Small businesses in the informal economy

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The Small Business Council was set up in May 2000 as a Non-Departmental Public Body that:

- reports to the Secretary of State for Trade and Industry on the needs of existing and potential small businesses in order to increase their opportunities for success and growth;

- advises the Chief Executive of the Small Business Service; and

- advises and reports on the effects on such businesses of the activities and potential activities of government including the Small Business Service itself.
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At a Small Business Council meeting two years ago we got into a discussion on businesses trading in the informal economy. One member argued that she would rather see measures to encourage businesses to comply from then on, rather than the Inland Revenue refuse to compromise for fear of being seen as ‘soft’ on these people.

I asked for a show of hands and was pleasantly surprised when every single Council member, business people of all backgrounds, sectors and ages, agreed with this.

I hope that the government will realise that the small business community wants action on this area. We want to see all businesses operate on a level playing field. We want businesses currently trading in the informal economy to register, start paying tax and become productive members of the formal business community. And we want to see this happen in the most efficient way possible – even if this means an initial compromise.

There are of course businesses that simply choose to trade illegally: deliberately evading tax, refusing to meet statutory requirements and selling unlawful goods or services. With these businesses there can be no compromise.

There are, however, a great many businesses that stumble into the informal economy. Having started to trade in this way it can be very difficult subsequently to register as part of the formal economy. These businesses need assistance and incentives, not punishment and penalties.

The Small Business Council wants to see change in this area. Too many businesses in the informal economy simply stop trading for fear of getting caught. If instead they were incentivised to legitimise, there would be tremendous potential for job and wealth creation.

We also want change because it is very much in our interests as well. Informal businesses drive prices artificially low, undercut legitimate competition and can undermine reputable businesses by association.

The Voluntary Disclosure scheme we are proposing in this report is of fundamental importance. More informal businesses will legitimise if the process upon which they must embark is made transparent and non-punitive. We also urge the government to support new transition services. These would help promising entrepreneurs legitimise their operations.

The informal economy is an area that needs action. We hope that the Government will support the constructive proposals put forward by the small business community in this report.

I should like to thank Paul Harrod who has been the driving force on the Council for this Review. He has been supported by other colleagues on the Council in particular Monder Ram and Simon Topman. We are also grateful to a team of officials from the Small Business Service who helped the Council with their research and provided secretariat functions.

William Sargent
Chair, Small Business Council
November 2004
 Businesses are encouraged to comply with the law by ensuring that the level of punishments and the probability of detection outweigh any perceived benefits of non-compliance.

However, there is increasing recognition that, beyond its negative impact, the informal economy is also a potential source of formal economic growth. Its entrepreneurship is an asset to be harnessed.

Rather than seeking to eradicate the informal economy, many governments are now attempting to shift informal work into the formal economy so as to move nearer to full employment. To achieve this it is recognised that deterrents need to be coupled with positive initiatives to assist businesses to make that transition.

1.1 Aims and objectives

This report reviews:

- the extent and nature of the informal sector;
- the reasons why some businesses operate within the informal sector;
- the factors encouraging businesses to become formal;
- examples of good practice on how small businesses could be encouraged and supported to make the transition from the informal economy to the formal economy; and
- approaches through which businesses operating within the informal economy might be brought into the formal economy.

1.2 Definitions

The ‘informal economy’ is known by a host of alternative names:

- underground sector;
- black economy;
- cash-in-hand work;
- hidden economy; and
- informal employment

Despite such an array of terms there is a strong consensus on how to define such work.

“Informal work involves the paid production and sale of goods or services which are unregistered by, or hidden from the state, for tax and/or benefit purposes, but which are legal in all other respects.”

This is the definition adopted in this report. It explicitly brings to the fore an aspect of the informal economy that has been largely overlooked until now. Many people engaged in the informal economy are displaying entrepreneurial talents, skills and endeavour which need to be harnessed rather than simply deterred.
1.3 **Entrepreneurial or Illegal?**

The adopted definition also makes an important distinction. It distinguishes between business activity that would be legal if it were registered (such as cash-in-hand cleaning work) and business activity that is in itself illegal (such as human trafficking, drugs and prostitution).

Because this distinction is often not made, the basic message to all people working in the informal economy remains uncompromising. As a result many people who have simply stumbled into self-employment are discouraged from formalising their activities.

1.4 **Entrepreneurship**

Not all those working in the informal economy are entrepreneurial. Four types of informal worker can be identified:

a) **Informal Employees**

Employees working on an organised basis for businesses, often paid low wages in exploitative sweatshop conditions.

b) **Micro-Entrepreneurs**

Those starting-up fledgling business ventures who use the informal economy primarily as a short-term risk-taking strategy to enable them to ‘get ahead’ in the establishment of their growth-orientated and wealth-enhancing business enterprises.

c) **Established Small Businesses**

Those who use the informal economy in a serial and on-going manner, primarily as a strategy for ‘getting by’.

d) **Favour Providers**

Individuals who undertake casual one-off tasks as ‘paid favours’, usually for friends, family and acquaintances.

The emphasis of this report is on helping those who are creating and running small businesses in the informal economy to make the transition to the formal economy. As such it will concentrate on groups b) and c).
Government Approach

- **Distinguish between the entrepreneurial and criminal elements of the informal economy and research, plan and act accordingly.**

   It is important to distinguish between business activity that would be legal if it were registered (such as cash in hand cleaning work) and business activity that is in itself illegal (such as human trafficking, drugs and prostitution). Many people engaged in the informal economy are displaying entrepreneurial talents, skills and endeavour which need to be harnessed rather than simply deterred.

- **Complement existing deterrent measures with incentives to move from the informal to the formal economy.**

   If the objective is not to eradicate work in the informal economy, but to encourage its transfer to the formal economy, deterrents are necessary but insufficient. Incentives, help and advice will also be required to help businesses formalise their activity. A list of suggested measures is given on page 11.

- **Implement a range of experimental measures followed by vigorous evaluation.**

   The informal economy is complex, and still relatively poorly understood. It is known that no individual factor appears to be responsible for businesses operating within the informal economy, and the extensive evidence base that we gathered for this report bears that out. It is unlikely that any one individual measure alone will succeed in reducing its size. Each measure that is implemented needs to be carefully assessed for its effectiveness at preventing businesses operating informally and encouraging more businesses to operate formally.

Support for Small Businesses Wishing to Legitimise Operations

- **Simplify formalisation procedures for businesses.**

   In order to make it as easy as possible for small enterprises to start-up and grow within the formal economy, two measures are needed:
   1. Lower the costs of establishing and operating a legitimate small business;
   2. Increase the potential benefits of legal registration.

   Legal and administrative requirements such as registration and licensing can become an obstacle to micro- and small enterprises. We know that the costs of compliance per worker are much higher in small businesses than in larger firms. Where the costs of full administrative compliance are prohibitive, compliance tends to be low. Particular attention, therefore, needs to be given to relieving this burden on new and existing small businesses.

- **Introduce tax relief for business loans to friends and family.**

   The principles behind tax relief, which is offered under the Enterprise Investment Scheme (EIS) and the Community Investment Tax Credits, could be extended. In particular it is recommended that friends and family who give loans to start-ups are entitled to claim tax reductions on their tax returns. This would help put start-ups on a more formal footing from the outset and alert
the relevant government agencies to their existence. At the same time it would support entrepreneurship.

■ **Bring together JobCentre Plus and Business Link to smooth the transition from benefits to self-employment.**

Build a comprehensive approach to support for smoothing the transition from benefits to self-employment, bringing together JobCentre Plus and Business Link, to encourage self-employment in the formal economy. This should build on the work already conducted as part of the government’s review into routes into self-employment.

■ **Introduce a ‘voluntary disclosure system’ based on the ‘offer in compromise’ (OIC) model in the USA.**

The objective of the OIC programme is to establish, in advance, the procedures for voluntary disclosure so that they are clear to all parties. It also enables the Revenue Departments to accept a compromise on previous undeclared earnings when it is in the best interests of both the taxpayer and the government. Its main objective however is to promote voluntary compliance with all future payment and filing requirements. Such a system could be used as an incentive to come clean about past misdemeanours and to facilitate voluntary compliance in the future. When Revenue Canada introduced a voluntary disclosure policy, it resulted in voluntary disclosures quadrupling.

■ **Develop an independent ’one-stop-shop’ service for businesses wishing to formalise operations.**

In order to move from the informal to the formal economy, micro-entrepreneurs and businesses require help and support on a variety of issues. ‘**One-stop formalisation shops**’ could provide business support, finance assistance, legal, tax, debt and benefit advisory services. They would take a business through each and every step from informality to full formalisation.

An independent business support network is likely to attract more clients from the informal economy than one with more direct links to government. This ‘third sector’ transition service could act as an ‘honest broker’ between the entrepreneur and the Inland Revenue, in the same way that ACAS operates in Employment Tribunal cases.

### Changing Public Attitudes

■ **Run information campaigns focussing on the benefits of using formal labour.**

Information campaigns are needed to make clear the risks and costs of participation in the informal economy, as well as the benefits of using formal labour. Such publicity has the double effect of highlighting the risks involved in informality and benefits of formality, as well as strengthening trust in the system by taxpayers.

■ **Educate young people about the benefits of the formal economy through citizenship classes.**

If the formal, rather than the informal economy is to grow, then it is vital that the next generation of entrepreneurs are fully aware of its benefits. Young people can also help in the education of their parents, as has happened successfully with anti-smoking campaigns.
Changing Public Behaviour

- Introduce tax incentives for employing formal labour in domestic services and building work.

The vast majority of the informal economy is concentrated firstly in the home maintenance and improvement sector and secondly other domestic services (e.g. household cleaning, gardening, child-care). Thus any tax measures developed should target these two economic sectors. One option would be to give straightforward relief on tax returns to customers using formal labour to do specific household maintenance tasks (e.g. roof maintenance, outside painting). This could be easily incorporated into the self-assessment tax returns.

Another option is to learn from initiatives in other advanced market economies. For example the home service scheme in Denmark allows people to claim back 40% of the costs of registered home service providers. This encouraged businesses from the informal economy to register and created 3,700 full-time equivalent jobs in three years.

- Introduce subsidised vouchers for paying for formal domestic labour.

Using ‘vouchers’ to encourage employers to use formal rather than informal labour is proving popular in many advanced market economies. All four ‘voucher’ initiatives outlined in this paper are strongly recommended as ‘good practice’ in the most recent European Commission report on tackling the informal economy. Furthermore, the fact that they address the domestic services sector directly means that they could be potentially highly relevant to the UK.

The basis of each scheme is that customers buy vouchers in order to pay for domestic services. The redeemable value of the voucher is more than the cost price. The difference is paid for by government. This effectively subsidises the difference between the cost of informal and formal labour, and in doing so it reduces the number of benefits’ claimants and increases tax revenue.
What is the Informal Economy?

3.1 Definition

“Informal work involves the paid production and sale of goods or services which are unregistered by, or hidden from the state, for tax and/or benefit purposes, but which are legal in all other respects.”

3.2 How large is the informal economy?

Measuring the size of the UK informal economy is inherently problematic. By definition it is ‘hidden from the state’. Estimates of its magnitude therefore vary enormously, ranging from 1% - 34% of GDP (depending on the method used).

6.8% of GDP appears to be the most generally accepted figure.

Whatever its size, most methods suggest that the UK informal economy is growing faster than the formal economy. Its share of GDP is increasing. This is not unique to the UK. The informal economy is found to be growing relative to the formal economy across all advanced market economies, as well as Central and Eastern Europe and in the developing world.

3.3 Who engages in the informal economy?

There has been no comprehensive national survey of the informal economy. Local surveys, however, have revealed a good deal of evidence about who arranges and participates in this work and on the types of work being undertaken. A range of case studies can be found on the Street UK website (www.street.uk.com) and in Copisarow and Barbour (2004).

It is not primarily ‘marginal’ populations (e.g. the unemployed, people living in deprived areas) who engage in this work but those already in employment and residing in relatively affluent populations.

It is difficult to define individuals and businesses as operating in either the formal or informal economy. Many people and businesses actually operate in both.

Wholly underground enterprises and people working exclusively on an informal basis are now acknowledged as representing only a small proportion of the informal economy as a whole.

People who operate within the informal economy can be divided into the following three camps:

- **25%** The informal work of micro-entrepreneurs, such as those starting-up fledgling business ventures who use the informal economy as a short-term risk-taking strategy to test-out their enterprise and/or establish themselves (about a quarter of all informal work);

- **50%** The informal work of more established small businesses and self-employed people who use this sphere in an on-going and serial manner as a strategy for ‘getting by’

- **25%** The informal work of ‘favour providers’ who conduct mostly casual one-off tasks as ‘paid favours’ for friends, family and acquaintances (about a quarter of all informal work).

3.4 What type of work occurs in the informal economy?

The main types of work occurring in the informal economy can be broken down as follows:

<table>
<thead>
<tr>
<th>Type of Work</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home Maintenance and Repair</td>
<td>43%</td>
</tr>
<tr>
<td>Routine Housework</td>
<td>28%</td>
</tr>
<tr>
<td>Gardening Services</td>
<td>3%</td>
</tr>
<tr>
<td>Caring</td>
<td>11%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>85%</strong></td>
</tr>
</tbody>
</table>

This finding that the informal economy is concentrated in the construction sector and a range of domestic consumer services has important consequences for designing policy initiatives. If policy measures were to deal with the four sectors listed above they would deal with 85 per cent of all informal work.
4.1 Why do some businesses operate in the informal economy?

There are a number of factors that have been found to combine together to effect whether businesses operate in the formal or the informal economy. The European Commission has adopted the following model:

- market factors:
  - the labour market;
  - goods and services market;
  - the information market.
- institutional relations:
  - degree of trust in government;
  - degree of inclusion in society;
  - strength of bureaucracy;
  - tax level.
- characteristics of individuals/households:
  - stage in life-cycle;
  - employment status;
  - income situation;
  - available skills;
  - level of education.

What is important here, however, is not the individual factors themselves. No factor alone appears to affect the level of informal work. What matters is how these factors combine together.

4.2 Factors that encourage businesses to formalise

A simple framework for understanding what might encourage businesses to formalise more of their activity is to distinguish between ‘push’ and ‘pull’ factors, or what might be termed ‘sticks’ and ‘carrots’.

4.2a Push factors (‘sticks’)

If the objective of public policy is merely to prevent informal work taking place and not to shift such work into the formal economy, push factors alone may well suffice. Punitive measures and ever more stringent regulations can be used as ‘sticks’ to deter businesses from engaging in the informal economy. These ensure that the expected cost of being caught and punished is greater than the potential economic benefits. These measures might include:

- increasing sanctions for employers and/or employees;
- stepping up controls;
- increasing the level of punishments;
- increasing co-operation and data exchange between authorities;
- installation of cooperation networks at national, regional and local multi-disciplinary levels;
- field checks;
- introducing a fraud hotline;
- a centralised population register;
- increasing registration and identification requirements;
arranging house visits or appointments with benefit claimants unannounced and/or during regular working hours;

strict immigration policy;

border controls; and

excluding from public tenders business that have made use of informal workers.

4.2b Pull factors (‘carrots’)

If the objective is not only to eradicate this work but also to encourage its transfer from the informal to the formal economy, ‘push’ factors are necessary but insufficient. ‘Pull’ factors will also be required to help businesses formalise their activity.

These more positive measures might include:

- VAT reductions on targeted goods and services;
- targeted tax measures;
- benefit reforms;
- formalisation vouchers;
- advisory services;
- business start-up grants;

coaching, training and advice (for employers and employees) in fulfilling formalities;

anonymous telephone lines providing advice to people wanting to leave the informal economy;

campaigns to change behaviour and attitudes;

greater co-ordination of government actions;

changes to the ‘earnings disregard’ so as to legitimise much of what is currently defined as informal work; and

the creation of new institutions for exchange that might replace the reliance on the informal economy.

By using a framework of ‘carrots and sticks’ to understand the measures that can influence businesses moving from the formal to the informal economy it is easy to see that the existing measures are predominantly deterrents or ‘push factors’. But unless deterrence initiatives are complemented by an equivalent range of ‘pull factors’ public policy will be providing no help to those who may wish to formalise their business.
5.1 Simplifying formalisation procedures

In order to make it as easy as possible for small enterprises to start-up and grow within the formal economy, two measures are needed:

1. Lower the costs of establishing and operating a legitimate small business:
   - Easier registration procedures;
   - Reasonable and fair taxation.

2. Increase the potential benefits of legal registration:
   - Legal protection;
   - More favourable credit markets;
   - Access to commercial buyers in the formal economy.

Comparing the costs related firstly to taxes and secondly, administrative procedures, the International Labour Organisation’s (ILO) [2002] reports that the latter are often more burdensome. Legal and administrative requirements such as registration and licensing can become an obstacle to micro- and small enterprises. Frequently the costs of compliance per worker are much higher in small businesses than in larger firms.

Where the costs of full administrative compliance are prohibitive, compliance tends to be low. Particular attention, therefore, needs to be given to relieving this burden on new and existing small businesses.

Until now, the focus in the UK has been on providing information to help people start businesses within the existing rules and regulations. Schemes such as the Starting up in Business campaign and the helpline for the newly self-employed have been implemented.

There is also a need to evaluate the degree to which regulation hinders formalisation. There is no information about this in the UK.

5.2 Tax Incentives

The principles behind tax relief, which is offered under the EIS scheme and the Community Investment Tax Credits, could be extended. In particular it is recommended that loans given by friends and family to start-ups are entitled to claim tax reductions on their tax returns. This would help put start-ups on a more formal footing from the outset and alert the relevant government agencies to their existence, (i.e in order to claim the tax credit there would need to be proof that a loan had been made). At the same time it would encourage support for entrepreneurship and be a further measure to tackle the funding gap for early-stage businesses.

5.3 Smoothing the transition from benefits to self-employment

In order to encourage self-employment in the formal economy it will be necessary to smooth the transition from benefits to self-employment and bring together JobCentre Plus and Business Link. This should build on the work already done as part of the review into routes into self-employment.

Current initiatives to assist people wishing to move from benefits to self-employment include:

5.3i Test trading initiative

This is an initiative designed to smooth the transition from benefits to self-employment which occurs under the New Deal at the Options stage 3 and involves the participants
test-trading their business for up to 26 weeks. This normally takes place after three months in the ‘Gateway’ stage and on approval of the business plan by the self-employment provider (SEP). During the test-trading period, the participants receive an allowance equivalent to their previous benefit entitlements and in addition a grant of up to £400 paid in equal weekly or fortnightly instalments. The money the business earns whilst in the test-trading period is either ploughed back into the business or stored in a special bank account until the test-trading period has ended. The SEP provides a mentor who supports participants during the test-trading period and for up to two years subsequently. During the test-trading period, New Deal for Young People participants are also required to undertake training leading to a formal qualification.

A recent evaluation of the initiative was carried out for the DWP (Kellard et al., 2002). The evaluation report concludes that for many people entry into (and success in) self-employment remains a difficult and at times a precarious activity and hence there are considerations about how far policies should encourage potentially vulnerable groups to choose such a difficult route. For some, the consequences of self-employment failure can have financial and personal implications, although for others the experience may enhance their future chances of making successful and sustained moves into the labour force (Kellard et al., 2002: 7).

Moreover, whether such an initiative does anything to reduce participation in informal work has not been evaluated. Those involved with clients ‘on the ground’, however, are convinced that this is the case. For the ‘test trading’ initiative to become more effective, the feasibility of the following needs to be evaluated:

- drastically reducing the eligibility period (currently 18 months unemployment);
- elongating the current 26 weeks test-trading period to up to three years; and
- developing a graduated withdrawal from benefits (e.g. 100 per cent of benefits guaranteed in first 6 months, 70 per cent in next 12 months and 40 per cent in last 12 months), and a parallel graduated release of the money earned by the business that is currently stored in a special bank account until test-trading has ended.

5.3ii Back to work bonus

The ‘Back to Work Bonus’ was introduced in October 1996 with the aim of encouraging individuals and their partners to ‘keep in touch’ with the labour market. They are incentivised to undertake small amounts of work whilst still claiming Income Support (IS) or Job Seekers Allowance (JSA). The rationale was that it would provide an incentive for claimants to move from unemployment into paid work. In effect it became a measure to condone paid informal work. It works in a complex way by the accrual of a bonus if the claimant’s earnings from part-time work reduce the amount of JSA or IS they are paid. They can then claim the bonus (a tax-free lump sum of up to £1,000) if and when they move off benefit and into proper work. The bonus is accumulated from 50 per cent of the declared earnings above the ‘earnings disregard’ (normally £5) but this can only commence after 91 days of being on IS /JSA. It also has to be claimed.
5.3iii ‘Twin track’

‘Twin track’ is a Department of Work and Pensions (DWP) pilot initiative running in two Government Office Regions (Wales and the North West). Under certain conditions a ‘lighter touch’ is taken with people working whilst claiming benefit in an effort to get them into formal work via contact with a Personal Advisor. This is one way in which government policy has displayed a level of tolerance towards those attempting to make the transition from benefits to work via the informal economy. So far, any evaluation of this scheme has not been available publicly.

within 12 weeks of leaving benefit (otherwise it is lost) and it can only be paid if the claimant starts work within 2 weeks of leaving benefit. It cannot be accrued by people over 60 claiming IS although men aged 60-64 on JSA can join the scheme. If a claimant is on IS, the earnings of the claimant’s partner are taken into account in the calculation of the bonus, but this is not the case if the claimant is on JSA.

Evaluations of the scheme have been carried out on behalf of the DSS/DWP, albeit not in relation to its effectiveness at reducing the informal economy. Research is required with participants on whether this initiative facilitates a shift of work from the informal to the formal economy.
6.1 Voluntary disclosure

Rather than evaluate the use of amnesties, which has already been considered by Grabiner (2000) and dismissed, this report explores whether a system of voluntary disclosure might facilitate the transition from the informal to the formal economy. Indeed, when Revenue Canada introduced a voluntary disclosure policy, this resulted in voluntary disclosures quadrupling.

One option is to follow a model developed in the USA. This allows an ‘offer in compromise’ about taxes to be paid when an informal worker makes a voluntary disclosure. This model is looked at in detail in the box below.

Offer in compromise (USA)

In the USA, if taxpayers are unable to pay a tax debt in full, and an instalment agreement is not an option, then they may be able to take advantage of the offer in compromise (OIC) programme. Generally, the OIC is seen as a last resort after taxpayers have explored all other available payment options. The IRS resolves less than 1 per cent of all balance due accounts through the OIC programme.

An OIC is an agreement between a taxpayer and the IRS that resolves the taxpayers tax debt. The IRS has the authority to settle or ‘compromise’ federal tax liabilities by accepting less than full payment under certain circumstances. A tax debt can be legally compromised for one of the following reasons:

- Doubt as to liability;
- Doubt as to collectability;
- Effective tax administration.

Under this third option there is no doubt that the tax is correct, and no doubt it is owed, but an exceptional circumstance exists that allows the IRS to consider a taxpayer’s OIC. To be eligible for a compromise on this basis, the taxpayer must demonstrate that collection of the tax would create an economic hardship or would be unfair and inequitable.

The objective of the OIC programme is to accept a compromise when it is in the best interests of both the taxpayer and the government and it promotes voluntary compliance with all future payment and filing requirements.

Such a system could be used as an incentive to come clean about past misdemeanours and to facilitate voluntary compliance in the future. If a person comes forward who has been working informally, an OIC could in some circumstances be offered.
6.2 Transition advice and support

Following the Grabiner (2000) report, the Inland Revenue established a Tax and Benefits Confidential Advice help-line from June 2000 to provide advice to people who want to leave the informal economy. This was perhaps the first tentative step in the UK towards the provision of a ‘transition service’. The infrastructure for providing such transition advice and support should be extended.

In order to move from the informal to the formal economy, micro-entrepreneurs and businesses require help and support on a variety of issues:

- tax rules;
- benefit rules;
- insurance;
- employment law;
- health & safety;
- credit;
- loans;
- book-keeping;
- marketing; and
- regulations.

At present, however, such support and advice is generally not widely available. There is currently a significant gap in the UK between the business advice and support available to formal businesses and those who operate informally. Indeed, the kind of business advice and support required by people seeking to transfer their current business ventures into the formal economy is very different to the advice and support required by start-up or growth businesses who wish to go through a formal business planning process.

Full consideration should be given to the establishment of ‘one-stop formalisation shops’. These could provide business support, finance assistance, legal, tax, debt and benefit advisory services. They would take a business through each and every step from informality to full formalisation. Indeed, such a service might be set up in conjunction with a voluntary disclosure initiative along the lines of the OIC system discussed above.

An independent business support network is likely to attract more clients from the informal economy than one with more direct links to government. This ‘third sector’ transition service would act as an ‘honest broker’ between the entrepreneur and the Inland Revenue, in the same way that ACAS operates in Employment Tribunal cases.

The symbolic value of the transition service may be as important as its actual function. The evidence is very clear that many people working informally fear the consequences of “coming clean” to the Inland Revenue, even if those fears are out of all proportion to the action that would be taken. Having a third-sector ‘broker’ available, as well as written rules of engagement, would help to alleviate those fears.

Once this voluntary disclosure system was in place there would be no excuse for informal businesses not to take advantage of it. The flip side of this constructive approach would be that the Inland Revenue would be entitled to take an even tougher stance with any business that they discovered acting illegally and who had elected not to disclose it.
Street(UK) is a project that sets out to help businesses move from the informal to the formal economy. It provides a good example of how a ‘specialised transition service’ can be provided.

### Street(UK)

Street(UK) was set up in 2000 to offer loans, advice and business support to self-employed people and micro-enterprises, especially those wishing to formalise their business. The project has around 200 clients and they fall into two main categories:

- people claiming benefits – such as disability benefit, carers’ allowance;
- those not claiming any benefit but who are either not declaring or under-declaring income from their enterprise activity;

Street(UK)’s approach is to provide them with the tools to make the transition into the formal economy.

Since Street(UK) clients include a wide variety of people at different stages of development of their enterprises, their approach is to monitor clients’ progression in each of the areas listed below:

1. Moving from part-time to full-time work;
2. Moving from home to business premises;
3. Keeping basic level records;
4. Keeping higher level accounts;
5. Purchasing public liability and employers liability insurance;
6. Hiring employees on a PAYE basis;
7. Using a bank account for their business transactions;
8. Opening a separate business bank account;
9. Obtaining the required licences and permits to operate the business; *e.g.* Health and safety inspection certificates, driver instructor licence, etc
10. Graduating off all non-work state benefits;
11. Graduating from majority cash revenues to majority invoiced revenues;
12. Incurring a formal business tax liability; and
13. Becoming VAT registered.

This third sector community-based business finance, support and advice service thus represents one model for developing a ‘transition service’ infrastructure.
Street(UK) currently focuses on wholly informal businesses rather than those formal businesses conducting a proportion of their trade informally. This latter group constitutes the vast bulk of the informal economy, so it is likely that a ‘specialised transition service’ would look somewhat different to the Street(UK) model when implemented.

6.3 Tutors & Mentors

Although developing a business advice and support network to facilitate formalisation is necessary, it needs to be recognised that there is also a need for more informal first points of contact for such enterprises from which they might graduate to these transition services. In this regard, the development of a system of formalisation mentors or tutors may be a way forward.

6.4 Co-operatives

For transition businesses the idea of creating ‘formalisation incubators’ could also be considered. These could be co-operatives where there is joint-ownership of marketing services, secretarial support, etc.
Changing public attitudes towards informal economic activity

7.1 VAT reductions on targeted goods and services

One measure that could encourage businesses and consumers to use formal rather than informal production is to reduce VAT on goods and services where the informal economy is known to be rife (e.g. household maintenance and repair). Such a strategy has been used in numerous countries.

Whether VAT reductions lead to a formalisation of informal work is open to debate. No known contemporary evaluations have been conducted. In addition, such an approach is based on the mistaken assumption that higher taxation always leads to a growth in the informal economy, and that lower taxation reduces its size. There is no evidence that this is always and everywhere the case.

7.2 Targeted tax measures

To encourage formal rather than informal labour to be employed, a diverse range of tax measures can be used. Although some may argue for general reductions in tax rates in order to decrease the magnitude of the informal economy, more targeted strategies are considered in this report.

As mentioned previously, the vast majority of the informal economy is concentrated firstly, in the home maintenance and improvement sector and secondly, other domestic services (e.g. household cleaning, gardening, child-care). Thus any tax measures developed should target these two economic sectors. One option is to give straightforward relief on tax returns to customers using formal labour to do specific household maintenance tasks (e.g. roof maintenance, outside painting).

Another option is to learn from initiatives in other advanced market economies.

In the boxes on the following pages, a number of possible targeted tax measures that might be introduced in the UK are outlined. All have been already recommended as ‘good practice’ in the most recent European Commission report.
The ‘Rich Aunt Agatha’ Arrangement (Netherlands)

To make it easier for people to start their own business in the Netherlands, the Tant Agaath-Regeling (‘Rich Aunt Agatha Arrangement’) was introduced. It is intended for fledgling entrepreneurs who need starting capital and receive a personal loan from family and friends (Aunt Agatha). These private moneylenders are then exempt from some taxes. Such loans are often made on an informal basis. By formalising the loans the business is prevented from relying on informal arrangements, which might carry over into everyday trade. The tax incentives could also be linked to business registration, which would also help to ensure trade was conducted in the formal rather than the informal economy.

Home Service Scheme (Denmark)

The Danish Home Service Scheme began in 1994 as a pilot. It was made permanent three years later in 1997. Its aim was:

1. to compete with the informal economy;
2. to promote the development of enterprises that provide household services; and
3. to offer job opportunities for low skilled jobseekers.

Once businesses register with the Danish Commerce and Companies Agency (DCCA) to participate in the scheme, they can provide services to households (e.g. cleaning, small jobs around the home, gardening). The government reimburses 40 per cent of the cost. (Only labour costs; expenses for materials are not reimbursed.)

In 1998, 3,506 companies were registered, 91 per cent of which were one-person businesses. Households find information on companies they can hire within the scheme at the town hall and are allowed to spend a maximum of €7,000 p.a. on such services.

In 1998, 1 in 8 Danish households used the Home Service Scheme, an average of 5 times per year. Almost 90 per cent of consumers were very satisfied with the company and its services.

In 1997 alone, more than 2,000 jobs were created; by 2000, it had grown to 3,700 Full-Time Equivalent (FTE) jobs.
Changing public attitudes towards informal economic activity

Chapter 7

7.3 Formalisation vouchers

Using ‘vouchers’ to encourage employers to use formal rather than informal labour is proving popular in many advanced market economies. All four ‘voucher’ initiatives outlined below are strongly recommended as ‘good practice’ in the most recent European Commission report on tackling the informal economy. Furthermore, the fact that they directly address the domestic services sector means that they are potentially highly relevant to the UK context.

The Melkert initiative in Holland

According to a 1995 survey in the Netherlands, one family in three needs more help at home, especially with cleaning, washing and ironing clothes (Cancedda, 2001).

Under the ‘Melkert Plan’, a programme was implemented in 1998 to subsidise the wages of declared domestic cleaners so that they could compete with informal domestic workers. Under this Cleaning Services for Private Persons Arrangement (RSO, Regeling Schoonmaakdiensten Particulieren), a subsidy of not more than 19,000 NLG was granted for every long-term unemployed individual hired by a private cleaning company.

The government, in effect, paid the difference between the cost of formal and informal domestic cleaners. The government thus paid a subsidy to firms to hire formal domestic cleaners rather than benefits to the unemployed. In 1997, only 250 jobs were created. In 1998, however, changes were made to the scheme and it now functions better. Cleaning companies however, have more trouble finding workers than they do customers since the potential workers are required to have been registered unemployed for at least a year, which excludes many women who would like such work but have not been registered unemployed.

The Melkert Plan also created subsidised jobs in other spheres of domestic service beyond cleaning, including home help services and childcare. In the realm of home help, the finding was that some of these jobs were replacing regular formal jobs. Moreover, some 1,700 Melkert jobs were created in the sphere of child-care by the end of 1998 (Cancedda, 2001).4

These Melkert schemes were thus not as successful as originally expected and are not recommended here.

Local Employment Agencies (Belgium)

In the mid-1990s in Belgium, Local Employment Agencies (Plaatselijke Werkgelegenheidsagentschappen; PWA) were introduced in all municipalities. These bring together the supply of labour of the long-term unemployed and the demand for labour in the domestic services sphere. Its legal form is a non-profit association, with local politicians and social partners on the executive board. Private persons, government bodies and firms buy vouchers. One voucher, with which one can pay for one hour of work, costs €7.45. When a household needs a job done (e.g. some odd jobs around the house), it makes its demand known at the PWA. The agency then searches its files for a suitable supplier. The worker receives the vouchers as payment and exchanges them for money at the PWA. They receive €4.10 per voucher/hour. The difference between the buying and selling price of the voucher is used for overheads and insurances. The long-term unemployed who earn the money can keep it as extra earnings alongside their social benefits allowance.

By June 1999, 120,904 unemployed were registered at PWAs, 38,500 of whom were active and working an average of 30 hours per week. Between 1994 and 1999, 37 million cheques were sold, almost two-thirds to private households. An evaluation of this scheme found that 44 per cent of the work now conducted by PWAs was previously done on an informal basis and 84 per cent of users of the PWA were glad not to have to turn to the informal economy (de Sutter, 2000).

Since many of the unemployed decided to stay in this scheme rather than seek a formal job, however, the Belgium government decided at the end of 2003 to transfer vouchers sold to private households into the ‘service vouchers’ scheme. The other purchasers of vouchers (i.e. government bodies and firms) remain in the PWA.
### Service Vouchers (Belgium)

This ‘service vouchers’ scheme was again created with the aim of stemming informal work in the household services sector. A household buys vouchers for a price of €6.20 (for an hour of work), which it then uses to purchase the services of certified businesses. These companies hire the unemployed at first on flexible contracts but after six months, the business has to offer them a permanent contract of at least a 50 per cent of the full time employee (FTE).

An employee of a certified company is allowed to do the following activities: housecleaning; washing and ironing; sewing; errands; and preparing meals. The household pays with the vouchers, the face value of which is €19.47 (to be indexed from 2005). The difference is paid to the company by the federal government. Households can recover 30 per cent of the price of the voucher in their tax return. So for them the price of a voucher for one hour is €4.34.

The Belgian government hopes to create 25,000 jobs by the end of 2005 when a full evaluation will be conducted. By July 2003 in Flanders alone, 10,000 cheques were sold (in three months) which is the equivalent of 350 jobs (Smets, 2003) and in November 2003, the system of service vouchers created 2,000 jobs (Rubbrecht and Nicaise, 2003). In 2004, the vouchers provided under the PWA scheme to private households (see above) are being transferred into the service voucher scheme. All other purchasers remain in the PWA. More than 40,000 users have bought vouchers, which have created 4,200 jobs. Altogether, 1.7 million vouchers have been sold and there are more than 600 certified companies providing help.

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### Cheque Emploi Service (France)

In France to combat informal work in the domestic services sphere (e.g. cleaners), the government in 1994 introduced the Cheque Emploi Service (CES) to simplify the process of hiring and paying a domestic worker and making social security contributions. In this scheme, anybody can legally employ a domestic worker, without complying with extensive administrative procedures and labour contracts, by paying his or her salary with the cheques, which can be purchased at the local bank. The benefit for the purchaser is that they can claim an income tax reduction of 50 per cent of the sum spent on purchasing such cheques.

At the end of 1995, 250,000 permanent users were registered, 160,000 being new customers of domestic services. Since its introduction, the number of households legally using domestic services grew to 800,000 in 2002 creating the equivalent of 88,000 FTE jobs (Adjerad, 2003), displaying how this scheme has legalised a significant share of the informal economy in domestic services.

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A similar scheme was created in 1996, the Titre Emploi Service (TES). The essential difference to CES is that vouchers are obtained not through a bank but through work councils, regional and local authorities and welfare associations. These institutions provide the vouchers to their employees and members to enable them to hire formal domestic help. For those employing domestic workers, therefore, there is now a clear reason for employing formal workers rather than paying on an informal basis for such services.

Six years after its introduction, a total of 1.3 million TES have been used, representing a value of €15.7 million, which is roughly equivalent to 1,000 FTE jobs [Guimot and Adjerad, 2003].

Formalisation vouchers could be used to stem the informal economy in the domestic services sector, which constitutes somewhere around a quarter of the UK informal economy. Vouchers could also be developed to cover the home maintenance and improvement sector, and the care sector. This would allow such a scheme to cover 85% of the informal economy.

### 7.4 Awareness raising and information campaigns

As well as practical incentives, awareness raising and information campaigns are required to encourage the transition from the informal to the formal economy. These need to make clear both the risks and costs of participation in the informal economy, as well as the benefits of using formal labour.

Awareness campaigns, recommended by the ILO as good practice, can do some or all of the following:

- Inform informal workers of the costs and risks
e.g. lack of advice, finance and opportunities
- Inform informal workers of the benefits of being formal
e.g. legal protection, holidays, sick pay, opportunities
- Inform potential users of informal labour of the risks and costs
e.g. no guarantee of quality
- Inform potential users of the benefits of employing formal labour
e.g. better legal protection.

Such campaigns can be either general awareness raising initiatives or targeted at particular sectors. It might be more effective to emphasise the benefits of working rather than the costs of working informally.

Publicity has the double effect of highlighting the risks involved in informality and the benefits of formality, as well as strengthening trust in the system by taxpayers. Both effects are essential, since compliant taxpayers must be confident of the state’s ability to prevent tax evasion, while informal workers must recognise the risks that they incur and benefits of formalisation.

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7.5 Previous Campaigns
In the UK, awareness raising and information campaigns have included a ‘targeting fraud’ pilot project in the North West between May and October 2000. This sought to publicise sanctions and encourage people to report fraud. TV and radio commercials were used to present case studies and these were supported by newspaper advertising and billboards. Little emphasis was put on the benefits of working formally, however, merely the risks of working informally. The results are not known.

7.6 Young people
Information campaigns could also be developed to target young people through:

- Extending the recommendations of the 2002 Davies Review of ‘Enterprise and Economy in Education’.
  This could include discussion of ethical issues for and against working informally as well as the benefits of paying tax. It could use the ‘Red Box’ educational game developed by the Inland Revenue in citizenship classes.

- The development of entrepreneurial skills.
  For example using the National Foundation for Teaching Entrepreneurship (NFTE) model.

- Developing generic financial management skills in schools.
8.1 Co-ordinating government actions

In addition to incentive measures and information campaigns, the co-ordination of government actions is required to help business activity move from the informal to the formal economy.

A large number of government institutions and agencies are involved in various aspects of tackling this problem. The outcome is that initiatives are often not ‘joined up’, leading to confusing messages.

Options for ‘joining up’ thinking and action in the UK might include:

■ expanding the Cross-Government Working Group to incorporate all relevant bodies. e.g. other departments, the voluntary sector, business representatives and academe;

■ establishing an Informal Economy Task Force located in a specific Department;

■ developing a free-standing more permanent agency located either inside one government department or independent of departments;

■ developing local organisations responsible for local action, as in France and Italy. These could be based in Regional Development Agencies, Business Links, local authorities or Chambers of Commerce.

One way forward may be for the body made responsible for tackling the informal economy in central government to set targets. Local authorities, due to their detailed knowledge of the local configuration of the informal economy, could then become responsible for delivery, working with the business support and advisory ‘transition services’. This might provide a framework responsive to a geographically diverse phenomenon.

8.2 Research gaps

■ Analysing the informal economy
The evidence on the extent and nature of the informal economy remains at best, very patchy and at worst, non-existent. No national survey has evaluated the extensiveness of the informal economy and its characteristics. As a consequence, it is not known how many businesses currently conduct some or all of their trade in the informal economy, the sectors affected and the types of business and people prone to using informal work. Such research is desperately needed. Until this is known, it will be difficult to be certain whether policy initiatives are targeting the major sectors where this work prevails and the principal types of informal work and worker. Targeting the registered unemployed and wholly underground businesses in the past, when these constitute only a small proportion of all informal work has shown that there is a great need for concrete empirical evidence to tackle this sector effectively.

■ Household Survey
It is now widely accepted that surveys of household ‘coping strategies’ generate reliable data on the extent and nature of informal work. These investigate households both as suppliers and customers of informal work, along with their motives for participation in this sphere. Until now, no representative national survey has been conducted. Only locality-studies exist. It is recommended that a representative national
survey is conducted. This could fill many of the significant gaps in understanding, including the sectors in which informal work occurs, where it is prevalent, who engages in such work and why. It would also establish the relationship between the informal economy and illiteracy, the lifecycle, local ‘work cultures’, employment histories, employment status and so forth.

■ **Business Survey**
A survey of a representative national sample of businesses to investigate the prevalence and character of the informal economy is also required. This would evaluate how, and to what extent, businesses are affected by the informal economy. It would assess where they have come across work ‘off-the-books’; their views on why trade is conducted ‘off-the-books’ and what, if anything, they believe is required to encourage formalisation. A final section of this anonymous survey might contain an optional section on whether their business has engaged in such work, what they did and why. With background data on the sector of the business, location, firm size, etc, this would provide a detailed map of the prevalence and character of the UK informal economy.

■ **Evaluating current policy initiatives**
Further work is required on evaluating the effectiveness of a number of policy initiatives in stemming informal work before a decision is taken either to transfer these measures to the UK or to develop them as a means of curtailing the informal economy.

■ **Co-ordinating actions**
Given that the range of initiatives seem likely to expand and that a rapidly growing number of agencies are becoming ever deeper involved in this issue, there is a need to move towards ‘joining up’ thought and action with regard to the informal economy.
The Small Business Council and its approach

The Small Business Council is an advisory Non-Departmental Public Body established in May 2000 to advise the Government about the needs and concerns of small businesses. The council is made up of 23 small businesses owners/managers (including the Chairman) and one academic. Council members come from a variety of backgrounds, business sectors and different parts of the UK. The Chair of the Council is William Sargent.

The Council’s terms of reference are:

■ To report to the Secretary of State for Trade and Industry on the needs of existing and potential small businesses in order to increase their opportunities for success and growth;

■ To advise the Chief Executive of the Small Business Service; and

■ To advise and report on the effects on such businesses of the activities and potential activities of Government including the Small Business Service itself.

Members of the Council are:

William Sargent Framestore-CFC
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University of Leicester Management Centre and its approach

To aid the production of this report, the University of Leicester Management Centre (ULMC) produced a specially commissioned volume that synthesises what is known about the UK informal economy and investigates its implications for public policy.9

The University of Leicester Management Centre is one of the largest providers of distance learning management education in the UK and a full-range provider of undergraduate, specialist Masters, MBA and PhD programmes. As one of the leading research centres worldwide for ‘critical management studies’, its aim is to challenge the prevailing orthodoxies in management and business studies. One way this is pursued is by pioneering new fields of enquiry in important subject areas so far considered unworthy of inspection. Its study of the informal economy constitutes a part of this agenda to extend the study of management and business beyond its conventional confines into virgin territories.

Colin C Williams, Professor of Work Organisation, leads the research on this issue within ULMC. He is author of over 100 academic journal articles and 16 books on the informal economy and related issues, including *Informal Employment in the Advanced Economies* (1998, Routledge) and *Cash-in-Hand Work* (2004, Palgrave-Macmillan).

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Small Business Council steering group

Members:
Paul Harrod
Monder Ram
Simon Topman
Sources of Information

This report has been based on information from many sources, including a specifically commissioned report from Professor Colin Williams of the University of Leicester Management Centre and interviews with:

- Small and medium-sized enterprises and their representative organisations;
- Government Departments;
- Small Business Service;
- East London Small Business Centre;
- Street(UK);
- Community Links; and
- National Federation of Enterprise Agencies.

It also includes information received through numerous written submissions.

Below is a full list of contributors. We are very grateful to all of them.

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