Developing a Holistic Approach for Tackling Undeclared Work: background paper

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EXECUTIVE SUMMARY

What is a holistic approach to tackling undeclared work? A holistic policy approach towards tackling the undeclared economy uses in a strategic and coordinated manner the full range of both the direct and indirect policy approaches and measures available to increase the power of, and trust in, authorities respectively.

Direct approaches reduce the costs and increase the benefits of operating on a declared basis, and increase the costs and reduce the benefits of operating undeclared. To do this, it uses:

- **Deterrence measures** that detect and punish participation in undeclared work firstly, by increasing the perceived or actual likelihood of detection and/or secondly, by raising the penalties and sanctions for those caught, and

- **Incentive measures** that make it easier to undertake, and reward, participation in declared work. These include:
  - Preventative measures that encourage citizens and businesses to not engage in the undeclared economy (e.g., by simplifying compliance, using direct and indirect tax incentives to make it beneficial to operate on a declared basis, and providing support and advice about how to start-up legitimately), and
  - Curative measures that incentivise citizens and businesses to make the transition to the declared realm. These can be either (a) supply-side incentives targeting businesses and workers in the undeclared economy or (b) demand-side incentives targeting their customers with rewards for using declared goods and services.

Indirect approaches, meanwhile, recognise that citizens and businesses are not just rational economic actors (purely calculating the costs and benefits). They are also social actors who engage in undeclared work when formal institutional failings lead to them adopting norms and beliefs regarding participation in undeclared work that do not align with the laws and regulations. To align them, therefore, indirect policy approaches either:

- **Change the norms, values and beliefs** regarding participation in undeclared work, so that these are in symmetry with the laws and regulations (e.g., using awareness raising campaigns and educational initiatives), and/or

- **Change the formal institutional imperfections** that lead to a lack of alignment between the norms, values and beliefs of the population, and the laws and regulations. This can involve either:
  - Changing the internal processes of formal institutions by improving procedural and distributive fairness and justice, so as to improve trust in government, and/or
  - Changing the products of formal institutions by pursuing wider economic and social measures associated with lower levels of undeclared work (e.g., increased social expenditure levels, more effective social transfers, active labour market policies targeted at vulnerable groups, greater equality).

To effectively tackle undeclared work, the emerging evidence is that both direct and indirect measures should be used. How to combine and sequence these measures, however, is being debated. Two approaches are being discussed: responsive regulation sequences them by using indirect measures first, then incentives, and deterrents only for those still failing to comply; and the slippery slope framework asserts that the most effective approach is to concurrently improve both the power of authorities using direct measures (i.e., enforced compliance) as well as trust in authorities using indirect measures (i.e., voluntary cooperation). This background paper thus provides a common understanding for Platform members to discuss how to tackle
undertaken work and encourages reflection on the approaches and measures currently being pursued in their own Member State.
1 INTRODUCTION

What approaches and measures are available for tackling undeclared work? How can these approaches and measures be most effectively combined and sequenced? And what implications does this have for EU Member State strategies for tackling undeclared work? The aim of this background paper is to start to answer these questions.

To commence, this background paper reviews the full range of policy approaches and measures available to Member States for tackling undeclared work. The second section then investigates the different ways of combining and sequencing these policy approaches and measures. The intended outcome is to develop a common understanding among Platform members of the full range of policy approaches and measures available, how they can be sequenced and combined, and to encourage reflection on the approaches and measures currently pursued in their country and whether they are the most effective.

Although no official universal definition exists of undeclared work, this background paper adopts the definition widely adopted across the European Union (EU) which defines undeclared work as ‘any paid activities that are lawful as regards their nature but not declared to public authorities, taking account differences in the regulatory systems of the Member States’ (European Commission, 2007: 2). The three key reasons for not declaring these otherwise lawful activities are:

- To avoid payment of income, value added or other taxes;
- To avoid payment of social security contributions; and
- To avoid having to meet certain legal labour standards, such as minimum wages, maximum hours, safety standards, etc.

The only feature differentiating undeclared from declared work is that it is not declared to the authorities for tax, social security and labour law purposes when it should be. If other differences exist, it is not undeclared work. If the goods and services provided are unlawful (e.g., the production or trafficking of drugs, firearms, persons or money laundering forbidden by law), it is part of the wider criminal economy (i.e., the ‘shadow economy’ is often defined as including both the undeclared economy and criminal economy), and if there is no monetary payment, it is part of the unpaid sphere (see Williams, 2014a).

2 POLICY APPROACHES AND MEASURES TO TACKLE UNDECLARED WORK

Key Question:

- Which policy approaches and measures are available for tackling undeclared work?

It is now widely accepted that the aim of governments is not to eradicate the undeclared economy, but to move undeclared work into the declared economy (Eurofound, 2013; European Commission, 2007; ILO, 2015). As Figure 1: Policy approaches and measures available for transforming undeclared work into declared work graphically displays, there are a wide range of policy approaches and measures available for transforming undeclared work into declared work.
Figure 1: Policy approaches and measures available for transforming undeclared work into declared work
On the one hand, direct policy measures transform undeclared into declared work by reducing the costs and increasing the benefits of operating on a declared basis, and by increasing the costs (and the risk of detection) and reducing the benefits of operating on an undeclared basis. This is achieved using either deterrence measures to increase the costs of non-compliance (‘sticks’) and/or incentives to make participation in declared work beneficial and easier (‘carrots’). On the other hand, indirect policy measures address undeclared work by dealing with the formal institutional failings which produce an asymmetry between the laws and regulations, and the norms and beliefs of citizens regarding participation in undeclared work. Each is here outlined in turn.

2.1 Direct policy measures

Direct policy measures reduce the costs and increase the benefits of operating on a declared basis whilst also increasing the costs and reducing the benefits of operating in the undeclared economy (OECD, 2008). Viewing the non-compliant as rational economic actors who engage in undeclared work when the pay-off is greater than the expected cost of detection and punishment, the objective is to elicit compliance by altering the cost/benefit ratio confronting those participating or considering participation in undeclared work (e.g., Allingham and Sandmo, 1972; Hasseldine and Li, 1999). This is pursued using two sets of measures: deterrents and incentives.

2.1.1 Deterrence measures

Deterrence measures increase the costs of non-compliance by firstly, increasing the sanctions for those caught, and/or secondly, raising the perceived or actual likelihood of detection.

Sanctions for engaging in undeclared work exist in all Member States. Although sanctions have been long used, innovative forms of sanction are emerging in many countries, such as the use of ‘black lists’ which prohibit offenders from applying for public support programmes or public procurement tenders, or ‘naming and shaming’ initiatives where the names of offenders are made public.

Increasing the perceived or actual likelihood of detection in order to increase the costs of non-compliance, meanwhile, is the area in which many Member States have focused their resources. Initiatives pursued include: workplace inspections; developing ICT systems to enable data matching; worker registration initiatives prior to starting work or on their first day of work; mandatory IDs in the workplace; coordinated data sharing initiatives across government; the coordination of operations between government departments; coordinating strategy across government, and the use of peer-to-peer surveillance (e.g. telephone hotlines).

These deterrence measures to increase the costs and risks of participating in undeclared work are at the core of most governments’ approaches. If the intention is solely to eradicate the undeclared economy, this is perhaps appropriate. When seeking to transform undeclared work into declared work, however, incentives are also important to entice citizens and businesses to shift work from the undeclared into the declared economy.
2.1.2 Incentive measures

With the growing recognition across governments that the goal is to move undeclared work into the declared economy, greater consideration is now being given to using incentives to make it easier and more beneficial to engage in declared work. These incentives are of two types: preventative and curative measures.

2.1.2.1 Preventative incentive measures
Preventative incentives encourage citizens and business not to start operating in the undeclared economy by making it beneficial and/or easier for them to participate in the declared economy. Such preventative incentives include: simplifying regulations and compliance; using direct and indirect tax incentives to make it beneficial to operate on a declared basis; initiatives to smooth the transition from employment to self-employment, and providing support and advice about how to start-up legitimately.

2.1.2.2 Curative incentive measures
Curative measures, meanwhile, incentivise citizens, workers and businesses to make the transition from the undeclared to the declared realm. These target either the supply-side or demand-side of the undeclared economy.

Supply-side curative incentives target businesses and workers in the undeclared economy. They include measures such as society-wide amnesties, individual-level voluntary disclosure schemes, and advisory and support services to those wishing to move from the undeclared into the declared realm.

Demand-side curative incentives, meanwhile, target the customers of undeclared work with rewards for using declared goods and services. This may include: granting income tax deductions on the costs incurred of obtaining services on a declared basis; the issue of vouchers so that consumers only pay a proportion of the hourly wage rate, leaving the remaining part to be covered by the state; and the use of indirect tax deductions.

2.2 Indirect Policy Measures

The problem with using solely direct measures, however, is that those operating on an undeclared basis are not always rational economic actors purely calculating the costs and benefits. They can be also social actors engaging in undeclared work because there is a lack of alignment between their norms and beliefs regarding participation in undeclared work, and national laws and regulations, for example due to a lack of trust in the state and what it is seeking to achieve.

Indirect measures therefore treat people as social actors and deal with the formal institutional failings that lead to the laws and regulations not aligning with the norms and beliefs of citizens and businesses regarding participation in undeclared work. The intention is to align them in order to create voluntary compliance/self-regulation, and overcome the problem whereby undeclared work, which is unlawful in terms of the laws and regulations of formal institutions, is deemed socially legitimate by citizens and businesses.

From this perspective, therefore, all societies are viewed as having institutions, or governance mechanisms, which prescribe, monitor and enforce the ‘rules of the game’ regarding what is socially acceptable (Baumol and Blinder, 2008; North, 1990). These institutions or ‘rules’ are of two types: formal institutions (i.e., the laws and regulations) that prescribe ‘state morality’
about what is socially acceptable, and informal institutions (i.e., the socially shared rules, usually unwritten) which describe ‘citizen morality’ (Helmke and Levitsky, 2004). To align citizen and state morality, two options are available.

2.2.1 Changing the informal institutions
On the one hand, policy can seek to change the norms, values and beliefs of the population regarding participation in the undeclared economy so that they align with the formal laws and regulations. As such, voluntary compliance is sought using awareness raising campaigns about the costs of undeclared work and benefits of declared work, educational initiatives and normative appeals.

Although such policy measures are increasingly common, not least due to a perception that it is a cost effective way of engendering compliance, it might be asserted that unless changes occur in the formal institutions, the failings that lead to a lack of alignment between state and civic morality will not be addressed, and there will continue to be an asymmetry between the laws, regulations, and citizens and businesses attitudes regarding participation in undeclared work.

2.2.2 Changing the formal institutions
Changing the formal institutions is particularly relevant in societies in which formal institutional failings result in a lack of trust in government, such as due to public sector corruption (European Commission, 2014), or in societies where citizens do not believe that they receive back from government what they expect. To resolve this requires changes in either the internal processes, or the products, of the formal institutions. Each is considered in turn.

2.2.2.1 Changing the internal processes of formal institutions
Changes are pursued in the internal processes of the formal institutions to improve the perception amongst citizens that there is procedural and distributive fairness and justice. The intention in doing so is to bring the norms, values and beliefs of citizens and businesses regarding participation in undeclared work more into line with the laws and regulations.

Procedural fairness refers to the extent to which citizens and businesses believe they are paying their fair share compared with others (Wenzel, 2004). Those who receive what they perceive as procedurally fair treatment will be more likely to trust the authorities and will be more inclined to accept their decisions and directions (Murphy et al., 2009). Indeed, the perceived fairness of the tax system is one of the most important determinants of whether citizens comply with the laws and regulations (Kirchgässner, 2010, 2011; Molero and Pujol, 2012). Conversely, where there is grievance that fair treatment is not being received non-compliance increases (Bird et al., 2006).

Distributive justice refers to whether citizens receive the goods and services they believe that they deserve given the taxes that they pay (Richardson and Sawyer, 2001). Taxes are prices for the goods and services provided by the government. The question for the moral evaluation of taxes is whether the price corresponds to the value of these services (i.e., whether it is seen as ‘just’), namely whether there is a ‘just price’ (Kirchgässner, 2010). The less citizens and businesses perceive the system as being fair, the more they feel justified being non-compliant and breaking the social contract with the state (McGee, 2005).
Procedural justice refers to the degree to which citizens and businesses believe that the authorities treat them in a respectful, impartial and responsible manner (Braithwaite and Reinhart, 2000; Murphy, 2005, 2008). As Wenzel (2006) finds, the compliance rate is significantly higher among those who perceive there to be interactional fairness. Being treated politely, with dignity and respect, being given a say, and having genuine respect shown for one’s rights and social status, all enhance compliant behaviour (Gangl et al., 2013).

2.2.2 Changing the products of formal institutions
Changing the products of formal institutions by pursuing wider economic and social developments are also important for reducing the prevalence of undeclared work. Which specific formal institutional failings, therefore, result in the prevalence of undeclared work? Reviewing studies of the relationship between cross-national variations in economic and social conditions, and cross-national variations in the size of the undeclared economy, the same findings consistently emerge. Whether the size of the undeclared economy is measured using MIMIC estimates (Williams, 2014b) or direct surveys (Williams, 2015b, 2016; Williams and Martinez-Perez, 2014), and whether studies compare the 28 member states of the European Union (Williams, 2016; Williams and Horodnic, 2016a,b), post-socialist transition economies (Williams and Horodnic, 2015) or countries across the developing world (Williams, 2015a,c), the finding is that reducing the prevalence of undeclared work is significantly associated with:

- increasing GDP per capita;
- improving the quality of governance and reducing corruption;
- increasing expenditure on labour market interventions to help the most vulnerable groups;
- increasing social expenditure, and
- developing more effective social transfer systems so as to reduce the level of inequality and severe material deprivation.

Unless these formal institutional failings are tackled, undeclared work will persist.

3 COMBINING AND SEQUENCING POLICY APPROACHES AND MEASURES

- What are the different ways of combining and sequencing policy approaches and measures?

Below, two alternative perspectives regarding how policy measures might be combined and sequenced are presented.

3.1 Responsive Regulation

The responsive regulation approach envisages a regulatory pyramid, sequenced from the least intrusive indirect policy measures at the bottom and used first, to the most intrusive direct controls of deterrents at the top and used last (see Figure 2).

The premise underpinning this approach is that in most cases an authority does not need to use deterrents to achieve compliance. Instead, it can start with indirect policy measures, and if these fail to elicit behavioural change with some groups, then incentives should be used on these groups, with deterrents only used as a last resort (Braithwaite, 2009). The level of intrusiveness therefore escalates up the pyramid until it reaches the policy intervention that elicits the desired response.

The recognition, therefore, is that there is a continuum of attitudes towards compliance and that different policy responses are appropriate for these different attitudes. The result is a temporal
sequencing of policy measures starting with indirect policy measures, then direct incentives and only after these fail are sanctions used (Braithwaite, 2002, 2009). The Australian government for example has adopted this ‘responsive regulation’ approach (Braithwaite, 2009; Job et al., 2007).

However, whether this is the most appropriate combination and temporal sequencing of measures is open to debate.

**Figure 2: The responsive regulation approach**

3.2 **Slippery Slope Framework**

An alternative perspective on the combining and sequencing of policy approaches and measures is the ‘slippery slope framework’. This firstly distinguishes between voluntary compliance which depends on the trust that individuals have in authorities (and is enhanced using indirect measures), and enforced compliance which depends on the power of authorities (and is enhanced using direct measures).

As Figure 3 displays, the argument is that citizens and businesses abide by the law either because they fear detection and fines due to the power of authorities (enforced compliance) or because they feel a commitment to be honest because they have trust in the authorities (voluntary cooperation). When there is effective enforced compliance as well as high voluntary cooperation (i.e., both power and trust), undeclared work is low. When there is ineffective enforced compliance and little voluntary cooperation, undeclared work is extensive (Alm and Torgler, 2011; Alm et al., 2012; Kastlunger et al., 2013; Khurana and Diwan, 2014; Kirchler, 2007; Kogler et al, 2015; Muehlbacher et al., 2011a,b; Prinz et al., 2013).
The argument is that a combination of both greater trust in authorities and the greater power of authorities is a potent combination in ensuring compliant behaviour. Based on this, the suggestion is that concurrently pursuing both voluntary compliance (using indirect measures) and enforced compliance (using direct measures) might be the most effective approach (Kogler et al., 2015; Williams and Horodnic, 2017).

4 ITEMS FOR DISCUSSION

A holistic policy approach towards tackling the undeclared economy uses in a strategic and coordinated manner the full range of both the direct and indirect policy approaches and measures available to increase the power of, and trust in, authorities respectively.

Drawing upon the first section of this background paper, therefore, seminar participants will be encouraged to reflect critically on the current policy approach adopted in their own Member States:

- Which are the dominant policy approaches and measures adopted in their Member States? By comparing answers with each other, is it possible to start to discern differences across EU regions?
- Which policy approaches and measures are currently not being given high priority in their Member States? Why?
- What is driving the adoption of some policy approaches and measures in their Member States, and not others?
- What are the barriers to adopting a fuller range of policy approaches? How, if at all, can these barriers be overcome?

The second section of this paper investigated the different ways of combining and sequencing these policy approaches and measures. This has shown that the criteria for determining whether a Member State adopts a holistic approach is not whether it simply uses a wide range of approaches and measures, but whether it does so strategically and in a coordinated manner that explicitly recognises the different roles that these approaches and measures play in concurrently
achieving both voluntary compliance by increasing trust in authorities (through indirect measures) and enforced compliance by increasing the power of authorities (through direct measures). Indeed, if a holistic approach that combines direct and indirect policy approaches and measures is to effectively achieve enforced and voluntary compliance, then some key questions will need to be answered in each Member State:

- What causes a lack of trust in Member States? Can this/these causes of a lack of trust be overcome?
- What limits the power of authorities? Can this/these constraints be overcome?
- Do you think that in practice enhancing power is always compatible with enhancing trust?
- Do we need a better evidence-based understanding of what limits the power of authorities and trust in authorities in Member States? If so, how can this be achieved?
REFERENCES


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