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Measures to tackle undeclared work in 27 European countries

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Measures to tackle undeclared work in the European Union

Executive summary

Introduction

1. Nature and extent of undeclared work in the EU27

2. Policy approaches to tackling undeclared work

3. Policy approaches adopted in individual countries

**4. Towards 'good practice' – evaluating the effectiveness of
policy measures**

5. Conclusions

References

Country codes

EU15 15 EU Member States prior to enlargement in 2004 (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the UK)

NMS 12 New Member States, 10 of which joined the EU in 2004 (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) and the remaining two in 2007 (Bulgaria and Romania)

EU27 27 EU Member States

EU27

AT	Austria	LV	Latvia
BE	Belgium	LT	Lithuania
BG	Bulgaria	LU	Luxembourg
CY	Cyprus	MT	Malta
CZ	Czech Republic	NL	Netherlands
DK	Denmark	PL	Poland
EE	Estonia	PT	Portugal
FI	Finland	RO	Romania
FR	France	SK	Slovakia
DE	Germany	SI	Slovenia
EL	Greece	ES	Spain
HU	Hungary	SE	Sweden
IE	Ireland	UK	United Kingdom
IT	Italy		

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Executive summary

Introduction

Across the 27 Member States of the European Union (EU27) and Norway, considerable effort is being invested in developing and testing policy measures that aim to tackle undeclared work. Although a number of previous attempts have been made to describe the array of measures used in different countries, one feature found to be lacking is a 'knowledge bank' which specifically identifies measures that have been proven to be most effective. In an attempt to bridge this knowledge gap, the European Foundation for the Improvement of Living and Working Conditions (Eurofound) embarked on a project to develop such a resource by commissioning research that would review the effectiveness of policy measures, as well as assess the transferability of such measures.

A report published in 2008 took the first step towards developing such a resource by commissioning a review of the effectiveness of policy measures adopted in five countries: Belgium, Denmark, Italy, Poland and the United Kingdom. The present report expands the scope of the original study by examining policy measures in 28 countries (the EU Member States and Norway). It also presents a new chapter on the nature and extent of undeclared work in the EU27, based on the findings of the 2007 Eurobarometer survey. The result of this initiative is a greatly expanded knowledge bank that reviews up to three policy measures in each of the 28 countries covered. It therefore represents the first important step in the creation of a comprehensive learning hub or resource bank where social partners can pool and share knowledge on how to tackle undeclared work, review evaluations of policy initiatives, and explore their feasibility and transferability across other sectors, countries and occupations.

Policy context

As undeclared work affects all EU Member States, it is one of the issues of common concern in the employment field and can have a significant impact on public finances, owing to the drain in tax and social contributions. Undeclared work also has a negative impact on individuals as regards social security cover. In order to tackle undeclared work in the EU27 as a whole, as well as in individual countries, it is therefore important to reduce the economic incentives for engaging in undeclared work and to change attitudes.

While the approach towards undeclared work in most countries remains embedded in a deterrence approach, there has also been a noticeable increase in the use of more enabling measures, particularly since Employment Policy Guideline No. 9 on transforming undeclared work into regular work was published in 2003. This has resulted in a greater move towards preventing people from entering the undeclared arena in the first place, as well as helping them make the transition to formal employment. The greater use of both 'carrot' alongside 'stick' type measures has recently been further reinforced by the European Commission's second Communication on undeclared work, *Stepping up the fight against undeclared work*, in 2007. The Commission recognises that although deterrent, curative and preventative measures are being adopted, few countries are pursuing measures to encourage tax morality; therefore, they recommend greater use of awareness-raising initiatives to change attitudes in this regard.

Given the greater experimentation since the turn of the millennium with a variety of different policy approaches and measures, it has become ever more crucial for the social partners to learn from each another about what works and what does not. However, while various policy actions have been taken across Member States, there is an apparent lack of evaluation of results and pooling of expertise. The problem arising from the lack of coordinated mutual learning has also been highlighted in a 2008 European Parliament resolution calling on Member States to step up the fight to combat undeclared work. The resolution called on the Commission to consider establishing a database 'on the various approaches and measures implemented nationally by each Member State, to assess their feasibility and transferability to other sectors and areas of work in other Member States'.

Key findings

Up until now, informed discussion about how to tackle undeclared work both in the EU27, as well as in individual countries, has been severely hampered by a lack of understanding of the nature of undeclared work. The study has revealed that undeclared work is not the same everywhere – for instance, in terms of the type of undeclared work, its sectoral distribution and the motives for engaging in such work. Therefore, a policy measure which is important in one country or region for tackling undeclared work may be less effective in another. Thus, a ‘one size fits all’ approach is not appropriate for tackling undeclared work; instead, policy approaches and measures will need to be tailored to fit the particular circumstances that prevail in different countries or regions.

In order to understand the range of practices currently employed in individual countries, a typology of the potential policy approaches and measures available has been used. This distinguishes between two broad policy approaches: a deterrence approach that seeks to detect and punish non-compliance and an approach focused on positively encouraging compliant behaviour. The key finding is that across the countries surveyed, the deterrence approach has traditionally been adopted in an effort to increase the actual or perceived likelihood of detection and penalties. However, in more recent years, particularly since Employment Policy Guideline No. 9 was published in 2003, there has been a noticeable increase in the use of a more enabling approach, with measures seeking to facilitate formalisation rather than punish informal employment. These include: preventive measures to stop non-compliance from the start; incentives encouraging undeclared workers to transfer to the declared realm; and measures encouraging an allegiance to tax morality. Notwithstanding these measures, the take-up of initiatives to engender commitment to ‘tax morality’ has been relatively slow to date.

An evaluation of the wide array of policy approaches and measures being pursued across the EU27 and Norway gives an insight into best practice and presents some practical examples in this field. The initiatives adopted span deterrence measures, prevention measures, ‘curative’ measures seeking to legitimise undeclared work, and measures aiming to change attitudes and engender commitment to the payment of tax. A key finding is that good practice is not simply about choosing the individual policy measures that are effective at tackling undeclared work, but also about considering the most effective way of putting these policy measures together in various combinations and sequences. Thus, evaluating which combinations and sequences of measures are effective and transferable should be an integral part of the review process.

Policy pointers

- The evaluations of specific measures provide a solid evidence base for countries to decide whether to test an initiative in their own country.
- More research is needed on the effectiveness of specific policy measures at tackling undeclared work as well as their transferability.
- Greater understanding is required of what combinations and sequences of policy measures are most effective and appropriate in various contexts.
- The study shows that it has been more the exception than the rule for countries to learn from the experiences of other countries before implementing policy measures. Therefore, attempts to actively share experiences and learn from others need to be encouraged to implement a cross-country, interregional approach.
- There is also a need to broaden the knowledge on policy measures by gathering data from a wider array of countries, including countries in Australasia, North America and the global ‘South’.
- Wider use of awareness-raising initiatives is needed to change attitudes, in particular with a view to encouraging greater tax morality.

Introduction

Across the 27 Member States of the European Union (EU27) and Norway, considerable effort is being invested in developing and testing policy measures that aim to tackle undeclared work. Although a number of previous attempts have been made to describe the array of measures used in different nations (EIRO, 2005; European Employment Observatory, 2004, 2007; Renooy et al, 2004; Williams, Horlings and Renooy, 2008), one lacking feature is a ‘knowledge bank’ that identifies which measures work and which do not. Recognising this, in 2007, the European Foundation for the Improvement of Living and Working Conditions (Eurofound) took the first step towards developing this resource by commissioning a study – **Tackling undeclared work in the European Union**¹ – on the effectiveness of the policy measures used in five countries, namely Belgium, Denmark, Italy, Poland and the United Kingdom (UK) (Williams, Horlings and Renooy, 2008). It was felt that by adding more countries a significant and important learning hub could be created for sharing knowledge on the effectiveness and transferability of approaches and measures. Thus, in 2008, a further survey of policy measures in each of the 27 Member States and Norway was commissioned by Eurofound. The result of this initiative is a greatly expanded **knowledge bank**² that reviews up to three policy measures in each of the 28 countries covered. This new report adds value to the earlier study by, firstly, providing a new chapter on the extent and nature of undeclared work in the EU27, based on the findings of the 2007 Eurobarometer survey. Secondly, the report synthesises the findings from 28 countries, rather than the original five Member States, when evaluating the effectiveness of different policy approaches and measures, along with their transferability to other sectors and areas.

The aim of this overview report is therefore not only to review the range of approaches and measures available for tackling undeclared work and the direction of change in the EU27 and Norway, but also to evaluate the effectiveness and transferability of these contrasting approaches and measures. To do this, the report begins by providing a background context to the evaluation of policy approaches and measures by reviewing the extent and nature of undeclared work in the EU27. This will reveal how undeclared work varies across countries or regions, and therefore how a policy measure that is important for tackling this phenomenon in one country or region may be less important in another. To understand the various approaches and measures adopted by individual countries, the second chapter of the report then sets out a typology of the potential policy approaches and measures available for tackling undeclared work. The third chapter uses this as a baseline for assessing not only the current policy approaches adopted across countries, but also the direction of change. Chapter 4 goes on to provide a detailed review of what is known about the effectiveness and transferability of the array of different policy approaches and measures before drawing some conclusions in Chapter 5 about the efforts to combat undeclared work and the way forward.

A central finding of this report is that the conventional approach pursued across the EU27 and Norway has been a deterrence approach, which seeks to increase the actual or perceived likelihood of detection and penalties. However, a noticeable increase in recent years has also been evident in the use of more enabling approaches and measures – particularly preventative and curative measures – since the **Employment Policy Guideline No. 9 on transforming undeclared work into regular work**³ was published in 2003. Further encouragement to move in this direction was provided by the publication in 2007 of the European Commission’s second Communication on undeclared work – **Stepping up the fight against undeclared work**⁴ (European Commission, 2007). Nonetheless, up until now, the take-up of initiatives to engender commitment to ‘tax morality’ has been relatively slow.

¹ <http://www.eurofound.europa.eu/publications/htmlfiles/ef0813.htm>

² <http://www.eurofound.europa.eu/areas/labourmarket/tackling/search.php>

³ [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003G1029\(01\):EN:NOT](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003G1029(01):EN:NOT)

⁴ http://ec.europa.eu/employment_social/news/2007/oct/undeclared_work_en.pdf (58Kb PDF)

With this diversification of policy approaches and measures, a notably absent element has been any overarching evaluation of the effectiveness of these approaches and measures – a shortcoming that is now widely recognised. As the second European Commission Communication on undeclared work concludes: ‘Piecemeal policy actions have been taken across Member States, but there is an apparent lack of evaluation of results and pooling of expertise’ (European Commission, 2007, p. 10). Similarly, a European Parliament resolution to enhance efforts to combat undeclared work has called on the Commission ‘to consider establishing a database on the various approaches and measures implemented nationally by each Member State, to assess their feasibility and transferability to other sectors and areas of work in other Member States’ (European Parliament Committee on Employment and Social Affairs, 2008, p. 6). This overview report and the accompanying ‘knowledge bank’ of policy measures seek to fill this gap.

Defining undeclared work

Before embarking on an overview of this policy field, it is first necessary to define undeclared work. To date, three contrasting types of definition have been used – namely, enterprise, jobs and activity-based definitions. Although in a third world context, an enterprise-based definition has been replaced by a jobs-based definition (Husmanns, 2005; ILO, 2002a,b,c, 2007), in Europe in particular and the western world more generally, the widespread consensus has been that an activities-based definition should be used (European Commission, 1998; OECD, 2002; Renooy, 1990; Renooy et al, 2004; Sepulveda and Syrett, 2007; Thomas, 1992; Williams, 2006; Williams and Windebank, 1998). In other words, rather than distinguishing between undeclared and declared enterprises or jobs, the tendency has been to differentiate between activities that are declared and undeclared.

Although different activities-based definitions exist and no official definition of undeclared work has been issued, there is a broad consensus on what should be included and excluded. In this report, such consensus is reflected by defining undeclared work as ‘any paid activities that are lawful as regards their nature but not declared to the public authorities, taking into account the differences in the regulatory system of Member States’ (European Commission, 2007, p. 2). In this context, the only difference between undeclared and declared work is that undeclared work is not declared to the authorities for tax, social security and/or labour law purposes. This covers diverse paid activities ranging from informal domestic services to clandestine activity conducted by illegal residents; however, it excludes the realm of criminal activity where illicit goods and services are exchanged.

As with any definition, there are of course blurred edges. Some definitions include work recompensed in kind or involving gifts, while others do not, often reflecting the different regulatory systems across countries. On the whole, however, this definition reflects the widespread agreement on what is to be included and excluded when discussing undeclared work. In this report, all activities that are remunerated – either with money or in kind – are included. As such, the barter and exchange of services are included since these are supposed to be declared, albeit usually only above a certain threshold. Indeed, including these activities is particularly important in those countries where the subsistence economy is still widespread and where payment in kind is considered a normal practice and an important element of social cohesion.

If an activity possesses additional differences to declared work besides the fact that it is not declared to the authorities for tax, social security and/or labour law purposes, it is generally not defined as undeclared work. For instance, if an activity involves illegal goods and/or services – such as in the case of drug-trafficking – it is separately defined as ‘criminal’ activity. Alternatively, if unpaid, it is defined as ‘unpaid community work’ if a household member undertakes this unpaid productive activity for a member of a household other than their own; if the household member engages in this unpaid productive activity for themselves or another member of their household, it is defined as ‘self-provisioning’.

However, the question may be asked: why does Europe adopt an activities-based rather than an enterprise or jobs-based definition of undeclared work? One significant reason is that this allows for the inclusion of forms of undeclared work that are popular in Europe and which are excluded in enterprise and/or jobs-based definitions. Prominent examples include: the under-reporting of income by self-employed people and formal businesses, which are excluded in an enterprise-based definition; and ‘envelope wages’, whereby a formal employee receives part of their wage on a declared basis and the remainder on an undeclared basis. Both jobs and enterprise-based definitions omit these forms of undeclared work, since the worker is in a formal job and the work takes place in a registered enterprise (Husmanns, 2005).

For analytical and policy reasons, it is important to differentiate between types of undeclared work. The following distinction is used in this report, drawing on the Eurobarometer survey on undeclared work in the EU cited in Chapter 1:

- undeclared work within a formal enterprise, or what might be termed as undeclared waged employment – this work can be either wholly undeclared, whereby all of the person’s wages are paid ‘off the books’, or partially undeclared whereby a portion of the wage from one’s formal employer is paid officially and the remaining portion is paid off the books (‘envelope wages’);
- own-account undeclared work – work for a formal enterprise or another client, such as a household, conducted under social relations akin to self-employment;
- more socially embedded own-account undeclared work – work involving the delivery of goods and services directly to consumers who are neighbours, family, friends or acquaintances.

1 Nature and extent of undeclared work in the EU27

Up until now, informed discussion about how to tackle undeclared work both in the EU27, as well as in individual countries, has been severely hampered by a lack of understanding of the nature of undeclared work. To analyse undeclared work, one can either conduct direct surveys or use indirect measurement methods, for example the number of high-value bank notes in circulation.

The results of a direct survey of undeclared work conducted across the EU27 in May and June 2007 are reported in the Special Eurobarometer No. 284 on **Undeclared work in the European Union**⁵, conducted as part of wave 67.3 of Eurobarometer. The results of this Eurobarometer survey are outlined in this chapter. Exponents of indirect methods often assert that respondents will not be forthcoming about their undeclared work. However, in 88% of the interviews conducted, the interviewers reported good or excellent cooperation on the part of the respondent. In only 2% of cases was cooperation deemed to be poor. Therefore, even if such work is hidden from the state for tax and social security purposes, it appears to have been openly discussed with the researchers by the respondents. Nevertheless, it is important to understand that such a direct survey only identifies intentional unreported income. It does not and cannot identify unintentional non-reporting – for example, where a worker does not know that an activity is taxable. Nor can such surveys identify various forms of unrecorded income, including statistical agency and tax office errors, which all form part of the overall undeclared economy. Thus, it should be recognised that the direct survey reported here does not record the whole undeclared economy.

To analyse the results, firstly, undeclared work is reviewed where the paid activities are unregistered and/or all of the resultant income is hidden from, or unregistered by, the state for tax, social insurance and/or labour law purposes (European Commission, 1998, 2007; Grabiner, 2000; ILO, 2002a,c; Thomas, 1992; Williams and Windebank, 1998). Secondly, and much less written about due to the assumption that a job is either declared or undeclared, ‘under-declared’ work is assessed; the latter refers to cases where a formal employer pays a formal employee a portion of their wage on a declared basis and a portion on an undeclared basis as an ‘envelope wage’.

Moreover, given the low participation rates in undeclared work, the 27 EU Member States are grouped for discursive purposes into four geographical regions, namely:

- Continental Europe – Austria, Belgium, France, Germany, Ireland, Luxembourg, the Netherlands and the UK;
- Eastern and Central Europe – Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia;
- the Nordic countries – Denmark, Finland and Sweden;
- Southern Europe – Cyprus, Greece, Italy, Malta, Portugal and Spain.

⁵ http://ec.europa.eu/public_opinion/archives/ebs/ebs_284_en.pdf (1.07Mb PDF)

Undeclared work in the EU

The results of the Special Eurobarometer on undeclared work in the EU reveal that some 5% of the surveyed population in the EU27 carried out undeclared work during the 12 months prior to the survey (Table 1). In some countries, however, the participation rate is much higher, including Denmark (18%), Latvia (15%), the Netherlands (13%), Estonia (11%) and Sweden (10%). This does not mean that the size of the undeclared economy is necessarily higher in these countries. While undeclared workers participated in this form of work for an average of almost 200 hours during the past 12 months across the EU as whole, undeclared workers in Southern Europe worked an average of 350 hours in this sphere compared with 330 hours among East-Central Europeans, 110 hours among those in Continental Europe and 60 hours in the Nordic countries. Thus, although a smaller proportion of the population in Southern Europe engage in undeclared work, they work more hours in this sphere than those in countries with higher participation rates – such as the Netherlands where undeclared work appears to be composed of smaller-scale and piecemeal activities, including babysitting and odd-jobs. This is reflected in the fact that although the average annual income from undeclared work is €164 per person and the average undeclared worker earns €3,294 a year across the EU, this is geographically uneven: for instance, significant proportions of undeclared workers in East-Central Europe and Southern Europe earn above the EU average in this respect, while those in the Continental and Nordic countries often earn below this average. Indeed, other surveys conducted in countries such as Latvia (Hazans, 2009) find undeclared work to be of much the same order of magnitude, providing some reinforcement for the validity of the findings of this Eurobarometer survey.

Table 1: *Prevalence of undeclared work and annual earnings in the EU, by country and country group*

Country	% engaged in undeclared work in last 12 months	Average total number of hours of undeclared work in last 12 months	Average annual undeclared income per person (€)	Average annual undeclared income per undeclared worker (€)
Continental Europe				
AT	7%	113	19	1,875
BE	6%	158	140	3,496
DE	3%	95	28	1,381
FR	6%	167	111	3,685
IE	4%	253	60	2,013
LU	5%	187	210	6,998
NL	13%	100	85	1,210
UK	2%	81	138	2,308
East-Central Europe				
BG	5%	649	240	4,802
CZ	7%	157	88	1,252
EE	11%	182	305	2,772
HU	7%	296	87	1,244
LT	7%	347	369	5,275
LV	15%	390	602	4,015
PL	5%	359	84	1,686
RO	4%	266	449	11,234
SI	5%	97	45	752
SK	6%	198	112	2,245

Table 1: *Prevalence of undeclared work and annual earnings in the EU, by country and country group (cont'd)*

Country	% engaged in undeclared work in last 12 months	Average total number of hours of undeclared work in last 12 months	Average annual undeclared income per person (€)	Average annual undeclared income per undeclared worker (€)
Nordic countries				
DK	18%	68	254	1,410
FI	4%	51	48	1,211
SE	10%	78	105	1,055
Southern Europe				
CY	1%	218	226	3,764
EL	4%	376	34	1,140
ES	3%	276	37	1,827
IT	3%	550	97	2,427
MT	2%	363	121	2,437
PT	3%	320	329	2,530
EU27	5%	199	164	3,294

Source: Eurobarometer survey on undeclared work in the EU, 2007

The nature of undeclared work also varies across the countries. As Table 2 reveals, some 75% of respondents across the EU report that their undeclared work was conducted on a self-employed basis and just 20% as waged employment. Nevertheless, this ratio varies across the countries. In general, a greater proportion of undeclared work is conducted as waged employment in Southern and East-Central Europe, while in the Nordic countries and Continental Europe a larger share is conducted on a self-employed basis.

This is not the only difference. Across the EU, the majority (55%) of all undeclared work is conducted for friends, family and neighbours (Table 2). A further 20% is conducted on a self-employed basis for other private persons or households, while just 20% relates to undeclared waged employment, and the remaining 5% is unrecorded or not known. Although a greater proportion of undeclared work is conducted for and by friends, family and neighbours in the Nordic and Continental countries, this is less the case in East-Central Europe and Southern Europe. Therefore, undeclared work is far more embedded in networks of familial and community solidarity than previously considered, particularly in the Nordic and Continental countries.

Table 2: *Type of undeclared work in the EU, by country and country group*

Country	Percentage of undeclared work that comprises:			
	Waged jobs for companies or businesses	Self-employment for friends, family and neighbours	Self-employment for other private persons or households	Other/do not know/refusal
Continental Europe				
AT	14	58	16	12
BE	24	57	17	2
DE	21	59	13	7
FR	13	70	12	5
IE	15	48	23	14
LU	7	72	16	5
NL	18	62	15	5
UK	28	56	11	5

Table 2: Type of undeclared work in the EU, by country and country group (cont'd)

Country	Percentage of undeclared work that comprises:			
	Waged jobs for companies or businesses	Self-employment for friends, family and neighbours	Self-employment for other private persons or households	Other/do not know/refusal
East-Central Europe				
BG	50	22	28	-
CZ	23	66	3	8
EE	20	41	35	4
HU	33	39	24	4
LT	15	43	42	-
LV	18	41	32	9
PL	26	32	31	11
RO	12	57	19	12
SI	15	66	13	6
SK	16	53	28	3
Nordic countries				
DK	16	68	13	3
FI	9	89	2	-
SE	14	68	16	2
Southern Europe				
CY	-	55	45	-
EL	27	41	32	-
ES	29	41	30	-
IT	13	41	44	2
MT	77	0	9	14
PT	35	33	26	6
EU27	20	55	20	5

Source: Eurobarometer survey, 'Undeclared work in the EU', 2007

Sectoral distribution of undeclared work

The findings also indicate that undeclared work is not always concentrated in the same sectors. As the results in Table 3 show, almost one in five undeclared jobs across the EU are found in the household services sector, which includes domestic cleaning services as well as child and elder care provision. The second most commonly cited sector is construction, where around one in six undeclared jobs are undertaken in areas ranging from household improvement and maintenance work to the construction of new houses or buildings. The third most commonly cited sector is personal services, such as hairdressing, where nearly one in 10 undeclared jobs are found.

Table 3: *Incidence of undeclared work in EU27, by sector and country group, %*

% of undeclared work in:	Continental Europe	East-Central Europe	Nordic countries	Southern Europe	EU27
Household services	23	7	11	30	19
Construction	16	19	27	3	16
Personal services	11	7	4	10	9
Hotels and restaurants	9	2	4	17	8
Repair services	7	5	4	9	7
Industry	1	5	7	13	5
Agriculture	2	9	2	3	4
Transport	2	4	11	2	3
Retail	2	6	1	1	3
Other	17	15	20	7	15
Refusal/don't know	9	22	9	7	12
Total	100	100	100	100	100

Source: Eurobarometer survey on undeclared work in the EU, 2007

Nevertheless, marked geographical variations are also evident in the sectors in which undeclared work is concentrated. While in the EU as a whole, some 44% of undeclared work is in household services, construction and personal services, in Continental Europe, this figure rises to 50% (Table 3). In contrast, in East-Central Europe, undeclared work is more concentrated in construction, followed by the production and sale of agricultural goods or services, including the selling of produce from *dachas* (country homes). Southern Europe, on the other hand, differs from other EU countries firstly in the sense that undeclared work is most concentrated in household services, which accounts for some 30% of this form of work; secondly, a considerably higher proportion (17%) of undeclared work in Southern Europe is also found in the hotels and restaurant sector, which mostly involves seasonal work. Construction activities, meanwhile, only account for a small proportion (3%) of undeclared work in this country group. Conversely, in the Nordic countries, the construction sector accounts for the largest proportion (27%) of undeclared work, followed by transport services (11%) such as household removal businesses, as well as household services (11%). In general, these marked spatial variations suggest that sector-specific policies – such as measures targeting the construction sector – will have greater overall impact on tackling undeclared work in some countries than others.

Motives for participating in undeclared work

Up until now, those engaged in undeclared work have been portrayed as doing so either due to their exclusion from the formal economy or as a result of their desire to voluntarily leave the legitimate realm. To evaluate these contrasting explanations, the motivations of consumers will firstly be evaluated, followed by the rationales of suppliers.

The results in Table 4 give an insight into consumers' motivation for purchasing undeclared goods and services. Just under half (44%) of undeclared purchases were motivated purely by lower prices, while 73% of consumers overall reported that price was either a major or contributory factor in the EU27. Not surprisingly, therefore, the cost factor is an important issue. However, it is not the sole factor explaining the decision to use undeclared work. Other important elements cited by respondents were the availability, quality and speed of formal service provision. Problems encountered in this respect included complaints that formal businesses often do not turn up to give quotes for work, fail to turn up to do the work itself, or only partially complete the work and then move on to another job until pressurised to return and finish the work. In this study, some 15% of undeclared transactions were reported to be purely due to poor formal provision, while a further 24% of consumers cited this issue in their rationale.

Table 4: *Reasons cited by consumers for participating in undeclared work, by country group, EU27 (%)*

Reasons given	Continental Europe	East-Central Europe	Nordic countries	Southern Europe	EU27
Lower price	44	47	35	44	44
Poor formal service provision	14	15	18	15	15
Social reasons	11	7	10	8	10
Lower price and poor formal service provision	14	19	22	16	16
Lower price and social reasons	9	5	7	7	8
Poor formal service provision and social reasons	3	2	3	4	3
Lower price, poor formal service provision and social reasons	5	5	5	3	5

Source: Eurobarometer survey on undeclared work in the EU, 2007

On the other hand, participation can also be driven by social or redistributive reasons – such as a desire to help someone who is in need of money or to do a favour for friends, colleagues and acquaintances. The findings indicate that some 10% of all undeclared goods and services are purchased purely for these social/redistributive reasons, while a further 16% of purchases included these social/redistributive rationales in their explanations (Table 4).

The reasons given by consumers for purchasing undeclared goods or services, however, vary across the countries. In the Nordic countries, for example, financial gain is less of a driver than in other EU regions, while poor formal provision appears to be a more significant factor either solely or in combination with the desire to save money. Social/redistributive rationales, meanwhile, are more important in the Nordic and Continental European countries than in the East-Central and Southern European countries. Thus, different explanations appear to be more relevant in different countries.

Turning to the reasons cited by suppliers in relation to undeclared work, Table 5 differentiates between whether participation is due to exit and/or exclusion factors. The rationale of ‘exclusion’ refers to those asserting that they engage in undeclared work either: because they could not find a regular job; or due to the claim that the non-declaration of activities and/or that working in the undeclared economy is common in the particular region or sector and that there is no real alternative. On the other hand, the following groups were categorised as willing undeclared workers driven by a desire to voluntarily exit the formal economy: those asserting that the bureaucracy or red tape required to carry out a regular activity is too complicated; respondents claiming that they were able to ask for a higher fee for their work; those reporting that both parties benefited from the arrangement; respondents claiming that taxes and/or social contributions are too high; those asserting that it is just seasonal work and as a result is not worth declaring; and/or respondents who argue that the state does not do anything for them, so why should they pay taxes. Respondents citing a mixture of these exclusion and exit drivers were classified as being driven by both exit and exclusion considerations.

Table 5: *Reasons cited by suppliers for participating in undeclared work, by country group, EU27 (%)*

Reasons given	Continental Europe	East-Central Europe	Nordic countries	Southern Europe	EU27
Factors relating to a desire to exit formal economy	63	54	78	50	60
Factors relating to exclusion from formal economy	17	19	5	28	18
Both exit and exclusion factors	20	27	17	22	22

Source: Eurobarometer survey on undeclared work in the EU, 2007

The findings reveal that some 60% of undeclared work in the EU27 was conducted due to a desire by suppliers to voluntarily exit the formal economy, while only 18% was attributable to factors related to exclusion from the formal economy (Table 5). A further 22% of undeclared work was conducted due to a mix of both exit and exclusion rationales. Once again, however, the rationales vary across the EU. Exit factors are more applicable to the Nordic and Continental European countries, while exclusion from the legitimate realm is more common in the countries of East-Central Europe and Southern Europe, although this factor applies to less than one fifth of undeclared work overall.

Under-declared work (envelope wages) in the EU27

Of the 26,659 face-to-face interviews carried out as part of the Eurobarometer survey on undeclared work in the EU, some 11,885 were conducted with employees in formal employment. Of these employees, about one in 20 (5%) – or 616 employees in total – had received all or part of their salary from their formal employer as undeclared wages within the past 12 months (Table 6). Extrapolating this to the EU, it is possible that some 11 million of the 210 million employees in the EU might be in receipt of under-declared or ‘envelope wages’. On average, envelope wages constitute two fifths of these workers’ total wage. However, this is not evenly distributed.

Of the 616 respondents in the EU27 who reported receiving envelope wages, 29% received such payments for their regular work, while a further 27% obtained envelope wages for overtime or extra work and 36% for both regular and overtime work. Analysing the geographical distribution of envelope wage payments, Table 6 reveals that such remuneration is most common in East-Central Europe, where 11% of employees reported receiving envelope wages, compared with just 2% of the employees in Continental Europe, 4% of those in Southern Europe and 3% of employees in the Nordic countries. Differences also emerge in the nature of envelope wages across these four country groups. Around two thirds of envelope wages in both Continental Europe (65%) and the Nordic countries (70%) are for overtime or extra work. Conversely, in East-Central Europe and Southern Europe, envelope wages are more frequently paid for regular work or for both regular work and overtime.

Table 6: *Prevalence and types of envelope wages, by country group, EU27*

	Number of waged employees interviewed	% of employees receiving envelope wages	Envelope wages received for:			
			Regular work (%)	Overtime/ extra work (%)	Both regular and overtime work (%)	Refusal/ don't know (%)
Continental Europe	4,404	2%	18	65%	14%	3%
East-Central Europe	4,511	11%	39%	21%	37%	3%
Nordic countries	1,534	3%	7%	70%	9%	14%
Southern Europe	1,933	4%	18%	43%	26%	13%
EU27	11,885	5%	29%	27%	36%	8%

Note: *Figures for EU27 are based on weighted average.*

Source: *Eurobarometer survey on undeclared work in the EU, 2007*

As the results in Table 7 show, although only over a third (36%) of the employees interviewed in the Eurobarometer survey were in East-Central Europe, over two thirds (68%) of those receiving envelope wages worked in these countries; moreover, some 84% of the employees receiving envelope wages in this country group did so for regular employment. Thus, envelope wages appear to be heavily concentrated in East-Central Europe.

Table 7: *Distribution of envelope wages, by country group, EU27 (%)*

	% of all waged employees interviewed	% of all employees receiving envelope wages	% of all employees receiving envelope wages for:		
			Regular work (%)	Overtime/ extra work (%)	Both regular and overtime work (%)
Continental Europe	36	14	8	27	6
East-Central Europe	36	68	84	43	81
Nordic countries	12	6	1	14	2
Southern Europe	16	12	7	16	11
EU27	100	100	100	100	100

Source: *Eurobarometer survey on undeclared work in the EU, 2007*

Within East-Central Europe, nevertheless, a clear segmentation between the countries can be identified with regard to envelope wages. On one side is a group of countries where envelope wages are common, paid more frequently for regular work and amount to an average of about half of formal employees' wages – the countries in question are Bulgaria, Latvia, Lithuania, Poland and Romania. On the other side is a group of countries where envelope wages are less common, paid more often for overtime or extra work and amount to an average of around one quarter of employees' wages – this group of countries comprises the Czech Republic, Estonia, Hungary, Slovakia and Slovenia. As a result of this segmentation, over a half (54%) of all employees surveyed receiving envelope wages are situated in just five East-Central European countries – namely, Bulgaria, Latvia, Lithuania, Poland and Romania; altogether, this group of countries only accounts for less than 16% of the EU adult population. Moreover, three quarters of all employees receiving envelope wages for regular work can be found in these five countries.

Impact of economic crisis on undeclared work

It is possible that the current recession and global economic crisis may lead to a growth in the undeclared sphere. However, this hypothesis assumes that the declared and undeclared economies operate in a counter-cyclical manner and as substitutes for one another, with the decline of one sphere leading to a growth in the other. The evidence that this is the case is in fact very thin. Great caution should be taken therefore before assuming that the current recession has led to a growth in undeclared work in all countries. Indeed, there is growing evidence that the declared and undeclared economies sometimes operate in a complementary rather than substitutive manner. In fact, the declared and undeclared economies tend to grow and decline in tandem because when money is short in one economy, it is also lacking in the other (Dzvinika, 2002; Williams and Windebank, 1998). At the macro level, this 'reinforcement thesis' views both spheres as simultaneously growing or declining nationally or regionally (Dzvinika, 2002). At the micro-level, meanwhile, this relationship is reflected in the finding that deprived households conduct less undeclared work than affluent households, meaning that undeclared work consolidates rather than reduces the disparities produced by the formal economy (see, for example, Pahl, 1984; Williams, 2004a).

Thus, it is by no means a foregone conclusion that the current economic crisis has led to a growth in undeclared work in the EU. Nevertheless, even if the impact of the economic crisis on the level of undeclared work varies across countries and is dependent on a range of social, economic, institutional and political variables, it could lead to new tendencies in the patterning of undeclared work – such as registered self-employed persons doing a greater proportion of their trade 'off the books'. Even if these precise patterns currently remain unknown, they will no doubt become more apparent over the next few years.

To summarise, although the findings of the Eurobarometer survey on undeclared work in the EU need to be treated with caution, the survey clearly displays that the characteristics of undeclared work vary across the EU27. This suggests that a policy measure for tackling undeclared work that is important in one country or region may be less relevant or effective in another. With this key point in mind, the report will turn its attention next towards evaluating the range and nature of policy approaches and measures used for tackling undeclared work.

2

Policy approaches to tackling undeclared work

This chapter presents a typology of possible policy approaches to tackling undeclared work, providing a lens through which the range of practices currently used in individual countries can be evaluated. In this context, the vast bulk of previous literature on tackling undeclared work distinguishes between two broad policy approaches: the dominant deterrence approach that seeks to detect and punish non-compliance; and an emergent approach focused on positively encouraging compliant behaviour. These approaches have been variously labelled as follows: an ‘economic deterrence’ approach versus a ‘fiscal psychology’ approach (Hasseldine and Li, 1999); a ‘chauvinistic’ versus ‘softy’ approach (Cullis and Lewis, 1997); a ‘deterrence model’ versus an ‘accommodative model’ (Murphy, 2005, 2008); ‘regulatory formalism’ versus ‘responsive regulation’ (Braithwaite, 2002); ‘deterrence’ versus ‘tax morale’ (Ahmed and Braithwaite, 2005); ‘command and control’ versus ‘responsive regulation’ (Commonwealth Association of Tax Administrators, 2006); a ‘sticks’ versus ‘carrots’ approach (SBC, 2004); or a ‘deterrence’ versus an ‘enabling’ approach (Williams, 2006).

As the overview presented in Table 8 shows, while the conventional deterrence approach seeks to engender compliance by detecting and punishing non-compliance, the emergent approach aims to encourage compliance by either preventing businesses or people from engaging in undeclared work from the outset, enabling the transfer of undeclared work into the declared realm, or by facilitating commitment to the ‘tax morality’ (see Mateman and Renooy, 2001).

Table 8: *Policy approaches used for combating undeclared work*

Approach	Method	Measures
Deterrence	Improve detection	<ul style="list-style-type: none"> • Data matching and sharing • Joining-up strategy • Joining-up operations
	Penalties	<ul style="list-style-type: none"> • Increasing penalties for evasion
Enabling compliance	Preventative	<ul style="list-style-type: none"> • Simplifying compliance • Direct and indirect tax incentives • Smooth transition into self-employment • Introducing new categories of work • Micro-enterprise development
	Curative	Purchaser incentives: <ul style="list-style-type: none"> • service vouchers • targeted direct taxes • targeted indirect taxes Supplier incentives: <ul style="list-style-type: none"> • society-wide amnesties • voluntary disclosure • business advisory and support services
	Fostering commitment	<ul style="list-style-type: none"> • Promoting benefits of declared work • Education • Peer-to-peer surveillance • Tax fairness • Procedural justice • Redistributive justice

Source: *Authors’ own overview*

Deterrence

Efforts to tackle undeclared work have traditionally been dominated by a deterrence approach that seeks to elicit a change in behaviour by detecting and punishing non-compliance. Based on the understanding that non-compliant persons are ‘rational economic actors’ who will evade tax as long as the pay-off from evasion is greater than the expected cost of being caught and punished (Allingham and Sandmo, 1972), the goal is to deter engagement in such activities by changing the cost/benefit ratio available to those engaged or thinking about participating in undeclared work (see, for example, Bardach and Kagan, 1982; Dodd and Hutter, 2000; Grabiner, 2000; Grabosky, 1995; Gramsick and Bursik, 1990; Hasseldine and Li, 1999; Job and Honaker, 2003; Lewis, 1982; Milliron and Toy, 1988; Richardson and Sawyer, 2001; Sandford, 1999). This is achieved by concentrating on the cost side of the equation, and increasing the actual and perceived risks and costs associated with participation by:

- firstly, raising the perceived or actual likelihood of detection – not least, by improving the coordination of strategy, operations and data sharing;
- secondly, raising the penalties and sanctions for those caught.

The deterrence method therefore constitutes a ‘negative reinforcement’ approach that seeks to elicit a change in behaviour using punitive measures for those engaged in non-compliant or ‘bad’ behaviour, so that they will change their actions.

Enabling compliance

In recent decades, however, calls for a more enabling approach to tackling undeclared work have emerged (Renooy et al, 2004; SBC, 2004; Slemrod, 1992; Williams, 2006). In this context, individuals are viewed not as ‘rational actors’, but as ‘social actors’ who are usually inclined to comply with the law, partly because of their belief in the rule of law and partly as a matter of long-term self-interest (Kagan and Scholz, 1984; Murphy, 2008). Thus, cooperation rather than coercion is pursued. This approach therefore seeks to encourage ‘good’ behaviour – that is, tax and benefit compliance – rather than taking it as given. It is grounded in a belief that punishing people for doing something wrong – in other words, negative reinforcement – is relatively ineffective compared with positive reinforcement of good behaviour. The role of the tax authorities, therefore, is not so much to act as a strict law enforcer that punishes bad behaviour, but more as a service provider that secures future compliance (Murphy, 2005). In the realm of undeclared work, such a positive reinforcement approach can take at least three different forms.

Firstly, preventative measures can be adopted to stop non-compliance from the outset. Such measures could include the following: simplifying regulatory compliance; introducing new categories of legitimate work; providing business support and advice, as well as direct and indirect tax incentives; and developing initiatives to smoothen the transition to self-employment.

Secondly, incentives can be used to help those already participating in undeclared work to transfer into the declared realm. These curative measures could include the following initiatives: offering amnesties on either a societal or individual level to those who put their affairs in order; offering business advisory and support services to those seeking to formalise their endeavours, and providing a range of targeted direct or indirect tax incentives encouraging customers to use declared rather than undeclared work.

Thirdly, commitment measures can be adopted that seek to encourage an allegiance to tax morality (Alm et al, 1995; Andreoni et al, 1998; Cullis and Lewis, 1997; Smith and Kinsey, 1987; Torgler, 2003; Weigel et al, 1987; Wenzel, 2002).

Such measures include not only some of the aforementioned incentives encouraging people to engage in legitimate endeavour, but also tax education and awareness raising about the benefits of declared work, along with peer surveillance, and the pursuit of perceived tax fairness, procedural justice and redistributive justice.

Of course, these contrasting approaches to tackling undeclared work are not necessarily mutually exclusive. For example, governments might simplify regulatory compliance as well as introduce incentives, such as amnesties, to enable people to enter the legitimate 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 among the public to tax morality. As such, these approaches are better represented as a continuum of possible policy approaches that, in theory, can be used alongside each other. The issue, of course, is whether this is indeed the case. In other words, do countries employ all of these approaches or do they tend to place heavy emphasis on one approach or set of measures, while only paying lip-service to other approaches and measures? To answer this question, the nature and direction of policy in the EU Member States is considered next.

Policy approaches adopted in individual countries

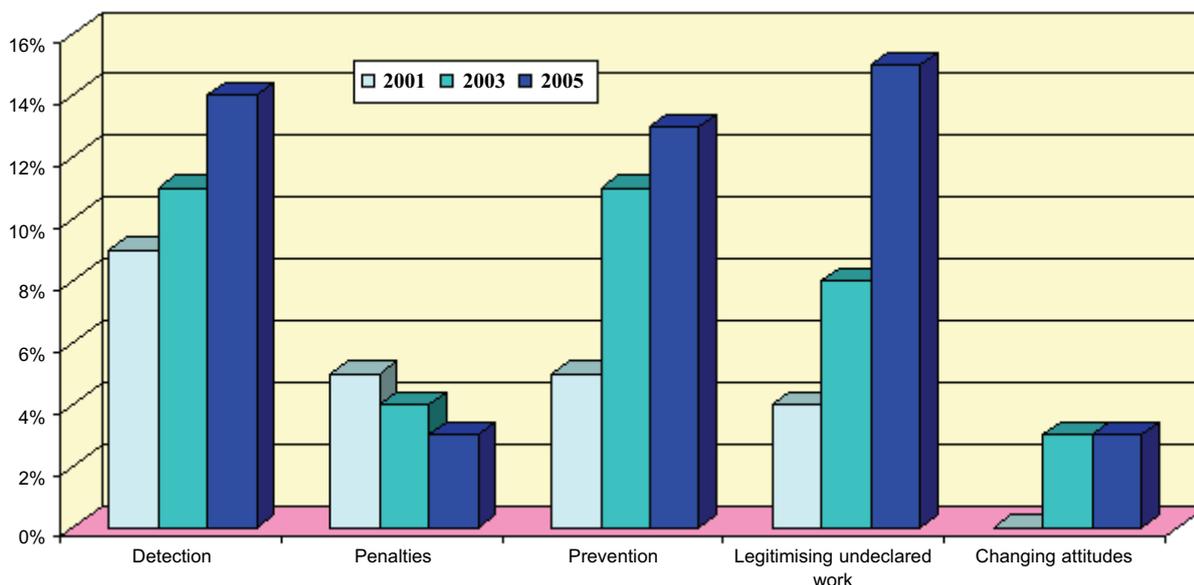
The European Commission's Employment Guideline No. 9 on undeclared work, adopted on 22 July 2003, was quite explicit concerning the approach that should be adopted in combating undeclared work:

Member States should develop and implement broad actions and measures to eliminate undeclared work, which combine simplification of the business environment, removing disincentives and providing appropriate incentives in the tax and benefits system, improved law enforcement and the application of sanctions.

In other words, tackling such activities requires not only the punishment of non-compliance in the form of 'improved law enforcement and the application of sanctions', but also a range of enabling initiatives to facilitate compliance – namely, a 'simplification of the business environment', 'removing disincentives' and the provision of 'appropriate incentives in the tax and benefits system' (European Commission, 2003b). The recommendation therefore is that EU Member States should combine deterrence measures with preventative and curative measures that enable compliance. The only major set of policy measures not covered in this guidance was the set that facilitates greater commitment to tax morality. However, this was later included in the European Commission's second Communication on undeclared work, *Stepping up the fight against undeclared work*, published in 2007 (European Commission, 2007).

To evaluate the extent to which the EU Member States have adopted these guidelines, an analysis is firstly made of the 2001 and 2003 National Action Plans for Employment (NAPs) and the National Reform Programmes 2005–2008 (NRPs) of each Member State (Figure 1).

Figure 1: *Approaches used to tackle undeclared work in EU27, by percentage of countries, 2001–2005*



Source: *National Action Plans for Employment, 2001 and 2003; National Reform Programmes, 2005–2008*

Secondly, and to complement these, several international reviews of the initiatives being pursued in different countries are analysed – namely, those conducted by the European Employment Observatory in 2004 and 2007 (European Employment Observatory, 2004, 2007) and the European Industrial Relations Observatory (EIRO) survey – **Industrial relations and undeclared work**⁶ (EIRO, 2005). Table 9 summarises the findings in this respect. Examining the approach

⁶ <http://www.eurofound.europa.eu/publications/htmlfiles/ef05135.htm>

most commonly adopted in 2001 before Employment Guideline No. 9 was published, the deterrence approach dominated – mostly through improved detection rather than penalties – with some countries adopting preventative measures. Following the publication of Employment Guideline No. 9 on undeclared work in 2003, however, not only has the punishing of non-compliance and preventative measures become more commonplace; at the same time, curative measures to enable compliance have been used in a wider array of Member States.

Table 9: Overview of measures used to tackle undeclared work in EU27, by country, 2001–2005

	Deterrence						Enabling compliance								
	Improve detection			Penalties			Preventative			Curative/ stimulating			Fostering commitment		
	2001	2003	2005	2001	2003	2005	2001	2003	2005	2001	2003	2005	2001	2003	2005
AT	●	●	○			●	●	●				●			
BE	●	●	○					●	○	●	●	●○			
CY									○						
CZ															
DE	●	●		●	●	○	●		○	●	●	○		●	
DK	●	●	●			●		●			●	○			●
EE			●○						○						
EL	●	●		●			●	●	○			●			
ES		●	●					●	●○			●			
FI	●			●				●	○		●	○			
FR	●							●	○		●	○		●	
HU			●						●			●			
IE	●	●		●	●		●								
IT									○	●	●				
LT			●○						●○			●			
LU															
LV			●						●			●			
MT															
NL	●	●	○	●	●		●	●		●		●○			
PL															
PT		●	●					●			●				
SE		●	●					●	●○						●○
SI			●												
SK			●○						●○						
UK		●	○		●	○		●	○		●	○		●	●
Total (●)	9	11	10	5	4	2	5	11	6	4	8	8	0	3	3
Total (○)			7			2			13			7			1

Notes: ● = Mentioned in the 2001 and 2003 NAPs, and the 2005 NRP.

○ = Mentioned in the European Employment Observatory (Autumn 2004) and in EIRO (2005).

Nevertheless, some marked differences emerge across various regions of the EU in terms of the sets of measures and combinations used. Measures that enable compliance, with a few exceptions, seemed to be mostly confined to the northern EU Member States in 2001 and 2003; however, by 2005, a wider range of Member States were starting to adopt such measures, albeit mostly only countries from among the original 15 EU Member States (EU15). In contrast, the new Member States (NMS) – that is, those that joined the EU in 2004 and 2007 – have shown a preference for measures seeking to detect and punish non-compliance. Where such countries have adopted measures to enable compliance, these have tended to be mostly confined to preventative measures. A common trend across most countries has been the notable absence of measures that aim to engender greater commitment to tax morality. This, however, seems likely to change with the publication of the European Commission's second Communication on undeclared work, which advocates the use of awareness campaigns to improve tax morality (European Commission, 2007).

At present, it seems that the policies adopted differ markedly by EU region and therefore according to the differing nature of undeclared work in these regions. Where undeclared work is more commonly conducted as waged employment and is strongly intertwined with the formal part of the economy, as exemplified by the prevalence of envelope wages, a more deterrence-oriented approach appears to have been adopted, often with some preventative measures. Where undeclared work is more commonly undertaken as 'own-account work', often for closer social relations and embedded in familial and neighbourhood networks, the tendency has been away from deterrence measures and towards more enabling measures of the preventative, curative and even commitment variety. Indeed, future research might seek to further develop this taxonomy, detailing how various clusters of countries have different configurations of undeclared work and consequently adopt different policy mixes. This would then enable an understanding of the geographies of the transferability of particular measures.

For the moment, however, great care must be taken with regard to the aforementioned conclusions about the nature and direction of approaches to combating undeclared work across the EU27 and Norway. The results in Table 9 simply note whether different initiatives are mentioned in relation to each country in the documents in question. The problem with this is that small-scale and piecemeal pilot experiments are therefore given the same importance as large-scale mainstream initiatives. Therefore, there is no way of qualitatively evaluating the emphasis placed in each country on the different sets of measures. As a result, the degree to which there has been a shift away from punishing non-compliance using 'stick' type measures, and towards pull or 'carrot' type measures that seek to enable compliance when tackling undeclared work, may be greatly exaggerated in this type of analysis. Nonetheless, even if this is the case, the analysis confirms that punishing non-compliance – in other words, the deterrence approach – is no longer used on its own to tackle undeclared work and that there is a greater move towards enabling compliance in the EU27.

It is important, nevertheless, to recognise the consequences of tax commitment measures being omitted from Employment Guideline No. 9 on undeclared work as a prescription of the way forward. Given that, at the time, the issue of tax morality constituted only a small tributary of thought in the policy-oriented literature on undeclared work – which, despite its growing popularity in recent years, still only covers some 10% of all literature published on this topic (Kirchler, 2007) – its omission is not necessarily a surprise. However, this omission has had a significant impact on the breadth of policy approaches adopted in EU countries. If measures to improve tax morality would have been highlighted, it seems likely – based on the aforementioned findings showing how Member States have followed the guidelines – that these measures would have been promoted more strongly. The fact that such measures were given greater prominence in the European Commission's second Communication on undeclared work in December 2007 (European Commission, 2007) intimates that such measures are now likely to be more widely considered as an additional policy option.

4 Towards ‘good practice’ – evaluating the effectiveness of policy measures

This chapter presents the diverse range of measures being used to tackle undeclared work throughout the 28 countries in question – that is, the EU27 and Norway. At the same time, it evaluates the effectiveness of the different policy measures where data are available.

More specifically, it will:

- review and evaluate deterrence measures;
- assess prevention measures;
- examine curative measures aimed at legitimising undeclared work;
- evaluate measures that aim to change attitudes and engender commitment to the payment of tax;
- review knowledge on what combinations of approaches and measures are most effective for tackling undeclared work.

Deterrence measures

Deterrence measures seek to force people to move from undeclared work into the declared realm, by changing the cost/benefit ratio confronting those engaged or contemplating participating in undeclared work. To achieve this, attempts are made, on the one hand, to increase the perceived or actual likelihood of detection; at the same time, penalties are used to ensure that the expected cost of being caught and punished is greater than the economic benefit of engagement (see, for example, Allingham and Sandmo, 1972; Falkinger, 1988; Hasseldine and Li, 1999; Milliron and Toy, 1988; Sandford, 1999). This section, therefore, firstly evaluates the range of measures available for improving detection; secondly, it goes on to review and evaluate the use of greater penalties.

Detection

Measures to improve the perceived or actual likelihood of detection have focused on four issues:

- increasing the effectiveness of inspections;
- joining-up strategy;
- joining-up operations;
- data matching and sharing, either at the national or cross-national level.

The assumption is that by increasing the probability of detection using such methods, undeclared work will be tackled more effectively.

Inspections

Nearly all tax authorities pursue initiatives to improve the effectiveness of inspections. In recent years, for example, new approaches have been adopted in Belgium, the Czech Republic, Denmark, Portugal, Slovakia and Spain. These initiatives include those simply seeking to increase the number of inspections conducted – as is the case in the Czech Republic, Denmark, Germany, Italy, Latvia, Lithuania, Luxembourg, Norway, Portugal, Romania, Slovakia, Slovenia and Sweden. They may also encompass initiatives that aim to improve the effectiveness of inspections, for instance in terms of the number of undeclared situations identified and the value of the undeclared tax collected or sanctions imposed. To achieve this, administrations have, for example, concentrated inspections on ‘suspect’ sectors where

undeclared work is widespread. In Romania, for instance, inspections have focused on the construction, clothing and textile industries. Other industries targeted include the hotels and restaurants sector in Latvia and Portugal, the taxi, hairdressing and restaurant industries in Sweden, driving schools in Slovenia, and the cleaning industry in Norway. ‘Announced inspection visits’ have also been used to reduce undeclared work, whereby a company or sector is informed that a visit from the authorities is to occur in the near future. In Denmark, for example, sectors such as hotels and restaurants, and construction, have been informed of such visits, along with groups such as bakers and door staff.

Two other common initiatives to improve the effectiveness of inspections are: measures seeking to ensure that workers are registered prior to commencing work; and measures encouraging the use of identity cards. In the past, it was common that when an inspector visited a workplace, the owner would claim that the worker had just started work that day and therefore had not yet been registered. To overcome this, and improve the effectiveness of inspections, many countries have now introduced a system for the compulsory registration of workers before they commence work. The obligation to report new employees to the relevant authorities is now in place in many EU countries – including Austria, Bulgaria, Italy and Slovakia. Moreover, in countries such as Germany, consumers of household services have been made liable since 2004 and are obliged to keep invoices of construction and maintenance services. Similarly, in Austria, the Customer Liability Act (*AuftraggeberInnen-Haftungsgesetz*) was endorsed since June 2008; this stipulates that companies subcontracting work to other firms are liable for the discharge of the subcontractors’ social insurance contribution obligations.

Another mechanism used to improve detection is identity cards, which have been introduced in countries such as the Czech Republic, Finland, Italy, Norway and Sweden. In Italy, identity cards have been used on construction sites since 2006, although employers with fewer than 10 employees may be absolved from the obligation of issuing these cards by keeping a daily register, endorsed by the provincial labour directorate, recording the details of the workers employed on site. Employers that fail to introduce this register or identity cards can incur a fine of between €100 and €500 for each unregistered worker. Moreover, they must give notify the relevant authority when they are hiring a worker the day before employment begins. Failure to do so incurs an administrative sanction of between €1,500 and €12,000 for each worker, which is increased by €150 for each day of effective work. One measure of this initiative’s lack of effectiveness as a deterrent, but efficiency as a tool for detecting unregistered workers, is the results of the inspections: between August 2006 and December 2007, inspections at 37,129 construction sites revealed that 57% of companies were irregular and that 63% of workers regularly employed on construction sites were unregistered, intimating that this measure has not acted as an effective deterrent (Ministero del Lavoro, della Salute e delle Politiche Sociali, 2008).

Similarly, in Finland, Section 52a of the Occupational Safety and Health Act obliges the parties directing or supervising a shared construction site to ensure that each person working on the site wears visible photo identification (ID) while on site. This requirement came into force at the beginning of February 2006. The ID must indicate whether the person is a worker in an employment relationship or a self-employed person. The minimum legal requirement is fulfilled by the identification of the person in question bearing their name and photograph, as well as the name of their employer. The wearing of ID is required on all shared construction sites – that is, sites involving several employers’ workers or self-employed workers. The regulation refers to both the construction of housing and to civil engineering construction, as well as to special contracting. ID is not required for persons temporarily carrying goods to the site, nor is it required for those working on a site where a building or a part thereof is built or renovated for the personal use of a private individual. However, if the construction contractor is a housing association, ID must be worn even where the completed construction is intended for the use of private individuals.

Furthermore, Section 58 of Finland’s General Conditions for Building Contracts 1998 states that all persons on the construction site in the service of a contractor must display ID identifying themselves and their employer. The General Conditions for Buildings Contracts assign the responsibility for management of personal ID to the project supervisor. However, according to law, the obligation rests with the construction contractor. During procurement, it must be

confirmed that the subcontractor is aware of the use of compulsory ID, and of the access control system in operation on the construction site.

Until now, identity card regimes have been largely focused on the construction sector in most countries. Nonetheless, they could be more widely implemented in other sectors, as shown in Sweden's restaurant and hairdressing industries, where a law on obligatory staff registration was implemented in 2007. Under this system, businesses are obliged to keep a daily staff register, which should include the name of the business, along with employees' names, birthdates and their working hours. If the workplace does not have a register, a fine of €1000 is imposed, as well as an additional fine of €200 for each employee not registered. During 2007, 80% of all workplaces in Sweden's restaurant and hairdressing industries were visited by the 120 National Tax Agency officials in charge of this initiative. Following the inspections, about 4,200 previously undeclared jobs have become legal. Fewer visits were then conducted in 2008 and 2009. Also noteworthy is an initiative by Sweden's construction industry, which has implemented its own voluntary registration scheme – namely, the ID06 (Textbox 1).

Textbox 1: ID06 project, Sweden

The Swedish construction industry has implemented its own voluntarily registration scheme, namely the ID06 project, initiated in 2007 by a group of organisations within the construction sector called the 'Construction Sector in Cooperation' (freely translated from *Byggbranschen i Samverkan*, **BiS**⁷). The group's members consist of seven business organisations and five trade unions within the construction sector. The head organisation is the Swedish Construction Federation (*Sveriges Byggindustrier*, BI).

The ID06 project consists of the following measures.

- A requirement that everyone who attends a construction site must carry valid ID06 identification.
- An obligation on the subcontractor to register the employees in advance with the head contractor.
- Daily registration of authorised employees at the workplace – the daily registration must be saved for two years and available at the site in case of a control visit from the Tax Agency.
- A right by the head contractor to remove anyone from the construction site who is not authorised.
- A right by the head contractor to demand a fine of SEK 500 (about €47 as at 6 May 2009) a day and for each person if an employee cannot show the required ID.

No evaluation of the initiative has been conducted to date. Around 300 card readers and about 60,000 ID cards have been distributed so far. The trend is an increase of 8,000 ID cards a month. Some 2,000 companies, including all major national firms, are now involved in the ID06 initiative. The ID06 card costs SEK 90 (€9) per employee, and the card reader device costs SEK 8,000 (€760). It is believed that this initiative could be implemented in other sectors.

Coordinating strategy and operations, including data sharing

To improve detection, another popular initiative involves enhancing the coordination of strategy and operations, including data sharing. This measure is based on the belief that one of the principal reasons efforts to tackle undeclared work are currently ineffective is due to the lack of coordination between agencies at both the strategic and operational level. As a result, new coordinating institutions have been established. In Germany, for instance, the Tax Enforcement

⁷ <http://www.byggbranschenisamverkan.se/webdoc.asp>

Unit for Undeclared Work (*Finanzkontrolle Schwarzarbeit*, FSK) has been founded, which coordinates strategy and operations. In Luxembourg, the Inter-administrative Unit for Combating Illegal Work (CIALTI) has been in place since 2000, while in Finland the Steering Group for the Fight against Economic Crime was established in 2000 under the Virke project. In Lithuania, the State Labour Inspectorate (*Valstybinė darbo inspekcija*, VDI) has been operating since 2001, while Poland's National Labour Inspectorate (*Państwowa Inspekcja Pracy*, PIP) was established in 2007. Elsewhere, in France, the Inter-Ministerial Delegation to Combat Underground Work (*Délégation Interministérielle à la lutte contre le travail illégal*, DILTI) has, since 1997, been pursuing a highly coordinated approach to data, strategy and operations at both national, regional and local government levels, with a wide array of social partners included at all spatial levels (ACOSS, 2004; DILTI, 2002, 2004a,b).

Moreover, in recent years, many countries have placed particular emphasis on the operational issue of improving data sharing or mining. On the one hand, this has occurred at national level. In Belgium, for example, the so-called Crossroads Bank for Social Security (*Banque Carrefour de la sécurité sociale/Kruispuntbank van de sociale zekerheid*, BCSS/KSZ), established in 1991, constitutes the central hub in an electronic network integrating the back office functions of all social security institutions, and facilitates a range of initiatives targeting undeclared work including the following: the Social Identity Card (1991) that made undeclared work harder to perform; the 'immediate declaration' system (*Déclaration immédiate/ONmiddellijke aangifte*, Dimona) (2003), which requires employers to electronically inform social security services as soon as an employee joins or leaves the organisation; and the International Migration Information System (*Landenoverschrijdend Informatiesysteem Migratie Onderzoek Sociaal Administratief*, Limosa) (2006), which requires the electronic and immediate registration of any activity by foreign workers in Belgium. All of these initiatives aim to increase the likelihood of detection, although none of them has been evaluated thus far.

In addition, limited attempts have been made to achieve cross-national cooperation not only on data sharing, such as the ownership of foreign bank accounts, but also in relation to other specific issues. For example, bilateral cooperation agreements have been concluded in the context of EU [Directive 96/71/EC](#)⁸ on the posting of workers between, among others, Belgium France and Germany. Meanwhile, a European Network on Undeclared Work has been established between public partners in five Member States – Belgium, France, Germany, Italy and Romania; the network is coordinated by the Italian Ministry of Labour (*Ministero del Lavoro*), and seeks to promote and exchange expertise on a wider undeclared work policy agenda. Such cooperation could be extended to a more comprehensive range of countries and also across the full range of strategic and operational issues, particularly data sharing.

Before doing so, however, evidence is required that cooperation and coordination of strategy and/or operations helps to tackle undeclared work. In France, for example, there is no evidence that detection has improved since 1997. Indeed, no known evaluations have been made of the relative costs of detection before and after 1997, nor has there been any evaluation of the marginal net benefits in terms of improved tax recovery of such a joined-up approach. In Germany, however, an evaluation has been conducted of the effectiveness of the aforementioned FSK in tackling undeclared work; the agency was established in 2004 to coordinate and bring together existing departments comprising 6,309 staff in 2007. The evaluation conducted by the Federal Court of Audit (*Bundesrechnungshof*, BRH) concludes that after four years of operation, the FSK was unable to provide evidence of the extent to which it has been effective in reducing undeclared work (Bundesrechnungshof, 2008). Similarly, in other countries where concerted attempts have been made to better coordinate strategy and/or operations, including data sharing or mining – such as Italy, Norway and the UK – no evaluations have so far revealed that these cross-departmental joined-up operations are any more effective than pursuing

⁸ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31996L0071:EN:HTML>

detection in conventional departmental structures (Williams, 2007). Thus, caution is urged in relying too heavily on such a measure for tackling undeclared work, at least until it is shown to be an effective way forward. In summary, evidence is lacking at this point to show that joining-up strategy and operations, or increased data sharing, result in a more effective approach.

Despite the widespread advocacy and adoption of policy measures to improve detection, evaluations are therefore far from conclusive as to whether such measures have proved effective. Some studies do indeed find that increasing the probability of detection reduces participation in undeclared work for some income groups at least (Beron et al, 1992; Dubin and Wilde, 1988; Dubin et al, 1987; Slemmerod et al, 2001). However, other studies find that it actually leads to a growth in undeclared work and/or has little or no effect on overall compliance levels (Bergman and Nevarez, 2006; Elffers et al, 1987; Friedland, 1982; Kornhauser, 2008; Murphy, 2008; Spicer and Lunstedt, 1976; Varma and Doob, 1998; Webley and Halstead, 1986). Instead, it is often argued that the level of voluntary compliance is only marginally explained by the existence of effective audit, inspection and detection regimes. Rather, a major part of such compliance is attributed to the degree to which there is a commitment to tax morality in the population (Kornhauser, 2008; Murphy, 2008). For these reasons, a cautious approach is urged regarding the use of improved detection as anything other than a contributory measure for tackling undeclared work.

Penalties

Given the high costs involved in increasing the probability of detection, it is sometimes decided to impose higher penalties for those participating in undeclared work. In Austria, for instance, the maximum fine for failing to register employees was increased in 2007 from €3,630 to €5,000 for each case of unregistered employment and to two years' imprisonment for those engaged in the organised recruitment, placement and hiring out of workers without registering them. No evaluations have been conducted on the effectiveness of this deterrent and, in any case, the courts have made virtually no use of these higher penalties and the possibility of imprisonment. In Slovakia, the penalty for failing to register an employee was also raised in January 2004 from the previous maximum of SKK 100 (about €3.30) for each employee per day, to a fine of up to SKK 500,000 (€16,600) for those breaching the registration obligation. Sanctions have also been strengthened in many other countries – including the Czech Republic, Denmark, France, the Netherlands and the UK.

One prominent aspect of this increasing use of penalties is that contractors have, in some circumstances, become liable for the actions of subcontractors. For example, in Finland, the 2006 **Contractors' Liability Act**⁹ (1233/2006) defines the obligations and liability of contractors when work is contracted out. This act entered into force in 2007 and obliges companies to ensure that their subcontractors and companies hiring out labour comply with their statutory obligations. The contractor's liabilities include establishing that the company in question is entered on the preliminary tax register, along with the employers' register and value-added tax (VAT) register. The contractors are also required to demand an extract from the Trade Register, a certificate or report of tax payments, certificates confirming that pension insurances have been taken out, and information on the collective agreement or central working conditions applicable to the work. This information must also be obtained in the case of foreign companies and may be no older than three months. Some exemptions are allowed under the Contractors' Liability Act. In terms of the penalty for violating these obligations, the Occupational Safety and Health Office of the Occupational Safety and Health Inspectorate, which supervises compliance with the act, can impose a fine amounting to no less than €1,500 and no more than €15,000. The amount of the fine is determined by the seriousness of the violation. Occupational safety authorities were allocated 12 new posts for supervising compliance with the act. An evaluation report due for publication in the summer of 2009 will assess whether the objectives of this legislation are being achieved.

⁹ http://www.mol.fi/mol/en/99_pdf/en/92_brochures/tme8019e.pdf

Despite the relatively widespread implementation of higher penalties to deter participation, the evidence is by no means clear-cut that this is an effective way of reducing undeclared work. While some studies do indeed find that increasing fines reduces undeclared work (De Juan et al, 1994; Friedland et al, 1978; Klepper and Nagin, 1989; Schwartz and Orleans, 1967), others conclude that raising penalties actually leads to a growth in such work or either has no or only a short-term effect on compliance (Chang and Lai, 2004; Elffers et al, 1987; Feld and Frey, 2002; Friedland, 1982; Murphy, 2005, 2008; Spicer and Lunstedt, 1976; Varma and Doob, 1998; Webley and Halstead, 1986; Williams, 2001). This is because imposing penalties can be counterproductive and undermine the relationship between the legal authorities and those they seek to regulate (Ayres and Braithwaite, 1992; Blumenthal et al, 1998; Tyler et al, 2007). Therefore, the use of threat and legal coercion can lead to the opposite behaviour from that sought. Increasing the penalties can result in greater non-compliance (Murphy and Harris, 2007), creative compliance (McBarnet, 2003), or criminal behaviour or overt opposition (Fehr and Rokenbach, 2003; Frey, 1997; Kagan and Scholz, 1984). In other words, it can increase resistance to compliance. As a result, some studies have even concluded that 'it is not sensible to penalise illicit work with intensified controls and higher fines' (Schneider and Enste, 2002, p. 192).

Thus, increasing penalties does not always have the intended impact. One principal reason for raising penalties is to increase the amount of tax revenue to be collected. In practice, however, this may not occur, as a reduction in undeclared work does not always lead to increased tax revenue. A Danish study hypothesised that if the 200 million hours of undeclared work provided in 1984 in Denmark was converted into jobs for unemployed people, some 110,000 new full-time jobs could be created, thus lowering the unemployment rate of 10.8% in 1984 to 7.8% (Mogensen, 1985). The study concluded that this could only be achieved if the price differentials between declared and undeclared labour supply were abolished. However, in this particular study, the purchasers of undeclared work stated that they would prefer to resort to do-it-yourself activities (34%) or simply not consume the services (30%) rather than pay the official formal price. Hence, nearly two thirds of undeclared work would not be converted into formal jobs. This applies not only to penalties but to all types of policy measure seeking to tackle undeclared work.

Another potential unintended impact of increasing penalties, and at the same time detection, is that it may cause a reduction in tax morality and therefore an unintended growth in undeclared work. For instance, an analysis of the 1987 American Taxpayer Opinion Survey (Smith, 1992) reveals that perceived procedural fairness and responsiveness in providing a service constituted positive incentives that increased taxpayers' commitment to paying taxes. Meanwhile, Kinsey (1992) found that while detection and punishment attempt to force people to comply, these processes also alienate taxpayers and reduce voluntary compliance. An increase in the perceived severity of punishment and likelihood of detection may therefore amplify rather than lower tax evasion by reducing respect for the system's fairness; this is also confirmed by the findings of Murphy (2005, 2008).

Indeed, Wenzel (2004a) in a survey of 1,406 Australian citizens finds that raising penalties only works in instances where individual ethics are weak. Where social norms are strongly in favour of tax honesty, stricter sanctions only increase the incidence of tax evasion. Harsh penalties and tax morality, therefore, do not always go side by side. Nonetheless, this does not mean that they cannot be used in a temporal sequence. For example, Davis et al (2003) find that harsh enforcement increases compliance among previously non-compliant taxpayers and that returning to the previous, more lax system does not necessarily cause them to revert to their former behaviour. This finding suggests that harsh penalties followed by their reduction and a shift towards more enabling measures could be an effective means of eliciting ongoing compliance, since those who were previously outside would then be within the compliance system. However, for people who are already compliant, such a regime could perhaps have the opposite effect, causing them to increase their non-compliance.

A final but important finding regarding the effectiveness of deterrents is that many participants engaged in undeclared work are not rational economic actors swayed by the potential cost/benefit ratio. As the 2007 Eurobarometer survey

reveals, the majority of undeclared work is conducted for and by family members, neighbours, friends and acquaintances, and such work is often carried out for reasons other than purely financial gain. This has important implications for tackling undeclared work. It can no longer be assumed that all participants are rational economic actors seeking to make or save money and that therefore undeclared work can be tackled simply by changing the potential cost/benefit ratio confronting them.

To summarise, the evidence that improving detection and increasing penalties improves compliance is less than conclusive. Not surprisingly, therefore, other approaches and measures are beginning to be used.

Prevention measures

To enable people to work in a legitimate manner from the outset, at least six broad policy measures can be adopted, namely:

- simplifying compliance;
- developing technologies to prevent undeclared transactions;
- introducing new categories of legitimate economic activity to enable people to make the transition from undeclared work to legitimate work;
- providing direct and/or indirect tax and social security incentives to encourage people to engage in regular declared employment;
- offering micro-enterprise development programmes (MDPs) to help businesses set up and develop in a formal manner;
- introducing initiatives to ensure a smoother transition into self-employment.

Simplifying compliance

At present, some activities may not – either intentionally or unintentionally – fully adhere to the regulations that apply to them. For example, people may deliberately ignore regulations in order to cut costs, or they may unintentionally engage in non-compliance, not realising that they are breaching the rules. For both groups, one option is to provide better advice on how to formalise their activities within the existing rules and regulations. Another option is to simplify the regulatory compliance framework itself. Such measures include simplifying the administrative framework by lowering the costs of establishing and operating a small business – for instance, through easier registration procedures, or reasonable and fair taxation. Moreover, the potential benefits of legal registration could be increased – for example, through access to commercial buyers in the formal economy, more favourable credit markets and legal protection.

Legal and administrative requirements, such as registration and licensing, can pose an obstacle to small companies. This is particularly evident where the transaction costs or costs of compliance for each worker are higher than in larger firms due to the smaller companies' lack of internal resources – such as time, money, specialist expertise – to cope with regulations and their inability to spread the costs of compliance across large-scale operations (Chittenden et al, 2002, 2003; Hansford et al, 2003; Hart et al, 2005; Michaelis et al, 2001; OECD, 2000). Where the costs of full administrative compliance are prohibitive, compliance is found to be low (see Adams and Webley, 2001; ILO, 2002a; Matthews and Lloyd-Williams, 2001). Examples of administrative costs associated with regulatory compliance include the filling out of forms, inspection (rather than advice), inconsistent application of the rules by different regulators or even different inspectors within the same regulator, and duplication of information requirements from different regulators. Indeed, in an analysis of 45 countries, Richardson (2006) revealed that non-economic determinants have the strongest impact on tax non-compliance. Specifically, he shows that complexity is the most significant determinant of non-compliance; this is followed by education, income source, fairness and tax morale. Overall, Richardson's regression results display that

the lower the level of complexity – and the higher the level of education, fairness and tax morale – the lower the level of tax non-compliance.

Thus, a potential way forward is to reduce administrative costs and complexity. Such efforts could include simplifying tax administration for small businesses – for example, by reducing the number of tax forms and returns, and pursuing an integrated approach to auditing with a single visit to inspect records rather than separate inspections for different taxes. Moreover, support and education could be enhanced to improve organisations' capacity to comply with the regulations. In Belgium, for instance, about 50 types of social security declaration forms have been abolished since the 1990s, leaving 30 different types of such forms in existence. Moreover, the number of headings on each form has been reduced, on average, to a third of the previous number (Robben et al, 2007).

Simplifying regulatory compliance, however, need not solely involve relatively minor administrative changes. Measures could also include more fundamental overhauls of the tax administration system, such as introducing a standard deduction for the expenses of self-employed people on their tax returns (Elffers and Hessing, 1997). It could also involve radically reforming the procedures required to create a legitimate business, as the following example from Portugal displays (Textbox 2).

Textbox 2: On the spot firm, Portugal

In 2005, Portugal's Ministry of Justice (Ministério da Justiça) announced the Simplex programme, which aims to encourage administrative and legislative simplification. One initiative of this programme is the 'on the spot firm' (Empresa na Hora), which seeks to alleviate the processes and procedures necessary to set up a new company. The 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 have been established: more specifically, 574 public limited companies (1% of the total), 34,934 private limited companies (59%) and 23,560 one-person companies (40%). 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 undeclared work has not yet been directly evaluated.

Many other countries, nevertheless, are investigating the transferability of this initiative to their own country. After the World Bank recognised the initiative as a success, companies such as Angola and Cape Verde have already asked for legal and technical support. In addition, countries such as Brazil, Chile, China, Egypt, Finland, Hungary, Mozambique, Slovenia and Sweden have visited the 'on the spot firm' service to gain an understanding of how Portugal has managed to simplify the procedures required for establishing a new company.

Developing technologies to prevent undeclared transactions

In some countries, technological developments have emerged in recent years to prevent non-compliance. One prominent technological innovation in this regard is the introduction of the 'certified cash register', particularly in business sectors that are heavily reliant on cash transactions.

In Sweden, for example, there has been a growing recognition that cash registers are being manipulated. Several methods are used – such as deleting a proportion of the sales at the end of the day; moreover, some parts of the sales are made in

‘training position’, resulting in cash not being registered but a receipt being issued, so that customers get a copy of a receipt and the sales are not registered. Indeed, some suppliers of cash registers even ‘guarantee’ that the accounted sales will be less than comprehensive.

Sweden has therefore introduced legislation stipulating that, from 1 January 2010, anybody selling goods and services in return for cash payments must have a **certified cash register**¹⁰. The purpose of this new legislation is to protect compliant businesses against unfair competition in sectors that are heavily reliant on cash transactions. The certified cash registers will make it more difficult for irresponsible companies to withhold revenue, and thereby finance undeclared work, and for owners to take the money for their own uses. The cash registers will also allow for controls to be put in place regarding the taxable revenue of companies and will significantly improve the control functions of the Swedish National Tax Board (*Skatteverket*). To achieve these goals, the cash register must record the information that is required to be able to check revenue. In addition, it is important that this information is stored and that the Swedish Tax Board has access to it. It should not be possible to manipulate or make any changes to the system. The law applies to companies that sell goods and services in return for cash payments. Cash payments also include payment by debit (bank) card. In addition, the law will apply to dentists in private practice, foot care therapists, massage therapists and others. Small businesses with sales that are less than four times the price base amount (in 2009, the price base amount is SEK 42,800 (about €4,088)) are exempted from the requirement to have a certified cash register. A company that can satisfy tax inspection requirements in some other way can also apply for an exemption – this applies most often to large companies.

Introducing new categories of legitimate work

Another possible method for encouraging people and businesses to engage in declared work is to introduce new categories of legitimate work, enabling work that is currently, often by necessity, conducted as undeclared work to move into the declared realm. For many years, like the governments of other Member States, the German government effectively shut its eyes to the fact that people undertake small jobs that they do not declare. Unlike other countries, however, the German government decided to address this issue, creating a new ‘mini-jobs’ category of employment, which encourages people to legitimise these small or ‘minor’ jobs. In 2002, the German government introduced three new types of mini-job: jobs with a €400 earning threshold; mini-jobs in the household sector; and ‘midi-jobs’ for earnings ranging between €400 and €800 (Williams, Horlings and Renooy, 2008). By 2004, the number of employees registered as being in minor employment amounted to seven million people. However, some 1.21 million were people already in a formal job, about 580,000 of whom are estimated to have transferred their add-on job from the undeclared to the declared realm (Baumann and Wienges, 2003). Schneider (2007) estimates that the mini-jobs initiative led to a reduction in undeclared work in the region of some €9 billion. In 2006, the rate of social security contributions paid by employers rose from 25% to 30%, thus reducing the incentive for employers to contract employees on a mini-job basis. Schneider (2007) estimates that this development will have increased undeclared work by some €2.5–€3.5 billion in 2006 and 2007.

In Slovenia, a similar simplified regulatory environment for small jobs was created. Under this initiative, supplementary personal work – such as household tasks, or picking and selling fruit – were deemed to a certain level to be free of taxation and other levies. Beyond this type of work, short-time work and small amounts of work have also been distinguished and treated separately from mainstream formal employment by the regulatory authorities.

¹⁰ See details on website of Swedish Tax Board at:
<http://www.skatteverket.se/fordigsomar/foretagare/kassaregister/newcashregisterlegislationbecomeseffective1january2010.4.69ef368911e1304a6258000272.html>.

As people in many other countries often feel that they have no option but to conduct such small jobs as undeclared work, not least due to the perceived problems involved in declaring it, creating a ‘mini-jobs’ category might represent a way forward in other countries. Otherwise, it seems likely that those who conduct small jobs ‘on the side’ on an occasional basis will decide not to declare these activities.

Providing direct and indirect tax and social security incentives

It is often assumed that the most basic way to eradicate undeclared work is to reduce overall tax rates. However, a more nuanced approach is sought here for two reasons. Firstly, there is no evidence that lowering overall tax rates reduces the size of the undeclared sphere. Indeed, quite the opposite seems to be the case. Undeclared work is generally higher in poorer countries with lower incomes per person and where tax rates are smaller; in contrast, such work is lower in affluent countries with higher average incomes and tax rates (Bird and Zolt, 2008). Secondly, the problem with using general tax reforms to deal with undeclared work is that these reforms have much broader impacts. For this reason, more targeted measures are often developed.

For example, it is well known that many people starting up in business secure their venture capital not from formal but from informal sources such as family, friends and acquaintances. A resulting problem is that these loans are often made on a relatively informal basis, which may contribute to an attitude from the outset that informal practices are part of the culture of the enterprise that is being established. In the Netherlands, it was formally recognised that this is how many entrepreneurs receive their venture capital. As a result, a scheme called the ‘Rich Aunt Agatha Arrangement’ (*Tante Agaath-Regeling*) was introduced. This provides an incentive to those making loans and in doing so helps individuals using personal loans from family and friends (Aunt Agatha) to start off on the right footing. The intention is that by exempting these private moneylenders from certain taxes, such loans will be put under the radar of the tax authorities, thus encouraging businesses to start off on a more formal basis rather than seeing themselves as being engaged in informal arrangements, which might well carry over into everyday trading practices (Renooy et al, 2004; Williams, 2004d). To date, no formal evaluation of this initiative appears to have been conducted.

It should be added that tax and social security incentives to exit the undeclared realm do not have to be provided solely by the state. It is also wholly feasible for other social partners to offer incentives to engage in the declared realm, as an initiative in Romania shows (Textbox 3).

Textbox 3: Builders’ Social House, Romania

In Romania, the ‘Construction Sector Social Agreement for 2007–2009’ (*Acordul Social Sectorial Pentru Construcții 2007–2009*) estimates that about one third of the country’s active workforce is undeclared and highlights the importance of tackling this sphere. The Builders’ Social House scheme (*Casa Socială a Constructorilor, CSC*) is one prominent initiative being used to enable the transition from undeclared to declared work. The CSC was established in 1998 as a privately run welfare organisation, to which the representative trade unions and employer organisations in the construction and building materials sector equally contribute. It provides welfare during the cold season, which runs from 1 November to 31 March, when the construction sector shuts down. The scheme targets people who are in registered formal jobs and, in doing so, provides an incentive for workers to engage in declared rather than undeclared work in the construction and building materials sector. CSC members comprise construction companies and manufacturers of building materials. Entitlement to welfare provision during these winter months is only available to declared employees – that is, those with employment contracts registered with the local labour inspectorates, and whose employer and employee social security contributions have been paid. Employers contribute 1.5% of their turnover to the CSC scheme, while employees contribute 1% of their gross base salary.

In 2008, the CSC had 573 member organisations, representing 40% of all employment in the construction and building materials industries. During the 2007–2008 winter period, some 102,387 persons benefited from this scheme as welfare recipients. The initiative is potentially transferable both to other economic sectors where work is largely seasonal, such as agriculture and forestry, and also to other countries.

Another tax incentive that might be used to prevent people from entering into undeclared work from the outset, especially in relation to envelope wage payments, is to raise the minimum wage level. In East-Central Europe, where envelope wages are most prevalent, the minimum wage level has been cautiously set to between around a third and a half of the average monthly gross wage – as seen in Bulgaria (50% of the average gross monthly wage), Slovenia (46%) and Romania (33%) (Eurostat, 2007). The rationale of governments was that this would prevent jobs from shifting from the declared to the completely undeclared economy. However, although a low minimum wage might stop jobs from shifting into the wholly undeclared sphere, employers have greater scope for paying a small official wage and a larger portion of employees' earnings as envelope wages. Raising the minimum wage closer to the average wage level thus reduces the portion that can be paid as envelope wages. Nevertheless, if the minimum wage is set too high, employers might then decide to employ workers on a solely undeclared basis. Thus, this policy measure of increasing the minimum wage level needs to be carefully piloted and evaluated, especially with regard to determining the tipping point at which employers shift from the declared to the wholly undeclared realm. Furthermore, even if this measure proves effective and transferable, it should be recognised that it only reduces the proportion of the salary paid as envelope wages; it does not eradicate the problem.

Micro-enterprise development programmes (MDPs)

Turning to the area of new business ventures, one way of encouraging legitimate start-ups is through Micro-enterprise Development Programmes (MDPs). These programmes provide 'micro-credit', advice, training and support to start-up ventures (Jurik, 2005). Although some MDPs are lending-oriented, others focus more on training or advisory services. Evaluations of MDPs in the advanced economies have found them to be effective at promoting business growth, creating jobs and increasing clients' incomes, self-esteem and community involvement. At the same time, they also appear to help smooth the transition from unemployment to self-employment (Balkin, 1989). In Poland, for example, a micro-enterprise development programme has been introduced to target young people in particular (Textbox 4).

Textbox 4: First Business Programme, Poland

Since the turn of the millennium, youth entrepreneurship has moved up the public policy agenda in Poland, as it became evident that the expected 5% growth of the national economy will be unable to absorb all of the unemployed and so-called 'baby boom' generation into the labour market. In 2005, the government initiated the 'First Business Programme' to supplement the 'First Job Programme'. While the First Job Programme was designed to boost employment among young people, the First Business Programme focuses on nurturing entrepreneurship and self-employment among the younger generations.

The First Business Programme aims to promote entrepreneurship among young persons such as secondary school graduates younger than 25 years of age and university graduates aged under 27 years. In particular, it seeks to help them establish and run their own business or start working as a self-employed person. The programme provides theoretical courses on setting up and running an enterprise, gives practical training in matters related to entrepreneurship, and provides loans and subsidies from the Labour Fund (*Fundusz Pracy*) and from the Bank of Domestic Economy (*Bank Gospodarstwa Krajowego*).

The main focus of the programme is to offer young entrepreneurs real assistance in setting up and conducting a business, and not just financial aid. No evaluations have been conducted of whether participants in this scheme are less likely to engage in undeclared working practices than those who have not benefited from it.

This First Business Programme in Poland is similar to many other MDPs. Up until now, little has been known about whether such MDPs are effective in helping fledgling micro-enterprises to start up legitimately. By providing formal loans, for example, MDPs may well help businesses to launch their operations on a formal footing. If such formal loans

are also coupled with advice, support and training, the likelihood of such ventures beginning on a formal footing could be further enhanced. At this point, however, it is not known whether this is actually the case in practice.

Smoothing the transition to self-employment

Unemployed people often represent only a small proportion of all persons engaged in undeclared work (see, for example, Jensen et al, 1995; Leonard, 1998; Pahl, 1984; Renooy, 1990; Williams, 2004a,b,c). Indeed, the 2007 Eurobarometer survey on undeclared work in the EU reveals that just 11% of those engaged in undeclared work are unemployed. Therefore, although unemployed people are nearly twice as likely as the population in general to engage in undeclared work, they still only constitute a small minority of the undeclared workforce. Despite this finding, a vast amount of policymakers' energy and attention is devoted to tackling undeclared work among unemployed people. Indeed, one of the most dynamic areas of public policy aimed at tackling undeclared work, and reflecting the shift towards active welfare policies, is easing the transition from unemployment to self-employment.

One such initiative is the Ich AG scheme in Germany (see Williams, Horlings and Renooy, 2008). An 'Ich AG' refers to a new business entity, and the scheme was introduced to help ease the transition from unemployment to self-employment. Individuals receive a monthly subsidy for three years while they are starting up their new business venture. In the first year, they receive 50% of the average unemployment benefit level, 30% in the second year and 20% in the third and final year. A start-up monitor shows that, in 2003, over 93,000 long-term unemployed persons started a small business under the Ich AG scheme. The German government had only expected about 20,000 start-ups to be launched (Renooy et al, 2004; Renooy, 2007). An analysis by the Institute for Employment Research (*Institut für Arbeitsmarkt- und Berufsforschung*, IAB) shows that between 2003 and 2006, some 400,000 businesses received financial support from the Ich AG scheme. About three quarters of these businesses were still in operation some 28 months after their launch. A survey by Baumgartner et al (2006), which analyses the motives of participants in Ich AG, reveals that 60% had already acquired their first customers before moving onto the Ich AG scheme, which is perhaps a tentative indicator of the extent to which this policy measure has enabled undeclared practices to become legitimate.

To date, policy measures seeking to smooth the transition to self-employment have largely focused on helping unemployed people move into self-employment in a legitimate manner. Less attention has been paid to easing the transition from employment to self-employment, despite the evidence that the vast majority of newly self-employed persons were previously employees rather than unemployed people (SBS, 2003) and that those in formal employment often start up their business ventures 'on the side' on an undeclared basis in the first instance (Williams, 2008). This lack of attention to smoothing the transition from employment to legitimate self-employment represents a major gap in policy that needs to be addressed.

Curative measures – legitimising undeclared work

Besides measures seeking to prevent people from engaging in undeclared work in the first place, policy measures have also been introduced to help those already participating in undeclared work to legitimise their activities. Such measures fall into two categories: measures designed to help undeclared workers make the transition to the declared realm; and measures that aim to encourage purchasers to use declared rather than undeclared labour and services.

In relation to undeclared workers, at least three types of measure can be pursued:

- society-wide amnesties;
- voluntary disclosure;
- tailored business support and advisory services to help unregistered enterprises make the transition to the formal economy.

Measures that aim to encourage purchasers – that is, either customers or employers – to acquire goods and services on a declared rather than an undeclared basis include:

- targeted indirect tax measures;
- targeted direct tax measures;
- wage costs subsidies, including voucher schemes;
- wage realignment contracts.

Society-wide amnesties

Society-wide amnesties have been used to tackle undeclared work in many countries (see, for example, Hasseldine, 1998; López Laborda and Rodrigo, 2003; Torgler and Schaltegger, 2005). In Italy, for example, a six-month amnesty in 2001 generated €1.4 billion in additional tax revenue, accounting for 0.4% of total tax revenue (Torgler and Schaltegger, 2005). Another amnesty in Italy in 2003 resulted in some 703,000 illegal immigrants coming forward, 48.6% of whom were women employed in undeclared work as domestic workers and caregivers (Ghezzi, 2009). Further afield, in the United States (US), more than 60 amnesty programmes have been conducted since 1982, with strong variations emerging in the repatriated revenue across the different states (Torgler and Schaltegger, 2005). In a comprehensive review of 43 of these tax amnesties pursued in 35 US states between 1982 and 1997, Hasseldine (1998) shows that the collection rate ranged from 0.008% to 2.6% of total tax revenue.

One option that has been put forward is the idea of an EU-wide amnesty. In this regard, a recent call has been made for a ‘pact to declare the undeclared’, which would allow undeclared activities to gradually move towards legitimisation over a transition period of say two years. During this period, no sanctions would be imposed; however, at the end of this period, stronger sanctions would be introduced for those who continue to work on an undeclared basis (European Parliament Committee on Employment and Social Affairs, 2008, p. 7). Whether this is appropriate across the EU as a whole, nevertheless, is open to debate. In high trust societies with generally good compliance levels, tax amnesties might run the risk of sending the signal that ‘it is not worth complying’ to the already compliant group. Hence, some societies might lose more than they gain in willingness to comply. For this reason, society-wide amnesties – similar to many other policy measures – might fit better in some contexts than in others and should not perhaps be applied universally.

Voluntary disclosure

Another policy option to encourage those participating in undeclared work to move to the legitimate realm is to offer amnesties on an individual basis to those voluntarily disclosing that they have been working on an undeclared basis. For example, in October 2001, the Italian government implemented a law known as the Regularisation Campaign (Law 383/2001), which ended in February 2003. This allowed undeclared workers and enterprises to regularise their situation with respect to issues such as tax, labour, safety, social security contributions and land use irregularities. In exchange, they were allowed to pay reduced taxes and social contributions for three years, as well as lower pension contributions for previous years, to enable them to adapt. Undeclared workers were given two options: to declare their irregularities and pay immediately all (reduced) taxes and contributions outstanding, or to engage in gradual regularisation; in relation to the latter option, a regularisation plan was submitted, including deadlines for rectifying any irregularities, to an ad hoc committee. If the individual failed to follow the plan and to meet the deadlines specified, they would be penalised by having to pay 100% of the tax and contributions owed rather than the reduced amount.

In total, this campaign produced some 1,794 declarations and 3,854 new regularised workers (Meldolesi, 2003). Superficially, this might suggest that the campaign was unsuccessful, as the Italian government had expected a much higher level of declarations. However, and as Meldolesi (2003) points out, although it failed to attain its targets, the initiative led to a process of ‘indirect’ or ‘silent’ regularisation. Between October 2001 and October 2002, which was a

period of economic stagnation, some 385,000 additional workers registered nationally. This is largely because – although small businesses were reluctant to submit the regularisation form, as it was generally perceived as a dangerous form of self-incrimination – they did regularise indirectly, thus resulting in a process of ‘silent’ formalisation (Meldolesi, 2003). Therefore, evaluated in terms of the indirect formalisation that ensued, this regularisation campaign was more effective than when solely assessed in terms of direct formalisation (Williams, Horlings and Renooy, 2008).

Perhaps as a result of the success of this scheme, a further regularisation campaign was launched in Italy in 2006, in accordance with Decree Law No. 296 of 27 December 2006 (subsections 1192–1201). Under this initiative, employers applying for regularisation to the National Social Security Institute (*Istituto Nazionale per la Previdenza Sociale*, Inps) have been exempt for one year, that is from the date when the application was submitted, from inspections and controls regarding their compliance with the regulations on social security and insurance payments. The exemption does not apply to compliance with workplace health and safety regulations (Article 11 of Law No. 123 of 3 August 2007). Employers first come to an agreement with the trade unions at a local level. One of the obligations in these agreements is that they have to guarantee employment for at least two years. After this, the employers can apply for regularisation. Applications are examined by a board consisting of managers from the Provincial Labour Directorate, along with authorities responsible for social security and workplace accidents. The regulations were included in the 2007 Budget Law but delayed until 30 September 2008. Initial Inps data for 2007 estimate that some 10,000 workers became regularised by means of these ‘regularisation’ contracts.

A further example of voluntary disclosure is the following ‘VAT short-term incentive’ scheme in the UK (Textbox 5).

Textbox 5: VAT short-term incentive scheme, UK

From April to September 2003, the UK government via Her Majesty’s Customs and Excise (now part of Her Majesty’s Revenue and Customs (HMRC)) ran a short-term one-off incentive scheme for businesses that should have registered for VAT but failed to do so. The government forecast that 6,300 businesses would take advantage of the scheme, raising GBP 11 million (about €12.36 million) in additional VAT and interest. Penalties would be waived so long as the business continued to comply for 12 months. The scheme cost GBP 500,000 (€561,645) in advertising costs and an estimated GBP 2.7 million (€3 million) in penalties foregone from businesses that would have registered anyway. When the scheme closed, the department had received 3,000 registrations, which raised GBP 11.4 million (€12.8 million) in tax and interest or an average of GBP 3,800 (€4,270) per case. Around 55% of businesses taking advantage of the scheme subsequently failed to submit a VAT return, causing the department to impose GBP 2.5 million (€2.8 million) in penalties. This had a return-to-cost ratio of 23:1, compared with the 4.5:1 ratio overall for all hidden economy compliance activity in the UK (NAO, 2008).

Another voluntary disclosure initiative, again in the UK, involved offshore bank accounts and in this instance targeted a particular economic sector. In 2006 and 2007, the UK government won a ruling that required financial institutions to disclose the details of offshore bank accounts held by UK residents. As a result, HMRC received details of some 400,000 bank accounts, from which it is estimated that up to 100,000 people should have included income and/or the resulting interest from these accounts on their tax return but had not. HMRC used a voluntary disclosure initiative to encourage people to come forward and disclose and pay all tax owed on their foreign bank accounts. By June 2007, the closing date of the scheme, HMRC had received 64,000 notifications and around 45,000 people came forward to make a disclosure under the arrangements, bringing in a return of some GBP 400 million (€449.4 million) at a cost of GBP 6 million (€6.7 million), or a return of 67:1 (NAO, 2008). Belgium ran similar voluntary disclosure schemes on offshore banking in both 2004 and 2005, as did the Australian Tax Office.

Voluntary disclosure schemes could be introduced in other spheres such as home repair, maintenance and improvement, as well as for landlords. These could comprise generic campaigns or might also involve more targeted campaigns, whereby information is obtained through data matching on potentially non-compliant groups, with the information then being used to contact those who might wish to consider taking advantage of the voluntary disclosure option. Lessons could be learned from a range of countries regarding the use of appeals and notification letters (see section on ‘Changing attitudes – from compliance to commitment’ later on in this chapter).

Advisory and support services

The development of a bespoke local advisory and support service for businesses seeking to formalise their operations has been widely discussed in public policy circles both in Italy (see, for example, Bàculo, 2005; Caianiello and Voltura, 2003; Meldolesi and Ruvolo, 2003) and the UK (see, for example, Evans et al, 2006; SBS, 2003; Williams, 2005). It has also been considered in Europe more generally (Mateman and Renooy, 2001; Renooy et al, 2004), as well as the US (see, for example, Jurik, 2005).

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 wanting to undergo a formal business planning process (Caianiello and Voltura, 2003; Copisarow, 2004; Copisarow and Barbour, 2004; ILO, 2002a,b; Meldolesi and Ruvolo, 2003; SBC, 2004; Williams, 2005). It is also acknowledged that support and advice is generally not widely available at present to businesses seeking to legitimise their operations about how they might resolve their situation (Copisarow and Barbour, 2004; ILO, 2002a; SBC, 2004; Williams, 2005). The development of a ‘formalisation service’ is one way forward.

The Operative Urban Centre for Economic Upgrading (*Centri Operativi per la Riqualificazione Economica*, CUORE) initiative in Italy, reviewed in Williams, Horlings and Renooy (2008), is an example of such a formalisation service. The initiative was established to provide enterprises with help and advice on formalisation, much like other measures in the broad Italian initiative towards combating undeclared work. CUORE comprises a network of neighbourhood service centres for entrepreneurs and prospective entrepreneurs. Each local CUORE centre services a low-income neighbourhood and their target group is small and micro-sized hidden entrepreneurs with the potential for growth. Once identified, CUORE centres offer information and advice to aid formalisation (Bàculo, 2001, 2002, 2005). Following a request by an undeclared worker, CUORE operators devise custom-made regularisation and development paths. The project workers closely monitor each step in the process to ensure that the enterprise follows the agreed path towards regularisation and that the path still suits the needs of the enterprise. Project workers tend to be familiar with the neighbourhood. In total, according to Bàculo (2005), some 1,280 hidden enterprises have received counselling and 326 problems have been solved under this initiative. Besides providing advice and support, attempts have also been made to provide incentives for businesses to formalise their operations. Business consortia have also been established to provide promotional aid and training, arrange trade fairs, help protect the originality of their labels and provide assistance with the internationalisation of their markets. This provides additional positive reasons for legitimising their business, enabling the businesses to compete on grounds other than labour cost and, in turn, reducing the necessity for hidden practices. The initiative has resulted in a set of opportunities for businesses joining these clusters and negated their perceived need to continue on a hidden basis (Comitato per l'emersione del lavoro no regolare, 2003). Since this experiment, which was piloted in Naples in western Italy, the initiative has started to be replicated elsewhere in the country.

Other initiatives of this kind, however, have been less successful. In the UK, for example, a pilot ‘formalisation service’ was implemented in 2005 in Hartlepool in northeast England. As part of the initiative, HMRC ‘offered’ individuals engaged in undeclared work a confidential and anonymous assessment of their existing liabilities. If the individuals concerned accepted the assessment of their liabilities 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 undertook a review of their liabilities. The subsequent evaluation found a lack of knowledge of the scheme, along with low levels of trust between the target group and the authorities. Moreover, the wording of the campaign was deemed unappealing, while the failure to use an independent body for people to approach, such as the local citizens advice bureau, was considered a further weakness (Centre for Economic and Social Inclusion, 2006).

Another local formalisation service – in this instance targeted at a particular sector – concerns the Nazaret neighbourhood in Valencia in eastern Spain, where a labour exchange has been created to deal with the provision of workers in the domestic services sphere. The labour exchange provides trained workers for households that are seeking domestic workers and also trains these workers. The exchange has contributed to formalising the labour market for domestic services. At any one time, some 60 employees are participating in this scheme. Evaluations have not been conducted, but if the initiative was found to be effective, this local formalisation service could be transferred to other countries and sectors where undeclared work is rife.

A further example of the provision of advisory and support services seeking to facilitate formalisation can be found outside of Europe – namely, in Australia. Many countries provide written advice, guidance and training on the records that businesses need to keep for tax purposes. The Australian Tax Office, however, has gone one step further by providing free record-keeping computer software. The assessment tool is designed to help small businesses understand the business records they need to keep and to evaluate how well the business is doing. The tax office also supplies factsheets for specific sectors on basic record-keeping requirements. The provision of this level of advice and support could be replicated in many other countries.

Targeting customers with indirect tax measures

One way of encouraging consumers and businesses to use declared rather than undeclared work is to reduce value-added tax (VAT) on specific goods and services where undeclared work is widespread; this could include areas such as the household repair, maintenance and improvement (RMI) sector (see Capital Economics, 2003). However, whether VAT reductions might lead to the increased formalisation of undeclared work is open to debate. Although early academic research argued that the introduction of VAT had little effect on the extent of undeclared work (Bhattacharyya, 1990; Feige, 1990; Frey and Weck, 1983; Macafee, 1980), few contemporary evaluations have analysed whether this is actually the case.

Despite this, some Member States seized the opportunity offered by **Directive 1999/85/EC**¹¹ to reduce VAT on specific labour-intensive services. In the sphere of building renovation and maintenance, for example, several Member States – such as Finland and Italy – opted for a reduction in VAT. Nevertheless, as the European Commission asserts: ‘There is limited evidence of the employment creating effect of a single reduction of VAT’ (European Commission, 2007, p. 7). Notwithstanding this, in March 2009, EU finance ministers agreed that the Member States can reduce rates of sales tax on local services such as meals, haircuts and home repairs from the standard rate of 15% to 5%.

Targeting consumers with direct tax measures and wage cost subsidies

Although general reductions in the rates of income tax might be used to try to counteract the prevalence of undeclared work, this has broad societal implications. More targeted strategies, however, are available. One option is to offer straightforward income tax relief, claimed on self-assessed tax returns, to customers using declared labour to do specific household tasks – such as roof maintenance, outside painting and household cleaning. In the RMI sphere, for example,

¹¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1999:277:0034:0036:en:PDF>

tax rebates on home maintenance expenses have been available in France since 2000, while tax reductions for house repairs have been introduced in Italy and Luxembourg. In Sweden, meanwhile, a tax reduction has been introduced for labour costs on home repairs and household services. As the European Commission (1998, p. 14) concludes with regard to such initiatives:

Tax deductions and subsidies for refurbishing and improvements of houses have been particularly successful in encouraging more people to use the opportunity to repair their houses legally, and had the effect of moving work which might have been done informally to the formal and registered sector.

In relation to other domestic services – including household cleaning and gardening – similar targeted direct tax measures have been introduced in countries such as Finland, Germany and Sweden to encourage such household work to be carried out in the declared rather than undeclared sector. In Finland, since the beginning of 2001, it has been possible to deduct costs for household work in taxation. For instance, it is possible to deduct 30% of the wage for such costs, including social security contributions, up to a maximum of €3,000 in 2009. The deduction is personal and can be given to both spouses. In 2004, some 6.6% of households applied for this tax deduction, with total tax deductions amounting to €111.3 million. Over 90% of householders purchased the deductible service from a company.

Another similar tailored measure directed at lowering wage costs for certain activities is the Danish Home Service Scheme (*Hjemmeserviceordningen*). This scheme was launched in 1994 as a pilot project and was made permanent in 1997 (Erhvervsfremmestyrelsen, 2001a). The aims of the initiative are as follows: firstly, to compete with undeclared work; secondly, to promote the development of formal enterprises that provide household services; and thirdly, to offer job opportunities to low-skilled jobseekers. Businesses registered with the Danish Commerce and Companies Agency (*Erhvervs-og Selskabsstyrelsen*) to provide services to households for which the government reimbursed a proportion of the cost. In 1998, one in eight Danish households used the Home Service Scheme an average of five times a year. Almost 90% of consumers were very satisfied with the company and its services. In 1997 alone, more than 2,000 jobs were created through the scheme; by 2000, it had grown to 3,700 full-time equivalent jobs (Renooy et al, 2004). Analysing the impact of the Home Service Scheme on undeclared work, it has been found that 10% of home service users claimed they had previously used undeclared work before they joined the Home Service Scheme (Platzer, 2002; Sundbo, 1997). Similarly, further research concludes that the scheme had reduced the incidence of undeclared work (Erhvervsfremmestyrelsen, 2001b). This initiative shows that it is wholly feasible to use demand-side measures to transfer undeclared work into the declared realm on a large society-wide scale. However, Larsen (2006) states that curtailing the Home Service Scheme for everybody other than elderly people has resulted in more people now buying their cleaning services as undeclared work, thus creating a new market for undeclared cleaning activities.

In Sweden, meanwhile, a tax reduction for domestic services was introduced in July 2007. The system will, from July 2009, be extended to house maintenance and rebuilding, covering the costs of jobs carried out after 7 December 2008. The rules are to remain permanent. The tax reduction totals 50% of the labour costs, including social security contributions and VAT on labour costs, up to a maximum of SEK 50,000 (€4,706) a year for each individual. As an example, if two persons own a house together they can claim a reduction of SEK 100,000 (€9,414) a year, corresponding to total labour costs of SEK 200,000 (€18,828). The aim of the tax reduction is to reduce undeclared work, increase labour supply by making it easier for men and women to combine work and family life, and raise demand in the construction and home service sector. Until July 2009, people had to apply to the Swedish National Tax Board for the reduction, which was included in individuals' yearly tax assessment. Under the new rules applying from July 2009 – referred to as the 'invoice model' system – the crediting of the reduction is to be speeded up: the purchaser will only pay half of the labour costs to the seller, and the latter will then claim the other half from the Tax Board together with the relevant information.

Despite the success of these initiatives, using direct tax incentives to bring undeclared domestic services into the declared realm has not, however, always proved successful, as the following examples show.

Textbox 6: Employment contract for domestic workers, Poland

In November 2005, the Polish government introduced new regulations enabling households wishing to hire a housekeeper to claim some tax deductions, while the domestic workers themselves could benefit from social and health insurance contributions. A person wishing to take advantage of such outsourcing of domestic services, such as housekeepers, babysitters or gardeners, had to notify the District Labour Office (*Powiatowy Urząd Pracy*, PUP) of their plans. In order to hire an unemployed person, a prospective employer had to establish an ‘activation employment contract’ with the domestic worker and then submit a copy of this contract to the local employment office. The regulations laid down a number of conditions to be met by the prospective employer and domestic worker, as follows:

- only unemployed persons could be hired on the basis of an ‘activation employment contract’;
- while employed as a domestic worker in one particular household, such workers were not allowed to enter into another contract of this type with anyone else;
- close relatives, such as an aunt or brother-in-law, could not be employed under this type of contract;
- pensioners and persons drawing disability benefits could not be hired under this type of contract;
- the minimum contract length was one year;
- only people registered with the fiscal authorities for payment of personal income tax (PIT) could employ another person under this type of contract;
- self-employed persons who had chosen to pay corporate income tax (CIT) were excluded from the scheme.

Once completed, the employer was entitled to deduct from their income tax all documented expenses borne with respect to the domestic worker’s social and health insurance contributions. Despite the ambitious nature of the scheme, it did not work. A major obstacle was the complicated conditions that both sides of the employment contract had to meet, along with the relatively small gain to justify the effort. Householders were put off by the bureaucratic burden that resulted and domestic workers preferred to collect their wages on an undeclared basis, which householders were willing to cater for. Furthermore, the exclusion of specific social groups – such as pensioners who often work as housekeepers or babysitters, and relatives who frequently help out – reduced the popularity of this scheme. As a result, less than a year after it came into force, it was proposed in October 2006 that the scheme be abandoned. The regulations providing for the scheme were eventually repealed in August 2007, and no replacement scheme has since been put forward.

A similar scheme, called the ‘white domestic worker’ initiative, failed in the Netherlands. Nevertheless, the scheme was replaced by another initiative, whereby employers (households) can pay their domestic workers cash-in-hand and do not have to worry about taxes and social security contributions. The domestic worker may, in turn, work for one or more employers for a maximum of three days a week, with no stipulation regarding the number of hours each day. The worker must then report the income earned to the tax authorities, but only has to pay income tax on these earnings; there are no obligations regarding social security contributions. The income has to exceed the hourly minimum wage level and the domestic worker is entitled to payment during the first six weeks of sickness absence.

Similar tax subsidy schemes have been introduced in the realm of care provision. In Spain, since 2007 – under the Personal Autonomy and Dependent Care Law (39/2006), known as the Dependency Law – public support has been available in the form of paid help for those whose lives have been curtailed due to illness, disability or age. The measure

seeks to formalise work in this realm, leading to the creation of between 300,000 and 500,000 new formal jobs. The government pays a grant to allow dependent persons to receive care at home. In each case, the main carer is registered in the social security system. Preliminary results indicate that some 77,604 new jobs were created as a result of the scheme in 2007 and a further 125,987 jobs in 2008. By October 2008, some 606,000 requests for assistance had been received, which is equivalent to 1.34% of the population.

A further example of the use of tax subsidies to tackle undeclared work in the realm of care provision can be found in Austria (Textbox 7).

Textbox 7: Subsidies for private geriatric nurses, Austria

In Austria, older people often engage foreign workers on an undeclared basis for private nursing care at home. To formalise this sphere, in 2007, the Nursing in the Home Act (*Hausbetreuungsgesetz*, HBeG) offered two alternatives for geriatric nurses. Firstly, the person requiring care can either employ one or two geriatric nurses under the terms of the existing Private Household Workers' Act (*Hausgehilfen- und Hausangestelltengesetz*). Secondly, nurses have the option of becoming self-employed under the new 2007 legislation, which means that they need to apply for a general trading licence and register with the Social Insurance Association for Entrepreneurs and Self-Employed Workers (*Sozialversicherungsanstalt der gewerblichen Wirtschaft*, SVA). The purchaser can claim subsidies for these formal workers of up to €400 per nurse each month under the former legislation and up to a maximum of €112.50 per self-employed nurse each month. Only persons requiring 24-hour stand-by care, and who do not possess assets worth over €5,000 (excluding their house), can claim these wage subsidies.

The measure has not been evaluated thus far. According to the Federal Ministry of Economy and Labour Affairs (*Bundesministerium für Wirtschaft und Arbeit*, BMWA), about 15,000 people have entered the self-employment scheme and applied for a general trade licence under the HBeG. No figures are available for geriatric nurses who have been regularly employed by the person requiring care. According to estimates from the Federal Ministry of Social Affairs and Consumer Protection (*Bundesministerium für Soziales und Konsumentenschutz*, BMSK), effective monthly costs of the new 24-hour care schemes are supposed to amount to €1,500–€2,000 in the case of self-employment and to €2,600–€2,850 for regular employment. For many older people, these costs are still not affordable; as a result, they are forced to continue engaging the services of illegally operating foreign workers – who do not have a trade licence and are thus often without social security cover – for private nursing care at home. This example demonstrates that, if such wage subsidy schemes are insufficiently funded, they will have little impact on the size of the undeclared sphere.

Wage realignment

The objective of wage realignment strategies is to reduce the tax and social contribution burden to help encourage greater compliance and less tax evasion, as the following example from Italy shows. In 1990, wage realignment contracts were adopted in the country, allowing trade unions and business associations located in a specific area in the south of Italy to determine a minimum wage at local level. This wage could be no less than 25% of the minimum wage established in the national labour contract and had to be adjusted within three years to 100% of the national contract wage. The two-fold objective of this initiative was to reduce the tax and social contribution burden for that time and rectify past non-compliance in terms of tax evasion, safety in the workplace and welfare. The idea behind this policy is that labour costs are the central reason driving companies to avoid national labour contracts. The three-year period and allowances granted were considered sufficient to enforce regulation. However, an analysis of the realignment contracts performed in the provinces of Lecce in the Puglia region of southeastern Italy and Avellino in the Campania region in the southwest shows that different results were obtained (Bàculo, 2003); this was attributed to initial differences in labour conditions and levels of unionisation. A few years later, realignment contracts were totally abandoned following a decision by the EU, which opposed interventions favouring individual areas of a country – in this case southern Italy.

Service voucher schemes

An increasingly popular initiative which is being used to tackle undeclared work is the use of vouchers. Belgium, in particular, has pursued the widespread use of service vouchers. As Williams, Horlings and Renooy (2008) report, service vouchers in Belgium have been used as a means of paying for everyday personal services. Each voucher costs €6.70 and this pays for an hour of work from certified companies that hire unemployed people. At first, the unemployed persons can be hired by the company on a part-time and temporary basis. After six months, the company has to offer them 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; and preparing meals. The household pays with the vouchers, whose cost price is €21.00 in 2005 prices. The difference is paid to the company by the federal government. The household can recover 30% of the price of the voucher in their tax return, meaning the price for one hour's work is €4.69. The Belgian government intended to create 25,000 jobs by the end of 2005 under this scheme.

According to Gevers et al (2005), by the end of 2005 some 28,933 people had been employed through this service voucher scheme. These employees were employed by 792 companies, of which 41% were temporary employment agencies, 25% were private not-for-profit enterprises and 18% were public companies. The majority (90%) of the workers were employed in part-time jobs, although most work more than half time. The 28,933 people in jobs represent 17,360 full-time equivalent jobs, a 70% increase compared with the number employed in 2004. However, 49% of the employed people already held a job before joining the service voucher scheme. The net effect on job creation therefore was some 9,000 jobs. By the end of 2005, two thirds of the employees were employed on permanent contracts.

During the two-and-a-half years that the scheme has been in operation, almost 200,000 households have used the voucher scheme. Although early studies found that customers previously sourced some 44% of the work now conducted using service vouchers from the undeclared economy (de Sutter, 2000), the most recent evaluation finds that only 25% of the respondents reported that it would have been conducted in the undeclared economy if the vouchers had not been available. One interpretation is that this scheme, in its early days, acted as a tool for transferring undeclared work into the formal economy, but is now becoming more of a measure for moving unpaid self-provisioning into the formal economy.

Gross costs for the service voucher schemes are estimated at €303.2 million, encompassing the government subsidy for the jobs, staffing costs and costs of tax deduction. However, the additional jobs also generate returns for the government, because they result in savings in unemployment benefits, as well as surpluses in social contributions and personal income tax. These returns are estimated at €93.1 million, which brings the net costs to €210 million in 2005. The outcome is that every full-time equivalent job created through this service voucher scheme has cost around €12,500.

Another service voucher scheme that has proved successful is an initiative introduced in France in the domestic services realm (Textbox 8).

Textbox 8: Universal Service Employment Cheque, France

The Universal Service Employment Cheque (*Chèque Emploi Service Universel*, CESU) scheme was introduced in France to simplify the process of hiring and paying a domestic worker. The worker's salary is paid using a system of cheques, which can be purchased at the local bank. Customers benefit by being able to claim an income tax reduction that amounts to 50% of the sum spent on purchasing the cheques. For the service supplier, meanwhile, the salary cannot be less than the national minimum wage, and a 10% indemnity is also given for paid leave. By 2002, some 765,411 households were legally using domestic service workers, while just under 88,000 full-time equivalent jobs had been created (Adjerad, 2003). By 2002, 53% of all formal employers of domestic workers used the CES scheme (Adjerad, 2003). Moreover, an estimated 20% of those previously working on an undeclared basis are now officially employed (Le Feuvre, 2000).

Not all countries, nevertheless, have had such positive experiences with service vouchers. In Finland, in the late 1990s, only 24,000 households used a service voucher scheme, primarily because the subsidy failed to make formal domestic services cheaper than services in the undeclared economy (Cancedda, 2001, p. 29). This proves that unless the incentive is sufficient, such demand-side experiments 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, the problem with this, as seen in Finland, is that the incentive offered can sometimes be too low to encourage consumers to make the transition. Therefore, countries need to experiment with different schemes to see what works in their context and what does not. Indeed, this is precisely what happened in Finland, where two different versions of the scheme were simultaneously piloted. Such experimental approaches need to be more frequently adopted elsewhere in the EU27.

Concerns have also arisen about whether service vouchers do indeed enable the legitimisation of undeclared work in the household services sector. In Austria, for example, there were concerns that the 2005 Household Service Cheque Act (*Dienstleistungsscheckgesetz*, DLSG) does not affect domestic workers who are illegal foreign nationals – it is believed that these workers, albeit with no evidence, constitute the bulk of domestic workers.

Moreover, until now, voucher schemes have targeted a relatively narrow range of domestic services. Thus, it might be useful in the future if the range of activities included was expanded to include other areas where undeclared work is widespread – such as home improvement and maintenance work, or seasonal work. One innovation in this respect has been the introduction of a pilot service voucher scheme in 2008 in Italy's agricultural sector (*Il sistema dei voucher nel settore agricolo*) during the grape harvest season (Textbox 9).

Textbox 9: Service vouchers in agricultural sector, Italy

In 2008, Italy introduced a pilot service voucher scheme in its agricultural sector during the grape harvest season. The scheme sought to regularise the students and pensioners who supply their services on an occasional basis during the grape harvest season. Each worker can only work for 30 days and the maximum remuneration is €5,000 in a calendar year. Each employer can use the voucher scheme for up to a maximum of €10,000 in vouchers a year. The workers are paid using vouchers, which are credited to the workers on a magnetic card and then used to make cash withdrawals at bank machines. The magnetic card also carries information on the worker, which is relevant for Inps social security records and those of the National Institute for Industrial Accident Insurance (*Istituto Nazionale per gli Infortuni sul Lavoro*, Inail).

Early results suggest that, since August 2008, some 540,000 vouchers (worth €10 each) were sold to employers, resulting in the regularisation of 36,000 workers for 108,000 working days. Decree Law No. 112 of 2008 (Article 22), enacted by Law No. 133, has now extended the voucher scheme to all agricultural activities, and a maximum of €7,000 worth of vouchers can be used by each employer. This scheme could be further extended to other sectors and activities – including private coaching, for example music lessons, along with gardening, holiday work by young people and door-to-door deliveries.

Changing attitudes – from compliance to commitment

A wealth of research shows a correlation between low tax morality and higher levels of undeclared work (Alm et al, 1995; Alm and Torgler, 2006; Riahi-Belkaoui, 2004; Richardson, 2006). Therefore, measures to improve commitment to paying taxes are important when tackling such work. Indeed, beliefs and attitudes towards undeclared work more strongly correlate with compliance than deterrence factors (Carroll, 1987; Etzioni, 1988; Murphy, 2005, 2008; Roth et al, 1989; Smith, 1990). In an analysis of 30 countries, Riahi-Belkaoui (2004) identifies that tax compliance is strongly correlated with high moral norms, as does Richardson (2006) in his comparison of 45 countries. Similarly, Alm et al (1995) and Alm and Torgler (2006) compare the extent of undeclared work and level of tax morale across various countries and find a strong evidence that societal attitudes towards tax compliance exert a measurable and significant impact on individual behaviour.

In adopting the commitment approach, therefore, it is not simply a case that rational economic actors are being encouraged to comply by altering either the costs of undeclared work or benefits of declared work. Rather, the objective is to engender commitment to tax morality so that such ‘sticks’ and ‘carrots’ are not needed. In other words, the focus is being shifted from direct to indirect controls, or from compliance to commitment. To achieve this, a variety of measures can be employed, as outlined in the following sections.

Campaigns

One tactic for engendering commitment to tax morality to help reduce undeclared work is to run awareness-raising and information campaigns. Such campaigns can either:

- inform undeclared workers of the costs and risks of such practices;
- inform potential users of undeclared labour of the risks and costs;
- inform undeclared workers of the benefits of formalising their work, such as increasing their credibility as business people and opening up business opportunities for them;
- inform potential users of undeclared work of the benefits of formal labour.

In Denmark, the ‘Fair Play’ campaign sought to change the attitudes and behaviour of various target populations – particularly young people – by showing them what tax revenue was spent on and therefore the benefits of declared labour (see Textbox 10). The campaign was also accompanied by increased controls and sanctions. Similarly, in Latvia, employers and employees were informed about the benefits of having a formal employment contract through the campaign ‘Work Contracts Work!’. Moreover, about 9,000 employers in Latvia received a letter from the Revenue Service urging them to increase salaries to a normal level, and 3,000 entrepreneurs were requested to provide explanations regarding their low apparent earnings. In addition, members of the public were sent a letter which highlighted the risks and negative effects of undeclared wages. The letter was issued in a black envelope, entitled ‘all which is under the table is not gold’. Such campaigns, nevertheless, do not always focus on emphasising the benefits of declared work. In Estonia, billboards across cities have been used to highlight the problems of undeclared work and handouts have been given to those visiting public offices. Although such campaigns are sometimes general, others target

Textbox 10: Information campaign targeting young people, Denmark

In November 2005, the Danish Ministry of Taxation (*Skatteministeriet*) launched an information campaign aimed at young people, under the slogan – ‘Imagine what would happen if everybody did undeclared work’. The campaign was launched on the basis of several studies which have shown that young people in particular are engaged in undeclared work and have a much higher acceptance of undeclared work and tax evasion.

The campaign gives examples of a number of scenarios that might occur in society if nobody paid taxes through a series of short commercials without speech. They show images such as a football field with a broken crossbar and a ploughed-up pitch, or a library without books and a closed hospital. The purpose of the commercials is not to moralise but rather to make young people think about why they should pay taxes.

The commercials were accompanied by posters in the larger cities, along with advertisements in national newspapers and free postcards in cafés. The campaign was also linked to another initiative targeting children in the final years of primary school, which has been running for over 10 years.

specific groups, such as the aforementioned Danish campaign targeting young people. Elsewhere, in Lithuania, tourist guides have been targeted, and in Portugal campaigns have been directed at hotel owners.

Until now, the majority of publicity campaigns seem to have focused on the costs and risks of participating in undeclared work. Nevertheless, as Thurman et al (1984) highlight, this approach is ineffective as individuals often neutralise their guilt about engaging in undeclared work: for instance, by regarding the adverse consequences as the result of actions of others, who could even be big players, rather than their own actions; or by disagreeing that their activity could have adverse consequences on others. Therefore, awareness raising and information campaigns should perhaps focus on the benefits of formal work, rather than the risks and costs of undeclared work, as found in countries such as Denmark and Latvia.

In the past, relatively little attention has been paid to advertising and publicity. As a result, the European Commission (2007) has identified significant opportunities for Member States to make greater use of advertising campaigns. Indeed, the limited evidence collected so far suggests that such a strategy is both effective and cost efficient. In the UK, an evaluation of the advertising campaigns run by HMRC reveals that some 8,300 additional people had registered to pay tax, who would otherwise not have done so; this was estimated to result in a total tax payment of around GBP 38 million (€42.5 million) over three years, providing a return ratio of 19:1 on the expenditure of GBP 2 million (€2.2 million) (NAO, 2008). This compares with an overall return of 4.5:1 on the GBP 41 million (€45.9 million) a year spent on all work in the country’s undeclared economy in the period 2006–2007 (*ibid*). Thus, it appears that advertising campaigns are relatively worthwhile in terms of their cost-effectiveness.

There is also considerable scope for most countries to improve the effectiveness of their awareness raising and information campaigns. Firstly, public service campaigns could better identify and target specific markets using tailored advertisements. The latter should also vary in both form and content to target different socio-demographic groups of taxpayers. Moreover, awareness raising could be tailored to match the target audience in terms of both the language and media used. The language style and slogans appropriate for one population group, such as elderly persons, will not be effective for another group, such as those in their early 20s. Similarly, the most effective media for one group, such as newspaper advertisements, will not cater for the internet savvy younger generation. Indeed, given the shift towards reality and game shows on television, some major opportunities could also be identified to use the media more creatively in order to convey the message of tax morality.

Secondly, awareness raising and information campaigns seeking to reduce undeclared work could learn a lot from other types of campaigns. For example, such campaigns could harness the power of celebrities to influence others, as politicians, commercial advertisers and even charities already know that a celebrity spokesperson can influence others to support their project. Tax administrations could use similarly influential people to support campaigns to improve tax morality. In the US in 2007, for instance, the Internal Revenue Service made use of the internet through the popular YouTube website during the 2006 filing season, sponsoring a rap video contest, with an award of USD 25,000 (€18,540) for the best tax video. The contest was introduced in a rap video called Turbo Tax Mojo by Vanilla Ice¹², which urged people to pay their taxes on time and to use the Turbo Tax facility to do so.

Furthermore, advertising and awareness campaigns do not always have to be state led. There are many opportunities for the involvement of social partners. Indeed, targeted educational campaigns aimed at specific sectors either led by, or in cooperation with, trade associations have been pursued in many countries. In Sweden, for example, campaigns have been used to tackle undeclared work in the construction sector and taxi driving industry. In Germany, public alliances have been established between the government and the social partners in construction and transport, involving the use of public information campaigns. Elsewhere, in France, a ‘good practice charter’, agreed by sector representatives, has been implemented in the construction sector. In Bulgaria, meanwhile, the Bulgarian Industrial Association has been running an ‘In the Light’¹³ campaign since 2007, and through a number of joint initiatives, publications and information the association is trying to provoke a large public discussion to help overcome the existing problems. The initiative is supported by the country’s state institutions and trade unions. In Canada, purchasers have been targeted through a national awareness advertising campaign – ‘Get it in Writing’ – which seeks to inform the public of the risks involved in dealing with home repair and maintenance contractors in the undeclared economy. The initiative has been established in partnership between the country’s tax authority and the Canadian Home Builders’ Association, which has provided assistance in advertising and promoting this message to consumers.

However, not all campaigns have been successful. In Portugal, in 2007, the Northern Hotel Workers’ Trade Union (*Sindicato dos Trabalhadores na Indústria de Hotelaria, Turismo, Restaurantes e Similares do Norte*) started a campaign against undeclared work, which it estimated affected about a third of the workforce. Although a strike by workers was successful in encouraging one employer to pay full wages and stop paying envelope wages, others were not so successful, with one company deciding to fire all of its workers. The case is still in the court of justice. The lack of success in this area has been partly attributed to a lack of support from the country’s labour inspectorate, the Authority for Working Conditions (*Autoridade para as Condições de Trabalho*, ACT).

Appeals

The question of whether normative appeals are more effective at eliciting compliant behaviour is open to debate. Although Blumenthal et al (2001) in the US state of Minnesota reveal that normative appeals only affected some groups of taxpayers, while Chung and Trivedi (2003) find that friendly persuasion is effective, it depends on the nature of the appeal made. Hasseldine et al (2007) examined 7,300 sole proprietors in the UK, comparing the effect of five different letters of appeal, ranging from a simple offer of assistance to a letter advising that their tax return had already been preselected for audit. They found that tax compliance appeals resulted in greater compliance, particularly among those who do not pay a professional to prepare their returns. Sanction appeals, however, were found to be more effective than normative appeals.

¹² See <http://www.youtube.com/watch?v=eMudXTz4NuQ>

¹³ See <http://www.nasvetlo.net>

Appeals can also be made in the form of notification letters. In Estonia, in January 2008, the Estonian Tax and Customs Board (*Maksu-ja Tolliamet*) sent notification letters to companies with low wage levels compared with the average level in the region and the respective business sector, which might suggest that ‘envelope wages’ are present. The notification letters informed the employers of the low competitiveness of the wage levels in their companies compared with average wage levels. As a result, 46% of the companies receiving these letters adjusted the wage levels in their companies and also increased their tax payments. In January 2008, such letters were sent to 2,000 employees and 1,000 enterprises in three categories: letters were sent either to employees only, to employers only, or to both employers and employees in the same company. Employees were informed about the risks entailed in undeclared wages, such as losing social guarantees. Companies were first given an opportunity to make necessary corrections in their declarations voluntarily. Strict control measures were then employed for the companies that did not formalise their practices after receiving notification letters. According to the audit department of Estonia’s Tax and Customs Board, 46% of the enterprises that received the notification letters in 2008 started paying more taxes. The remaining 43% of companies did not react to the letters, while tax behaviour worsened in 8% of the companies. When comparing different methods of sending notification letters, the most successful in terms of improved tax behaviour were those where both the employer and the employees received the letters. In such instances, 56% of the enterprises improved their tax behaviour, while 36% did not react. After four months, the notification letters generated an additional EEK 10 million (about €639,115) in tax income – including EEK 8.8 million (€562,420) arising from notifications sent to enterprises and EEK 1.2 million (€76,695) resulting from those sent to individual employees.

Overall, therefore, the effectiveness of these measures depends not only on the nature of the appeal; it is also influenced by the individuals addressed, including their perceptions of the social norms, the fairness of the tax system and whether there is perceived procedural justice in the tax administration. In relation to the individuals addressed and their perceptions of the social norms, Wenzel (2005a) finds the following: that tax ethics causally affected tax compliance, and also that tax ethics are themselves affected by compliance levels; that perceived social norms causally affect personally held tax ethics, but only for respondents who identified strongly with their respective group; and that perceived social norms causally affect tax compliance. Wenzel (2005b) also reveals that misconceptions about social norms can have a significant impact on tax compliance. If undeclared work is viewed as extensive, tax compliance declines. Wenzel (2004b) also finds that, in Australia, when taxpayers strongly identify with the group to whom social norms are attached – that is, ethics and morality attributed to other taxpayers – they internalise the social norms and act accordingly. Thus, if tax morality is perceived as high, they engage in tax compliant behaviour; however, if morality is seen as low, non-compliance increases.

Perceived fairness and justice of tax system

The perceived fairness and justice of the tax system and administration also have a significant impact on tax morality and compliance (Wenzel, 2002). ‘Fairness’ refers to the extent to which individuals believe that they are paying their fair share of tax compared with others (Kinsey and Gramsick, 1993; Wenzel, 2004b); ‘justice’ refers to whether citizens receive the goods and services that they believe they deserve, given the taxes that they pay (Kinsey and Gramsick, 1993; Kinsey et al, 1991; Mason and Calvin, 1984; Richardson and Sawyer, 2001; Scholz and Lubell, 1998; Thurman et al, 1984); and ‘procedural justice’ implies the degree to which people believe that the tax authority has treated them in a respectful, impartial and responsible manner (Braithwaite and Reinhart, 2000; Murphy, 2005; Tyler, 1997; Wenzel, 2002). As Murphy (2005) finds, when people feel that they have been treated in a procedurally fair manner by an organisation, they will be more likely to trust that organisation and more inclined to accept its decisions and follow its directions

Tax knowledge

Given that tax morality is found to be highly correlated with the level of tax knowledge (Eriksen and Fallan, 1996; Lewis, 1982), one potential way of improving tax morality, and therefore compliance, is to improve tax knowledge. As Eriksen and Fallan (1996, p. 399) conclude: ‘a successful means of preventing tax evasion is to provide more tax

knowledge to larger segments of society in order to improve tax ethics and people's conception of the fairness of the tax system'.

Changing the organisational cultures of tax offices

Shifting towards a commitment approach requires a fundamental shift in the organisational cultures of tax administrations. Braithwaite (2002) distinguishes between 'regulatory formalism' and 'responsive regulation'. Regulatory formalism is where an agency lists its problems in advance, specifies the appropriate response and generates sets of rules to achieve these responses. This approach arguably enables process efficiency and outcome consistency to be achieved. For example, an automatic data-processing function enables tax authorities to process a large number of tax documents in a timely, impartial and fully accountable fashion. In recent years, and as displayed previously, the nature of regulatory formalism has been revised by shifting away from reliance mostly on deterrents and towards the use of incentives to engage in declared work. Greater consideration has also been given to the fair and respectful treatment of taxpayers (Bentley, 1998). Nonetheless, such 'humanising' of regulatory formalism is not the same as responsive regulation or what is also here termed as a commitment approach.

'Responsive regulation is a process that ... openly engages taxpayers to think about their obligations and accept responsibility for regulating themselves in a manner that is consistent with the law' (Braithwaite, 2007, p. 6). Such an approach seeks to win people's 'hearts and minds' in order to engender a culture of commitment to tax morality so that they will regulate themselves rather than need to be regulated by external rules. Until now, governments outside of Europe have been pioneering this approach, most prominently in Australia and New Zealand. In an evaluation of the difficulties involved in developing such a commitment approach, Job et al (2007) find that in introducing this cultural change in Australia, New Zealand, as well as East Timor, the major challenges faced by the tax administrations in implementing responsive regulation were as follows: resistance to change; meeting the legal principles of consistency and equity; allowing staff discretion while avoiding corruption; sometimes inappropriate recognition of different occupational skill sets and the language used to present the new ideas.

To summarise, a shift from compliance to commitment – or what might be termed as a move from direct to indirect controls – requires a fundamental shift in organisational culture within the government departments responsible for tackling undeclared work. Indeed, Sweden has similarly found that changing the attitudes of staff, such as tax auditors, has been one of the major requirements necessary for the successful implementation of a commitment approach.

Combining various policy approaches and measures

Developing good practice is not simply about choosing the individual policy measures that are effective at tackling undeclared work. It is also about considering the most effective way of putting these policy measures together in various combinations and sequences. After all, the array of contrasting policy approaches and measures considered in this report are not mutually exclusive. For example, governments might simplify regulatory compliance as well as introduce incentives, such as amnesties, to enable people to enter the legitimate realm; at the same time, in relation to those who fail to comply with the regulations, the government may implement tougher sanctions for those subsequently caught, while also introducing campaigns to elicit greater commitment among the public to tax morality.

A key policy issue, therefore, is deciding which combinations of policy measures are most effective at tackling undeclared work. At present, for example, measures to improve detection through inspections are often combined with campaigns seeking to raise awareness or warn customers that inspections are about to occur. Amnesty and voluntary disclosure schemes, meanwhile, are frequently followed by tougher sanctions. However, whether these combinations are more effective than others has not been evaluated thus far.

There are also various ways of temporally sequencing policy measures, some of which might be more effective than others. For instance, the Australian government in its ‘responsive regulation’ approach uses commitment measures in the first instance to facilitate compliance, followed by persuasion and only then punitive measures to tackle tax non-compliance (Braithwaite, 2007; Job et al, 2007). As Figure 2 shows, this responsive regulation approach consequently envisages a regulatory pyramid with various options that a tax authority can use to engender compliance, sequenced from the least intrusive and first-used measure at the bottom to the most intrusive at the top.

Figure 2: Compliance Model adopted by Australian Tax Office



Source: Australian Tax Office

The idea behind this approach is that a tax authority that is legitimate and engaging seriously with people’s democratic will does not need, in most cases, to pursue the coercion option at the top of the pyramid to achieve compliance. Instead, it can start with the measures at the bottom of the pyramid; if these measures do not work with some groups, the level of intrusiveness can be escalated up the pyramid until it reaches the type of intervention that elicits the desired response. This approach also recognises that compliance is influenced by many factors – business, industry, sociological, economic and psychological elements – all of which shape whether a person engages in undeclared work. The outcome is recognition of a continuum of attitudes towards compliance and different policy responses that can be temporally sequenced, starting with commitment measures and moving through to sanctions.

Whether this is the most appropriate combination and temporal sequencing of measures is open to debate. To date, no evaluation has been made of whether this sequencing of policy measures used by the Australian Tax Office is the most appropriate and effective sequencing combination for engendering compliance. Neither has it been tested whether this particular sequential approach would also be the most appropriate to use elsewhere for tackling undeclared work. In other words, although it appears an appropriate and effective way of tackling undeclared work, there is currently no evidence base. Evaluating which combinations and sequences of measures are effective and transferable, therefore, is just as important as evaluating the effectiveness and transferability of individual policy measures.

Thus, in the future, evaluations will need to be conducted of which combinations of measures ordered in what sequence are most effective. 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. At present, and as displayed throughout this report, few evaluations even exist of the effectiveness of individual policy measures, not to mention their effectiveness when used in conjunction with other measures. Only when such evaluations have been conducted, therefore, will it be possible to consider whether these policy measures could be transferable across sectors and countries, as well as which combinations and sequences of policy measures could be experimented with in different contexts.

This report has presented the range of policy approaches and measures available for tackling undeclared work. The report began by reviewing the nature of undeclared work. This has revealed that undeclared work is not the same everywhere and therefore that a policy measure which is important in one country or region for tackling undeclared work may be less effective in another. Thus, a ‘one size fits all’ approach is not appropriate for tackling undeclared work: instead, policy approaches and measures will need to be tailored to fit the particular circumstances that prevail in different countries or regions.

Nevertheless, reviewing the current policy approaches adopted in the EU27 and Norway, it appears that most countries currently use a relatively narrow range of policy measures to tackle undeclared work. On the whole, most countries seem to adopt measures that are heavily embedded in a deterrence approach, which seeks to increase the actual or perceived likelihood of detection and penalties. Notwithstanding this, there has been a noticeable increase across many countries in the use of a more enabling approach and measures, particularly preventative measures, especially since Employment Policy Guideline No. 9 was published in 2003. The outcome has been the adoption of an array of incentives both to prevent people from entering the undeclared sphere in the first place, as well as to help them make the transition to formalisation. This greater use of both ‘carrot’ alongside ‘stick’ type measures has recently been further reinforced by the European Commission’s second Communication on undeclared work, *Stepping up the fight against undeclared work*, in 2007 (European Commission, 2007). Recognising that few are pursuing measures to engender ‘commitment’ to tax morality, although deterrent, curative and preventative measures are being adopted, the Commission has recommended greater use of awareness-raising initiatives to change attitudes.

Whether the most effective and efficient approaches and measures are now being used remains open to debate, as does the question regarding which measures are most suitable for different regional and national contexts. Until now, there has been no knowledge bank available which policymakers can use to:

- determine what has been tried and tested elsewhere, and in which context;
- assess the relative effectiveness of different approaches and measures;
- evaluate the transferability of different approaches and measures across countries, sectors and occupations.

Indeed, from the policy measures reviewed for this knowledge bank, it appears that it has been more the exception than the rule for countries to have learned from the experiences of other nations before implementing policy measures. For example, the measures adopted in Poland for hiring unemployed people to work in the domestic services sphere seem to have encountered similar problems as those earlier experienced by a Dutch domestic services scheme. Moreover, the Austrian voucher system could perhaps have learned much from the extensive expertise of similar schemes in Belgium and France. Until now, therefore, attempts to actively share experiences and learn from others have been largely lacking. Indeed, it has been difficult to do so, given the lack of a resource bank that draws together countries’ experiences of developing policy measures to tackle undeclared work.

This report has sought to fill that gap. Through this report and the accompanying ‘knowledge bank’,¹⁴ pertaining to the individual countries, a wide array of policy approaches and measures being pursued across the EU27 and Norway have been evaluated, along with the feasibility of transferring them to other sectors and countries. In doing so, it has provided for the first time a pooling of knowledge on the approaches and measures available for tackling undeclared work. It is intended that this resource can be drawn on by all those who are interested in intensifying the fight against undeclared

¹⁴ See <http://www.eurofound.europa.eu/areas/labourmarket/tackling/search.php>

work. The development of such a learning hub that addresses the effectiveness of different measures is therefore an important step forward in the efforts to tackle undeclared work. Those social partners wishing to intensify the move against undeclared work now have a pool of knowledge available to them to evaluate the feasibility and effectiveness of different policy approaches and measures, along with their transferability.

To date, as the database and this overview report highlight, the evidence base on what works and what does not is perhaps not as comprehensive as desired due to the lack of evaluations of many policy initiatives. Although some comprehensive evaluations of specific measures have been carried out – which provide a solid evidence base for countries to make decisions on whether to test the initiative in their own country – many other measures have not been subject to rigorous evaluation in terms of their effectiveness at tackling undeclared work. Hence, although a knowledge bank is now available, it has become apparent that the evaluations of policy measures are fewer than first expected. Further evaluative work is therefore now required across a wide array of measures and approaches to determine their efficacy, as well as their transferability. When evaluating policy initiatives, although priority needs to be given to evaluating whether the objectives originally sought were achieved, a further fruitful way forward might also be to collect common evaluation data across all policy measures in order to harmonise evaluations. Such indicators could include the number of jobs formalised, the number of new businesses registered, the reduction in tax losses and the return-to-cost ratio of the measure. At the same time, there needs to be a better understanding of which combinations and sequences of measures operate most effectively together in different contexts.

Moreover, this knowledge bank could be further strengthened by reviewing more policy initiatives across the EU27 and Norway beyond the maximum of three measures considered in each country in this report. In addition, policy measures could be evaluated in a wider array of countries, including Australasia and North America, as well as in a broader range of transition economies and also in countries and regions in the global ‘South’. This would greatly expand the wealth of knowledge at the disposal of those wishing to review the range of policy measures available for tackling undeclared work and their feasibility and transferability. If this could be achieved, then the current knowledge bank has the capacity to become a truly global learning hub.

In summary, this overview report and the accompanying knowledge bank represent an important first step in producing a comprehensive learning hub, where social partners can pool and share knowledge on how to tackle undeclared work, review evaluations of policy initiatives and explore their feasibility and transferability to other sectors and areas. If this resource is used accordingly, then this project will have served its purpose. At the same time, it is hoped that having identified the gaps in understanding in this database, a more proactive and concerted effort can now be taken to address these shortcomings. If pursued, this database has the potential to become the prime global site for pooling expertise on the fight against undeclared work.

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