinforcement’ approach was pursued to detect and punish those engaged in ‘bad’ (non-compliant) behaviour. In many other realms of social life such as child-rearing, this approach is now considered as ineffective in eliciting the behaviour changes desired. In the realm of tackling informal work, however, it remains widely used (Williams et al., 2013a), despite a growing body of evidence displaying that increasing deterrents can result in a growth of informal work (Feld and Larsen, 2012).

Table 3: Policy measures for transforming informal work into formal work

<b>Approach</b>	<b>Method</b>	<b>Measures (examples)</b>
‘Hard’ approach: compliance through deterrence	Improved detection	Data matching and sharing Joined up strategy Joint operations
	Increased penalties	Increased penalties for evasion
	Increase perception of risk	Advertising the penalties for informal work Advertising the effectiveness of detection procedures
‘Hard’ approach: compliance through incentives to formalise	Prevention	Simplification of compliance Smooth transition to self-employment Introducing new categories of work
	Curative	Demand-side incentives (e.g. service vouchers; targeted direct taxes) Supply-side incentives (e.g. voluntary disclosure; formalisation services)
‘Soft’ tax morality approach	Fostering culture of commitment	Promoting benefits of formal work Education and awareness raising

Recognising that the objective is not simply to discourage informal work but rather, to transform informal work into formal work so that broader societal goals can be achieved (e.g., economic growth, fuller-employment and social cohesion), since the turn of the millennium HMRC have begun to supplement deterrents with ‘carrots’ to make it beneficial and easier to engage in formal work (Williams and Renooy, 2013). The outcome has been a gradual shift away from a negative reinforcement approach that punishes ‘bad’ behaviour and towards a positive reinforcement approach that encourages and rewards ‘good’ (compliant) behaviour. Whatever combination of sticks and carrots are used however, the underlying premise of this hard compliance approach is that participants are ‘rational economic actors’ and all that is required to make them compliant is to change the cost/benefit ratio so that they make the rational economic calculation to engage in formal work.

This assumption is problematic for two major reasons. On the one hand, it fails to explain why so many citizens remain compliant and engage only in formal work even in the absence of an appropriate cost/benefit ratio (Williams, 2014). On the other hand, the growing evidence is that many engaged in informal work are not rational economic actors seeking monetary gain, but are social actors motivated by goals such as redistribution, displayed by the fact that 60 per cent of informal work is paid favours for close social relations in the UK and only in 60 per cent of cases was the reason to seek a lower price according to the 2007 Eurobarometer survey. For a large and growing segment of suppliers and purchasers of informal work, therefore, altering the cost/benefit ratio will have little impact on them since their reasons for participation are social rather than financial.

For these reasons, a ‘soft’ tax morality policy approach has begun to emerge. Rather than use ‘sticks’ and ‘carrots’, this instead focuses on developing a culture of commitment amongst citizens to contributing fully to the wider goals of society. This is achieved by educating people about the benefits of formal work and not evading tax, social security and labour laws, as well as pointing out through awareness campaigns the benefits that result (Williams and Renooy, 2013). ‘Soft’ and ‘hard’ policy approaches and their accompanying measures, of course, are not in practice mutually exclusive. They can be combined. To see this and also to highlight various measures that the UK could adopt, firstly, various preventative, curative and commitment measures used in other western countries are here reviewed that might be transferable to the UK, followed by a discussion of how they can be combined in order to more effectively transform informal work into formal work.

### **‘Hard’ approach: incentives to formalise**

To transform the informal work of those living in poverty into formal work, measures can be taken to: simplify compliance; legitimise the wide range of odd-jobs currently undertaken on an informal basis; ease the transition from unemployment to self-employment, and target purchasers to use people employed on a formal rather than informal basis. Each is considered in turn.

#### *Simplifying compliance*

Simplifying compliance so as to enable those living in poverty to transform their informal work into formal work, or to establish legitimate ventures easily, is not the same as reducing the regulatory burden. Reducing regulations is just one means of simplifying compliance. Compliance can be simplified without de-regulating, as the following example displays, a version of which could be adopted in the UK context.

#### *Box 1 On the spot firm, Portugal*

In 2005, Portugal’s Ministry of Justice (Ministério da Justiça) announced the Simplex programme whose aim is to encourage administrative and legislative simplification. One initiative was the ‘on the spot firm’ (*Empresa na Hora*), which seeks to alleviate the processes and procedures necessary to set up a new company. This initiative makes it possible to establish a company in a single office (one-stop shop) in a single day. On completion, the definitive legal person ID card is handed over, the social security number is assigned and the company immediately receives its memorandum and articles of association, as well as an extract of the entry in the Commercial Register. The security of

the incorporation procedure for new enterprises is thus ensured by having all the details sent to the tax authorities. Between 2005 when the initiative started, and September 2008, some 59,068 new enterprises were established, including 574 public limited companies (1 per cent of the total), 34,934 private limited companies (59 per cent) and 23,560 sole trader businesses (40 per cent). The average time taken to complete the procedure is 1 hour 14 minutes and the average cost of setting up a company is €360. Whether such administrative simplification has reduced the incidence of informal work, however, has not been directly evaluated. Many other countries, nevertheless, have explored the transferability of this initiative, including Angola, Brazil, Cape Verde, Chile, China, Egypt, Finland, Hungary, Mozambique, Slovenia and Sweden.

Source: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/pt003.htm>

In December 2013, the Office of Tax Simplification in HM Treasury announced the terms of reference for a review of the competitiveness of the UK tax administration. Given that this benchmarks the UK using the World Bank Doing Business reports, which advocate the above initiative as ‘good practice’, the UK could significantly improve its current position of 28<sup>th</sup> on the ease of starting a business by introducing this initiative (Office of Tax Simplification, 2013). If made freely available to the registered unemployed and others living in poverty, this would help prevent start-ups in the informal economy.

#### *Moving small-scale informal work into the formal economy*

Another measure for transforming informal work into formal work is to change regulations so that work such as odd-jobs which are currently, often by necessity, conducted as informal work can be undertaken on a formal basis. Given the small scale of much informal work in the UK, making it simple to do odd-jobs on a formal basis is an important means of legitimising a significant portion of the informal economy and allowing people to do such odd-jobs without fear of reprisal. Perhaps the best known example of how this has been achieved is the ‘mini-jobs’ category of employment in Germany.

#### *Box 2 Mini-jobs, Germany*

Until 1999, ‘minor employment’ was allowed up to a certain income level (DM 630) and with a weekly working time cap of 15 hours. This work was exempt from social security payments for employers and employees alike. Employers had to pay a lump-sum tax of 23 per cent; employees had to pay no tax at all. This minor employment could be combined with formal regular employment and still be exempt from tax and social security contributions. At the start of 1999, there were over 6.5 million minor jobs, representing almost 70 per cent of all jobs in catering and 60 per cent of jobs in cleaning. In 1999, the government reformed the minor employment scheme, aimed at limiting its growth. This drove much of this work into the informal sphere. In 2002, therefore, the German government introduced three new types of mini job:

1. *€400 jobs* - the income limit of the former DM 630 jobs was raised to €400. Within this income limit, mini-jobs enjoyed reduced social security contributions of 23 per cent (15 per cent for the pension insurance system and 13 per cent for the health insurance system) and a lump-sum tax of 2 per cent. However, the 15 hours per week limited was lifted.
2. *Mini jobs in the household sector* - introduced to combat informal work in this sphere.

The employer pays a levy of 12 per cent and can deduct a certain amount from their tax payments.

3. *Midi jobs* - to ease the transfer from minor to normal employment, a transition zone ranging between €400-800 was introduced, social security contributions for the employee rising gradually from around 4 per cent to the full 21 per cent.

Compared with 4.1 million employees in minor employment in September 2002, there were 5.5 million at the end of April 2003, one month after the introduction of mini jobs; a rise of 1.36 million. Some 1.21 million were people already in a formal job, about 580,000 of which are estimated to have transferred their add-on job from the informal to the formal realm (Baumann and Wienges, 2003). Since the onset of recession, this scheme has been even more widely used by the German population, with mini-jobs in household services rising from 102,907 in December 2004 to 234,453 in March 2012. In 2013, there were about 7.5 million €400 mini-jobs and every fourth newly created job is a mini job; in the hospitality sector 50 per cent of all jobs are mini jobs (Woudwijk, 2012). Many are undertaken by married women, not least because the income tax threshold for family income and child allowances are not affected.

Source: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/de016.htm>

Similar schemes to enable people to undertake odd-jobs legitimately have also been implemented in other countries. In Hungary, a new category of minor employment that simplifies obligations when declaring such endeavour has been introduced.

#### *Box 3 Simplified Employment Act 2010, Hungary*

In 2010 the Hungarian government introduced the Simplified Employment Act (Egyszerűsített foglalkoztatási törvény) to simplify seasonal employment and casual or temporary work. This Act enables an employer to notify this work either by a simple text message (SMS) or electronically via the Client Gate System once registered on the system. For seasonal work, the employer has to pay taxes of HUF 500 (€1.75) and for casual work HUF 1,000 (€3.50) on a daily basis. According to the National Tax and Customs Administration, between April and May 2010, 505,621 simplified employment cases were registered, of which 417,937 were for ad hoc or casual employment, 15,877 for seasonal agricultural employment, 6,393 for seasonal tourism employment, 761 at non-profit organisations, and 10,326 in plant cultivation. Some 499,987 lasted less than five days. Between 1 August 2010 and 31 December 2011, around 12.5 million working days were registered and HUF 8 billion (€28 million) flowed into the state treasury.

Source: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/hu015.htm>

A further and important example of how odd-jobs can be legitimised by simply changing the regulations is Denmark where not only are family and friendly favours (*vennetjenester*) in private homes now tax-free (thus legalising overnight what was previously the vast majority of informal work in Denmark), but young people under 16 years of age can also be paid for domestic work or childcare for other private households without paying tax and pensioners can earn up to DKK 10,000 annually (€1,341) by working in private homes with no consequence for their state pension. If such family and friendly turns, or paid favours, were similarly legitimised in the UK, a significant proportion of informal work conducted by those living in

poverty would become legitimate overnight, thus enabling them to conduct friendly favours for others without fear of punitive punishment for doing so.

There is also a need to analyse the potential for using universal credit to enable those living in poverty to engage in small odd-jobs legitimately. By shifting the earnings disregard to an annual allowance, rather than a weekly disregard, this could potentially legitimise overnight many odd-jobs undertaken by those living in poverty. How it can be used in a manner that does so needs to be analysed.

#### *Easing the transition from unemployment into self-employment*

Facilitating the transformation of informal work into formal work can also occur by making easier the transition into self-employment for the unemployed. One such successful initiative is the start-up premium in Germany which has replaced the earlier Ich AG scheme.

#### *Box 4 Start-up premium (Gründungszuschuss, GZ), Germany*

In 2002, the commission on 'Modern services in the labour market' (known as the Hartz Commission) was asked to present reform proposals for national labour market policy. One aspect was the introduction of a new public subsidy for business start-ups (*Existenzgründungszuschuss*). Introduced in 2003, this subsidy became known as 'Ich-AG', or 'Me PLC'. In the beginning, the scheme was criticized for performing the same function as a second, existing scheme, the 'bridging grant' (*Überbrückungsgeld*), resulting in the federal government fusing the two initiatives together in 2006 in the form of the 'start-up premium' (*Gründungszuschuss, GZ*). This GZ can be granted to recipients of unemployment benefit wanting to start up their own business. In addition to their continued unemployment benefit, recipients receive an additional monthly grant of €300 in the first six months. If after these six months, the recipient proves intense business activity and initial successes, the additional €300 monthly grant is paid for another nine months. Until the end of 2011, the timing of the two stages was reversed, lasting nine months and six months respectively. The prerequisites for participation in the scheme are firstly, they must still be entitled to 150 days of unemployment benefit on the day of the company's foundation, and secondly, they must prove themselves capable of self-employed work. Part-time self-employed work is not supported by the scheme. Thirdly, they must provide evidence of an economically viable business plan (e.g. by statements from the local chamber of commerce and industry, the chamber of skilled crafts or a bank). In a study of the GZ before its reform at the end of 2011, participants found the GZ easy and transparent. However, the evaluation shows that the new scheme does not attract as broad a clientele as the two earlier instruments. More women applied for 'Ich-AG' funds (Bernhard and Wolff, 2011). GZ participants are also older and have higher educational qualifications compared with participants in the two earlier schemes (Caliendo et al., 2011). Between 119,000 and 147,000 recipients of unemployment benefit enrolled annually in the GZ scheme between 2007 and 2010 (Bernhard and Wolff, 2011). There is also a high survival rate: 19 months after start-up, 75-84 per cent of former GZ recipients were still in business (Caliendo et al., 2011). No evidence has been provided, however, of the scheme's effectiveness in reducing informal work or its impacts on poverty.

Source: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/de017.htm>

### *Tax incentives for customers of informal work*

In recent years, various countries have introduced tax incentives to encourage customers to use formal rather than informal labour, as displayed in the following examples.

#### *Box 5 Tax deductions for household work, Sweden*

Since December 2008, Swedish citizens can receive a 50 per cent tax deduction on labour costs for household services (RUT) and the renovation, conversion and extension of homes (ROT), up to a maximum of SEK 50,000 (€6,000) per annum. Companies charge the customer the costs of materials and half the labour costs, including VAT. The company requests the outstanding sum from the Swedish Tax Agency. In 2010, 1.1 million people used this scheme and the Swedish Tax Agency paid out SEK 1.4 billion (€16.6 million) in RUT deductions and SEK 13.5 billion (€1.6 billion) in ROT deductions. Some 7.6 million hours of RUT services and 53 million hours of ROT services were performed. The Swedish Tax Agency (2011) estimate that informal work decreased by 10 per cent between 2005 and 2011 in these sectors. In the autumn of 2009, the Swedish Federation of Business Owners conducted a survey among 1,857 companies in the construction sector. The result showed that nearly 80 per cent of the surveyed companies felt that the measure had a positive impact on reducing informal work. No evidence is available on whether it transferred the informal work of those living in poverty into formal work.

Source: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/se015.htm>

In Denmark, a similar scheme has been adopted, again with the objective of formalising a sphere where the informal economy was previously rife. As shown below, the major difference is that Sweden has a tax deduction of €6,600 compared with €2,000 in Denmark. As can be seen in Box 6, there is little doubt that this has resulted in the formalisation of a large amount of informal work. Similar measures have also been initiated in Finland and Germany.

#### *Box 6 Home-job plan, home-job tax deduction, Denmark*

Since 1 June 2011 until the end of 2014, it is possible for each household member over 18 years of age to deduct from their taxes up to DKK 15,000 (€2,000) for the costs of employing craftspeople and domestic helpers under a pilot project called 'Home-Job Plan' (Bolig-Jobplan). The expenses that can be deducted include payment for cleaning, indoor-outdoor maintenance of the house, gardening and babysitting and from April 2013 it also includes subsidies to summerhouses. The cost to the government is estimated to be DKK 1 billion (€134 million) in 2011 and around 1¾ billion (€234 million) in 2012 and 2013. Relative to expectations, the pilot project has so far been a success; 270,000 people have used the deduction in 2011 and most of the work involved home improvement, maintenance and repair. They have on average reported deductions of DKK 9,800 (€1,315) per person. In total, the deductions reported constitute DKK 2.7 billion (€362 million). The tax value of those deductions is around DKK 900 million (€121 million). The success of the measure was partly due to the simplified way of realizing the deduction. The Danish tax authority introduced an electronic system to pay for services and at the same time for the deduction on the tax return of the buyer and for reporting the income on the tax returns of the person performing the work. Again, no evidence is available on whether it transferred the informal work of those living in poverty into formal work.

Source: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/dk015.htm>

### *Service vouchers*

Many countries have developed service voucher schemes to encourage customers to purchase from the formal economy in spheres where informal work is rife.

#### *Box 7 Service Vouchers, Belgium*

Service vouchers are a means of paying for everyday personal services. Each voucher costs €9 for the first 400 vouchers per person (2014) and €10 for the next 100. Each individual is allowed to buy 500 vouchers a year, or 1000 vouchers for each family. Up to €1350 per year is tax deductible (at a 30 per cent tax rate). Every voucher can be used to pay for an hour of work from certified companies that hire unemployed people. At first, the unemployed person can be hired by the company on a part-time, temporary basis. After six months, the company has to offer the worker a permanent employment contract for at least half-time employment if the person was registered as unemployed. An employee of a certified company can carry out the following activities: housecleaning, washing and ironing, sewing, running errands, preparing meals or accompany people who are not mobile. The customer pays using the vouchers, of which the cost price was €22.04 in 2013; the difference is paid to the company by the government. The total cost of the voucher scheme in 2011 was some €500m. Per employee net costs amounted to €3,520 in 2011 and €2,793 in 2010 (Maarten et al. 2012).

Although early studies found that customers previously sourced some 44 per cent of the work now conducted using service vouchers from the informal economy (De Sutter, 2000), more recent evaluations find that only 25 per cent reported that it would have been conducted in the informal economy if there had been no vouchers. One interpretation is that, in its early days, the scheme acted as a tool for transferring informal work into the formal economy, but is now becoming more of a means for moving unpaid self-provisioning activities into formal employment. At the end of 2011 there were 2,754 companies involved, 830,000 users and 108,663,966 vouchers sold. During 2011, around 150,000 persons were employed. Although only 4.6 per cent (10.2 per cent in Brussels) of employees stated they started working in the voucher system to avoid the informal economy, this ignores that without it, many customers would doubtless source these services on an informal basis. Examining the labour force of the voucher system, it is mainly women (97 per cent of all the employees) aged 30-55 with low educational levels. This profile is growing stronger over time; the proportion aged 50 and over is growing, as are the proportion that are non-Belgian nationals; some 20 per cent of all voucher workers (55 per cent in Brussels) are non-Belgian EU28 nationals and a further 10 per cent are from outside the EU28.

*Source:* European Commission (2013)

A further scheme which has proved successful is the *Chèque Emploi Service Universel* (CESU) scheme, which was introduced in France to simplify the process of hiring and paying a domestic worker and to formalise informal work.

#### *Box 8 Chèque Emploi Service Universel (CESU) scheme, France*

The domestic worker's salary is paid using a system of cheques which can be purchased at the local bank. The benefit to the customer is that they can claim an income tax reduction amounting to 50 per cent of the sum spent on purchasing the cheques. For the supplier, meanwhile, the salary cannot fall below the national minimum wage, and a 10 per cent

indemnity is also given for paid leave. By 2002, the number of households legally using domestic service workers amounted to 765,411 households, while just under 88,000 full-time equivalent jobs were created (Adjerad, 2003). By 2002, some 53 per cent of all formal employers of domestic workers used the CESU scheme (ibid). An estimated 20 per cent of those previously working in the informal economy are now officially employed (le Feuvre, 2000).

Source: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/fr003.htm>

Not all countries, however, have had such a positive experience with service voucher schemes. In Finland, in the late 1990s, only 24,000 households used a service voucher scheme; the low take-up was mainly due to the fact that the subsidy was insufficient to make formal domestic services less costly than informal economy services (Cancedda, 2001: 29). This displays that, unless the incentive is sufficient, such demand-side measures will be ineffective. It also raises a key issue for tax administrations: the tendency will be to keep costs to a minimum by providing as low an incentive as possible; however, as seen in the case of Finland, the incentive offered can sometimes be too low to encourage consumers to make the transition.

### *Formalisation services*

It is now commonly recognised that the kind of business advice and support required by those seeking to legitimise their business ventures differs from that required by start-up or growth businesses who wish to go through a formal business planning process (Williams et al., 2012). It is also acknowledged that support and advice is generally not widely available to them at present about how they might resolve their situation. The development of a bespoke ‘formalisation service’ is one way forward and various models are now available regarding the form such a ‘formalisation service’ might take (Barbour and Llanes, 2013).

In the UK, a pilot ‘formalisation service’ in 2005 in Hartlepool by HRMC offered individuals engaged in informal work a confidential and anonymous assessment of their liabilities. If the individuals concerned accepted the assessment and paid the amount outstanding, their activities would be ‘legitimised’ and they would be reintegrated into the formal economy with no legal action taken against them. Nevertheless, only one individual came forward and underwent a review of their liabilities. The subsequent evaluation found that there was a lack of knowledge of the scheme locally, alongside low levels of trust between the target group and HMRC. Moreover, the failure to use an independent body, such as the local Citizens Advice Bureau, to which people could make their initial approach, was considered a further weakness (Bivand *et al.*, 2006).

Learning from this experience, Llanes and Barbour (2013) have recently proposed a model for a ‘formalisation service’ which includes:

- Introducing an immediate referral policy of ‘informal’ clients onto a specialist Work Programme provider;
- Work Programme providers and business support organisations should incorporate formalisation services into local service delivery such as by being granted special consideration on the ‘duty to disclose’. Providers should be in the position to reassure clients that no recovery action is attached to the offer of support, on the condition that informal entrepreneurs formalise their activities.
- Increase eligibility for test trading to prevent benefit claimants from setting up

informal businesses. Giving claimants day one eligibility to test trade or go onto the New Enterprise Allowance will stop people from setting up informal businesses before they relinquish their benefits.

- Design Universal Credit so that it enables self-employment and encourages formalisation. Adopt a suitable payment model for benefit payments to the self-employed and develop a suitable conditionality regime for claimants moving into self-employment.

## **Soft approach: commitment measures**

Rather than alter either the costs of informal work and/or benefits of formal work so as to encourage compliance, the intention in the ‘soft’ tax morality approach is to engender commitment to working formally so that such ‘sticks’ and ‘carrots’ are not needed. Put another way, there is a shift from the use of direct controls to engender compliance to indirect controls to foster the commitment of citizens to contributing to society through paying taxes and ensuring that decent work conditions prevail. Since the onset of recession, measures to foster such commitment have blossomed throughout the EU-28 as governments and social partners have sought to educate and raise awareness about the importance of paying taxes, foster decent work conditions and improve the psychological contract between the state and its citizens.

### *Awareness raising and educational campaigns*

To improve tax morale and encourage understanding of the contribution citizens make to society by fully paying their taxes, awareness raising and educational campaigns have been pursued in many Member States to improve citizens’ attitudes and norms towards paying taxes by explaining why they should do so and why it is unfair not to pay the required taxes. Such campaigns have either informed:

- informal workers of the costs and risks of informal work;
- potential users of informal labour of the risks and costs;
- informal workers of the benefits of working formal, and/or
- potential users of informal work of the benefits of employing formal labour.

An example of such an awareness raising campaign is to be found in Latvia.

#### *Box 9 ‘Against the informal economy – for fair competition’, Latvia*

In October 2011, the Latvian Employers’ Confederation (Latvijas Darba Devēju konfederācija, LDDK) conducted an awareness raising and educational campaign which included an advertising campaign with the slogan ‘I spit on it’ (*Man uzspļaut*) and an online test for measuring the impact of an individual’s informal activity. Around 12,000 individuals tested their impact in the online test. Answering 11 questions in the test, individuals could discover their informal behaviour in shops, markets and with service providers (taking or leaving a receipt when purchasing), in hospitals (extra payments to doctors), transport (extra payments to officers), employment (working with or without an employment contract, informal income from work and accepting ‘envelope wages’) and their total impact on the informal economy in Latvia. Participants were advised how to reduce their own informal economy impact, for example by paying official prices for

services, acquiring a receipt in shops and other shopping places, ensuring that a taxi meter was working, and only purchasing certified car fuel.

*Source:* European Commission (2013)

Indeed, evaluations of awareness campaigns suggest that they represent good value for money, at least measured in terms of the revenue-to-cost ratio. In the UK, an evaluation of the advertising campaigns informing informal workers of the costs and risks of working informally run by Her Majesty's Revenue & Customs (HMRC) in 2006/7 reveals that some 8,300 additional people had registered to pay tax who would otherwise not have done so, paying tax of around £38 million over three years, providing a return of 19:1 on the expenditure of £2 million. This compares with an overall return of 4.5: 1 on the £41 million a year spent on all its informal economy work in 2006-07 (National Audit Office, 2008). It therefore appears that awareness raising campaigns can be relatively effective in terms of value-for-money.

#### *Measures to change perceptions of the tax system*

Taxes are the prices paid for the goods and services provided by governments. Citizens see themselves as more justified being non-compliant and breaking the psychological contract with the government, if they do not believe that the price is fair and/or they do not adhere to the distributive principles of the government. To narrow the difference between the taxes owed and paid therefore, the tax system should be perceived as fair by citizens, and they need to know what their taxes (i.e., their contribution to society as citizens) is being used to pay for in terms of goods and services.

#### *Box 10 'Unpaid taxes will leave a mark', Estonia*

A 2009 survey in Estonia revealed that awareness of the services people receive from the state is relatively low; 26 per cent of respondents did not know what kind of services they receive from the state, while around half of them (11 per cent) said that they got nothing from the state. In 2010 and 2011, therefore, an information campaign, 'Unpaid taxes will leave a mark', was implemented by the Estonian Tax and Customs Board with the aim of raising awareness among the population regarding how tax payer's money is used by the state by explaining why it is important to pay taxes and what each citizen receives in return. The campaign was implemented in two parts. The first part was conducted in nine Estonian cities during 2010. The main message of the campaign was: 'Unpaid taxes will leave a mark. You like highways in order, a good ambulance, fire and police service. So do we.' For instance, a message was displayed on the back of buses together with a picture of rescue workers 'Should we take the trolley bus to an emergency call-out? This can happen if you do not pay your taxes.' In addition, a thank you message was attached to rescue cars in Tallinn, Harju and Virumaa counties and ambulance cars in Tallinn saying that these cars have been bought with tax payers' money. The aim was to raise awareness of what is financed by tax income and to bring to the fore the services citizens receive for their tax payments. Thus, even after the campaign had ended, the adverts remain visible on rescue and ambulance cars.

The second part of the campaign was conducted in eight Estonian cities during October 2011. This follow-up campaign retained the same main message 'Unpaid taxes will leave a mark', although sub-messages were introduced geared towards particular issues and groups. TV and radio commercials were also added. For instance, given that it was the 100<sup>th</sup>

anniversary of the Estonian film industry, a TV commercial was produced stating that if the current tax arrears were resolved, 722 domestic films could be produced a year instead of the current three films. Radio commercials, meanwhile, stated the number of computers that could be bought for children whilst the outdoor advertising hoardings pointed out that 295 new kindergartens could be built if taxes were fully paid. Each of these messages were made socially relevant to the Estonian context since in addition to the 100<sup>th</sup> anniversary of the Estonian film, the lack of facilities for children in schools and the provision of childcare and kindergarten places were widely held to be important problems by the Estonian population that needed to be resolved.

Compared to other state campaigns, the average results of the 'Unpaid taxes will leave a mark' campaign was relatively effective. The second part of the campaign was noticed by 59 per cent of respondents aged 15-74. Considering that the average share for different campaigns is 45 per cent, the results are relatively good. The respondents considered the main message of the campaign to be that the maintenance of the state is the responsibility of all citizens. 65 per cent of the respondents found that the campaign was suitable for increasing awareness of unpaid taxes.

Source: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/ee015.htm>

## **Combining policy measures**

Developing effective methods to transform informal work into formal work is not simply about choosing effective individual policy measures. It is also about putting policy measures together in various combinations and sequences that are effective. For example, governments might simplify regulatory compliance as well as introduce incentives, such as amnesties, to enable people to move into the formal realm; at the same time, in relation to those who fail to comply, they may implement tougher sanctions for those subsequently caught, while also introducing campaigns to elicit greater commitment amongst the public to tax morality.

Importantly, which combination of measures to use will be determined by the structure of the informal economy. Tackling an informal economy dominated by small-scale paid favours between close social relations for redistributive rationales in the domestic services realm will require different measures to tackling an informal economy where exploitative sweatshop like work exists, such as unlicensed 'gangmasters' using illegal immigrant labour in the agricultural sector. An effective mix of measures will tackle the specific structure of the informal economy it confronts and directly address the key drivers that elicit such informal behaviour.

In future, in consequence, evaluations will need to be conducted of which combinations of measures ordered in what sequence are most effective in which contexts. Before doing this, however, evaluations will be required of which individual policy measures work and which do not, albeit perhaps in conjunction with other measures. Until this is done, it will not be possible to know what works and what does not in different contexts.

## **5 WHAT IS THE RELATIONSHIP BETWEEN THE INFORMAL ECONOMY AND BROADER ECONOMIC AND SOCIAL POLICIES?**

Evaluating the relationship between broader social and economic policies and the informal economy, this chapter reveals that pursuing ‘austerity’ measures of de-regulation and tax cuts have little effect on reducing the size of the informal economy. Instead, the finding is that the informal economy is smaller in societies characterised by higher levels of expenditure on social protection and active labour market policies, lower income disparities and higher social transfers.

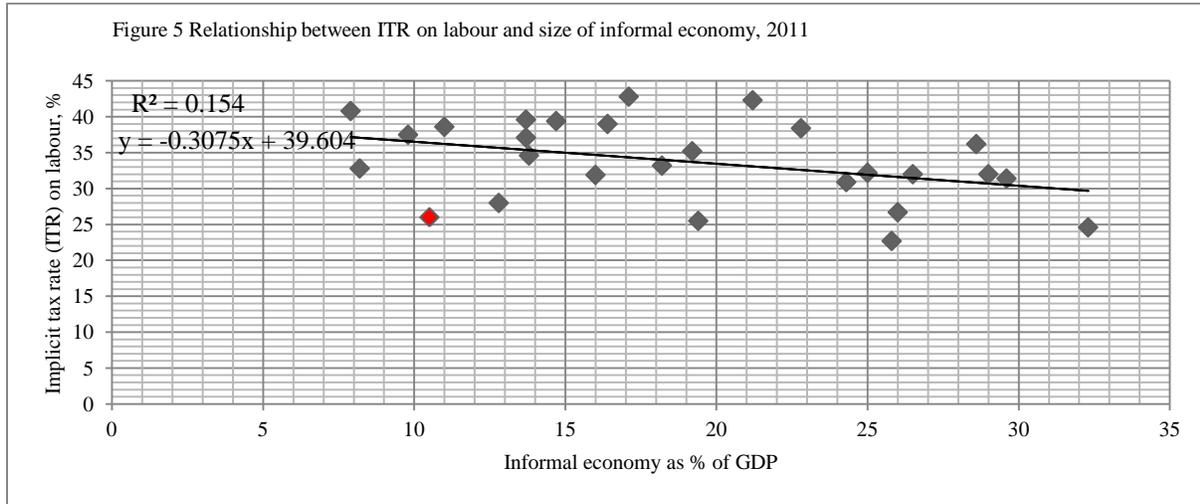
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What is the relationship between broader economic and social policies and the level of the informal economy? Two competing views exist. On the one hand, a neo-liberal approach argues that the informal sector is a direct result of high taxes, over-regulation of the economy and too much government interference in the realm of welfare provision, and that economies should therefore pursue tax reductions, de-regulation and minimal state intervention to prevent the informal sector from growing (De Soto, 1989, 2001; London and Hart, 2004; Nwabuzor, 2005; Williams, 2013). On the other hand, a political economy viewpoint is that the informal sector is a by-product of economic de-regulation and reductions in state welfare provision, and that labour market interventions and welfare provision should be therefore bolstered to tackle the informal sector (Ahmad, 2008; Ghezzi, 2010; Meagher, 2010; Slavnic, 2010). Here, these two competing discourses regarding whether informalisation is associated with under- or over-regulation in the economy are evaluated.

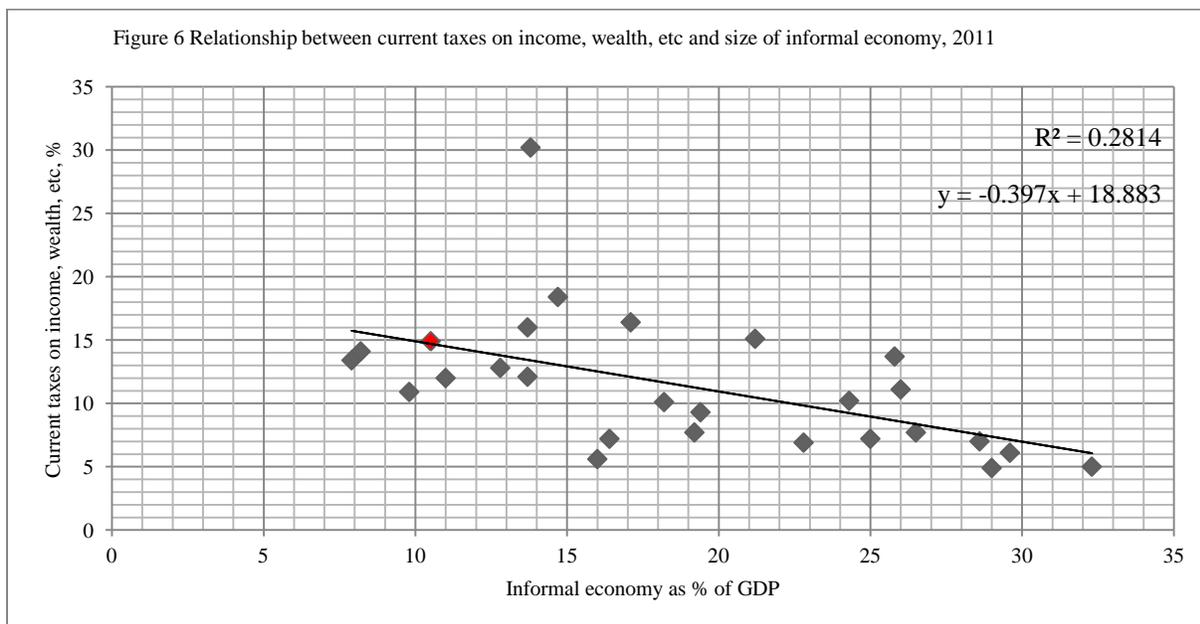
### **Do neo-liberal ‘austerity’ policies reduce the size of the informal economy?**

From a neo-liberal perspective, high tax rates are a key driver of the level of the informal economy. To analyse the impacts on the informal economy of the average effective tax burden on employed labour, the relationship between the size of the informal economy in the 27 member states of the European Union (EU-27) and the level of implicit tax rates (ITR) on labour can be analysed. The ITR on labour aggregates all direct and indirect taxes along with all employees’ and employers’ social contributions that are levied on employed labour income, and divides this by the total compensation paid to employees (Eurostat, 2010). The sum of all direct and indirect taxes and employees’ and employers’ social contributions levied on employed labour income divided by the total compensation of employees working in the economic territory increased by taxes on wage bill and payroll. The ITR on labour is calculated for employed labour only (so excluding the tax burden falling on social transfers, including pensions). The ITR on labour should be seen as a summary measure that approximates an

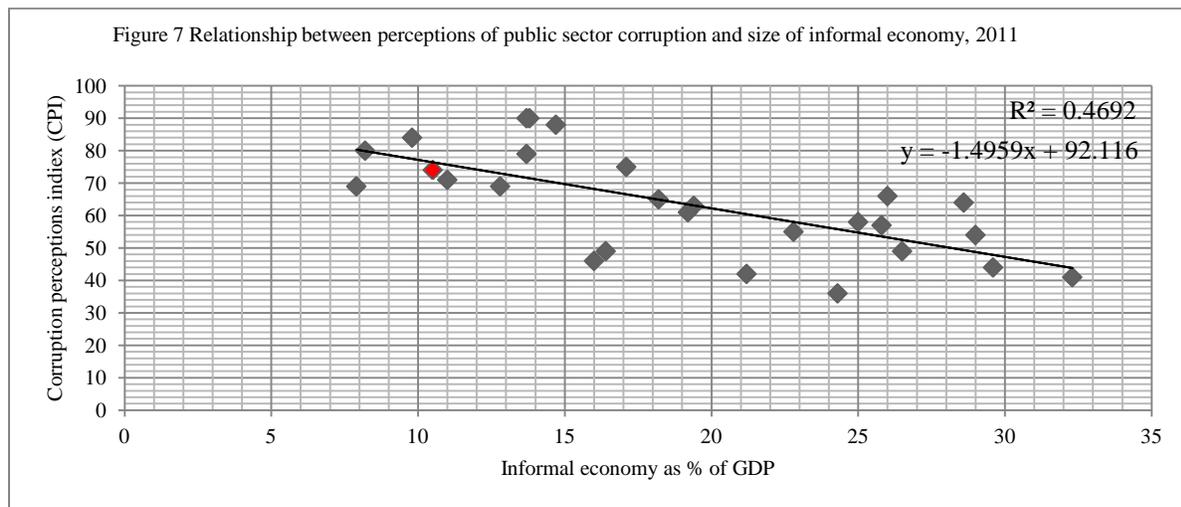
average effective tax burden on labour income in the economy. A statistically significant correlation is identified between the cross-national variations in the ITR on labour and the cross-national variations in the size of the informal economy ( $r_s = -.409^*$ ). However, the association is in the opposite direction to that assumed by neo-liberals. Nations with higher tax burdens on employed labour have smaller informal economies.



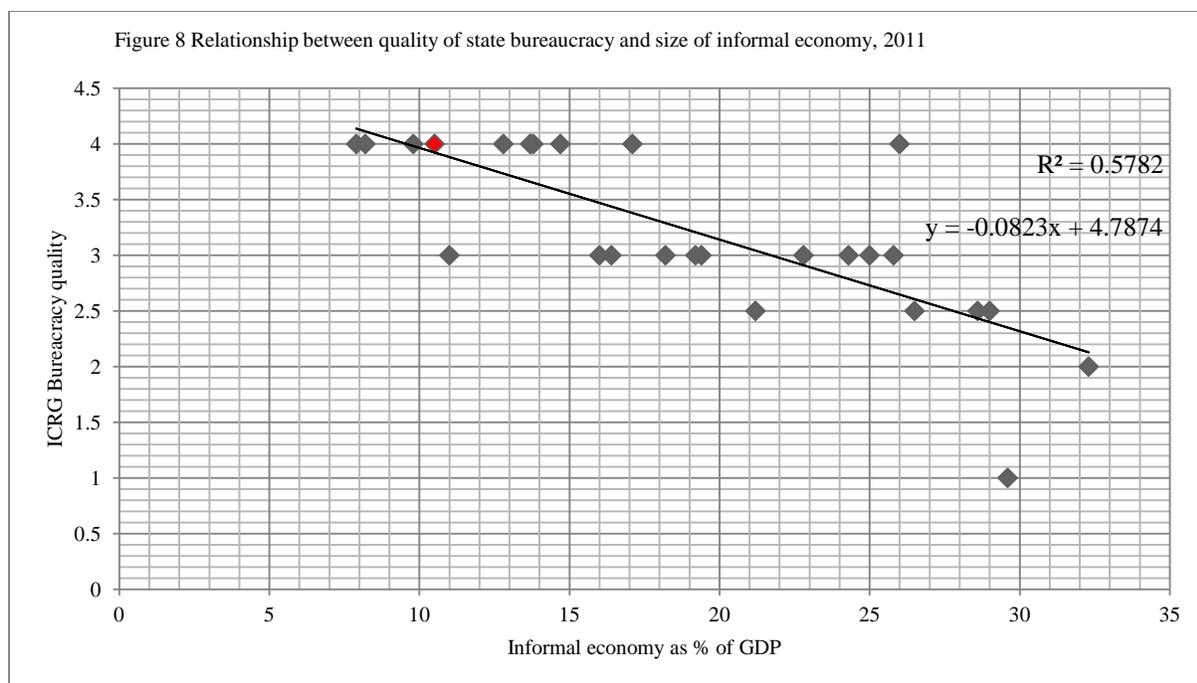
The same is found when another measure of tax rates is analysed, namely current taxes on income, wealth etc, which covers all compulsory, unrequited payments, in cash or in kind, levied periodically by general government and by the rest of the world on the income and wealth of institutional units, and some periodic taxes which are assessed neither on the income nor the wealth. A strong significant relationship is found between the cross-national variations in current taxes and the cross-national variations in the size of the informal economy ( $r_s = -.607^{**}$ ) but again in the opposite direction to that suggested by neo-liberals; higher current taxes on income, wealth, etc result in lower levels of informal work.



It is also the case that there is a relationship between cross-national variations in the size of the informal economy and public sector corruption. Transparency International's 2011 Corruption Perceptions Index (CPI) is a composite index which synthesises 14 expert opinion surveys and scores countries on a 0-10 scale, with zero indicating high levels and 100 low levels of perceived public sector corruption (Transparency International, 2013). The finding is that a strong correlation exists between the cross-national variations in the level of perceived public sector corruption and the cross-national variations in the size of the informal economy ( $r_s = -.710^{**}$ ). The level of the informal economy is higher the greater is the perceived level of public sector corruption.



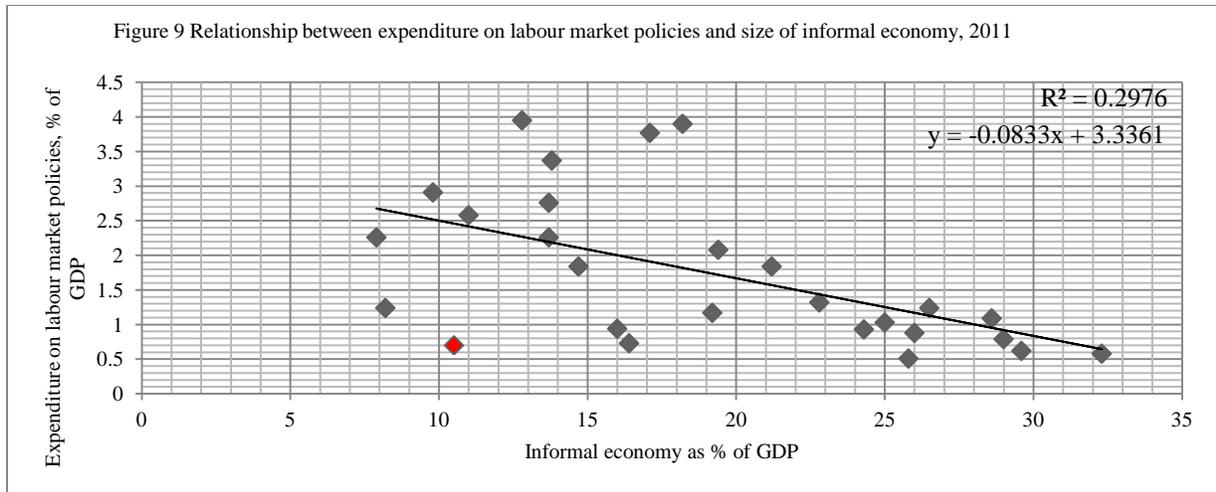
It is similarly the case when the relationship between the informal economy and the institutional strength and quality of the state bureaucracy is evaluated. The International Country Risk Guide (ICRG) uses a 0-4 scale to measure the quality of bureaucracy in a country where 4 indicates that the quality of state bureaucracy is high and 0 that it is low. Countries with high quality state bureaucracy have the strength and expertise to govern without drastic changes in policy or interruptions in government services, a bureaucracy that is autonomous from political pressure and an established mechanism for recruitment and training. Countries with low quality state bureaucracy are those where a change in government is traumatic in terms of policy formulation and day-to-day administrative functions (ICRG, 2013). The finding is that there is a strong correlation between cross-national variations in the quality of the state bureaucracy and the variable magnitude of informal employment ( $r_s = -.785^{**}$ ). The higher the quality of state bureaucracy, the smaller is the magnitude of the informal economy.



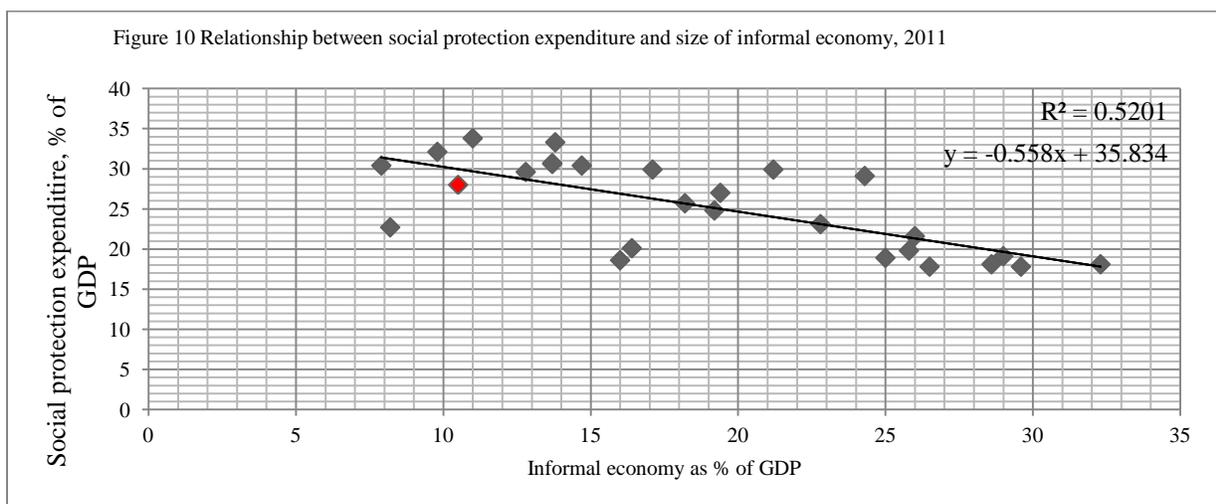
In consequence, there is little evidence to support the neo-liberal argument that informal work is driven by higher tax levels, although it is higher in countries with higher levels of public sector corruption. Is it also the case as neo-liberals assert that greater levels of state interference leads to higher levels of informal work? Or is it as structuralists assert that greater levels of informal work are the result of a lack of state intervention and reduces with greater public intervention in work and welfare arrangements?

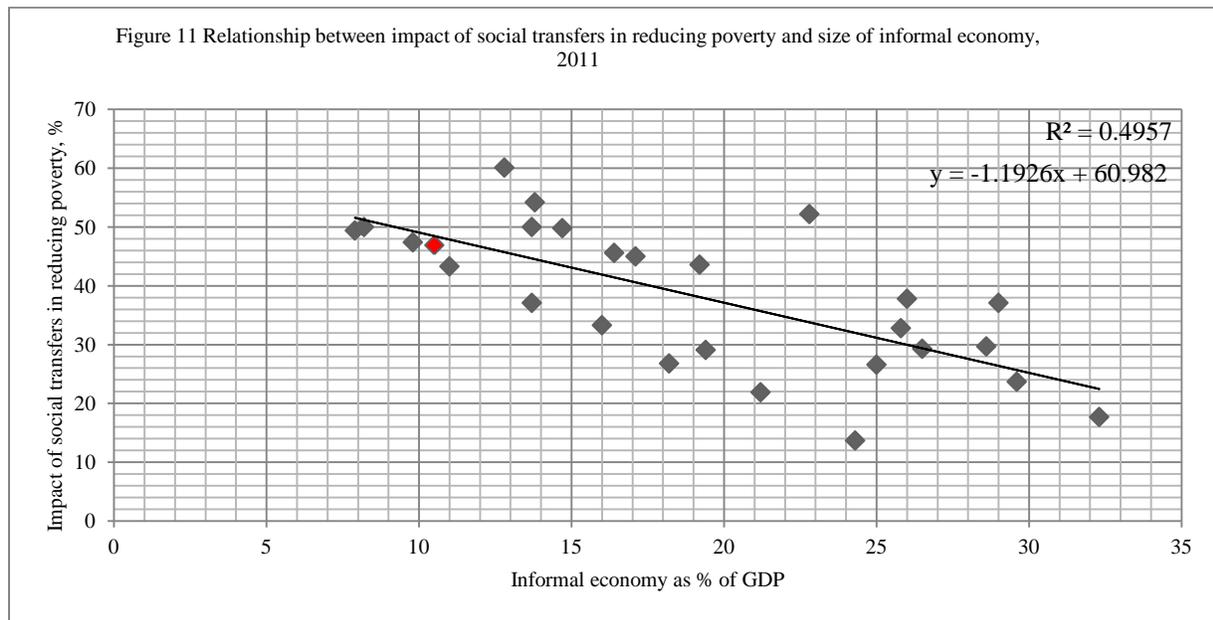
### The relationship between state intervention and the size of the informal economy

To evaluate the relationship between cross-national variations in the level of state intervention in work and welfare and the size of the informal economy, the first issue here investigated is whether and how state intervention in the labour market aimed at correcting disequilibria is correlated with informal work. To do this, an analysis is undertaken of cross-national variations in the proportion of GDP spent by governments on interventions in the labour market, covering both actual disbursements and foregone revenue (reductions in taxes or social contributions normally payable), targeted at groups with difficulties, including the unemployed, people in jobs but at risk of involuntary job loss, and inactive persons currently not part of the labour force but who would like a job and are disadvantaged in some manner (European Commission, 2011: Table 3). A statistically significant relationship is found between the cross-national variations in the level of expenditure on labour market interventions and the cross-national variations in the size of informal employment ( $r_s = -0.581^{**}$ ). In economies which pursue higher levels of expenditure as a proportion of GDP on labour market interventions, the magnitude of the informal economy is smaller (see Figure 9).



Turning to welfare expenditure, and as Figure 10 displays, it is similarly the case that the greater the level of expenditure on social protection (excluding old age benefits) as a proportion of GDP (European Commission, 2011: Table 3), the smaller is the size of informal employment ( $r_s = -0.740^{**}$ ). Indeed, this reveals that a reduction in the size of the informal economy from 10 per cent to 5 per cent could be achieved by increasing social protection expenditure from 30 per cent to 38 per cent of GDP. It is also the case that the more the state reduces the proportion of the population at risk of poverty using social transfers, the smaller is the level of informal work in economies (see Figure 11). Analysing state redistribution via social transfers, measured by the reduction in percentage points of poverty (defined as the proportion of the population with an income below 60 per cent of the national median income) after social transfers (European Commission, 2011: Table 3), a statistically significant correlation is identified. The greater the reduction in poverty due to state redistribution via social transfers in a nation, the smaller is informal employment ( $r_s = -0.687^{**}$ ).





The outcome is that the informal economy is smaller in more equal societies. This is the case whatever measure is used. Firstly, there is a strong association between income inequality and the size of the informal sector. Using the ratio of total income received by the 20 per cent of the population with the highest income (the top quintile) to that received by the 20 per cent of the population with the lowest income (the bottom quintile), that is, the income quintile share ratio S80/S20, as a measure of income inequality, Figure 12 displays a significant association between income inequality and the size of the informal sector ( $r_s=0.508^{**}$ ). The higher the equality of income, the lower is the level of the informal sector in a society. A significant correlation can be also identified between the level of equality in a society, as measured by the gini-coefficient (European Commission, 2011), the relationship of cumulative shares of the population arranged according to the level of equivalised disposable income, to the cumulative share of the equivalised total disposable income received by them, and the extent and nature of the informal sector. Again, and as Figure 13 displays, greater equality in a society is significantly correlated with lower levels of informality ( $r_s=0.460^*$ ).

Figure 12 Relationship between income inequality and size of informal economy, 2011

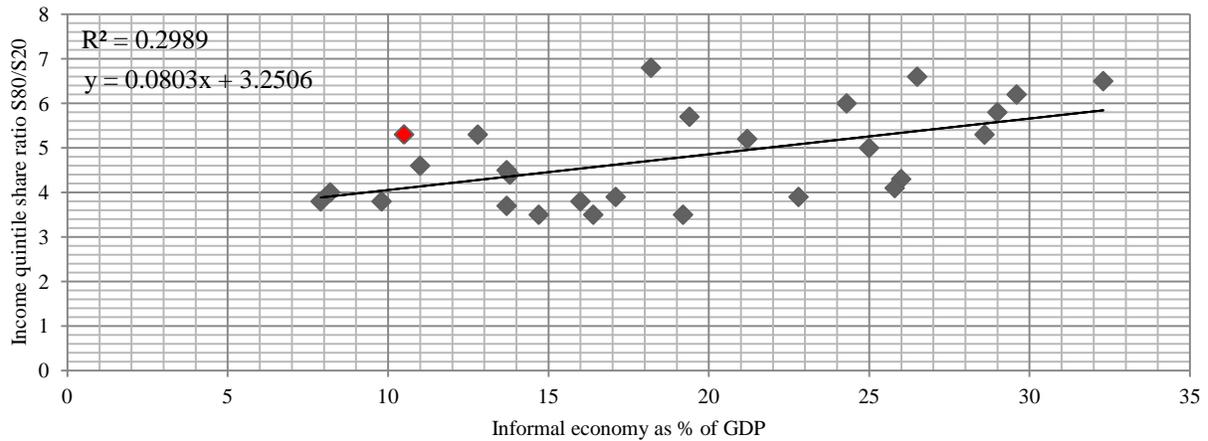
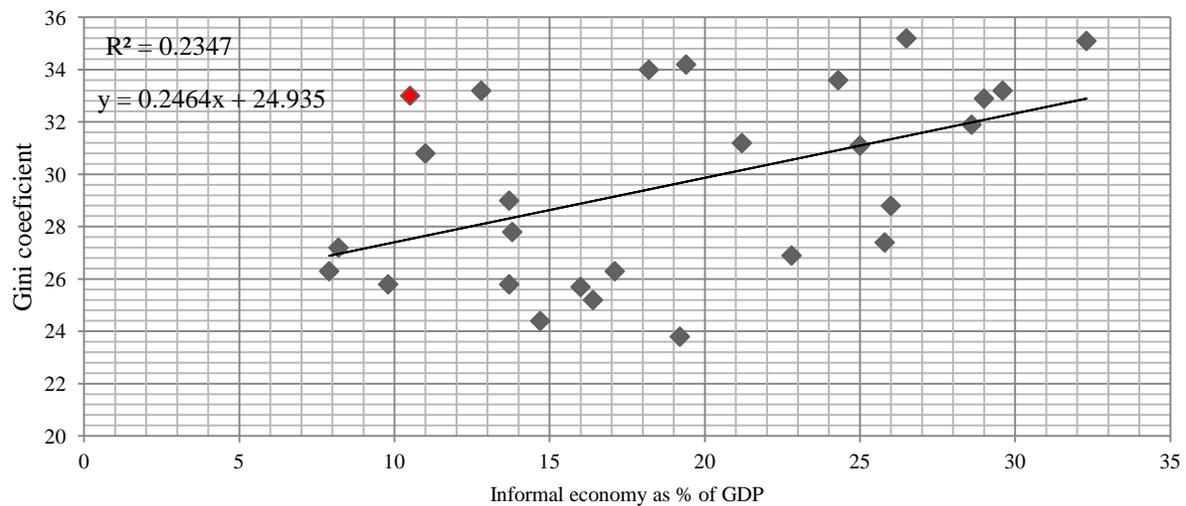


Figure 13 Relationship between gini coefficient and size of informal economy, 2011



In sum, this chapter has shown that pursuing ‘austerity’ measures of de-regulation and tax cuts appear to have little effect on reducing the size of the informal economy. Instead, the finding is that the informal economy is smaller in societies characterised by higher levels of expenditure on social protection and active labour market policies, lower income disparities and higher social transfers. A strong statistically significant correlation thus exists between these broader economic and social policies and the size of informal economies. These correlations, however, need to be treated with caution. Although such correlations do not suggest a cause-effect relationship, they do hint that some relationship exists between the type of economic and social policies pursued and the size of the informal economy.

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### **Biography**

Colin C Williams is Professor of Public Policy in the Management School at the University of Sheffield. He has published 20 books and over 300 journal articles on the informal economy over the past 25 years. His books include *The Shadow Economy* (2013, Institute of Economic Affairs), *Informal Work in Developed Nations* (2010, Routledge), *The Hidden Enterprise Culture* (2006, Edward Elgar) and *Cash-in-Hand Work* (2004, Palgrave Macmillan).