Small businesses in the informal economy: the evidence base

Colin C Williams, University of Sheffield
Informal Economy

Small Businesses in the Informal Economy: making the transition to the formal economy
Evidence and key stakeholder opinion

2005
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.
Informal Economy: Evidence and key stakeholder opinion

Background

In this report, the term informal economy is used to refer to entrepreneurs who are producing legal goods and services but who are hidden from the state for tax or benefits purposes.

The informal economy causes a number of problems for legitimate businesses, not least:

- the unfair competitive advantage of firms who use informal labour;
- the emergence of ‘micro-level de-regulatory cultures’ – companies operating informally creates pressure on law-abiding competitors to move away from regulatory compliance; and
- as formal businesses ‘informalise’ to compete, ‘hypercasualisation’ takes place in the labour market – that is, there is an increase in casual employment, sporadic self-employment and informal employment supported by social security fraud.

The existence of the informal economy also has important broader social costs:

- it is fraudulent activity that causes a loss of revenue for the state in terms of non-payment of Income Tax, National Insurance and VAT;
- it leads to a loss of regulatory control over the quality of jobs and services provided in the economy;
- if a significant proportion of the population is routinely engaged in illegal activity, it may well encourage a more casual attitude towards the law generally; and
- it can lead to the exploitation of individuals and specific groups.

The Small Business Service, on behalf of the Small Business Council has sought evidence and opinion during 2004 to improve understanding of the nature and extent of the informal economy.

Report Structure

The report is formed of two main sections. The first is focussed on available evidence from UK and overseas literature. That is, testable findings that have an underlying research methodology or data source. The second section contains the views of businesses and other key stakeholder and interest groups. The views expressed in this section are experiential or anecdotal rather than from a testable source.

The following outlines what is included within the two sections:

Section A

An international literature review carried out by Professor Colin Williams of the University of Leicester Management Centre.

Colin is a Professor of Work Organisation at the University of Leicester Management Centre. He has written some 15 books and over 100 academic journal articles on the informal economy and related issues, including Informal Employment in the Advanced Economies (1998, Routledge) and Cash-in-Hand Work (2004, Palgrave Macmillan).

Section B

A summary of responses to a call for submissions and meetings with key stakeholders.
International Literature Review

This was a review of the current literature and data sources, which aimed to:

- provide a comprehensive overview and understanding of the current position;
- identify key issues; and
- outline issues for future research.

This study was commissioned by the Small Business Service on behalf of the Small Business Council and undertaken by Professor Colin Williams of the University of Leicester Management Centre. The key sources drawn upon are described in the bibliography.

Call for submissions and stakeholder meetings

A call for submissions – with structured questions – was sent out to key stakeholders to obtain their views, opinions and experiences of the informal economy. An overview summary of the responses is provided.

Some meetings were also carried out with key stakeholders to complement the submissions.
Small businesses in the informal economy: making the transition to the formal economy

International literature review for the Small Business Council

Professor Colin C. Williams
University of Leicester Management Centre (ULMC)
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1 Throughout this report terms such as small firms and small business are interchangeable with the term small and medium sized enterprises and are used to signify businesses employing up to 250 people and turnover of less than 50 million.
SECTION B
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The key question considered in this study is how can those businesses conducting some or all of their trade outside the formal economy be persuaded to transfer such activity into the legitimate sphere? The evidence demonstrates that to achieve this, the deterrence (‘push’) approach needs to be coupled with an enabling (‘pull’) approach that encourages and helps businesses to formalise their activity.

Aims and Objectives
This report gathers together what is known about the informal economy and explores the public policy implications of the findings. To do this, it reviews:

- the rationales for encouraging the formalisation of informal businesses and activities;
- the extent and nature of the informal sector;
- the reasons why some businesses operate within the informal sector;
- the factors encouraging businesses to become more formalised;
- ways that informal businesses might be brought into the formal economy; and
- examples of good practice from the UK and abroad showing how businesses are being encouraged and supported in making the transition to the formal economy.

Background
In 2003, the European Council decided that tackling the informal economy should be one of its top ten priorities for employment reform. This was because of the wide range of ways in which individuals and businesses are systematically disadvantaged by operating outside the formal economy, as well as the individual and societal benefits of formalisation. Since then, public policy-makers throughout the member states have been considering what can be done about such work.

Until now, UK public policy has predominantly pursued the eradication of such work using a deterrence approach. This sought to ensure that the probability of detection and the level of punishments outweighed the economic benefits of participating in the informal economy (e.g. Grabiner, 2000). It is now increasingly evident, however, that governments do not wish to simply eradicate the informal economy. They also want to shift informal work into the formal economy to support the goal of full employment.

Deterrence measures, though necessary, are insufficient. There is an emerging recognition that deterrence needs to be coupled with initiatives to help those currently participating in the informal economy to make the transition to the formal economy. It is in this broader context that the Small Business Service commissioned this report to inform a report on the informal economy prepared by the Small Business Council.

Key findings
Measuring the size of the UK informal economy is inherently problematic, not least
because, by definition, it is hidden from, and unregistered by, the state. Reflecting this, estimates of its magnitude range from 1–34 per cent of GDP (depending on the method used), with 6.8 per cent being the average guesstimate.

About half of the UK informal economy is located in the construction sector, particularly the home improvement and maintenance sphere, and another quarter in a range of other domestic services (notably routine housework, gardening services and caring).

Analysing who engages in this work, it is not primarily ‘marginal’ populations (e.g. the unemployed, people living in deprived areas) but those already in employment and residing in relatively affluent populations. Indeed, although informal work continues to be popularly depicted as conducted by people working as employees for informal or formal businesses (often on an exploitative low-paid basis under sweatshop conditions), such an arrangement applies to less than five per cent of all such work. Instead, the vast majority is carried out on a self-employed basis, of which three kinds can be identified:

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

- the informal work of more established small businesses and self-employed people who use this sphere in an ongoing and serial manner as a strategy for ‘getting by’ (around a half of all informal work); and

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

The causes of the informal market are complex. It is the result of a number of economic, social, institutional and environmental conditions that defy simple explanation. Consequently, the informal market can only be tackled successfully by a joined-up set of policy initiatives that deliver both pull and push pressures.

To complement deterrence (push) measures, the following ‘pull’ initiatives currently operate in Europe and elsewhere:

### Demand-side measures

- Tax relief for friends and family who loan money to business start-ups, such as the Rich Aunt Agatha arrangement in the Netherlands, so as to encourage business to start-off on a more formal footing rather than see itself as engaged in informal arrangements, which might carry over into everyday trade;

- Tax incentives for those employing formal labour to do specific domestic tasks that are popularly carried out in the informal economy, for example, the Home Services Scheme in Denmark; and

- Voucher schemes to encourage the use of formal labour in the domestic services sphere. Good practice includes the Local Employment Agencies and Service Voucher schemes in Belgium and the Cheque Emploi Service and Titre Emploi Service schemes in France.
Executive Summary

Supply-side measures

- A voluntary disclosure system such as the ‘offer in compromise’ system in the USA.
- Transition services like Street UK. This is a one-stop formalisation shop that offers support and advice for those seeking to make the transition to the formal economy.
- Formalisation mentors like the Prince’s Trust to provide a first point of contact for informal enterprises from which they might graduate to using the above advisory and support services; and
- DWP’s test-trading, ‘back to work’ bonus and ‘twin-track’ initiatives to help those working whilst claiming to make the transition to the formal economy.

Awareness raising and information campaigns

Focusing on the benefits of formal work for customers and suppliers, rather than the risks and costs of informal work, these can be either general campaigns or targeted at specific sectors (e.g. home improvement and repair as well as domestic services).
Introduction

How many entrepreneurs start-up their business conducting either a portion or all of their trade on a ‘cash-in-hand’ basis? What should be done about those who start-up in this manner and continue to participate in the informal economy once they are established? Should governments adopt ever more punitive measures to eradicate such business enterprises? Or should they take measures to formalise informal business ventures? These questions provide the starting point for this report.

1.1 The policy background

In 2003, the European Council decided that tackling the informal economy was to be one of its top ten employment reform priorities (European Commission, 2003). Member states have therefore been considering what can be done about such work. The aim of this report is to explore what is known about the informal economy.

Until now, in both the UK and other advanced economies, public policy towards the informal economy has been largely based on deterrence. It has sought to ensure that the probability of detection and the level of punishments outweigh the economic benefits of participating in the informal economy (e.g. Grabiner, 2000). economy. However, increasingly governments also want to shift this work into the formal economy to promote full employment. As Anna Diamantopoulos, Commissioner for Employment and Social Affairs, so clearly puts it,

“Member states must increase efforts to quantify undeclared work, to cut it down and to transform it into regular employment. This is vital because of the direct link between combating undeclared work and hitting the Lisbon target of full employment by 2010 within a sound macroeconomic environment” (European Commission, 2002:1).

In consequence, there is a growing appreciation that deterrence measures, though necessary, are insufficient. To transfer such work into the formal economy, deterrence needs to be coupled with initiatives that help those currently operating in this sphere to formalise their operations.

It is in this broader context that the Small Business Service commissioned this report to inform a report on the informal economy prepared by the Small Business Council.

1.2 Definitions and research focus

The ‘informal economy’ is known by a host of alternative names such as the ‘underground sector’, ‘black economy’, ‘cash-in-hand work’, the ‘hidden economy’ and ‘informal employment’. Indeed, some 35 different adjectives and six nouns have been used to denote this sphere (Williams, 2004a). Despite such an array of terms, however, a strong consensus exists on how to define such work. Informal work involves the paid production and sale of goods and services that are unregistered by, or hidden from, the state for tax and/or benefit purposes but which are legal in all other respects [European Commission, 1998; Feige, 1999; Portes, 1994; Thomas, 1992; Williams and Windebank, 1998, 2001a,b]. It includes only paid work that is illegal because of its non-declaration to the state for tax and/or social security purposes. Paid work in which the good and/or service itself is illegal (e.g. drug trafficking) is excluded, as are businesses operating in a ‘non-cash’ environment.
In this report, the view of the 'informal economy' very much conforms to this widely used definition. Here, the informal economy refers to entrepreneurs who are producing legal goods and services but who are unregulated in the process of production. This working definition is adopted in this report because it explicitly brings to the fore an aspect of the informal economy that has been largely hidden from view until now, namely that many engaged in the informal economy are displaying entrepreneurial talents, skills and endeavour which need to be harnessed rather than simply deterred.

What does 'entrepreneurship' mean in this context? Currently it is a contested term with numerous, contrasting definitions (e.g. Casson, 1990; Galloway and Wilson, 2003; Hurley, 1999; Morrison, 2000). For the purposes of this report, we take it to mean 'risk-taking activities that are aimed at creating or running a growth-orientated and wealth-enhancing new business venture' (e.g. Beaver, 2002; Levie, 1999; Reynolds et al, 2001).

Four types of informal worker can be identified:

- 'informal employees' working on an organised basis for businesses [often on low wages in exploitative sweatshop conditions];
- 'micro-entrepreneurs' such as 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;
- more established small businesses who use the informal economy in a serial and on-going manner, primarily as a strategy for 'getting by'; and
- 'favour providers' who undertake mostly casual one-off tasks as 'paid favours' usually for friends, family and acquaintances.

Since this report looks at those who are creating and running small businesses in the informal sphere, the first and last types of informal worker are not its principal focus. Instead, it considers how the middle two groups (ranging from 'informal micro-entrepreneurs' to small businesses working on an informal basis) have been helped to make the transition from the informal to the formal economy in various different countries.

Aims and objectives

Through a review of the current literature and data sources, the aim of this report is to: (i) provide a comprehensive overview and understanding of the current position, (ii) identify key issues, and (iii) outline issues for future research. To achieve these aims, the following objectives are addressed:

- identify established rationales for encouraging the formalisation of informal sector businesses and activities;
- define the extent and describe the nature of the informal sector in England;
- identify and describe the reasons why some businesses operate and remain within the informal sector. In particular, identify and describe the barriers which keep businesses in the informal economy;
- identify the factors encouraging businesses to become more formalised; and
- identify approaches and policies that have been implemented in the UK and other countries to encourage businesses to move into the formal sector.
This report has reviewed a large amount of literature on this topic in the form of peer reviewed academic journal articles, books and official reports and data. Although the focus has been upon the UK, where relevant, literature has been incorporated from other developed market economies. However, a sizeable proportion of the literature relates to the developing world. This has been incorporated only where it has a direct bearing on understanding the UK situation.

Reports and literature produced by professional bodies, banks or other non-governmental organisations, have been included in the review, but great care has been taken when using such sources to consider and acknowledge the reliability or otherwise of their findings.

There is also a growing body of evidence held by various institutions, programmes and agencies. The European Commission, for example, is researching and collating evidence on how to formalise the informal economy. The approaches that they are adopting, as well as the evidence that has informed their approach, have been reviewed in some depth (e.g. Commission, 1990, 1998; Mateman and Renooy, 2001; Renooy et al, 2004). Outside the EU, institutions such as the ILO (already mentioned) and OECD also have active informal economy research programmes that have been mined for relevant data and information on approaches.

In the UK, a number of groups are reviewing the informal economy. These include:

- the cross-government Informal Economy Steering Group set up primarily to implement the Grabiner (2000) recommendations;
- the Cross-Cutting Policy Team in the Inland Revenue that is primarily investigating the informal economy from the perspective of tax-compliance;
- the Illegal Work Stakeholder Group;
- the Office of National Statistics (ONS), which is seeking to understand measurement methods; and
- the Office of the Deputy Prime Minister (ODPM) ‘Employment and Enterprise’ project team that is examining this topic from the perspective of ‘worklessness in deprived neighbourhoods’ (Evans et al, 2004).

As part of this report, public reports produced by these teams have been reviewed.
The rationales for formalising the informal economy are rooted in a wider appreciation of how both individuals and businesses can be disadvantaged by operating outside the formal economy and the recognition that there are benefits to formalisation.

For individuals, formalising their informal work can resolve a number of direct practical problems including:

- a lack of access to health and safety standards in the workplace [e.g. Evans et al., 2004; Gallin, 2001; ILO, 2002];
- a loss of various employment rights such as annual and other leave, sickness pay, redundancy, training [e.g. Evans et al., 2004];
- low job security [e.g. Jordan and Travers, 1998; Ross, 2001];
- an inability to get an employer’s reference [e.g. ILO, 2002];
- a lack of access to a range of other legal rights such as the minimum wage and the Working Tax Credit [e.g. Jordan and Travers, 1998; Leonard, 1998; Renooy et al., 2004; Sassen, 1997;];
- an inability to gain access to credit [e.g. Kempson, 1996; Leonard, 1998];
- an inability to build-up rights to the state pension and other contributory benefits, and a lack of access to occupational pension schemes [e.g. Gallin, 2001; ILO, 2002; Sassen, 1997];
- a lack of bargaining rights [e.g. Dagg, 1996; ILO, 2002; Ross, 2001];
- a loss of employability, due to the lack of evidence of engagement in employment; and
- a fear of detection and risk of prosecution due to their activities being illegitimate [e.g. Cook, 1989, 1997; Grabiner, 2000].

For businesses, meanwhile, facilitating the formalisation of informal enterprises helps resolve a number of problems. Informal businesses can overcome problems resulting from operating outside, or at the margins, of the formal sector. These include:

- pressurisation into exploitative relationships with the formal sector [e.g. Benton, 1990; Gallin, 2001; Lobo, 1990a,b; Williams and Windebank, 1998];
- lack of legal protection relative to legitimate businesses [e.g. Castells and Portes, 1989; ILO, 2002; Williams and Windebank, 1998]; and
- problems developing and growing a business due to difficulties in getting access to capital and securing the support available to formal businesses [e.g. ILO, 2002].

For legitimate businesses, the informal economy underpins a number of problems including:

- the unfair competitive advantage of firms who use informal labour [e.g. Grabiner, 2000; Renooy et al., 2004; Evans et al., 2004];
- the emergence of ‘micro-level de-regulatory cultures’ – where formal businesses feel compelled to informalise to compete [e.g. Grabiner, 2000; Renooy et al., 2004; Williams and Windebank, 1998]; and
- the competition between informal and formal workers and businesses generates ‘hypercasualisation’ in the labour market – that is, there is an
increase in casual employment, sporadic self-employment and informal employment supported by social security fraud. (e.g. Gallin, 2001; Mateman and Renooy, 2001; Evans et al, 2004); The existence of the informal economy also has important broader societal costs:

- it is fraudulent activity that deprives the state of Income Tax, National Insurance and VAT revenues (e.g. Evans et al, 2004; Grabiner, 2000; Williams, 2004a; Williams and Windebank, 1998);
- it has knock-on effects on attempts to create social cohesion by reducing the money available to governments to pursue social integration (e.g. Williams and Windebank, 1998);
- it results in weakened trade union and collective bargaining (e.g. Gallin, 2001);
- It leads to a loss of regulatory control over the quality of jobs and services provided in the economy (e.g. Gallin, 2001); and
- if a significant proportion of the population is routinely engaged in illegal activity, it may well encourage a more casual attitude towards the law generally (Renooy et al, 2004).

The above evidence suggests that a concerted effort is required if activities in the informal economy are to be legitimised.
This section looks at the magnitude and character of the UK informal economy.

5.1 **Size of the informal sector**

Given that the informal economy is by its very nature hidden from, or unregistered by, the state, estimating its size is a difficult task. The methods used until now range from direct surveys to indirect measurement by statistical analysis of data collected for other purposes (Bajada, 2002; Thomas, 1992; OECD, 2002; Renoy et al, 2004; Williams, 2004a; Williams and Windebank, 1998). These indirect methods use measures including:

- non-monetary proxy indicators (e.g. based on labour force estimates, the number of very small enterprises, electricity demand);
- monetary indicators (e.g. the number of large denomination notes in circulation, the cash-deposit ratio or level of money transactions); and
- income/expenditure discrepancies either at the household and/or national level. The average estimate of the size of the informal economy in the UK is 6.8 per cent of GDP, which puts the UK at the lower end of the scale in terms of western nations (see Table 1). Indeed, whichever measurement technique is employed, the UK is usually shown as having a relatively small informal economy compared with other advanced market economies.

However, using different methods produces some varying measures of its size. For

### Table 1: Estimates of the size of the informal economy in advanced economies, as % of GDP

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<th>Highest</th>
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<td>11.2</td>
<td>20.0</td>
<td>15.6</td>
</tr>
<tr>
<td>Italy</td>
<td>7.5</td>
<td>30.1</td>
<td>17.4</td>
</tr>
<tr>
<td>Greece</td>
<td>28.6</td>
<td>30.2</td>
<td>29.4</td>
</tr>
</tbody>
</table>

Source: Williams (2004a: Table 6.11)
example, as Table 2 shows, for the period 2000 until the present, estimates of the size of the UK informal economy have ranged from 2 per cent of GNP using direct survey methods (Pedersen, 2003) to 12.3 per cent using the cash demand approach of Schneider (2001).

Nevertheless, whatever its size, most methods suggest that the UK informal economy is growing faster than the formal economy as a percentage of GDP. This is not unique to the UK. The informal economy is growing relative to the formal economy across not only all of the advanced market economies but also in central and east Europe and the developing world (ILO, 2002).

| Table 2: The size of the UK informal economy as % of GNP: by year and measurement method |
|-----------------------------------|---|---|---|---|---|---|---|
| Direct surveys | 1.5 | | | | | | 2.0 |
| Tax auditing | | 9.7-12.9 | | | | | |
| Income/expenditure discrepancy | 2.5 | 3.6 | 5.5 | | 10.6 | | |
| Physical input method | | | | | 13.2 | 13.1 | |
| Currency demand (Tanzi) | 4.3 | 7.9 | 8.5 | 9.7 | 14.3 | 12.7 | 12.5 |
| Cash deposit ratio (Gutmann) | 14.0 | 7.2 | 6.2 | | | | |
| Transactions approach (Feige) | 17.2 | 12.6 | 15.9 | | | | |
| MIMIC method (Frey-Weckl) | 8.0 | | | | | | |
| Cash demand (Schneider) | 2.0 | 8.4 | | 9.6 | 12.5 | 13.0 | 12.3 |

Sources: derived from Schneider and Enste (2002: Table 4.8), Williams (2004a, chapter 3)

It is important, however, to employ caution whenever using estimates of its size, especially so far as the higher figures are concerned. As Table 2 displays, these are produced using indirect measurement methods and there is a strong consensus that these are very limited in their usefulness. Indeed, this is the conclusion both of OECD experts in their handbook on measurement methods (OECD, 2002) and of the most recent European Commission report on the informal economy (Renooy et al, 2004). The latter report concluded that direct survey methods are more valid and reliable when measuring the extent and nature of the informal economy (see also Thomas, 1992; Williams, 2004a; Williams and Windebank, 1998).

A long-standing criticism was that direct methods did not uncover all informal work. However, as MacDonald (1994) displays in his study of informal work amongst the unemployed in Cleveland, ‘fiddly work’ was not a provocative subject from their perspective. They happily talked about it in the same breath as discussing, for instance, their experiences of starting up in self-employment or of voluntary work. This willingness was also identified in Belfast (Leonard, 1994). Indeed, a survey of the
informal economy in UK deprived urban neighbourhoods (Williams and Windebank, 2001a) finds that the total amount customers reported spending on informal work was £23,354 and this was near enough exactly the same amount that informal workers asserted that they had received (£22,986). So too was the mean price customers paid (£90.24) broadly equal to the mean price suppliers asserted that they received (£84.48). Similar results were found when affluent suburbs and rural areas were analysed (Williams, 2004a; Williams and Windebank, 2003). No evidence was found either that suppliers greatly under-report such work or their income, or that customers falsely allocate economic activity to informal work when this is not the case. Given that the order of magnitude of customer and supplier responses are approximately the same, there are few grounds for believing that direct surveys under-report either the level of this work or the income from such activity.

This emerging consensus that direct methods are more valid and reliable, however, has not yet led to the commissioning of nationally representative surveys. Until now in the UK, direct surveys have consisted of small-scale local studies, such as on Teesside (MacDonald, 1994), West Belfast (e.g. Leonard, 1994, 1998, 2000), the Isle of Sheppey (Pahl, 1984), or the English Localities Survey of eleven deprived and affluent urban and rural localities (Williams, 2004a; Williams and Windebank, 2001a). The local surveys so far conducted, nevertheless, uncover a good deal of evidence on who conducts this work and the types of work being undertaken, however they do not provide a nationally representative picture.

5.2 Who operates in the informal sector?

Until the 1990s, a widely held belief was that the informal economy was concentrated in marginalised populations (e.g. Blair and Endres, 1994; Button, 1984; Castells and Portes, 1989; Gutmann, 1978; Henry, 1982; Isachsen and Strom, 1985; Matthews, 1983; Parker, 1982; Petersen, 1982; Rosanvallon 1980; Simon and Witte, 1982). The ‘marginality thesis’, suggested that it was predominantly the unemployed, women, ethnic minorities and people living in deprived areas who undertook informal work. This in turn led to a perception that people and businesses could be defined as being either formal or informal workers and enterprises.

Over the past decade, however, this view that ‘marginalised’ populations disproportionately participate in, and benefit from, informal work has been widely refuted. The vast majority of direct empirical surveys conducted in the advanced market economies have revealed that:

- The unemployed do not participate in informal work to the same extent as those in formal employment (Koopmans, 1989; Lemieux et al, 1994; Lozano, 1989; Marcelli et al, 1999; Mingione, 1991; Mingione and Magatti, 1995; Mingione and Mortlicchio, 1993; Morris, 1994; Nelson and Smith, 1999; Pahl, 1984; Tievant, 1982; Warde, 1990; Warren, 1994; Williams, 2001, 2004a,b; Williams and Windebank, 2001a,b);

- The temporary or short-term unemployed, nevertheless, engage in more informal work than the long-term unemployed, especially in northern European nations. This is because they
retain many of the contacts, resources and skills that they gained from their formal employment [Engbersen et al., 1993; Hellberger and Schwarz, 1987; Morris, 1995; Williams, 2001; Williams and Windebank, 2003];

- Deprived areas both supply, and consume, a lower absolute and relative amount of informal work than more affluent localities [e.g. van Geuns et al., 1987; Mingione, 1991; Renooy, 1990; Williams, 2004a; Williams and Windebank, 1995, 1998, 2003];

- Women engage in less informal work than men [Fortin et al., 1996; Lemieux et al., 1994; Mogensen, 1985; Pedersen, 2003; Pahl, 1984; Renooy, 1990]; and

- There is no strong correlation between ethnicity and participation in the informal economy. Ethnic minorities, for example, represent only a very small proportion of the informal labour force [e.g. Jensen et al., 1995; Williams and Windebank, 1998].

In consequence, it is not appropriate to define individuals and businesses as operating in either the formal or informal economy. Many of the people and businesses working informally also engage in the formal economy, wholly underground enterprises and people working exclusively on an informal basis are now acknowledged to represent only a small proportion of the informal economy [e.g. ILO, 2002; Williams, 2004a].

Table 3: Sectoral distribution of informal work: by type of activity, Britain, 2000

<table>
<thead>
<tr>
<th>Sector</th>
<th>% of all informal work</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, forestry &amp; fishing</td>
<td>(1.1)</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>14.0</td>
</tr>
<tr>
<td>Trade</td>
<td>(0.7)</td>
</tr>
<tr>
<td>Construction</td>
<td>46.7</td>
</tr>
<tr>
<td>- painting &amp; decorating</td>
<td>17.2</td>
</tr>
<tr>
<td>- carpentry &amp; joinery</td>
<td>11.1</td>
</tr>
<tr>
<td>- bricklaying</td>
<td>1.3</td>
</tr>
<tr>
<td>- other [e.g. electrical &amp; plumbing]</td>
<td>17.2</td>
</tr>
<tr>
<td>Service Functions</td>
<td>23.8</td>
</tr>
<tr>
<td>- repair work</td>
<td>11.6</td>
</tr>
<tr>
<td>- other services [e.g. hairdressing, cleaning]</td>
<td>12.2</td>
</tr>
<tr>
<td>Other [e.g. transport]</td>
<td>(4.8)</td>
</tr>
<tr>
<td>Activity not stated</td>
<td>8.9</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: In parentheses when respondents in a cell are less than 20. Note: In parentheses when respondents in a cell are less than 20.

Source: Rockwool Foundation Research Unit, 2003 (cited in Renooy et al, 2004: Table 4.4).
Table 4: Tasks conducted in the informal economy in England

<table>
<thead>
<tr>
<th>% conducted in informal economy</th>
<th>Share of informal economy (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>House maintenance</strong></td>
<td></td>
</tr>
<tr>
<td>- Outdoor painting</td>
<td>10</td>
</tr>
<tr>
<td>- Indoor painting</td>
<td>7</td>
</tr>
<tr>
<td>- Wall papering</td>
<td>6</td>
</tr>
<tr>
<td>- Plastering</td>
<td>12</td>
</tr>
<tr>
<td>- Mending broken window</td>
<td>7</td>
</tr>
<tr>
<td>- Maintenance of appliances</td>
<td>11</td>
</tr>
<tr>
<td><strong>Home improvement</strong></td>
<td>10</td>
</tr>
<tr>
<td>- Double glazing</td>
<td>7</td>
</tr>
<tr>
<td>- Plumbing</td>
<td>13</td>
</tr>
<tr>
<td>- Electrical work</td>
<td>12</td>
</tr>
<tr>
<td>- House insulation</td>
<td>1</td>
</tr>
<tr>
<td>- Put in bathroom</td>
<td>24</td>
</tr>
<tr>
<td>- Build a garage</td>
<td>0</td>
</tr>
<tr>
<td>- Build an extension</td>
<td>0</td>
</tr>
<tr>
<td>- Convert attic</td>
<td>25</td>
</tr>
<tr>
<td>- Put in central heating</td>
<td>9</td>
</tr>
<tr>
<td>- Carpentry</td>
<td>9</td>
</tr>
<tr>
<td><strong>Routine housework</strong></td>
<td>10</td>
</tr>
<tr>
<td>- Do housework</td>
<td>2</td>
</tr>
<tr>
<td>- Clean the house</td>
<td>2</td>
</tr>
<tr>
<td>- Clean windows</td>
<td>10</td>
</tr>
<tr>
<td>- Spring cleaning</td>
<td>2</td>
</tr>
<tr>
<td>- Do the shopping</td>
<td>1</td>
</tr>
<tr>
<td>- Wash clothes/sheets</td>
<td>1</td>
</tr>
<tr>
<td>- Ironing</td>
<td>1</td>
</tr>
<tr>
<td>- Cook the meals</td>
<td>1</td>
</tr>
<tr>
<td>- Wash dishes</td>
<td>1</td>
</tr>
<tr>
<td>- Hairdressing</td>
<td>8</td>
</tr>
<tr>
<td>- Administration</td>
<td>1</td>
</tr>
<tr>
<td><strong>Making &amp; repairing goods</strong></td>
<td>2</td>
</tr>
<tr>
<td>- Make/repairing clothes</td>
<td>0</td>
</tr>
<tr>
<td>- Knitting</td>
<td>0</td>
</tr>
<tr>
<td>- Repair clothes</td>
<td>0</td>
</tr>
<tr>
<td><strong>Car maintenance</strong></td>
<td>9</td>
</tr>
<tr>
<td>- Wash car</td>
<td>6</td>
</tr>
<tr>
<td>- Repair the car</td>
<td>19</td>
</tr>
<tr>
<td>- Car maintenance</td>
<td>4</td>
</tr>
<tr>
<td><strong>Gardening</strong></td>
<td>2</td>
</tr>
<tr>
<td>- Indoor plants</td>
<td>0</td>
</tr>
<tr>
<td>- Outdoor borders</td>
<td>3</td>
</tr>
<tr>
<td>- Outdoor vegetables</td>
<td>0</td>
</tr>
<tr>
<td>- Lawn mowing</td>
<td>4</td>
</tr>
<tr>
<td><strong>Caring</strong></td>
<td>8</td>
</tr>
<tr>
<td>- Baby sitting (day)</td>
<td>11</td>
</tr>
<tr>
<td>- Baby sitting (night)</td>
<td>12</td>
</tr>
<tr>
<td>- Courses (e.g. Piano lessons)</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: English Localities Survey (n=861 households) [see Williams, 2004a: Table 5.2]

5.3 What type of work occurs in the informal sector?

5.3.1 A sectoral analysis of the UK informal economy

Although there have been numerous studies of the prevalence of the informal economy in particular UK sectors and occupations, such as the hospitality industry (Williams and Thomas, 1996), the restaurant and clothing sectors (e.g. Ram et al, 2002) and taxi drivers (Jordan and Travers, 1998), little overarching evaluation has taken place of the sectors in which it is concentrated. In recent years, however, this gap has started to be bridged. As Table 3 reveals, Pedersen (2003) has surveyed the sectors in which informal work takes place in the UK as part of a four-nation study (based on a small sample). This reveals that just under half of all UK informal work (46.7 per cent) takes place in the construction sector and another quarter (23.8 per cent) in a range of
consumer services. The English Localities Survey identifies similar results in relation to the domestic services sector, [see Table 4]. Examining eleven affluent and deprived urban and rural areas, it finds that some 43 per cent of all informal work is concentrated in the home repair and maintenance/construction sector (46.7 per cent in the Pedersen study) and a quarter in domestic service activities. Indeed, the tasks identified as most frequently using informal rather than formal labour are:

- making/repairing garden equipment, such as repairing lawnmowers or sharpening tools (one in three such tasks are conducted on an informal basis);
- attic conversions (one in four are primarily done informally);
- installing a bathroom (24 per cent);
- car repairs (19 per cent);
- plumbing (13 per cent);
- electrical work (12 per cent);
- plastering (12 per cent);
- baby-sitting (12 per cent);
- maintaining appliances (11 per cent);
- outdoor painting (10 per cent); and
- window cleaning (10 per cent).

This finding that the informal economy is concentrated in the construction sector and a range of consumer services has important consequences for policy-makers, as these sectors would cover 85 per cent of all informal work.

While this is not based on a nationally representative sample (but is instead skewed towards the populations of deprived neighbourhoods [Williams and Windebank, 2001a]), there is little reason to believe that the national situation would be much different.

5.3.2 Characteristics of informal work

Grounded in the now refuted marginality thesis, conventional depictions of the informal economy in advanced market economies viewed it as an exploitative, low-paid and organised form of fraudulent employment [e.g. Castells and Portes, 1989; Gallin, 2001; Sassen, 1997; Williams and Windebank, 1998]. The recognition that such work is not conducted primarily by the marginalised, however, has led to this portrayal being seen as but a partial and skewed sketch of the informal economy. Rather than view informal work as sitting at the bottom of a hierarchy of employment, the informal economy is now seen as a heterogeneous labour market with a hierarchy of its own. In other words, just as there is a segmented formal labour market, there is now a segmented informal labour market [see Benton, 1990; Warren, 1994; Williams and Windebank, 1998]. As Williams and Windebank (1998: 32-3) put it:

"Existing alongside the formal labour market is a heterogeneous informal labour market composed of very different groups of people engaged in widely varying types of informal employment for diverse and contrasting reasons and receiving varying rates of pay. This informal labour market, to adopt a simplistic dual labour market model, ranges from 'core' informal employment which is relatively well-
paid, autonomous and non-routine and where the worker often benefits just as much from the work as the employer, to ‘peripheral’ informal employment which is poorly paid, exploitative and routine and where the employee does not benefit as much as the employer.”

Following Williams (forthcoming, 2005), we divide this informal labour market into four principal types, namely ‘organised’ informal work; informal work conducted by micro-entrepreneurs; informal work by more established small businesses, and informal work undertaken by friends, kin and acquaintances (see box below).

Until now, few attempts have been made to estimate the proportion of all informal work that falls into each of these four categories. The only data currently available are from the English Localities Survey whose sample was heavily skewed towards deprived urban neighbourhoods (some 46 per cent of the sample). It reveals that 18 per cent of all informal work reported is conducted using organised informal work, 11 per cent by micro-entrepreneurs, 22 per cent by more established small businesses and 49 per cent by kin, friends and neighbours as paid favours (Williams, 2004a).

**Four principal types of informal work**

1. **‘Organised’ informal work.** This involves people working as employees on an informal basis for a business that undertakes some or all of its activity informally. Although this is normally highly exploitative low-paid work, as exemplified by organised cockle-picking gangs, gang-masters in agriculture and back-street sweatshops in the ‘rag’ trade, instances have been identified where such informal employees earn high wages for skilled work in advanced highly capitalised firms (e.g. Benton, 1990);

2. **Informal work conducted by ‘micro-entrepreneurs’.** This type of informal worker tends to be starting-up fledgling business ventures and using informal work as a short-term risk-taking strategy to either test-out the business venture or to establish themselves. They are usually either in employment or classified as ‘economically inactive’ and in the process of setting themselves up as self-employed. Occasionally, they are registered unemployed people working whilst claiming. These are usually small-scale operations. When they begin to grow and establish themselves, they are here defined as moving from this category of informal work into a third category if they continue to do some trade ‘off-the-books’;

3. **Informal work by more established small businesses.** Although there are businesses that are wholly underground, most of the informal work undertaken by more established small businesses is carried out by formal businesses and those registered as self-employed. These tend to engage in informal work in a serial and on-going manner as a means of ‘getting by’. For these more established businesses who conduct a portion of their trade ‘off-the-books’, in consequence, ‘cash-in-hand’ is not generally some short-term strategy but is continuously used and heavily embedded in their working practices; and
4. Informal work by friends, family and acquaintances. As the advanced market economies have become ever more commodified, monetary exchange has penetrated deeper into areas of everyday life. One instance is exchange between friends, family and acquaintances. Exchanges that used to take place on an unpaid basis now often involve money. Giving ‘cash for favours’ occurs mostly when casual one-off tasks are undertaken for friends, family and acquaintances. This is especially true in deprived populations where giving a ‘back-hander’ or ‘drink’ for a favour is a widespread practice – not least because it prevents relations from turning sour if the favour is not returned.

There is a strong probability that a nationally representative sample would not show the same proportions as the English Localities Survey. It is estimated that, the proportion of organised informal work and ‘paid favours’ would be significantly lower, while the share undertaken on a for-profit self-employed basis would be considerably higher.

Based on these findings, it can be estimated that at a national level approximately 5 per cent of all informal work might be conducted on an organised informal basis,

Figure 1: Estimate of the structure of the informal economy: by type of labour

23 per cent by micro-entrepreneurs, 47 per cent by more established small businesses and 25 per cent by kin, friends and neighbours as paid favours (see Figure 1). This, however, is an approximation (based on evidence from 861 interviews) that seeks only to give a broad overview of the informal economy at a national level. More research at the national level is required, to confirm such data.

This analysis only considers the labour used to conduct tasks on an informal basis. It does not provide any indication of the amount of money earned and spent in each sector. However, based on the above reported research it is highly likely that the organised sector would be larger if measured in terms of wages earned and the small business segment slightly larger than portrayed in Figure 1, while the sphere of paid favours would be significantly smaller and the sector comprising micro-entrepreneurial activity somewhat smaller.

To conclude this section, we present two case studies that show the diversity in the micro-entrepreneurs category of informal work.
From informal micro-entrepreneur to formal business: ‘Justin’

Justin is an example of somebody who had used informal work as a temporary strategy and as a stage in the establishment of his formal business venture. He is in his mid-20s, self-employed and runs his own car valet business with employees. As a young teenager, he had washed cars one Saturday morning for a charity event and following this, decided to do so at weekends to earn extra cash for himself. Knocking on doors and offering his services, he had built up a regular clientele and had carried on doing this throughout his school years. On leaving school, he had used the money accumulated to buy a van and equipment to set up as a car valet and built upon his existing client base. At the time of interview, he employed three people and was busy expanding the commercial side of his operation, working for various second-hand car dealers for example. Over the years, he had slowly transferred a greater proportion of his business to the formal realm and was intending to be fully legitimate within the next year or so. For him, therefore, informal work had been his route into creating his own formal business. Although he continues to conduct a portion of his business informally, it is a relatively small and a rapidly dwindling share of his total turnover.

The serial use of informal work: ‘Diane’

Diane is a long-standing user of informal work as a coping strategy. Living in a deprived neighbourhood, she is self-employed as a household cleaner – mostly for clients in neighbouring affluent suburbs. Having made contacts with customers by working on a self-employed basis for a formal business, she had then asked her customers about people she could clean for on a ‘cash-in-hand’ basis. In this way, she had broken into the local market where there was a shortage of cleaners and had done so in a manner that enabled her to overcome the principal barrier which was a distrust of ‘strangers’ being left in homes and given door keys. She had used the formal cleaning company to establish both relations of trust and ‘word of mouth’ recommendations. For her, nevertheless, this endeavour was purely a means of earning sufficient extra cash to ‘get by’. She had no desire to expand beyond finding sufficient work and no intention of formalising this work. Indeed, attempts were made to move into the informal economy any formal work that she received from the cleaning company if clients were willing.
Research on the informal economy has traditionally sought single causes to explain its existence. Increasingly, however, there is recognition that the informal economy arises out of the interaction of a wide range of factors (e.g. Mateman and Renooy, 2001; Renooy et al, 2004; Williams, 2004a; Williams and Windebank, 1998). The existence of a number of very small enterprises in an area, for example, is no longer seen as a proxy indicator of a sizeable informal sector. Rather, it is whether a host of other factors also exist and how these factors inter-relate, that matter.

This is reflected in the call of Williams and Windebank (1998: 46) to investigate ‘the ways in which economic, social, institutional and environmental conditions combine to produce specific local outcomes’. Reviewing the extensive literature on the various reasons for the informal economy, they identify the following determinants:

- economic regulators;
  - level of unemployment;
  - level of affluence;
  - duration of unemployment;
  - industrial structure;
  - level of sub-contracting;
  - tax and social contributions;

- social regulators;
  - socio-economic mix of area;
  - social cohesiveness of population;
  - existence of shared ‘political’ values
  - local and regional cultural traditions,
  - social mores and moralities;
  - the nature of social networks;
  - education levels;

- institutional regulators;
  - welfare benefit regulations;
  - taxation levels;
  - labour law;
  - state interpretation and enforcement of rules and taxation regulations;
  - corporatist agreements;

- environmental regulators;
  - size and type of settlement;
  - type and availability of housing; and
  - access to formal goods and services.

This model was employed by the European Commission (1998) to explain why businesses operate in the informal economy.

More recently, however, the European Commission has adopted a slightly different model that divides the factors as follows:

- 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; and
  - level of education.

Both models cover many of the same determinants but aggregate them together in different ways. What is important is that neither approach identifies any individual factor as leading to a higher and/or lower level of informal work. Instead, it is how factors combine together in different circumstances that are seen as the key. As Renooy et al (2004: 9) put it,

‘There are no general, universal causes
for the existence and development of an informal economy. It is brought about by a complex interplay of variables.”

For example, to identify high taxation rates as always being a cause of informal work is at best a partial explanation. It is true that a lack of trust in government and little ‘buying into’ the necessity of taxation for social cohesion and inclusion might lead high taxes to cause a growth in informal work. However, where trust in government is higher and there is awareness of the benefits of taxation for social cohesion, then an expansion of informal work will not necessarily result from higher tax levels. Of course, in reality, a whole host of other factors will come into play – such as attitudes towards tax evasion, the labour and welfare laws, whether rules and regulations are strictly enforced and so forth.

In summary, the reasons why businesses operate in the informal economy are complex, multi-layered and subtle and the causes can only be meaningfully captured by explanatory models that include a whole range of factors.
A simple framework for understanding what might encourage businesses to formalise more of their activity is provided by distinguishing between ‘push’ and ‘pull’ factors, or what might be termed ‘sticks’ and ‘carrots’. The advantage of this framework is that it shows deterrence initiatives as only one part of the equation. Unless these push factors are complemented by a range of pull factors, public policy will be providing no help to those who may wish to formalise their business.

7.1 Push factors (‘sticks’)  
If the objective of public policy is 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 increasing detection rates can be used as ‘sticks’ by ensuring 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 co-operation 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 businesses having made use of informal workers from public tenders.

7.2 Pull factors (‘carrots’)  
If the objective is not just to eradicate this work but also to encourage its transfer to the formal sphere, then ‘pull’ factors will also be required. These more positive measures (which are discussed in the next section) might include:

- VAT reductions on targeted goods and services;
- targeted tax measures;
- benefit reforms;
- changing the earnings disregard;
- formalisation vouchers;
- amnesties for informal workers to declare themselves;
- advisory services;
- subsidised formal employment;
- business start-up grants;
- coaching, training and advice [for employers and employees] in fulfilling formalities;
- greater flexibility in the ‘self-employment’ route-way on New Deal;
- 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.

Deterrence, in consequence, acts to suppress engagement in informal work but provides no help to those who may wish to formalise. To achieve this, initiatives are required that provide ‘carrots’ to move economic activity from the informal into the formal economy.
Recently it has been recognised that governments should not simply eradicate informal work but also seek to transfer it into the formal economy. Such a change of emphasis is in part, the result of a recognition that:

- the vast majority of informal work is conducted on a self-employed basis; and
- entrepreneurship in the informal economy represents a potential asset to be harnessed (e.g. Evans et al, 2004; Global Employment Forum, 2001; International Labour Office, 2002; Leonard, 1998; Tabak, 2000; Vaknin, 2000; Williams, 2004a).

As indicated previously there are four distinct groups of informal workers:

- employees working in organised businesses on an informal basis;
- micro-entrepreneurs using the informal economy usually to test-out their venture and/or start-up;
- established self-employed people and businesses using this sector in a serial manner as a strategy for ‘getting by’; and
- those conducting ‘paid favours’ for family, neighbours and friends on a casual one-off basis.

These four groups require different approaches (although in this report we consider only the second and third groups on the list).

On the whole, the evidence suggests that the raft of deterrence measures currently employed in the UK take the right approach. They could, however, perhaps be coupled with pull measures. This would then allow deterrents to be increased for those who do not actively formalise their activities.

Sections 8.1-8.4 cover a range of enabling measures which complement the existing deterrence initiatives in other European countries. These are demand-side measures, supply-side measures, awareness raising approaches and measures to co-ordinate government actions.

### 8.1 Demand-side measures

These are measures that encourage customers to reduce their use of informal labour and employ formal labour instead.

#### 8.1.1 VAT changes

One potential means of encouraging businesses and consumers to use formal rather than informal production is to reduce VAT on specific goods and services where the informal economy is rife (e.g. household maintenance and repair). Such a strategy has been used in numerous countries. In France, according to a directive of May 25 1999, VAT was reduced on both services and goods related to the improvement, transformation and organisation of household maintenance work. In Italy, similarly, the 2000 Finance Act decreased the VAT rate from 20 per cent to 10 per cent on rebuilding and restructuring services for residential buildings, including ordinary and extraordinary household repairs.

Although early academic research argued that the introduction of VAT had little effect on the size of the informal realm (Bhattacharya, 1990; Feige, 1990; Frey and Weck-Hannemann, 1983; Macafee, 1980), no contemporary evaluations have been conducted on whether VAT reductions result in a formalisation of informal work.
Along with this lack of knowledge on the impact of VAT reductions, there are two further notes of caution. First, there is a concern that stripping away taxes to tackle informal employment has the dangerous consequence of kick-starting a ‘race to the bottom’. Secondly, such an approach relies on the discredited assumption that higher taxation always leads to a growth in the informal economy. As we have already established, there is no evidence that this is the case.

8.1.2 Targeted tax measures

Other European countries use a range of tax measures to encourage the employment of formal rather than informal labour.

In the household maintenance and repair sphere, for example, numerous targeted tax measures appear to have been successful, such as the Home Services Scheme in Denmark; tax reductions for house repairs in Italy and Luxembourg; and a French system of tax rebates on home maintenance expenses and the purchase of large equipment such as heating systems and elevators. As the European Commission [1998: 14] concludes,

“...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, meanwhile, similar tax measures have been introduced in countries such as Denmark, Finland and Germany in order to encourage household work to be carried out in the formal rather than informal economy. In the boxes below, a number of targeted tax measures that are currently operated in Europe are outlined. All have been recommended as ‘good practice’ in the most recent European Commission report (Renooy et al, 2004)

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. This is intended for fledgling entrepreneurs who need start-up capital and receive a personal loan from family and friends (‘Aunt Agatha’). These private moneylenders are then exempt from some taxes. The idea is that such loans are often made on an informal basis and if formalised, this might draw the business into the formal set-up and set it on the right road.
Home Service Scheme (Denmark)

The Danish Home Service Scheme began in 1994 as a pilot and was made permanent three years later in 1997. Its aim was to: (i) compete with the informal economy; (ii) promote the development of enterprises that provide household services; and (iii) 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) for which the government reimburses 40 per cent of the cost (only on 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, one in eight Danish households used the Home Service Scheme, an average of five 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, this had grown to 3,700 FTE jobs.

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 up to 19,000 NLG was granted for every long-term unemployed person hired by a private cleaning company. The government, in effect, was paying 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, 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. Some 1,700 Melkert jobs were created in the sphere of child-care by the end of 1998 (Cancedda, 2001). In the realm of home help, the finding was that some of these jobs were replacing regular formal jobs. These Melkert schemes were thus not as successful as originally expected.
8.1.3 Formalisation vouchers

Using ‘vouchers’ to encourage employers to employ formal rather than informal labour is proving popular in many advanced market economies, not least due to the effectiveness of such schemes in stemming the informal economy. So much so that all four ‘voucher’ initiatives outlined in the boxes below are strongly recommended as ‘good practice’ in a recent European Commission report [Renooy et al, 2004]. Furthermore, the fact that they directly address the domestic services realm, a sphere in which the UK informal economy is concentrated, means that they are potentially relevant to the UK.

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 contacts 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 can keep the money 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 1994-99, 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 €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 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 cost price 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, reducing the price of a voucher to €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). By November 2003, the system of service vouchers had created 2,000 jobs (Rubbrecht and Nicaise, 2003). In 2004, the vouchers provided under the PWA scheme to private households (see above) were 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.

Cheque Emploi Service (France)

In 1994, to combat informal work in the domestic services sphere (e.g. cleaners), the French government introduced the Cheque Emploi Service (CES), which aimed 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 the 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), perhaps displaying how this scheme has legalised a significant share of the informal economy in domestic services.
Titre Emploi Service (France)

A similar scheme to CES 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).

Besides using formalisation vouchers to stem the informal economy in domestic services the evidence suggests that there is no reason why such vouchers could not also be extended to the home maintenance and improvement sector.

8.2 Supply-side measures

Supply-side measures are also available to encourage informal businesses to formalise their endeavour.

8.2.1 Targeted tax and benefit measures

The European Commission recently highlighted two tax and benefit measures as ‘good practice’ in reducing the supply of informal labour (Renooy et al, 2004). The measures, which are described in the boxes below, both originate in Germany.

For many years, the German government effectively shut its eyes to the fact that people occasionally undertake small jobs that they do not declare. The creation of a ‘mini-jobs’ category of employment was a move to encourage people to legitimise these jobs. It is possible that a similar initiative might help address cases where the perceived problems involved in declaring small jobs leads people to conduct them informally. Creating a ‘mini jobs’ category of employment might thus represent a significant breakthrough, especially for those in formal employment who occasionally do work ‘on the side’.
Mini Jobs (Germany)

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

1. **€400 jobs** – the income limit was raised from DM 630 to €400. Within this income limit, mini-jobs enjoyed reduced social security contributions of 23 per cent (12 per cent for the pension insurance system and 11 per cent for the health insurance system) and a lump-sum tax of 2 per cent. In addition, the 15 hours per week limit was lifted.

2. **Mini jobs in the household sector** – introduced to fight informal work in the household sector. The employer has to pay a levy of 12 per cent and pays reduced taxes.

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

Around 600,000 changed their side-job from the informal to the formal economy due to this system of minor employment (Baumann and Wienges, 2003). In September 2002 there were 4.1 million employees in minor employment. At the end of April 2003, one month after the introduction of mini jobs, there were 5.5 million, a rise of 1.36 million. Some 1.21 million are people already in a formal job, about 580,000 of whom are estimated to have transferred their add-on job from the informal economy into the formal sphere.

A second targeted measure, again recently adopted in Germany, is the introduction of a new business entity, namely ‘Me-PLC’. This is intended to help unemployed people wishing to start up their own self-employed business venture and enables them to receive a subsidy for the first three years equivalent to a maximum of 50 per cent of unemployment benefits. The objective is to help smooth the transition from unemployment benefits to being self-employed (Evans et al, 2004).

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1 Throughout this report terms such as small firms and small business are interchangeable with the term small and medium sized enterprises and are used to signify businesses employing up to 250 people and turnover of less than €50 million.
'Me-PLC' (Germany)

In 2003, following a recommendation of the Harz Committee, which looked at improving the functioning of the German labour market, Ich A.G.’s ['Me-PLC’s'] were introduced. This is a new legal entity. Where unemployed people want to start a one-person business (ich-AG) or a family business (familien AG), they receive a monthly subsidy for three years:

- Year I: 600 euros (50 per cent of the average unemployment benefit in 2002);
- Year II: 360 euros (30 per cent of the same); and
- Year III: 240 euros (20 per cent of the same).

A start-up monitor shows that in 2003 over 93,000 long-term unemployed started a small business using this Ich-AG scheme. The German government expected around 20,000 start-ups.

A variant of this ‘Me-PLC’ initiative in Germany is found in the Netherlands. Here, the Bbz [Besluit Bijstandverlening Zelfstandigen], meaning ‘Decision Social Security Self-Employed’, allows people to apply for social security benefits while they start their own business. It also applies to self-employed people who anticipate that, in the start-up period, they will earn less than a person on social security would receive.

The Me-PLC scheme has some similarities to some existing UK initiatives, such as test-trading. However, the principle of a graduated withdrawal from benefits could be incorporated into these initiatives to help smooth the transition from benefits to work (see below).

8.2.2 Simplifying formalisation procedures

Besides tax/benefit measures, there is also a need to consider the administrative procedures associated with establishing a formal business. Simplifying the procedures involved in starting and operating a small business – for example, easier registration procedures – might well encourage formalisation. Emphasising the benefits of legal registration, such as access to commercial buyers in the formal economy, more favourable credit markets, legal protection etc., might well be expected to have a similar effect. Both sets of measures might encourage new businesses to start-up in the formal rather than the informal economy, and also help lever informal micro and small businesses into the formal economy.

The ILO (2002) reports that the administrative requirements are often more burdensome than taxes. Legal and administrative requirements such as registration and licensing can be an obstacle to micro and small enterprises, where the transaction costs or costs of compliance per worker are higher than in larger firms. Where the costs of full administrative compliance are prohibitive, compliance tends to be low (ILO, 2002).

The focus in the UK has been on providing information to help people start businesses within the existing rules and regulations, such as:
the Starting up in Business campaign;
the helpline for the newly self-employed; and
the provision of guides such as The right way to start your business.

There is perhaps a case for simplifying existing formalisation procedures, rather than just providing advice on how to formalise. However, given that start-up procedures and regulation in the UK are amongst the least burdensome in the developed world (see for example World Bank 2004), the potential of such measures may well be limited in the UK.

8.2.3 Voluntary disclosures
Grabiner (2000) evaluated the use of society wide amnesties and was unsupportive because:

- there is the practical difficulty of defining the amnesty precisely enough to make it workable and lawful; and
- there is the question of whether it is appropriate to treat all kinds of informal economy fraud in the same way. For example, benefit fraud is normally seen as worse than tax fraud in the UK. Additionally, an amnesty on VAT fraud would be difficult to operate since it has already been collected from customers.

Evidence from other countries also suggests that amnesties are not effective in practice.

For example, in the 1980s, several states in the USA, as well as France, Italy and Ireland, used them. They were perceived as unfair, as a free lunch for those who had not met their responsibilities at the expense of honest taxpayers. Holding an amnesty, moreover, tended to create an expectation of future amnesties that in turn reduced the incentive for tax-evaders to come forward immediately. These factors undermine public confidence in the system, and even encourage honest taxpayers to become more fraudulent. Finally, the revenue generated by amnesties tends to be exaggerated. In practice, the net return (i.e. the revenue that would not have been collected without an amnesty, less the costs of operating the amnesty) is often low. One reason for this is because amnesties appear to be most effective when accompanied by tougher enforcement measures. It is thus likely that much of the revenue collected attributed to amnesties would have been collected by enforcement alone (Grabiner, 2000). The value of amnesties has, in consequence, been highly contested.

Instead of exploring the amnesty route further, we therefore focus here on the possible impact of a system of individual level voluntary disclosure. We begin by examining two initiatives from abroad. The first is an Italian approach, which has been recommended as ‘good practice’ in the most recent report to the European Commission (Renooy et al, 2004).
Regularisation campaign, 2001-03 (Italy)

In October 2001, the Italian government implemented a law known as the Regularisation campaign (L.383/01) that ended in February 2003. This allowed employers and workers who declared that they had operated informally to regularise their situation with respect to tax, labour safety, social security contributions, land use irregularities and so forth. In exchange, employers paid reduced sanctions and reduced taxes and social contributions for three years, so as to adapt to the increased (labour) costs. The workers involved could pay reduced pension contributions for the past and would have to regularise their own tax situation. Employers and employees involved in informal work had two options:

- declaration at once, in which the entrepreneur and his/her workers declare the irregularities and pay immediately all (reduced) taxes and contributions to be paid; or
- gradual regularisation, in which the entrepreneur submits a regularisation plan, including deadlines to solve an irregularity, to an ad hoc committee. If the deadlines are not met the entrepreneur is penalised by paying 100 per cent rather than the reduced tax and contributions.

In total, this produced some 1,029 declarations and 3,854 new regularised workers. This outcome was viewed as disappointing, in part perhaps due to its focus solely on labour costs when this is not the sole reason for working informally.

The second option is the US system of allowing an ‘offer in compromise’ about taxes to be paid when an informal worker makes a voluntary disclosure (see box).

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. An OIC is an agreement between a taxpayer and the IRS that resolves the taxpayer’s 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 where there is either: doubt as to liability; doubt as to collectability; or when it would make for effective tax administration. 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 can 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.

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.
According to Bajada [2002], when Revenue Canada introduced a voluntary disclosure policy, this resulted in voluntary disclosures quadrupling. This indicates that voluntary disclosure may offer some potential to be used.

### 8.2.4 Advisory and support services

Following the Grabiner [2000] report, the Inland Revenue established a Tax and Benefits Confidential Advice help-line 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’.

In order to move from the informal to the formal economy, micro-entrepreneurs and businesses require help and support on issues such as tax and benefit rules, insurance, credit, loans, book-keeping, marketing, regulations and so forth. At present, however, such support and advice is generally not widely available (ILO, 2002). As Copisarow and Barbour [2004] highlight, 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 that need help with formal business planning. There is thus a need to tailor advice and support services more to the differing needs of micro-entrepreneurs and businesses in the formal and informal economies. Below are two examples of current initiatives aimed specifically at the needs of those in the informal economy.

### The Naples CUORE Initiative (Italy)

CUORE (Centri Operativi per la Rqualificazione Economica) started in 1998 with an agreement between the municipality of Naples and the University Frederico II to research the local business environment. The research revealed that the labour market problem was not unemployment but the informal economy. Today, the CUORE project consists of a network of neighbourhood service centres for entrepreneurs and would-be entrepreneurs. Each local centre services a low-income neighbourhood and targets small and micro-sized entrepreneurs with the potential for growth. CUORE project workers conduct fieldwork to identify local firms, regardless of their formality. Once identified, CUORE centres offer information and advice for formalisation, support by designing business development strategies and help with enterprise creation. Regularisation services are a distinctive innovation of the project. On the request of the entrepreneur, CUORE operators devise custom-made regularisation and development paths. The project workers closely monitor each step in the process to make sure that the entrepreneur follows the agreed path towards regularisation and that the path still suits the entrepreneur’s needs. Project workers tend to be familiar with the neighbourhood. Since the Naples experiment, the initiative has spread to Apulia and other regions.
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: (1) people claiming benefits – such as disability benefit, carers allowance, and (2) 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. Their activities cover three areas:

- providing tailored financial services and business development support tools;
- offering a back-office loan administration and systems support service for other community loan funds; and
- undertaking research, policy recommendation and advocacy work.

A range of case studies of clients can be found on the Street (UK) website (www.street-uk.com) and in Copisarow and Barbour (2004). What is important to highlight here is the strategy that Street (UK) adopts. Since its clients include a wide variety of people at different stages of development of their enterprises, its approach is to monitor the progression of clients in each of the following areas:

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 and/opening a separate business bank account;
8. obtaining the required licences and permits to operate the business, e.g. health and safety inspection certificates, driver instructor licence, etc;
9. graduating off all non-work state benefits;
10. graduating from majority cash revenues to majority invoiced revenues;
11. incurring a formal business tax liability; and
12. becoming VAT registered.
The evidence from current initiatives suggests that an independent third sector business support network is likely to attract more clients than a government run network, due to such institutions being seen as relatively detached from the state. Given that Street (UK) currently focuses on wholly informal businesses [which are a minority of the informal economy], it is likely that support networks dealing with other parts of the informal economy would in practice look somewhat different to the Street (UK) model.

8.2.5 Formalisation mentors

The development of a business advice and support network to facilitate formalisation could be accompanied by more informal first points of contact from which enterprises might progress to these transition services. In Italy, a system of formalisation mentors/tutors has been developed (see box).

In the UK, such ‘formalisation mentors/tutors’ could be developed as an extension of the ‘business mentors’ system. The Business Volunteer Mentor Association, which is led by the National Federation of Enterprise Agencies, currently operates a ‘national mentoring scheme’. The Prince’s Trust has demonstrated that there is a market of available mentors and that having a mentor assist a start-up business has a direct affect on their longevity and success (Meager et al, 2001; Westall et al, 2000).

### Formalisation ‘Tutors’ (Italy)

In Italy, a network of regional ‘tutors’ has been established to support companies who want to leave the informal economy. These tutors are independent professionals who have backgrounds in socio-economic disciplines, such as law and economics, and who understand the labour market situation in the region. Set up under the auspices of the Comitato per l’emersione del lavoro no regolare (Committee for the Exposure of Undeclared Work), the national committee temporarily hires them on a freelance basis. These tutors tend to have no central office where the informal entrepreneur could go for information. Instead, they approach entrepreneurs directly by visiting companies.

8.2.6 DWP’s ‘test trading’ initiative

This initiative, to smooth the transition from benefits to self-employment, occurs at the New Deal Options stage 3 and involves the participants test-trading their business for up to 26 weeks.

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 self-employment provider is 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)

Whilst those involved with clients ‘on the ground’ believe that the initiative reduces participation in informal work, this has not been properly evaluated. It would be useful to evaluate the feasibility of a range of different options. These options might include:

- reducing the eligibility period (currently 18 months unemployment);
- extending 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 six months, 70 per cent in next 12 months and 40 per cent in last 12 months), as in the Me-PLC initiative in Germany, 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.

8.2.7 ‘Back to work bonus’

The ‘back to work bonus’ was introduced in October 1996 with the aim of encouraging individuals and, where relevant, their partners to ‘keep in touch’ with the labour market by undertaking small amounts of work whilst still claiming Income Support (IS) or Jobseekers 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 work proper. 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 on IS /JSA. It also has to be claimed within 12 weeks of leaving benefit (otherwise it is lost) and it can only be paid if the claimant starts work within two 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. This research did not specifically consider the scheme’s effectiveness at reducing the informal economy (Thomas, et al., 1999; Ashworth and Youngs, 2000). Further research would be required to validate the usefulness of this initiative in this respect.

8.2.8 ‘Twin track’

‘Twin track’ is a DWP pilot initiative running in Wales and the North West of England.
This initiative takes a ‘lighter touch’ with people working whilst claiming benefit. The aim is that, by selective use of this ‘lighter touch’, people will receive help from an advisor on moving into formal work. This scheme is one way in which a level of tolerance in government policy has been displayed towards those attempting to make the transition from benefits to work. So far, no results have been made publicly available of any evaluation of this scheme. Given that the unemployed provide only a very small proportion of all informal work, however, it is unlikely that such an initiative alone would have any significant impact on the size of the informal economy. It is, nevertheless, potentially useful as one initiative in a package of measures to tackle the informal economy.

8.3 Awareness raising and information campaigns

Besides developing demand- or supply-side measures, awareness raising and information campaigns can encourage the transition from the informal to the formal economy. Publicity will be a key factor in making 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 (2002: 108) as good practice, may be about the costs of informal work (e.g. the lack of advice, finance and opportunities), or the benefits of working formally, or they may focus upon enhancing the feeling of belonging to a common society from which everybody receives and to which everybody should contribute. Such awareness raising and information campaigns could inform:

- informal workers of the benefits of being formal;
- potential users of informal labour of the risks and costs; and
- potential users of the benefits of employing formal labour.

Such campaigns can be either general awareness raising initiatives or more targeted at particular sectors.

Publicity can also help strengthen taxpayers’ trust in the system, enhancing the confidence of compliant taxpayers in the capability of the state to prevent tax evasion.

Examples of such awareness campaigns include:

- the ‘illegal ist unsocial’ (illegal is unsocial) campaign in Germany, which is a general encouragement to the population to declare their informal work;

- the ‘Zwartwerk is broodroof’ (‘black work is taking the bread out of someone else’s mouth’) campaign in the Netherlands, which is organised by the National Institute of Social Insurance. Operating between 1996 -98, it targeted the general public and consisted of billboard, radio and television commercials and newspaper ads. An evaluation shows that the majority of the target audience knew of the campaign and what it was about. The impacts on informal work, however, have not been determined;

- a campaign in France on the risks of households using informal labour in the construction industry – where there is no recourse against any defects in the work carried out or when using such labour means that there is no cover
against the risk of burglary or damage;

- other more targeted campaigns in France including:
  - one on the risks of using informal labour for house removals in 1996 by the employers federation of removal and storage which issued 200,000 brochures and posters;
  - a campaign by the Confederation of Craft Industry and Small Building Enterprises (CAPEB) in Paris in 1995;
  - a campaign in the Upper Alps warning against informal work; and
  - a campaign in the Loiret in which the prefecture, the guild chamber, the professional trade unions of the building, automobile repair and hairdressing industries participated.

- an attempt in New Zealand to improve attitudes towards tax compliance by promoting the consequences to the evader and to society generally of people cheating on their tax obligations (IRD, 1999; Bajada, 2002);

- an Underground Economy Initiative launched in Canada. In 1993 the initiative appeared to have little effect on participation. In 1994, a Canadian television programme conducted a poll to measure community attitudes towards informal economy, the results revealed that 58 per cent of callers were willing to participate in the informal economy. In 1997, a Gallup Poll suggested that attitudes had worsened, as 73 per cent of respondents would willingly participate in the informal economy if the opportunity arose (Bajada, 2002);

- participation by Revenue Canada in home renovation and industry trade fairs to raise industry awareness of informal economy issues and to provide the consumer with information on the pitfalls of dealing in the informal economy; and

- a move by the Swedish Tax Agency to make control measures more visible through information campaigns. This was introduced following a report by the Swedish National Audit Office (RRV). One of the campaigns was specifically targeted at young people. Through free information to vocational schools and media campaigns, information was given about the risks of not participating in the social security system. A poll conducted after these campaigns shows that there had indeed been a change in attitudes in the group of young people. The fraction of young people that considered informal work acceptable fell from 29 per cent in 2002 to 21 per cent in 2003.

The Cash Economy Task Force in Australia has also recommended the introduction of such education campaigns.

It might be that the benefits of working formally rather than the costs of working informally need to be emphasised in such campaigns. Indeed, Thurman et al (1984) caution against approaches that publicise the adverse consequences of working informally because the individual may neutralise their guilt about working informally in one of a number of ways (see ATO, 1998b):

- denial of responsibility – the individual will regard the adverse consequences arising from the informal economy as the
result of others, who could even possibly be big players in the informal economy;

- **denial of injury** – the individual disagrees that their activity could have adverse consequences on others. In fact, the person may rationalise their actions by arguing that without their services the community may pay a higher price;

- **denial of victim** – the individual accepts the adverse consequences their actions may have on the community but believes the victims deserve it;

- **condemnation of condemners** – the individual may believe that the law, the lawmakers and law enforcers are to blame for an unjust system that burdens the community at large. The individual believes that the community should not succumb to these laws and evade if possible;

- **appeal to higher loyalties** – the individual justifies their action as the result of ‘non-conventional social order’. The individual believes that similar and across the board behaviour justifies their actions;

- **metaphor of the ledger** – the individual contemplating evasion believes that their actions, although they may be illegal, are not reflective of their true and good nature. The individual regards these as temporary deviations from otherwise good behaviour; or

- **defence of necessity** – the individual justifies their actions as the result of personal circumstances that have led to their non-compliance.

In the UK, awareness raising and information campaigns have included a ‘targeting fraud’ pilot project in the North West between May and October 2000 that sought to publicise sanctions and encourage people to report fraud. TV and radio commercials were used presenting 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. No results are known.

### 8.4 Co-ordinating government actions

Some countries have established national, regional or local agencies to provide co-ordinated action on informal economy.
Délégation Interministériel \ à la Lutte Contre le Travail Illégal (France)

In France, since 1997, the Delegation Interministériel \ à la lutte contre le travail illegal (DILTI) has co-ordinated the fight against informal work and has set up institutions in each department. It is located under the authority of the Ministry of Employment and Solidarity, and consists of officials and civil servants of the ministry, magistrates, military personnel, officials and civil servants of other ministries and bodies concerned with the fight against informal work.

On a national level, the co-ordinating role of DILTI is to: implement policy measures; provide assistance to the control services and magistrates, including the provision of specialised documents, reference books and periodical publications; provide a central institution for the analysis of all information concerning informal work; develop partnerships with professional organisations that represent the sectors touched by informal work; and present to public authorities measures that would improve the efficiency of the fight against informal work.

At the local level, DILTI have been created in each department who are responsible for establishing annual reports, including proposals for action.

Comitato per l’Emersione del Lavoro No Regolare (Italy)

In Italy in 1998, the Comitato per l’emersione del lavoro no regolare (Committee for the Exposure of Undeclared Work) was established under Law No. 448/98 in the Office of the Prime Minister. This committee’s primary task is to analyse and co-ordinate formalisation initiatives. Besides the national committee, regional and provincial committees were set up with the tasks of analysing local situations, promoting agreements and providing support for the achievement of formalisation agreements. Each regional committee has 15 members, seven appointed by the public administration and eight appointed jointly by social partners. More than 40 local commissions have been established.

At a national level, its function is to analyse and coordinate all relevant initiatives such as:

- information and awareness campaigns through the media and in schools;
- periodical evaluation of the local control commissions’ activities; and
- examination of possible proposals for the exposure of informal work.

At a regional and provincial level, special local commissions (located in the Chambers of Commerce) of 15 members:

- provide regional analysis;
- promote team work and agreement with the state authorities;
- provide support to enterprises; and
- arrange special areas dedicated to the execution of wage alignment agreements.
Other examples of co-ordinated action include:

- the Cash Economy Task Force established in Australia in 1996 by the Tax Commissioner to examine what motivates participation in the informal economy and to make recommendations on how to improve tax compliance (ATO, 1998a; Bajada, 2002).

- the ‘Central Commission for the Coordination of the Inspection Services and Control of all Tax Contributions and Safety Duties’ in Italy based in the Ministry of Labour. This:
  - studies, researches and conducts other work on tax contribution and tax evasion in the labour, social and tax fields;
  - sets general planning criteria for inspection;
  - collects and analyses national data, including those coming from the ‘Committee for the Exposure of Undeclared work’ and the Chambers of Commerce; and
  - identifies local areas and economic sectors where undeclared work is more prevalent, using data from the above Committee and local commissions appointed to the Chambers of Commerce.

- Partnership arrangements in France in sectors including: craft and industrial building; hairdressing; clothing industry; removal industry; garages and car repair; taxis; flower shops; and live and audio-visual shows and performances. At the local level, more than 200 agreements have been signed since 1992.
Future research

From the evidence presented it is apparent that there are significant gaps in our knowledge of the informal economy.

9.1 Research gaps

9.1.1 Analysing the informal economy

The evidence on the extent and nature of the informal economy remains at best, very patchy and at worst, almost non-existent. No national survey has assessed the extent 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. Until comprehensive research is done, it will be difficult to know whether policy initiatives are targeting the major sectors where this work prevails and the principal types of informal work and worker. The historical targeting of the registered unemployed and wholly underground businesses, when we now know that they constitute only a small proportion of all informal work, provides an indication of the need for more research.

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 as both suppliers and customers of informal work, along with their motives. To date, only local studies of this type exist. A representative national survey to gather data 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 inform under-explored issues such as the relationship between the informal economy and illiteracy, the lifecycle, local ‘work cultures’, employment histories etc.

Business survey. A survey of a representative national sample of businesses to investigate the prevalence and character of the informal economy could evaluate:

- how businesses are affected by the informal economy;
- 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 include 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.


References


Rusbroicht, I. and Nicasie, I. [2003] Service vouchers to create 25,000 legal jobs, European Employment Observatory n. 12, December.


Economy', *Central Europe Review*, vol. 2, no. 40, 20th November.
Informal economy

Summary of responses to a call for submissions and meetings with key stakeholders

Small Business Council

1 Throughout this report terms such as small firms and small business are interchangeable with the term small and medium sized enterprises and are used to signify businesses employing up to 250 people and turnover of less than €50 million.
Responses to a call for submissions and meetings with key stakeholders

B1.1 Background

During the summer of 2004 a range of key stakeholders, from businesses, representative groups, professional bodies and government departments or agencies, were asked for their views, opinions and experiences of small businesses in the informal economy. They were asked for responses to a series of questions based on their experience or, where possible, a data source. The responses have been summarised below under headings that broadly correspond to the areas of questioning.

The following people/organisations responded to the call for submissions:

1. National Federation of Enterprise Agencies
2. Business Link for Cumbria
3. Entrust
4. Solihull Business Enterprise
5. South Hampshire Enterprise Agency
6. Enterprise Fenland
7. Isle of Wight Enterprise Agency
8. Surrey Business Enterprise Agency Ltd
9. East Durham Business Service
10. Jill Levens
11. Jerry Bix
12. Hilary Farnworth
13. Community Economic Regeneration Team Ltd
14. Community Enterprise Wales
15. Enterprise Plymouth Ltd
16. Wales Co-operative Centre
17. Goole Developments Trust
18. Ilyas Patel – Small Business Council member
19. Toni Meredew – Account3
20. Train 2000 Ltd
21. West Yorkshire Enterprise Agency
22. Perlex Associates
23. Whitby & District Business Development Agency
24. Derbyshire Chamber and Business Link
25. Chester and Ellesmere Port Enterprise Agency
26. Albert Wright
27. Invest Northern Ireland
28. Manchester Metropolitan University Business School
29. Newlon Housing Trust
30. Darlington Business Venture
31. D M Brown
32. Prowess Ltd
33. Home Office
34. Welsh Assembly
35. Business Counselling Service – Milton Keynes and North Bucks
36. Bucks Enterprise Ltd – Buckinghamshire
37. Newport & Gwent Enterprise/Chamber of Commerce
38. ECJ Associates Ltd
39. Clark and Drummond
40. Tayside Dancewear
41. Federation of Small Business
42. British Chambers of Commerce
43. The University of Central England and Birmingham
44. Institute of Chartered Accountants in England and Wales
45. Chwarae Teg

B1.2 Types of businesses that are particularly prone to operating in the informal economy

Respondents appeared to be strongly of the view that businesses providing services direct to the general public, particularly trades and personal services, were more prone to operating in the informal economy. Examples included gardening, cleaning, motor vehicle maintenance, building, decorating, taxi driving and hairdressing. A
number of respondents were of the view that informal businesses tended to be in sectors that were characterised by low pay, low profit margins and strong competition.

On the extent to which businesses in the informal economy had common characteristics, a wide number of characteristics were mentioned. A significant number of respondents identified the following characteristics as common:

- the businesses were sole traders;
- they involved labour intensive activities;
- they required relatively limited capital or equipment to start-up or continue operating;
- they were in service sectors where cash payments could be made; and
- they were operating from home or at other people’s homes as opposed to having fixed premises.

**B1.3 Sections of society more likely to operate in the informal economy**

The respondents had differing views on which particular groups could be thought of as being more likely to operate within the informal economy – for example, people receiving benefits, people on lower incomes more generally, women, the poorly qualified, ethnic minority groups, young migrant workers. A number of respondents characterised the people most likely to be in the informal economy as those who found themselves on the margins of the labour market. However it was the view of some respondents that the informal economy included people equally from all sections of society.

**B1.4 Developing entrepreneurial skills**

The majority of respondents agreed to some extent that the informal economy helped develop entrepreneurial skills which could be later transferred into the formal economy. A recurrent theme in the responses was that the informal economy provided opportunities for people to “have a go” at running a business, to test ideas and the market, while minimising the risks, particularly to incomes. Some of the respondents had seen this in practice and were assisting people who had realised they had a potential viable business to make the transition into the formal economy. One respondent made the distinction between informal businesses running in parallel to a formal business, and those informal businesses operating in isolation. Only the latter was perceived as developing entrepreneurial skills in a positive sense.

**B1.5 Informal economy undermining or supporting the formal economy**

The informal economy was equally seen to support the formal economy and undermine it, with many respondents seeing both sides of the issue. In terms of undermining the formal economy issues raised included reducing tax revenue, disturbing pricing structures and undermining the willingness of consumers to pay an amount required by formal businesses to cover their additional costs. It was also viewed as perpetuating unfair competition and reducing the protection offered to employees. On the positive side it was viewed as encouraging people into self employment, acting as a business incubator, supporting people in legitimate but low paying jobs and helping people who have difficulty accessing the formal economy survive and as providing people with more money to spend which in turn supported the local economy.

On the question of whether peer pressure
from other businesses supports or undermines the formal economy few
respondents answered the question with certainty. On the one hand it was speculated
that other businesses, particularly formal ones, could exert positive pressure on those
acting informally. However, on the other hand pressure could come equally from
other businesses in the informal economy.
I suspect that for every business which is
prepared to pay a supplier in cash is another
one which will only deal with legitimate
suppliers. NFEA

B1.6 The extent to which tax evasion
motivates businesses to operate in the
informal economy
Generally respondents saw tax evasion as
one of a number of influences that
motivated businesses to operate within the
informal economy. Other key influences
were thought to be fear of the tax system,
maximising income, supplementing benefits
and avoiding benefit withdrawal,
exacerbated by the fear of not being able to
make enough money from their business
activities to support themselves. Some
respondents considered the tax income lost
to be relatively small scale. Respondents
also suggested that businesses might start
off in the informal economy, sometimes by
accident, and then end up afraid of leaving it
because of the fear of being caught out or
through not knowing how to formalise the
business.

"[The] main reason is that people work
in small ways to supplement income and
do not consider operating as a business.
Some through lack of
understanding/knowledge and because
of perceived (or actual) complications. A
business can sometimes start as a
hobby and then individuals are afraid to
take steps to make it formal or are
unsure how to go about it.” Enterprise
Section – WEW & LPV

B1.7 Contribution of the benefit system
to the scale of the informal economy
A substantial number of respondents saw
the rigid operation of the benefit system and
the complexity of its rules as a
discouragement to declaring earnings and
entering the formal economy, particularly
for those people just starting up their
businesses. The risk of losing the security of
benefits was thought to be too high for many
people. The difficulties faced when trying to
re-enter the benefit system if a business
idea failed was also seen as a barrier to
formal business start-up. Further some
respondents mentioned that JobCentre staff
have a limited knowledge of enterprise and
self-employment as an option, and that the
rules of the system had a negative effect.
The view of a small number of respondents
was that benefits were too easily obtained,
the system was often abused and not
adequately policed, making working in the
informal economy a risk worth taking.

B1.8 The effect of formal record
keeping and other regulatory
requirements
Many respondents did view record keeping
and regulatory requirements as something
that deterred businesses from operating
within the formal economy. It was suggested
that people were intimidated by the idea of
keeping records, the ‘red tape’ and the
complexities of tax. A couple of respondents
mentioned that people often didn’t know
what records they were supposed to keep or
who to present the information to. A small
number of respondents highlighted how
easy it was to set up a business but that the
complexities really emerged at a later stage
Responses to a call for submissions and meetings with key stakeholders

when the VAT threshold became an issue and regulations associated with taking on a first employee.

Another view was that people simply ignored the need to keep formal records, or didn’t see it as applying to their activities. Many of those who clearly did not see regulatory requirements as a major contributory factor did not elaborate as to their reasons. One respondent, however, did view non-compliance as being a purely financial decision.

B1.9 The effect of literacy and numeracy skills

Views were very divided on the issue of whether poor literacy and numeracy skills influenced people’s decisions to operate in the informal economy. Some respondents had experience of this being the case and saw poor key skills as affecting people’s confidence and ability, while others thought it could possibly have an affect and others did not consider it to be a significant factor. One respondent who did not think it was a key issue suggested that running a business, whether formally or informally, required some degree of numeracy skills.

B1.10 Motivations to move from the informal to the formal economy

On this issue there was clearly a wide range of views, both in terms of push and pull factors, but key themes did emerge. One was that the fear of being caught and of severe reprimand was a strong motivation. Another key theme in the responses was that better information and understanding of the legal requirements would motivate people to make the transition, along with mentoring and support and an understanding of the benefits of operating in the formal economy. Actual business success was identified as a key motivation both in terms of achieving a stable level of income and giving the confidence to enter the formal economy. The opportunity to develop and grow the business was another factor identified. One view was that formalising the business would also allow entrepreneurs to access more formal sources of finance to expand the business.

B1.11 Hurdles facing businesses when trying to enter into the formal economy

A view widely held was that fear of enforcement action, prosecution and large tax arrears were key hurdles to entering the formal economy. Other hurdles mentioned were: the sudden impact of the loss of benefits; the loss of income through increased costs which may lead to financial difficulties; finding out where to and how to register the business; the burden of taxation on new businesses and budgeting to pay this every six months; compliance with regulations more generally and the stigma of their current position.

“A business in such a situation may have concerns about the potential loss of income resulting from a transfer from the informal to the formal economy. Compliance with tax and regulatory requirements in the formal economy will probably mean that their income is lower than it was previously and this may cause them financial difficulties, at least in the short term. Another potential hurdle is that businesses may not know who to obtain guidance from in helping them to establish a legitimate enterprise. They may simply decide that it is easier to continue operating in the informal economy.” BCC
B1.12 Increasing awareness of the practical and legal benefits of the formal economy

There were mixed views on this question. Some questioned the importance of this compared to other factors such as lack of income. One view was that this was particularly important at the pre-start stage, to get people running legitimate businesses from the start. One respondent’s view was that encouraging existing informal businesses through awareness raising would be difficult. Increasing awareness was thought by some to be more potentially effective where this was accompanied by appropriate business support. However, some respondents held the view that people would find it difficult to see practical benefits from legitimising the business, and so had made a clear choice to operate in the informal market.

B1.13 Encouraging businesses into the formal economy through improving information or training

Many respondents thought this wouldn’t help. Again some expressed the view that this approach was more likely to work with new start-ups and that training would not be enough of a motivation to make informal businesses make the change. Another view was that information and training were not the main issue, and would not be enough on their own if there was no support to overcome the hurdles identified. Some respondents who did see improving information and training as having a role to play highlighted the need for this to be accessible. Also highlighted were the difficulties in reaching and communicating with businesses in the informal economy.

B1.14 Should government departments encourage businesses into the formal economy or force them to comply?

Overall the view was that encouraging businesses to comply with tax and regulation would be more effective than force, but a significant number proposed that there should be both a ‘carrot and stick’ approach. One view was that many informal businesses had developed through ignorance or circumstance and needed a supportive approach. The experiences of one respondent was that the monetary value of the activities businesses were engaged in did not warrant a large scale enforcement approach. A view held by a number of respondents was that the unintended consequence of force would be to encourage more businesses to remain very small and hidden rather than moving into the formal economy and growing their business.

On the question of whether fear of penalties discourages businesses to legitimise there was no consensus. Some clearly thought this was not a factor, while others strongly thought it was and was not just a fear of penalties, but of other sanctions and tax arrears.

B1.15 Encouraging businesses to become legitimate

Respondents were asked for suggestions as to what would encourage or enable businesses to become legitimate. In summary the suggestions covered:

- simplifying the tax system;
- increasing the tax breaks for low income businesses;
- VAT changes;
- increasing the flexibility in the benefit system and improving the
Responses to a call for submissions and meetings with key stakeholders

- understanding amongst JobCentre staff of the issues involved with the self employment route off benefits;
- improving access to information and advice;
- amnesty periods; and
- stronger enforcement and more visits, by health and safety officers, for example.