

Informal Sector Entrepreneurship

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Executive Summary

This paper provides the background paper for the OECD/European Commission policy brief on informal entrepreneurship which provides an overview of the main issues and policies on this subject. In this paper, informal entrepreneurs are defined as those starting a business or are the owner/manager of a business who engage in monetary transactions not declared to the state for tax, benefit and/or labour law purposes when they should be declared but which are legal in all other respects.

Extent and nature of informal sector entrepreneurship

In the 27 member states of the European Union (EU-27), the 2007 Eurobarometer survey no. 284 on informal work reveals that 1 in 28 (nearly 4%) of the 26,659 adults surveyed reported engaging in entrepreneurial endeavour in the informal sector over the last 12 months, spending 73 hours on average in such work and earning an average €11.05/hour, producing a mean annual income from informal entrepreneurship of €806.

Participation rates in informal entrepreneurship however, are not even across EU regions and population groups. Some 9% of participants reported engaging in informal entrepreneurship in Nordic nations but just 3% in Western Europe, 4% in East-Central Europe and 2% in Southern Europe. There are also higher participation rates amongst men, younger age groups, those with higher educational qualifications, the self-employed, manual workers, unemployed people, students, lower- and middle-income groups, and those living in rural areas. Examining earnings moreover, the finding is that there is a segmented workforce of informal entrepreneurs which both mirrors and reinforces the formal labour market in the EU. Women, those with fewer years in education, those not working and those living in rural areas earn less than men, those with higher levels of education, the employed and those living in urban areas. Entrepreneurship in the informal sector therefore, reinforces the inequalities in the formal labour market.

Policy options

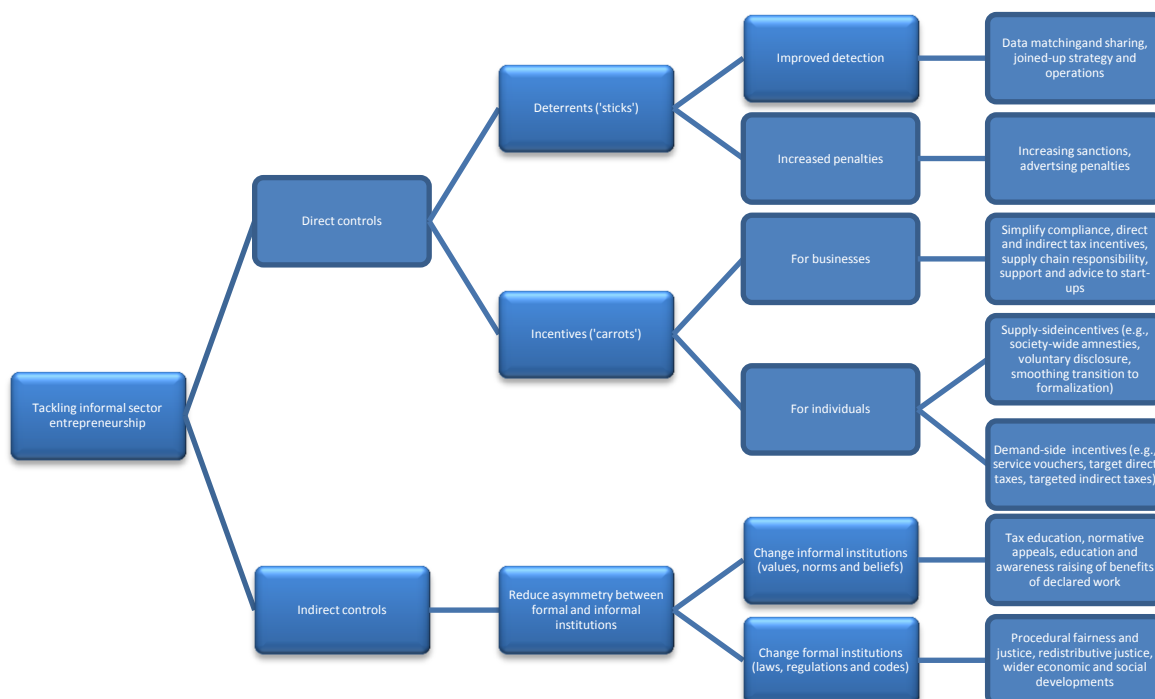
Four hypothetical policy choices exist when tackling informal entrepreneurship: do nothing; de-regulate formal entrepreneurship; eradicate informal entrepreneurship, or formalise informal entrepreneurship. Reviewing these choices, the first option of doing nothing is unacceptable. This is because it leaves intact the existing negative impacts on formal businesses (e.g., unfair competition), informal businesses (e.g., the inability to gain access to credit to expand), customers (e.g., no guarantee that health and safety standards have been followed) and governments (e.g., taxes owed are not collected). Secondly, de-regulating formal entrepreneurship is unacceptable because it results in a levelling down rather than up of working conditions and third and finally, eradicating informal entrepreneurship is unacceptable because it leads to governments repressing precisely the enterprise culture that they otherwise wish to nurture. Formalising informal entrepreneurship thus appears to be the most viable policy choice.

Nevertheless, this does not mean that the other choices are not useful. Although formalising informal entrepreneurship is the most viable choice, it may be that doing nothing sometimes will have a supporting role to play such as in relation to small-scale entrepreneurial endeavour for closer social relations since it is not susceptible to conversion into formal entrepreneurship. A de-regulatory approach, meanwhile, may be in some instances useful when seeking to simplify compliance in relation to business start-ups, and an eradication approach when tackling those who fail to comply.

Policy measures

The figure below provides a conceptual framework for understanding the range of policy measures available for formalising informal sector entrepreneurship. This distinguishes between direct and indirect controls. Direct controls seek compliant behaviour by ensuring that benefits of operating in the formal economy outweigh the costs of working in the informal economy. This is accomplished either by using deterrence measures to increase the costs of non-compliance ('sticks') and/or by making the conduct of formal entrepreneurship more beneficial and easier ('carrots'). Indirect controls meanwhile, shift away from using 'sticks' and 'carrots' to elicit behaviour change and instead focus on developing the psychological contract (or what might also be called the social contract) between the state and its citizens by fostering a high trust high commitment culture.

A typology of policy measures for tackling informal entrepreneurship



Policy recommendations

The debate is not so much over whether to use direct or indirect controls. Both are required. Rather, the major discussion concerns which specific policy measures are most effective and what is the most effective way of putting these policy measures together in various combinations and sequences to elicit formalisation. The 'responsive regulation' approach and 'slippery slope' framework provide two options. Which policy measures are most effective and which sequences and combinations are most effective now needs evaluating. What is certain, however, is that there needs to be a move away from deterring informal entrepreneurship and towards the use of incentives and indirect controls if a formalisation of informal entrepreneurship is to occur. The European platform for tackling undeclared work now needs to develop and share best practice and mutual learning between countries on the most effective ways of achieving this.

1. INTRODUCTION

Over the past decade or so, there has been a growing recognition that entrepreneurs sometimes operate partly or wholly in the informal sector, especially when starting-up business ventures (Antonopoulos and Mitra, 2009; Bureau and Fendt, 2011; Gurtoo and Williams, 2009; Hudson et al., 2012; Ram et al., 2007; Small Business Council, 2004; Webb et al., 2009, 2013, 2014; Williams 2006, 2007; Williams and Martinez, 2014a,b; Williams et al., 2012a). The outcome has been a burgeoning literature examining issues such as the characteristics of informal entrepreneurs (Aidis et al., 2006; Mróz, 2012; Williams, 2006; Williams et al., 2012c), their motives for operating informally (Chen, 2012; Williams, 2009; Williams and Lansky, 2013; Williams et al., 2012b, 2013) and what might be done to facilitate their formalisation (Barbour and Llanes, 2013; Dellot, 2012; Williams and Nadin, 2012a,b, 2013, 2014; Williams et al., 2013b). The aim of this paper is to provide a review of this literature.

To do this, this policy briefing firstly reviews the extant knowledge on the magnitude and character of informal sector entrepreneurship and secondly the contrasting explanations for informal entrepreneurship. The third section then evaluates the range of potential hypothetical policy choices available for tackling this phenomenon. Identifying the formalisation of informal entrepreneurship as the way forward, the fourth section then provides a conceptual framework for understanding the range of potential measures available. This is followed by a review of the direct controls that can be used to facilitate formalisation in the fifth section and the indirect controls in the sixth section. The seventh and final section then demonstrates various ways in which direct and indirect controls can be combined when tackling informal sector entrepreneurship. The outcome will be a comprehensive review of the policy measures available to policy makers along with a review of how they can be combined.

At the outset, it is necessary to denote how informal sector entrepreneurship is being defined in this briefing paper. Reflecting the strong consensus in the literature, the informal sector is here defined as monetary transactions not declared to the state for tax, benefit and/or labour law purposes when they should be declared but which are legal in all other respects (e.g., European Commission, 2007; Evans et al., 2006; Katungi et al, 2006; OECD, 2002, 2012; Renooy et al., 2004; Williams, 2004, 2006). The working definition of an entrepreneur adopted, meanwhile, is somebody actively involved in starting a business or is the owner/manager of a business (Harding et al., 2006; Reynolds et al., 2002). Informal entrepreneurs, therefore, are those starting a business or are the owner/manager of a business who engage in monetary transactions not declared to the state for tax, benefit and/or labour law purposes when they should be declared but which are legal in all other respects. The only illicit aspect of their activity in consequence, is that when trading licit goods and/or services, some or all of their monetary transactions are not declared. Entrepreneurs trading illicit goods and services (e.g., drug trafficking, gun-running) are not informal entrepreneurs. They are part of the much wider criminal economy participating in what has been termed ‘criminal’ entrepreneurship (McElwee et al., 2011; Smith and Christou, 2009; Smith and McElwee, 2013).

2. EXTENT AND NATURE OF INFORMAL SECTOR ENTREPRENEURSHIP

2.1 Extent of informal sector entrepreneurship

Entrepreneurship in the informal sector is not some minor peripheral feature of the global economic landscape. The ILO (2012) reveal that 1 in 6 (17%) of the global non-agricultural workforce are engaged in informal sector entrepreneurship as their main job. The share of the

non-agricultural labour force engage in informal entrepreneurship however, varies across global regions, ranging from 26% in sub-Saharan Africa, 23% in Latin America and the Caribbean and 19% in East Asia and the Pacific, to 11% in the Middle East and North Africa, 10% in South Asia and 8.5% in Europe and Central Asia.

Turning to participation in informal sector entrepreneurship in the 27 member states of the European Union (EU-27), an analysis of the 2007 Eurobarometer survey no. 284 on informal work reveals that 1 in 28 (nearly 4%) of the 26,659 adults surveyed reported engaging in entrepreneurial endeavour in the informal sector over the last 12 months, spending 73 hours on average in such work and earning an average €11.05/hour, producing a mean annual income from informal entrepreneurship of €806. Nearly three-quarters (73%) of this informal self-employment is conducted for closer social relations (e.g., kin, neighbours, friends, acquaintances and colleagues). Just over one-quarter (27%) is conducted for previously unknown other private persons and households.

Table 1 Prevalence and nature of informal entrepreneurship in the EU-27: by region and population group

	% engaged in informal entrepreneurship in past year	% of all informal entrepreneurs surveyed:	% of surveyed population	Average total hours	Average hourly informal earnings(€)	Mean total annual informal earnings (€)	% of informal entrepreneurship conducted for:	
							closer social relations	other private persons/household
EU27	4	100	100	73	11.05	806	73	27
<i>EU region:</i>								
Nordic	9	11	4	39	13.85	536	84	16
Western	3	49	48	58	12.78	742	83	17
East-Central	4	24	22	90	7.48	673	64	36
Southern	2	16	26	133	7.58	1,006	53	47
<i>Gender:</i>								
Man	4	63	48	75	11.71	878	79	21
Woman	2	37	52	69	8.13	561	64	36
<i>Age:</i>								
15-24	6	30	15	76	9.61	736	75	25
25-39	5	43	26	58	12.01	700	58	42
40-54	3	24	26	68	11.25	769	71	29
55+	<1	3	33	69	8.50	591	0	100
<i>Education ended:</i>								
15-	2	15	25	115	9.52	1,100	62	38
16-19	3	40	42	70	10.51	736	76	24
20+	4	25	23	46	13.13	605	80	20
Still studying	6	20	10	66	8.84	584	69	31
<i>Employment status:</i>								
Self-employed	6	12	7	34	17.39	582	72	28
Managers	2	7	10	49	12.25	605	88	12
Other white	3	9	12	55	9.47	521	83	17
Manual workers	4	29	22	74	11.71	870	75	25
House persons	2	6	9	115	10.20	1176	71	29
Unemployed	6	11	6	92	7.59	718	62	38
Retired	1	8	25	66	7.84	522	74	26
Students	6	18	10	66	8.84	585	69	31
<i>Gross formal income/month:</i>								
<€500	6	18	14	82	7.43	610	62	38
€500-1,000.99	4	20	20	68	9.94	672	89	11
€1001-2000.99	4	29	31	51	12.28	620	90	10
€2001-3000.99	6	21	15	49	14.53	709	83	17
€3001+	2	12	20	46	18.80	874	74	26
<i>Urban/rural area:</i>								
Rural area	4	40	32	79	10.40	822	80	20
Small/ medium town	3	40	42	68	10.72	732	68	32
Large urban area	3	20	26	61	11.28	693	71	29

Source: Williams et al. (2012c: Table 1)

Participation rates in informal entrepreneurship however, are not even across EU regions and population groups. Some 9% of participants reported engaging in informal entrepreneurship

in Nordic nations but just 3% in Western Europe, 4% in East-Central Europe and 2% in Southern Europe. In Nordic nations therefore, one finds 11% of all informal entrepreneurship despite only 4% of the surveyed population being located in this EU region. Even if participation rates are lower in Southern Europe however, informal entrepreneurs work longer hours and earn a greater amount of money. In Nordic nations and Western Europe, informal entrepreneurs work fewer hours but the hourly wage rate is higher.

2.2 Characteristics of Informal Entrepreneurs

Which population groups are more likely to engage in informal entrepreneurship? As Table 1 reveals, the groups over-represented and with higher participation rates include men, younger age groups, those with higher educational qualifications, the self-employed, manual workers, unemployed people, students, lower- and middle-income groups, and those living in rural areas. Examining earnings, the finding is that there is a segmented workforce of informal entrepreneurs which both mirrors and reinforces the formal labour market in the EU. Women, for example, earn only 69% the average hourly wage rate of men (€8.13 compared with €11.71) from their informal entrepreneurship. Similarly, those with fewer years in education earn less than those with higher levels of education, as do those not working (e.g., the unemployed, retired, students) earn less than the employed and self-employed, those with lower gross formal incomes earn significantly less than those with higher gross formal incomes, and those living in rural areas have lower hourly wage rates than those in urban areas. Entrepreneurship in the informal sector therefore, reinforces the inequalities in the formal labour market.

Importantly for policy makers, this work is not evenly distributed across all sectors. Some 25% takes place in the household services sector (compared with just 3% of all surveyed self-employment), 19% in the construction industry (12% of all self-employment), 11% in the personal services sector (17%), 9% in repair services (4%), 6% in the hotels and restaurant sector (4%), 5% in agriculture (13%), 4% in industry (5%), 4% in transport (3%) and 3% in the retail sector (23%), with 14% in other sectors (16%). Those engaging in entrepreneurial endeavour in some sectors (e.g., household services and construction) are therefore more likely to work on an informal basis than in other sectors (e.g., retail, personal services).

2.3 Motives of Informal Entrepreneurs

When examining informal entrepreneurs' motives, it has become increasingly common to differentiate between 'necessity' entrepreneurs pushed into entrepreneurship because other choices are absent or unsatisfactory and 'opportunity' entrepreneurs doing so out of choice. Early studies simply assumed that informal entrepreneurs are necessity-driven (Castells and Portes, 1989; Gallin, 2001; Sassen, 1997). A second wave of studies however, asserted the inverse, namely that many choose to work informally (Maloney, 2004; Snyder, 2004). A third wave of thought then transcended this depiction of informal entrepreneurs as universally necessity- or opportunity-driven, and evaluated the ratio of necessity-to-opportunity entrepreneurs (e.g., Williams, 2007). This was then followed by a fourth wave that mirrored pioneering studies on formal entrepreneurs' motives (Aidis et al., 2006; Smallbone and Welter, 2001), by questioning the separateness of opportunity- and necessity-drivers, arguing that both can be co-present and that shifts in the balance of these motives take place over time, often from more necessity- to opportunity-driven (Snyder, 2004; Williams, 2009; Williams and Round, 2007; Williams et al., 2012b, 2013a).

This fourth wave of thought on informal entrepreneurs' motives is reinforced when examining the results of the 2007 Eurobarometer survey no. 284 on undeclared work. As Table 2 reveals, of the 944 participants reporting that they engaged in informal sector

entrepreneurship, 60% cited purely voluntary opportunity-oriented reasons, 17% stated purely necessity-driven rationales and 23% both pull and push factors. This displays that informal entrepreneurship is not driven by either choice or necessity, but by both and these can often be co-present when examining an entrepreneur's motives for operating in the informal sector.

Table 2. Are those participating in informal entrepreneurship doing so out of choice and/or necessity? by EU region and socio-demographic group

	Purely voluntary	Purely necessity-driven	Both voluntary and involuntary factors
EU-27	60	17	23
<i>By EU region:</i>			
Nordic	77	6	17
Continental	60	17	23
East-Central Europe	60	15	25
Southern Europe	49	26	25
<i>Gender:</i>			
Men	63	13	24
Women	56	23	21
<i>Age:</i>			
15 – 24	55	20	25
25 – 39	64	15	21
40 – 54	65	16	19
55+	52	16	32
<i>Education, end of:</i>			
15-	45	25	30
16-19	54	21	25
20+	78	11	11
Still studying	65	10	25
<i>Employment status:</i>			
Self-employed	65	14	22
Managers	82	4	14
Other white collar	64	20	16
Manual workers	57	19	24
House person	51	33	16
Unemployed	51	17	32
Retired	51	20	29
Students	64	10	26
<i>Gross formal income/month:</i>			
<€500	56	27	17
500-1,000.99	65	18	17
1001-2000.99	63	18	19
2001-3000.99	80	1	19
3001+	63	8	29
<i>Urban/rural area:</i>			
Rural area or village	61	15	24
Small/medium town	56	19	25
Large urban area	63	18	18

Source: Williams et al. (2012c: Table 2)

Nevertheless, the proportion driven by necessity- and/or opportunity varies across EU regions and population groups. In Nordic nations, where informal entrepreneurship is more likely to be embedded in networks of familial and community support, voluntarism is more commonly cited, whilst in Southern Europe and East-Central Europe, where informal entrepreneurship is more usually for previously unknown private persons/households, necessity is more often stated. Similarly, informal entrepreneurship conducted by lower-income groups, women, those with lower educational levels and those not formally working (e.g., the retired, house persons) are significantly more likely to be necessity-driven, whilst those participating in higher-income brackets, men, middle-aged workers, the better educated, and managers, the self-employed and other white collar workers, along with students, are significantly more likely to be willing participants.

3 EXPLAINING INFORMAL SECTOR ENTREPRENEURSHIP

What are the causes of informal sector entrepreneurship? Until now, four competing theories have been proposed to explain such entrepreneurship.

3.1 Modernization explanation

For much of the twentieth century, the widespread belief was that the formal economy was extensive and growing while the informal economy was a minor remnant and disappearing. Informal entrepreneurs were thus depicted as a leftover from an earlier mode of production and informal entrepreneurship explained to be a product of the ‘under-development’, ‘backwardness’ and ‘traditionalism’ of societies (Geertz, 1963; Gilbert, 1998; Lewis, 1959). From this perspective therefore, informal entrepreneurship is portrayed as greater in less developed and less modernised economies, measured by indicators such as GDP per capita. With economic development and modernisation however, there is seen to be a natural and inevitable diminution of this form of entrepreneurship.

Since the turn of the millennium, there has been widespread recognition that the informal sector in general (ILO, 2002; Jütting and Laiglesia, 2009; Schneider, 2013; Schneider and Williams, 2013), and informal entrepreneurship particularly (De Soto, 2001; Minard, 2009; Perry and Maloney, 2007; Williams, 2006), is extensive, enduring and expanding in many global regions. The result has been a refutation of this modernization explanation of informal entrepreneurship as some minor diminishing remnant of a previous mode of production existing in a few peripheral corners of the global economic landscape, and the emergence of new theorizations to explain its persistence and growth.

3.2 Structuralist explanation

One such explanation for the persistence and growth of informal entrepreneurship is a political economy perspective which explains such endeavour to be a direct product of the subcontracting and outsourcing practices being used in the emerging de-regulated open world economy. Such subcontracting and outsourcing is asserted to have integrated informal entrepreneurship into the supply chains of contemporary capitalist production, resulting in downward pressure on wages in the context of the hollowing out of social protection. Informal entrepreneurship is thus seen to be an unregulated, insecure and low paid survival-driven endeavour conducted out of necessity and as a last resort by populations excluded from the formal labour market (Castells and Portes, 1989; Gallin, 2001; Portes, 1994; Slavnic, 2010; Taiwo, 2013). Viewed through this lens, informal sector entrepreneurship is thus a result of the under-regulation of work and the lack of social protection and social transfers, and thus the direct product of poverty. Consequently, this practice is deemed to be more prevalent in countries with inadequate state intervention to protect workers from

poverty (Davis, 2006; Gallin, 2001; Slavnic, 2010).

3.3 Neo-liberal explanation

Rather than portray informal entrepreneurship as necessity-driven endeavour conducted by marginalized populations, neo-liberal scholars have instead contended that the growth of informal entrepreneurship signals how many are choosing to voluntarily exit the formal economy in order to avoid high taxes, public sector corruption and an over-burdensome state. From this perspective therefore, informal entrepreneurs are heroes rejecting the bureaucratic shackles of an over-regulated state and choosing to work informally to avoid the costs, time and effort of formal registration (e.g., de Soto, 1989, 2001; Perry and Maloney, 2007; Small Business Council, 2004) and informal entrepreneurship is viewed as a direct response to high taxes, the over-regulation of the market and public sector corruption (De Soto, 1989). Viewed in this manner, informal entrepreneurship is thus a sign of popular resistance to state over-regulation and a rational economic tactic which is voluntarily pursued by entrepreneurs stifled by state-imposed constraints (Maloney, 2004, Packard et al., 2012).

3.4 Evaluating the explanations in a European context

Until now, these theoretical perspectives have been usually treated as mutually exclusive rival explanations with scholars adopting one or other (e.g., De Soto, 2001). In recent years however, cross-national comparisons of the prevalence of informal entrepreneurship in developing and transition countries have started to show the need for a synthesis of these contrasting explanations (Williams, 2013c). In Europe nevertheless, this need for a synthesis of the competing explanations has so far been revealed only in relation to the informal sector more generally (Williams, 2013a).

Table 3 reveals evaluates critically these three contrasting explanations in relation to Europe by comparing cross-national variations in the prevalence of informal employment (using the mean of all indirect estimates). In relation to the modernisation thesis, the finding is that wealthier modern economies where GDP per capita, purchasing power standards and the quality of state bureaucracy are higher, the prevalence of informal employment is smaller. In contrast, no evidence is found to support the neo-liberal explanation that cross-national variations in the size of informal employment are related to cross-national variations in tax rates. However, greater levels of public sector corruption are found to be strongly correlated with greater levels of informal employment, albeit not due to workers voluntarily exiting the informal sector as suggested by neo-liberals but more due to employers exiting the formal economy and then imposing informal employment relationships on their employees. Turning to the neo-liberal thesis that greater state intervention in work and welfare provision is a driver underpinning greater levels of informal employment meanwhile, little evidence is found to support this thesis. Instead, quite the opposite is the case. As the structuralist perspective suggests, greater state intervention in labour markets and welfare provision is strongly correlated with lower levels of informal employment. Those nations with higher levels of state intervention in labour markets, greater social protection expenditure, where state redistribution via social transfers is higher and there is greater equality in the distribution of income have lower levels of informal employment characterised by workers doing so more out of choice.

The clear theoretical implication is that no one existing theoretical explanation for the cross-national variations in the extent and nature of informal employment suffices. Instead, a synthesis is required of previous explanations. There is a strong correlation between societies with lower levels of informal employment where it is conducted mostly out of choice and wealthier, more developed, less corrupt and more equal economies where there is greater state intervention in the labour market, higher levels of social protection and more effective

redistribution via social transfers. Whether this set of explanations remain valid when examining informal entrepreneurship in Europe now needs to be evaluated. Although this has been shown to be the case in transition and developing countries (Williams, 2013c), it has not been so far evaluated in a European context.

Table 3 Relationship between cross-national variations in the magnitude and nature of informal employment and societal characteristics: bivariate analyses using Spearman's rank correlation coefficient (r_s)

Societal characteristic	Magnitude of informal employment (mean of indirect estimates)	Nature of informal employment (% conducted out of choice)
<i>Modernisation explanation:</i>		
GDP per capita	-.656**	.510*
Purchasing power standards (PPS)	-.710**	.510*
Quality of state bureaucracy	-.672**	.521**
<i>Neo-liberal explanation:</i>		
Implicit tax rate on labour income	-.011	.062
Total tax revenue	-.357	.412*
Public sector corruption	-.625**	.614**
<i>Structuralist explanation:</i>		
State expenditure on labour market measures	-.411*	.178
Social protection expenditure	-.480*	.368
State redistribution via social transfers	-.538**	.452*
Income distribution inequality	.520**	-.419*

Note: ** Correlation is significant at the 0.01 level, * correlation is significant at the 0.05 level

Source: derived from Williams (2013a: Table 2)

4 POLICY OPTIONS

Hypothetically, there are four contrasting policy choices available when tackling informal sector entrepreneurship.

4.1 Do nothing

A first option is to do nothing. The rationale for doing so is that informal entrepreneurship is a seed-bed for enterprise creation, a breeding ground for the micro-enterprise system and a test-bed for fledgling business ventures and should therefore be left alone. Indeed, reporting a 2012 survey of 595 small business owners in the UK, Williams and Martinez (2014a) identify that 20% report that they traded informally when starting their business, with 64% asserting that the main reason was to test its viability. The problem with doing nothing however, and as Table 4 summarises, is that informal entrepreneurship has significant negative implications for formal businesses, informal businesses, customers as well as governments. Reviewing these positive and negative impacts of informal entrepreneurship, the strong consensus of scholars and policy-makers is that the negative impacts outweigh the positive impacts and thus that interventions are required to tackle informal entrepreneurship. What form of intervention, therefore, is needed?

Table 4 Positive and negative impacts of entrepreneurship in the informal sector

Negative Impacts	Positive Impacts
<i>For informal sector entrepreneurs:</i>	
Lack of access to credit and financial services, partly due to limited credit history.	A source of income to stay out of poverty.
Difficulty in expanding a business which cannot be openly advertised.	Flexibility in where, when and how to work (especially important for women who remain responsible for child-care).
May face higher barriers of entry to the formal market on account of an inability to provide employment history to back up their skills.	Reduces barriers to entry into work because the majority of informal work starts with close social relations.
<i>For formal entrepreneurs:</i>	
Results in an unfair competitive advantage for informal over formal entrepreneurs	Provides entrepreneurs with escape route from corrupt public sector officials
Results in de-regulatory cultures enticing law-abiding entrepreneurs into a ‘race to the bottom’ away from regulatory compliance	Provides an exit strategy in contexts where the regulatory burden stifles business development
Results in ‘hyper-casualisation’ as more legitimate entrepreneurs are forced into the informal economy to compete	Enables outsourcing and sub-contracting to lower production costs
<i>For customers:</i>	
Lack legal recourse if a poor job is done, insurance cover; guarantees in relation to the work conducted, and certainty that health and safety regulations have been followed.	A more affordable product or service can be offered to or asked for by customers if payment is made in cash and no receipts change hands
<i>For governments:</i>	
Causes a loss of revenue for the state in terms of non-payment of taxes owed	Income from informal entrepreneurship spent in the formal economy boosts demand for formal goods and services and contributes to ‘official’ economic growth.
Reduces state’s ability to achieve social cohesion by reducing the money available to governments to pursue social integration and mobility	‘On the job’ training in informal enterprises alleviates pressure on the state and its agencies during times of reduced public spending.
Leads to a loss of regulatory control over work conditions and service provision in the economy	Breeding ground for the micro-enterprise system
Such endeavour may encourage a casual attitude towards the law more widely	Test-bed for fledgling businesses

Source: derived from Llanes and Barbour (2013), Williams (2006) and Williams and Nadin (2012b)

4.2 De-regulating the formal economy

One interventionist option is to de-regulate the formal economy. This is based on the belief that informal entrepreneurship arises due to the over-regulation of the market (Sauvy, 1984; De Soto, 1989, 2001), and the objective is to de-regulate the formal economy so that all activities are performed in the manner now called informal, although they would not be informal since they would be conforming to the regulations that remain. However, some intransigent problems exist with this policy approach. The view is that de-regulation reduces informality. However, there is growing evidence that decreasing the degree of regulation does not result in a formalisation of informal entrepreneurs (Kus, 2010, 2014; Williams, 2013b, 2014a,b). Indeed, even if de-regulation were to lead to higher levels of formalisation, the

outcome appears to be poorer quality work conditions and a levelling down rather than up of working conditions (Williams, 2006, 2014a). In sum, even if de-regulation reduced the magnitude of informality which by definition is a product of the regulations imposed on formal entrepreneurship, the impact would be to widen inequalities and reduce working conditions compared with more regulated states.

4.3 Eradicating informal sector entrepreneurship

Another interventionist option is to pursue the eradication of informal sector entrepreneurship. To achieve this, informal entrepreneurs are viewed as ‘rational economic actors’ who will evade tax as long as the pay-off is greater than the expected cost of being caught and punished (Allingham and Sandmo, 1972), and change is sought by seeking to alter the cost/benefit ratio confronting those engaged or thinking about participating in informal entrepreneurship (e.g., Grabiner, 2000; Hasseldine and Li, 1999; Richardson and Sawyer, 2001). In the eradication approach, this is achieved by raising the costs of operating informally firstly, by increasing the perceived or actual likelihood of detection and secondly, the penalties and sanctions for those caught. In this ‘negative reinforcement’ approach therefore, behaviour change is elicited through the use of ‘sticks’ that punish ‘bad’ (non-compliant) behaviour.

Whether this is a practical and desirable approach however, is questionable. On the practicality side, there is the issue of whether it is effective. Although some find that improving detection and/or penalties reduces informality (De Juan *et al.*, 1994; Slemerod *et al.*, 2001), others identify that informality grows (Bergman and Nevarez, 2006; Murphy, 2005). Indeed, some even conclude that ‘it is not sensible to penalize illicit work with intensified controls and higher fines’ (Schneider and Enste, 2002: 192). This is because it can alienate informal entrepreneurs, reducing their willingness to comply and amplifying informality by reducing their belief in the fairness of the system (Murphy, 2005).

There is also the question of whether its eradication is desirable. If the informal economy is recognised as a breeding ground for the micro-enterprise system and seedbed for entrepreneurship, this sphere is a potential asset to be harnessed and driver of economic development (e.g., Williams, 2006). Pursuing its eradication will therefore eliminate precisely the entrepreneurship and enterprise culture that governments are seeking to nurture. The resulting challenge for public policy is to ‘join-up’ its policy approach towards informal entrepreneurship with its agendas to nurture enterprise culture and entrepreneurship. Indeed, unless achieved, then governments with each new initiative to eradicate informal entrepreneurship will further destroy the entrepreneurship and enterprise culture that they desire.

4.4 Formalising informal entrepreneurship

Rather than do nothing, de-regulate formal entrepreneurship or stamp out such enterprise, a final option is to formalise informal entrepreneurship (Dekker *et al.*, 2010; European Commission, 2007, Renooy *et al.*, 2004; Small Business Council, 2004, Williams, 2006; Williams and Renooy, 2013). The positive impacts of formalising informal entrepreneurship vary according to whether formal and informal businesses, customers or the government, are considered.

For formal businesses, this would eliminate the unfair competitive advantage informal businesses have over those who play by the rules (Evans *et al.*, 2006; Renooy *et al.*, 2004). It would also enable businesses to pursue a ‘high road’ rather than ‘low road’ approach by moving towards greater regulatory standards on working conditions such as health and safety and labour standards (Grabiner, 2000; Renooy *et al.*, 2004; Williams and Windebank, 1998). For informal businesses meanwhile, the key benefits of moving into the formal economy are

manifold. They can escape pressurization into exploitative relationships with the formal sphere (Gallin, 2001; Williams and Windebank, 1998) and achieve the same levels of legal protection as formal businesses (ILO, 2014; Morris and Polese, 2014). They are also able to secure formal intellectual property rights to their products and processes (De Beer *et al.*, 2013) and overcome the structural impediments that constrain their growth such as the lack of access to capital as well as advice and support (ILO, 2014).

For customers, the advantages of formalising informal entrepreneurship are that they benefit from legal recourse if a poor job is done, have access to insurance cover, enjoy guarantees in relation to the work conducted, and have more certainty that health and safety regulations have been followed (Williams and Martinez, 2014c).

Finally, for governments, the benefits are that it improves government revenue, thus enabling social integration and mobility to be pursued (Williams and Windebank, 1998). It also allows more formal jobs to be created and thus improvements in employment participation rates and enables a joining-up of the policy approach towards the informal economy with the policy approaches towards entrepreneurship and social inclusion (Dekker *et al.*, 2010; European Commission, 2007, Small Business Council, 2004). It also leads to greater control over the quality of jobs and services provided in the economy (Gallin, 2001) and a more positive attitude towards the law more widely (Polese, 2014; Renooy *et al.*, 2004; Sasunkevich, 2014).

4.5 Summary

This review of the four choices available reveals that the first option of doing nothing is unacceptable. This is because it leaves intact the existing negative impacts on formal businesses (e.g., unfair competition), informal businesses (e.g., the inability to gain access to credit to expand), customers (e.g., no guarantee of health and safety standards) and governments (e.g., taxes owed are not collected). Secondly, de-regulating the formal economy is unacceptable because it results in a levelling down rather than up of working conditions and third and finally, eradicating informal entrepreneurship is unacceptable because it leads governments to repress through their approach towards the informal sector precisely the enterprise culture that they otherwise wish to nurture. Formalising informal entrepreneurship thus appears to be the most viable policy choice.

5. CHALLENGES FACING FORMALISATION STRATEGIES

Given that formalising informal entrepreneurship is the way forward, it is important to understand firstly the negative (potentially unintended) impacts of pursuing a strategy of formalising informal entrepreneurship and secondly, the main barriers to formalisation that policy-makers need to overcome.

5.1 Impacts of formalising informal entrepreneurship

The positive effects of pursuing the formalisation of informal entrepreneurship have been reviewed in section 4.4 above. Although the strong consensus is that these positive effects of formalising informal entrepreneurship outweigh the negative impacts, it is nevertheless necessary to review these potential negative (unintended) impacts of pursuing such a formalisation strategy.

The first main potential negative implication is that entrepreneurs will no longer be able to use the informal sector to test-trade their business when starting-up. This, however, can be largely overcome by policy-makers recognising that in some instances, it might be necessary to adopt a de-regulatory approach towards business start-ups to allow the informal

sector to act as an incubator for new business ventures. The second main negative impact of pursuing formalisation is that customers of entrepreneurs operating in the informal sector will need to pay the full market price, since the function of the informal sector in providing access to cheaper goods and services will no longer be available. The third and final negative impact of pursuing the formalisation of informal entrepreneurship is that it might not be feasible to move all informal entrepreneurship into the formal sector, such as small-scale piecemeal paid favours conducted to help others out, not least because such endeavour does not seem susceptible to being shifted into the formal sector. This can be partially overcome, however, by policy-makers adopting a laissez-faire approach towards informal entrepreneurs pursuing such small-scale paid favours for close social relations.

As such, although formalising informal entrepreneurship is the most viable policy option for policy-makers to pursue, many of the negative impacts can be overcome by recognising that the other policy options may sometimes have a subsidiary supporting role to play. Doing nothing may sometimes have a supporting role to play such as in relation to small-scale entrepreneurial endeavour for close social relations because such activity is not susceptible to conversion into formal employment. A de-regulatory approach, meanwhile, may be in some instances useful when seeking to simplify compliance in relation to business start-ups and an eradication approach when tackling those who fail to comply. In other words, although formalising informal entrepreneurship needs to be the main policy approach due to the positive impacts of formalisation, the other approaches may well in some instances have a supporting role to play if the negative impacts of pursuing formalisation are to be minimised.

5.2 Main barriers to formalisation

What barriers will policy-makers confront when seeking to formalise informal entrepreneurship? To understand the main barriers to formalisation faced by policy-makers, it is first necessary to differentiate informal entrepreneurs firstly, by whether they operate wholly or partially in the informal sector, and secondly, by whether they have the intention of formalising in the foreseeable future or whether they have no intention of undergoing a process of formalisation. Table 5 provides a typology of the types of informal entrepreneurship

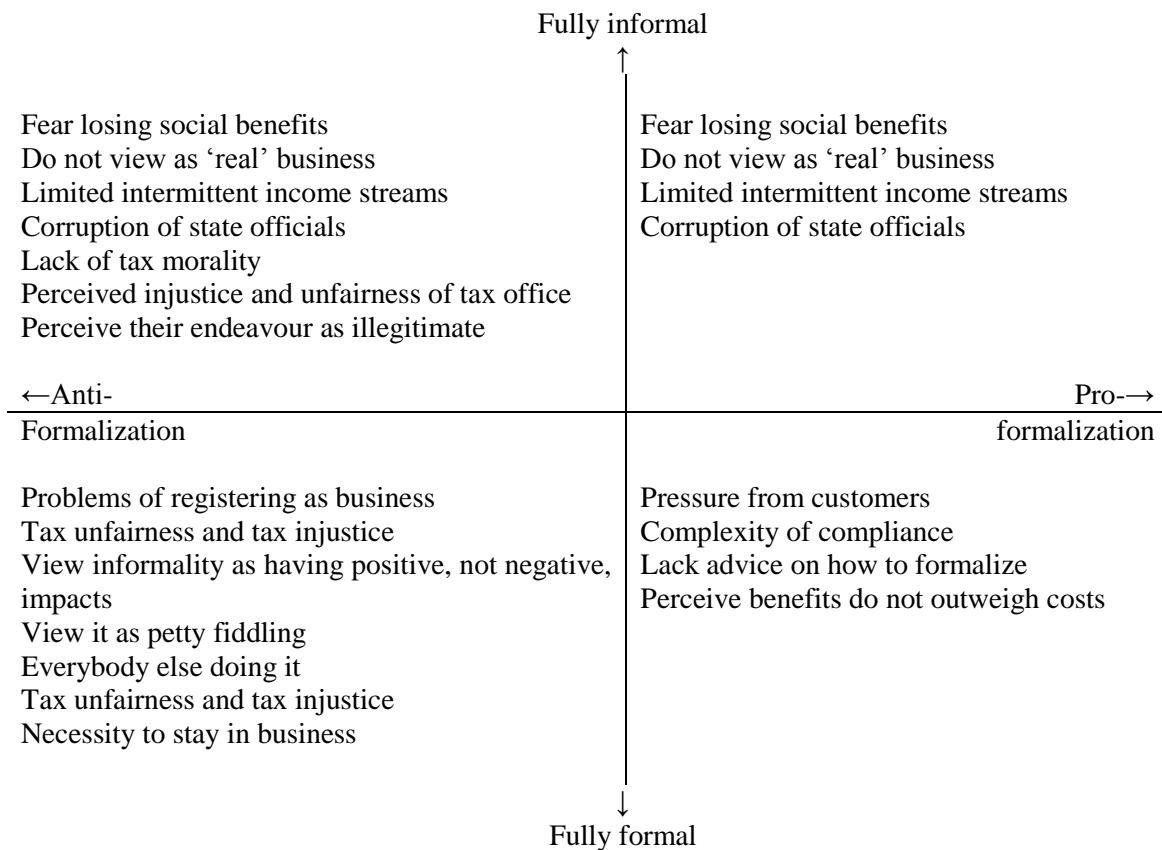
Table 5 Typology of informal entrepreneurship

Type of Informal Entrepreneur	Description	Intention to formalise
Wholly Permanent	Operating unregistered enterprises wholly in the informal economy	No intention of formalising in the foreseeable future
Wholly Temporarily	Operating unregistered enterprises wholly informally	An intention to formalise
Partially Permanent	Operating registered businesses and paying tax but not declaring a proportion of their income	No intention of increasing the share they declare
Partially Temporary	Operating registered businesses that do not declare a proportion of their income	Intention to and who are making the transition to the formal economy

Based on this categorisation of the different types of informal entrepreneurship, Figure 1 provides a summary of the qualitative research so far conducted in a diverse range of

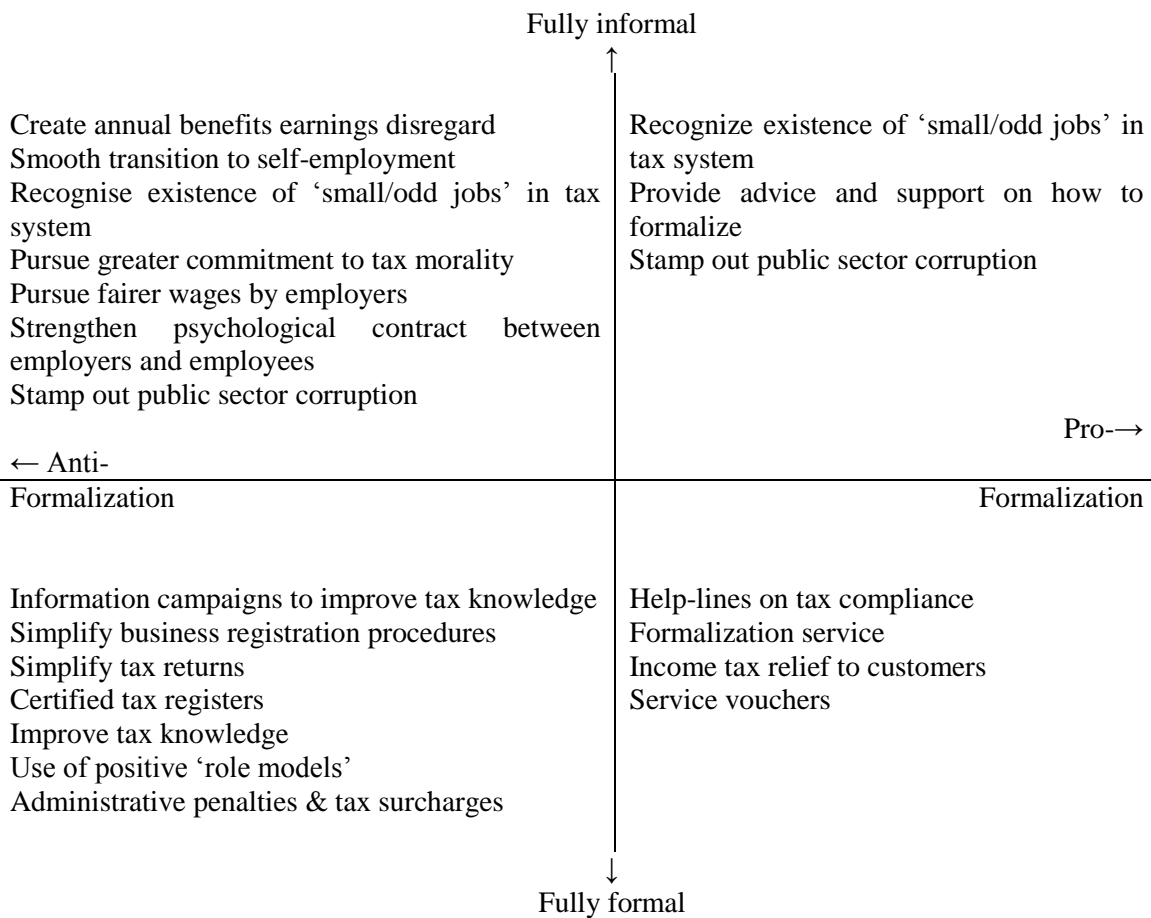
countries, including the UK and Ukraine, regarding entrepreneurs' reasons for working informally (Williams and Nadin, 2012a,b, 2013, 2014). These represent the main barriers faced by policy-makers when seeking to formalise each of these types of informal entrepreneur.

Figure 1 Entrepreneurs' reasons for working informally: by type of informal entrepreneur



Given that the formalisation of informal entrepreneurship is the most feasible option, and that the rationales for working informally and barriers to formalisation vary according to whether entrepreneurs operate partially or wholly in the informal sector and whether they view themselves as on a path of formalisation or not, different policy measures will be therefore required for these different types of informal entrepreneur. In other words, a tailored approach towards formalising informal sector entrepreneurship is required that tackles the specific barriers to formalisation confronted by these different segments of the hidden enterprise culture. Figure 2 summarises a range of bespoke policy measures that can be used to tackle the barriers to formalisation and contrasting rationales for operating informally for each of these four types of informal entrepreneur.

Figure 2 Policy measures required to tackle informal entrepreneurship: by type of informal entrepreneur



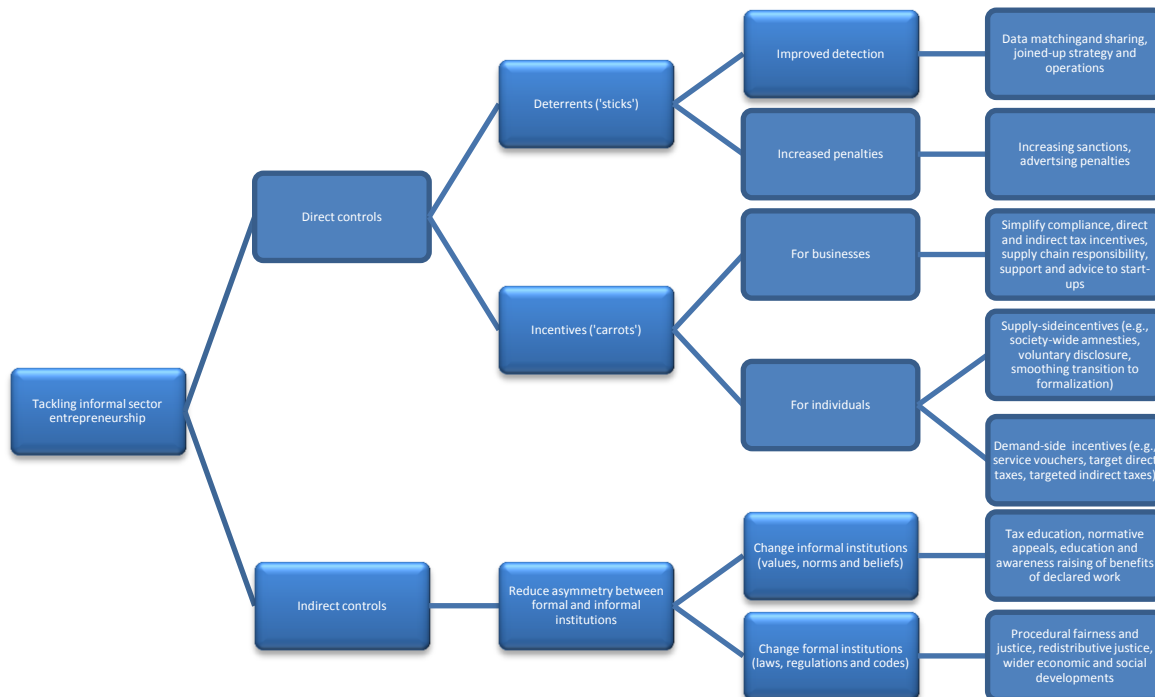
To provide a way of understanding the diverse array of policy measures required for formalising informal entrepreneurship, the next section sets out a heuristic conceptual framework of the types of policy measure that are available and can be used for tackling this phenomenon.

6. POLICY MEASURES

6.1 A Conceptual Framework

Figure 3 provides a conceptual framework for understanding the range of policy measures available for formalising informal sector entrepreneurship. This distinguishes between direct and indirect controls. Direct controls seek compliant behaviour by ensuring that benefits of operating in the formal economy outweigh the costs of working in the informal economy. This is accomplished either by using deterrence measures to increase the costs of non-compliance ('sticks') and/or by making the conduct of formal entrepreneurship more beneficial and easier ('carrots'). Indirect controls meanwhile, shift away from using 'sticks' and 'carrots' to elicit behaviour change and instead focus on developing the psychological contract (or what might also be called the social contract) between the state and its citizens by fostering a high trust high commitment culture.

Figure 3: A typology of policy measures for tackling informal sector entrepreneurship



6.2 Policy measures adopted in European nations

Having outlined the various policy approaches available, attention now turns to the approaches and measures used in practice in Europe. To do this, a 2010 web-based survey is reported of senior officials responsible for tackling the informal economy in 31 European countries in labour inspectorates, revenue administrations, social security administrations, trade unions, employer organizations and other relevant agencies (e.g., customs, border police, immigration) (Dekker et al., 2010; Williams et al., 2013b)

To report the results, the analysis of the direct controls is broken down into firstly, deterrence measures, secondly, supply-side incentives for businesses, thirdly, supply-side incentives for individuals and fourthly, demand-side incentives for customers, and following this, attention turns towards the adoption of various measures that comprise the indirect controls approach. Below, the share of the 31 countries who in 2010 adopted various policy measures is reported:

Direct controls - deterrence penalty measures:

- 87% used administrative sanctions for purchasers/companies;
- 83% administrative sanctions for suppliers/employees;
- 74% penal sanctions for purchasers/companies, and
- 53% penal sanctions for suppliers/employees.

Direct controls - deterrence measures to improve detection:

- 100% used workplace inspections;
- 83% data matching and sharing;
- 74% registration of workers prior to starting work or on first day of work;
- 65% certification of business and/or payments of social contribution and taxes;

- 65% coordinated data sharing across government;
- 65% used mandatory IDs in the workplace;
- 61% the coordination of operations across government;
- 57% coordinated strategy across government, and
- 39% used peer-to-peer surveillance (e.g. telephone hotlines).

Direct controls - supply-side incentives for businesses:

- 87% have simplified compliance procedures;
- 61% training and support to business start-ups;
- 61% direct tax incentives (e.g., exemptions, deductions)
- 61% advice on how to formalize;
- 52% micro-finance to business start-ups;
- 48% changing minimum wage upwards;
- 48% have reduced regulations;
- 43% restricting free movement of (foreign) workers;
- 43% introduced technological innovations (e.g. certified cash registers);
- 35% social security incentives;
- 30% provided formalization advice to business;
- 30% formalization support services to businesses;
- 22% fact sheets on record-keeping;
- 22% free advice/training on record-keeping;
- 17% targeted VAT reductions;
- 17% introducing supply chain responsibility;
- 13% free record-keeping software to businesses, and
- 9% changed minimum wage downwards.

Direct controls - supply-side incentives for individuals:

- 65% ease transition from unemployment into self-employment;
- 61% connecting pension schemes to formal labour;
- 44% ease transition from employment into self-employment;
- 35% new categories of work (e.g., for small or mini-jobs);
- 17% individual-level amnesties for voluntary disclosure;
- 13% gradual formalization schemes, and
- 9% society-wide amnesties.

Direct controls - demand-side incentives:

- 61% targeted direct tax incentives at customers of undeclared work;
- 26% service vouchers;
- 17% targeted indirect taxes at customers of undeclared work;

Indirect controls:

- 65% measures to improve tax/social security/labour law knowledge;
- 61% campaigns on risks and costs of shadow work;
- 61% campaigns to inform users of shadow work of the risks and costs;
- 57% campaigns on benefits of formalising their work;
- 52% campaigns to inform users of the benefits of declared work;
- 52% used normative appeals to people to declare their activities;
- 39% campaigns to encourage a culture of commitment to declaration;
- 30% adoption of commitment rather than compliance approach;
- 26% measures to change perceived fairness of the system, and
- 17% measures to improve procedural justice of the system.

This reveals that deterrence measures are widely used in all 31 countries. Many countries in 2010 also used incentives to make it easier and/or reward compliant behaviour as well as indirect controls to elicit a psychological and social commitment to legitimate behaviour and self-regulation. What these figures on the preponderance of different policy measures do not reveal however, is which measures are the most important means of tackling the informal economy. To evaluate this, stakeholders ranked the different sets of policy measures from those accorded the most importance to the least importance in their country when tackling the shadow economy. Table 6 reports the results. This displays that 57% state that deterrence measures are accorded the most importance in their country and just 43% deem other measures being accorded the most importance, with 19% citing supply-side incentive measures, 14% demand-side incentives and just 10% indirect controls. Indeed, examining the type of policy measure accorded the least importance; only 16% cite deterrence measures. The clear intimation is that despite the call by the European Commission for innovative new measures to move beyond deterrence and to seek to transfer informal work into the formal economy (European Commission, 2003a,b, 2007b; Vanderseypen et al., 2013), the majority of countries remain entrenched in a deterrence approach.

Table 6 Stakeholder opinion of the relative importance accorded to different types of policy measure in their country

% citing:	Most important	2 nd Important	Least important
Direct controls: deterrents	57	17	16
Direct controls: supply-side incentives	19	46	23
Direct controls: demand-side incentives	14	19	32
Indirect controls	10	18	29

Asked to rank the policy approach they view as most effective, second most effective and least effective at tackling informal work, Table 7 reveals that the majority (55%) of stakeholders surveyed in 2010 assert that deterrence measures are the most effective means of tackling the informal economy. Just 20% view supply-side incentives, 15% demand-side incentives and 10% commitment measures as the most effective type of measure. This provides further reinforcement for the notion that European countries remain entrenched in a view that deterrence is a more effective means of tackling informal work. In other words, the negative reinforcement approach remains dominant when it comes to tackling the informal economy. Only a minority believe that either a positive reinforcement approach which rewards compliant behaviour or an indirect controls approach, which seeks to improve the psychological contract between the state and its citizens, are more effective at eliciting behaviour change than the detection and punishment of bad (non-compliant) behaviour.

Table 7 Type of policy measures social partners view as most and least effective in Europe

	Most effective	2nd most effective	Least effective
Direct controls: deterrents	55	13	12
Direct controls: supply-side incentives	20	41	13
Direct controls: demand-side incentives	15	27	31
Indirect controls	10	19	44

7. DIRECT CONTROLS

The conventional policy approach for tackling the informal sector in general and informal entrepreneurship in particular, is to use direct controls. As the OECD (2008: 82) put it, ‘Combating informal employment requires a comprehensive approach to reduce the costs and increase the benefits to business and workers of operating formally’. To evaluate this direct controls approach therefore, firstly, the use of deterrence measures to detect and punish non-compliant (‘bad’) behaviour is reviewed followed secondly, the use of incentives to make it easier to undertake, and reward, compliant (‘good’) behaviour.

7.1 Deterrence measures

During the early 1970s, Allingham and Sandmo (1972) argued that the non-compliant are rational economic actors who evade tax when the pay-off is greater than the expected cost of detection and punishment. To deter engagement therefore, the goal is to change the cost/benefit ratio facing those participating or considering participation in non-compliance (e.g., Grabiner, 2000; Hasseldine and Li, 1999; Job et al., 2007; Richardson and Sawyer, 2001). When using deterrence measures, this is achieved by focusing on the cost side of the equation and increasing the actual and perceived risks and costs associated with participation by firstly, raising the perceived or actual likelihood of detection and/or secondly, raising the penalties and sanctions for those caught. This, therefore, is a ‘negative reinforcement’ approach; it seeks behaviour change by using ‘sticks’ that punish non-compliant (‘bad’) behaviour.

A substantial and growing body of literature nevertheless, reveals that increasing penalties or the probability of detection does not lead to greater compliance (Feld and Frey, 2002; Murphy, 2005; Varma and Doob, 1998; Shaw et al., 2008; Webley and Halstead, 1986). Instead, it increases non-compliance, not least due to a breakdown of trust between the state and its citizens (Ayres and Braithwaite, 1992; Murphy and Harris, 2007; Tyler et al., 2007; Williams, 2001). Indeed, the most telling rebuttal of deterrents is the finding that many voluntarily comply even when the level of penalties and risks of detection would suggest that they should act in a non-compliant manner if they were truly rational economic actors (Murphy, 2008). Obviously therefore, other factors must be at work engendering this commitment to compliant behaviour that lie beyond the level of deterrents.

These deterrence measures also have a range of unintended and unwanted broader impacts. As highlighted above, they lead to one hand of government repressing precisely the enterprise culture that other hands of government wish to foster. When this is combined with the recognition that punishing non-compliant (‘bad’) actions is not necessarily the most effective means of changing behaviour, the outcome has been that many have begun to question the value of such measures. New measures have thus emerged.

7.2 Incentive measures

With the growing recognition across governments that the goal is to formalise informal entrepreneurship, a shift has begun to take place. Rather than employ deterrence measures, there has been a shift towards measures that make it easier and more beneficial to engage in formal entrepreneurship (Small Business Council, 2004; Williams, 2006). In other words, rather than punish ‘bad’ (non-compliant) behaviour, these measures reward ‘good’ (compliant) behaviour, rather than taking it as given. When tackling informal entrepreneurship, and as displayed in Figure 1 above, these measures take three forms. Firstly, it can be made easier and/or more beneficial for businesses to engage in compliant

behaviour. This can involve simplifying compliance, developing direct and indirect tax incentives, introducing supply chain responsibility, or providing support and advice to informal entrepreneurs about how to formalise. Secondly, it can be made easier and/or more beneficial for individuals supplying informal work to engage in compliant behaviour such as society-wide amnesties, voluntary disclosure schemes or introducing schemes to smooth the transition to formalization. Third and finally, it can be made easier and/or more beneficial for customers to use the formal rather than the informal economy to source goods and services using for example service vouchers, target direct taxes or targeted indirect taxes. Boxes 1-4 below provide some examples of such incentive measures.

Box 1. Home-job plan (Bolig-Jobplan), Denmark

Target group: consumers purchasing domestic services in the informal economy.

Objectives: To provide a 15% tax deduction to people having work undertaken in their household so as to prevent them using the informal economy.

Intervention type: incentive for consumers to purchase domestic services in the formal economy.

Programme requirements and length: The measure was implemented on 1 June 2011 and will run as a pilot project until the end of 2013.

Description: The types of household work covered by the tax deduction scheme includes: house cleaning, including windows; indoor and outdoor maintenance, including new installations; gardening; and babysitting, including bringing and picking up children from school. The measure is targeted especially at work undertaken by micro and small enterprises in the home repair, maintenance and improvement sector, such as plumbing and heating, electricity and construction work. The expenses and the company involved are informed digitally by the buyer of the services to the Danish tax authorities (TAX) using a special template, who then deduct 15% of the amount in the yearly tax or fiscal income. The action involved for the buyer of these services resembles an ordinary payment transfer, and the system does the rest. Each person can deduct from their taxes up to DKK 15 000 (€2000) of the costs of employing craftspeople and domestic helpers under this scheme. The estimated tax value of these deductions is estimated as €134 million (DKK 1 billion) in 2011 and around €234 million (DKK 1.75 billion) in 2012 and 2013.

Results achieved: Relative to expectations, this pilot project has been a success. Some 270,000 people used the deduction in 2011 and most of the work involved home improvement, maintenance and repair. They have on average reported deductions of DKK 9800 (€1315) per person. In total, the deductions reported amount to DKK 2.7 billion (€362 million). The tax value of those deductions is around DKK 900 million (€121 million) (Jørgensen, 2013).

Lesson for other initiatives: A similar home service measure has been a success in Sweden where the deduction is higher (€6,000) and such a scheme is potentially transferable to all EU countries with certain national adaptations to tailor the initiative to sectors where informal entrepreneurship is rife.

Box 2 ‘On the Spot’ Firm (*Empresa na Hora*), Portugal

Target group: Nascent entrepreneurs wishing to establish a business venture

Objectives: to simplify the process of establishing a formal business venture

Intervention type: to facilitate formalisation by making it easier to formalise

Programme requirements and length: Since 2005

Description: In 2005, the Ministry of Justice in Portugal announced the Simplex programme, a programme for administrative and legislative simplification. The ‘On the Spot’ firm is one initiative under this Simplex programme, which seeks to alleviate the processes and procedures necessary to set up a new business venture. This initiative makes it possible to create a company in a single office in a single day. Upon completion, the definitive legal person identification card is provided, the social security number given and the company immediately receives its memorandum and articles of association and an extract of the entry in the Commercial Register. Compliance is ensured by having all the details sent to the tax authorities.

Results achieved: Between 2005, when the initiative started, and September 2008, 59,068 new enterprises were created: 574 public limited companies (1% of the total), 34,934 private limited companies (59%) and 23,560 one-person companies (40%). The average time taken is 1h14m and the average cost of setting up a company is €360. Whether such administrative simplification has prevented many new businesses from operating in the informal sector at the outset has not been directly evaluated.

Lesson for other initiatives: This ‘one-stop shop’ measure is transferable to many other nations.

Box 3 ‘Mini jobs’, Germany

Target group: those people conducting small-scale odd-jobs, which constitutes the vast bulk of informal work in Europe

Objectives: to reduce the informal economy by simplifying compliance regulations for small odd jobs

Intervention type: incentive scheme to enable small odd jobs to be conducted in the formal economy

Programme requirements and length: Since 2002

Description: Until 1999, the German government allowed ‘minor employment’ up to a certain income level of about €325 and with a weekly working time cap of 15 hours. This work was exempt from social security payments for employers and employees alike. Employers had to pay a lump-sum tax of 23%, while employees were not obliged to pay any 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, over 6.5 million minor jobs existed, representing almost 70% of all jobs in the catering industry and 60% of jobs in the cleaning industry. In 1999, the government reformed the minor employment scheme in an effort to limit its growth. This drove much of this work into the informal economy. As a result, in 2002, the German government introduced three new types of mini job, which has undergone various revisions. At present, there are:

- Jobs with a €400 earning threshold – employees are exempt from social security contributions.
- Mini jobs in the household sector - introduced to combat informal work in this sphere. Accordingly, the employer pays a levy of 12% and can deduct a certain amount from their tax payments.
- ‘Midi jobs’ – in order to ease the transfer from minor to normal employment, a transition zone was introduced for earnings ranging between €400 and €800, with social security contributions for the employee gradually rising from around 4% to the full 21%.

Results achieved: Compared with 4.1 million employees in minor employment in September 2002 when this new scheme was introduced, there were 5.5 million at the end of April 2003, one month after the introduction of the new mini jobs scheme; this therefore amounted to a rise of around 1.4 million people in minor employment. By 2004, the number of employees in minor employment grew to 7 million. However, some 1.21 million of these were people already in a formal job, about 580,000 of whom have transferred their add-on job from the shadow economy to the declared realm (Baumann and Wienges, 2003). Indeed, Schneider (2008) argues that mini-jobs led to a reduction in the informal economy of some €9 billion and that between 2006 and 2007 alone, it decreased the informal economy by some €2.5-3.5 billion. The number of registered commercial mini-jobbers has slightly fallen from 6,837,866 in December 2004 to 6,760,039 in March 2012. The opposite trend has occurred for mini-jobs in household services, with numbers rising from 102,070 in December 2004 to 234,453 in March 2012 (Williams and Renooy, 2013).

Lesson for other initiatives: Germany is not the only nation where much of the informal economy is composed of small odd jobs and that by simplifying compliance regulations, one can move this work into the formal economy.

Box 4 Service Vouchers, Belgium

Target group: The target group is unemployed people who find it difficult to get a job and customers of domestic services who might otherwise use the informal economy.

Objectives: The service voucher scheme aims to:

- create new jobs, particularly for low-skilled workers;
- provide an incentive to move from informal work to a regular job in economic sectors where informal work is common;
- offer certain categories of unemployed people who perform service jobs the opportunity to move towards a regular employee status;
- improve the work-life balance of customers of this scheme by making it easier to outsource domestic work.

Intervention type: a wage cost subsidy for labour-intensive low-skilled domestic work. All residents of Belgium can buy services vouchers in order to purchase domestic help, ranging from housecleaning, laundry and ironing to sewing, meal preparation and transport for less mobile people.

Programme requirements and length: Since 1 January 2004

Description: Service vouchers are available to pay for everyday personal services. Each voucher costs €9.00 for the first 400 vouchers per person (2014) and €10.00 for the next 100. Each individual can buy 500 vouchers each year or 1000 vouchers for each family (although single parents or mothers returning to work with young children can buy more). Up to €1350 per year is tax deductible (at a 30% tax rate). Every voucher pays for an hour of work from certified companies that hire unemployed people to do this work. At first, the company can hire the unemployed person on a part-time temporary contract. After six months, the company has to offer the worker a permanent employment contract for at least half-time employment if the person was previously registered as unemployed. An employee of a certified company can carry out the following activities: housecleaning, washing and ironing, sewing, running errands, preparing meals or accompany people who are not mobile. The customer pays using the vouchers, of which the cost price was €22.04 in 2013; the difference is paid by the government. The total cost of the service voucher scheme to the government in 2011 was some €500m. Per employee net costs amounted to €3520 in 2011 (€2793 in 2010) (Gerard et al., 2012).

Results achieved: Although early studies found that customers previously sourced some 44% of the work conducted using service vouchers from the informal economy (De Sutter, 2000), recent evaluations find that only 25% reported that they would have purchased these services in the informal economy if there had been no vouchers. One interpretation is that, in its early days, the scheme acted as a tool for transferring informal work into the formal economy, but it is now becoming more of a means for moving unpaid self-provisioning activities into formal employment. At the end of 2011, there were 2754 companies involved, 830,000 users, 108,663,966 vouchers were sold and around 150,000 persons employed. Although only 4.6% (10.2% in Brussels) of employees stated they started working in the voucher system to avoid working in the informal economy, this ignores that without it, many customers would doubtless source these services in the informal economy if the service voucher scheme did not exist (Ajzen, 2013). Examining the labour force employed in the service voucher system, the finding is that it is mainly women (97% of all employees), aged 30-55 with low educational levels. This profile is growing stronger over time; the proportion aged 50 and over is growing, as are the proportion that are non-Belgian nationals; some 20% of all voucher workers (55% in Brussels) are non-Belgian EU28 nationals and a further 10% are from outside the EU28 (Ajzen, 2013).

Lesson for other initiatives: Some variant of this scheme is potentially transferable to many other countries, although budget constraints are likely to be a limiting factor as is the level of development of the domestic service market. Some countries, that is, have little or no tradition of domestic services being conducted for payment by people outside the family. It is also possible to widen the scope of activities covered by such a scheme to activities where the informal economy is rife in different countries.

8. INDIRECT CONTROLS

The problem with changing behaviour using direct controls to alter the cost/benefit ratio confronting informal entrepreneurs is that they are not always rational economic actors with perfect information available. They are limited in their ability to compute the costs and benefits, often misperceive or do not perceive the real costs of their actions and are influenced by social context. Most importantly, they are not just motivated by self-interest and what is most profitable for them but by additional motives, including redistribution, fairness, reciprocity, social customs, norms and morality (Alm, 2011).

Given this, a move has taken place away from the use of ‘sticks’ and ‘carrots’ to change behaviour. Instead, indirect controls seek to improve the psychological contract between the state and entrepreneurs in order to nurture a high trust high commitment culture (Alm et al., 1995; Torgler, 2003; Weigel et al., 1987; Wenzel, 2002). The intention is to engender willing or voluntary commitment to compliant behaviour rather than force entrepreneurs to comply using threats, harassment and/or incentives (Kirchler, 2007; Torgler, 2007, 2011).

To understand the tools used, it is first necessary to recognize that there exists an institutional incongruity between the laws, codes and regulations of formal institutions and the norms, beliefs and values of informal institutions. Informal entrepreneurship occurs where the norms, values and beliefs differ to the laws and regulations, resulting in what formal institutions deem to be illegal activities being legitimate in terms of the norms, values and beliefs of entrepreneurs. To tackle the informal sector entrepreneurship therefore, there is a need to reduce this institutional incongruence. This can be achieved either by changing the informal institutions and/or the formal institutions. Before examining how this can be achieved, it is first useful to provide an indicator of the level of institutional incongruence across the EU-27.

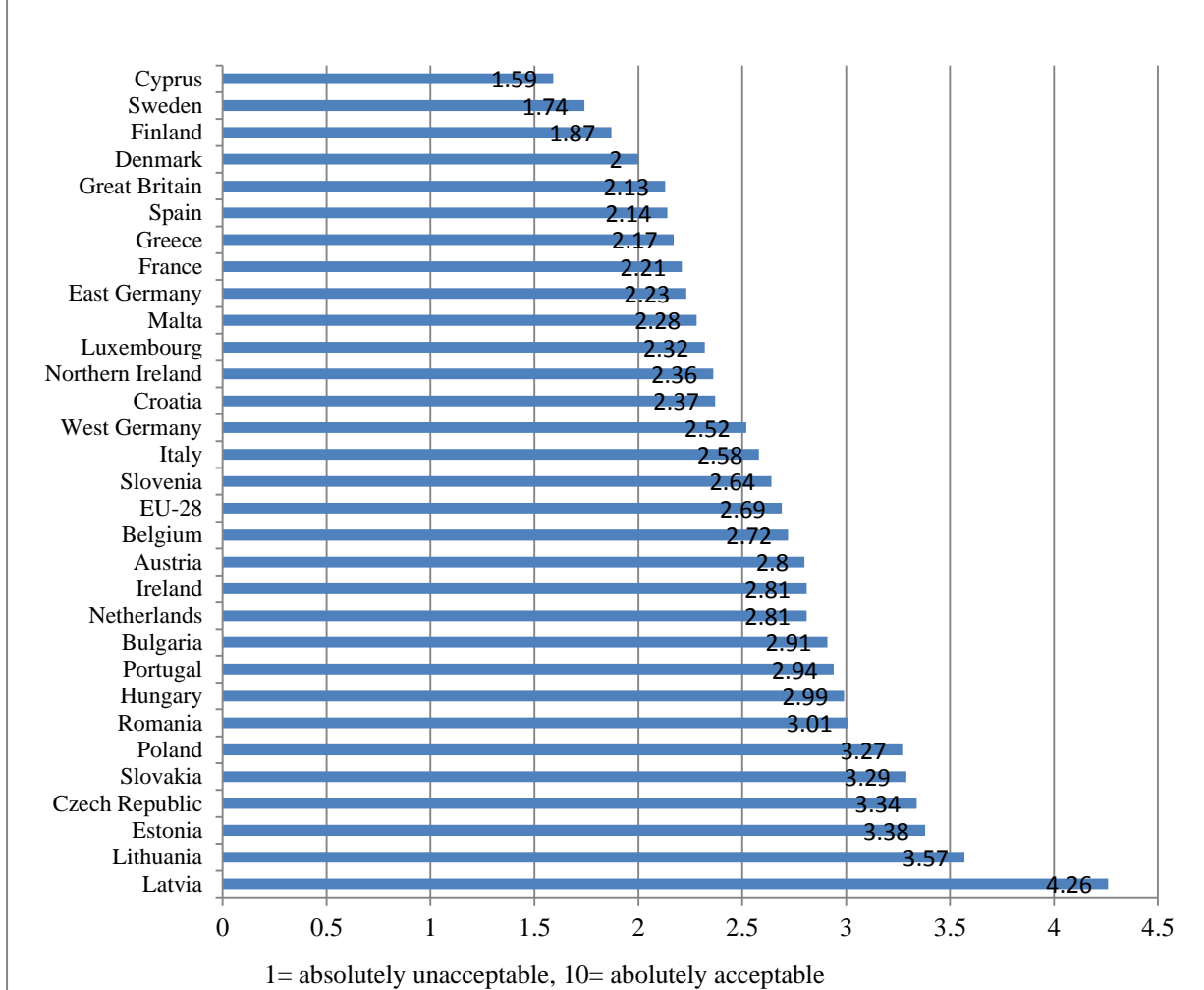
8.1 Acceptability of the informal sector in Europe

The 2013 Eurobarometer survey asked participants to rate the acceptability of various types of informal work, using a 10-point scale where 1 means ‘absolutely unacceptable’ and 10 means ‘absolutely acceptable’. The six types examined were:

- Someone receives welfare payments without entitlement;
- A firm is hired by another firm and does not report earnings;
- A firm hires a private person and all or part of their salary is not declared;
- A firm is hired by a household and doesn’t report earnings;
- Someone evades taxes by not or only partially declaring income; and
- A person hired by a household does not declare earnings when it should be declared.

As Figure 4 reveals, the finding is that participants in Cyprus are the least tolerant of the informal sector, followed by three Nordic countries (Finland, Sweden and Denmark). The countries most tolerant of the informal sector meanwhile, and where the greatest institutional incongruence exists between formal and informal institutions, are all East-Central European nations, with participants in Latvia the most likely to view the informal sector as acceptable, followed by Lithuania, Estonia, the Czech Republic, Slovakia, Poland, Romania and Hungary. How, therefore, can this tolerance of the informal sector be reduced?

Figure 4 Acceptability of informal sector, by European country 2013



Source: Eurobarometer survey on undeclared work 2013

8.2 Changing the informal institutions

To change this institutional incongruence that leads to tolerance of the informal sector, one approach is to change the norms, values and beliefs of potential and existing entrepreneurs regarding the acceptability of working in the informal sector so that these align with the laws, regulations and codes of formal institutions. This is achieved by improving tax knowledge using awareness raising campaigns about the costs of informal work and benefits of formal work, and normative appeals.

8.2.1 Improving tax knowledge

Educating entrepreneurs about taxation is important if the norms, values and beliefs are to align with the codified laws and regulations of formal institutions. To do this, two types of education are required. Firstly, there is the need to educate entrepreneurs about what the current tax system requires of them by providing easily consumable information on their responsibilities. A significant portion of supposed tax evasion is unintentional, resulting from lack of knowledge, misunderstanding and ambiguous interpretation of tax law (Hasseldine and Li, 1999; Natrah, 2013). One way forward therefore, is to provide greater information to taxpayers (Internal Revenue Service, 2007; Vossler et al., 2011)

Secondly, and more widely, there is the need to educate entrepreneurs about the value and benefits of paying taxes in order to elicit an intrinsic motivation to comply. In many countries for example, substantial voluntary donations to private charities occur but at the same time, some entrepreneurs are reticent about paying their taxes, despite private charities often having parallel missions to government. This is doubtless because they know what happens to voluntary donations given to private charities but not what happens to their taxes (Li et al., 2011). A way forward therefore, is to educate entrepreneurs about what happens to their taxes. This can be done by informing them of the current and potential public goods and services received (Bird et al., 2006; Saeed and Shah, 2011). Signs such as ‘your taxes are paying for this’, for example on public construction projects (e.g., new roads), are one way of doing this by conveying a clear message that money collected is paying for public goods and services.

8.2.2 Awareness-raising campaigns

A further tactic to change attitudes towards informality is to run awareness-raising campaigns. Such campaigns can either inform: entrepreneurs of the costs and risks of informality; potential customers of the risks and costs; entrepreneurs of the benefits of being formal, and/or potential customers of the benefits of formality. Indeed, the evidence suggests that advertising campaigns are effective and cost efficient. In the UK for example, an evaluation of the advertising campaigns run by HMRC reveals that some 8300 additional people had registered to pay tax who would otherwise not have done so who will pay tax of around £38 million over three years, providing a return of 19:1 on the expenditure of £2 million. This compares with an overall return of 4.5: 1 on the £41 million a year spent on all its compliance work in 2006-07 (National Audit Office, 2008).

8.2.3 Use of normative appeals

Normative appeals to entrepreneurs to declare their activities are another potential way forward. Their effectiveness however, depends in part on the nature of the appeal made. Chung and Trivedi (2003) examine the impact of normative appeals on a friendly persuasion group who were required to both generate and read a list of reasons why they should comply fully and compared with a control group not asked to do so. The participants in the friendly persuasion groups report higher earnings than the control group.

8.3 Changing the formal institutions

Besides changing norms, values and beliefs to align with formal institutions, policy can also seek to change the formal institutions to align with the norms, values and beliefs of society. Two options exist in this regard. Firstly, this can involve internal *process* changes in the formal institutions to improve the perception that there is tax fairness, procedural justice and redistributive justice amongst entrepreneurs. Secondly, this can involve changing the *products* of formal institutions by pursuing wider economic and social developments.

8.3.1 Procedural justice

This refers to the extent to which entrepreneurs perceive the government to have treated them in a respectful, impartial and responsible manner (Braithwaite and Reinhart, 2000, Murphy, 2005; Taylor, 2005; Tyler, 1997, Wenzel, 2002). This has a significant effect on compliance. If they view the tax administration as treating them in such a manner, then they will be more likely to engage in compliant behaviour (Hartner et al, 2008; Murphy, 2003; Murphy et al., 2009; Torgler and Schneider, 2007; Wenzel, 2002). As Wenzel (2006) finds, the compliance rate was significantly higher among taxpayers who perceived there to be interactional fairness. Being treated politely, with dignity and respect, being given a say, and having

genuine respect shown for one rights and social status all enhance compliant behaviour (Alm et al., 1993; Feld and Frey, 2002; Gangl et al., 2013; Hartner et al., 2008; Murphy 2005; Tyler, 1997, 2006; Wenzel, 2002).

8.3.2 Procedural fairness

This refers to the extent to which entrepreneurs believe they are paying their fair share compared with others (Kinsey and Gramsick, 1993; Wenzel, 2004a,b). Entrepreneurs who receive procedurally fair treatment will be more likely to trust the authorities and will be more inclined to accept its decisions and follow its directions (Murphy, 2005). The fairness of the tax system is one of the most important determinants of tax morale (Bobeck and Hatfield, 2003; Hartner et al., 2007, 2011; Kirchgässner, 2010, 2011; McGee, 2005, 2008; McGee et al., 2008; Molero and Pujol, 2012). Conversely, where there is grievance that fair treatment is not being received non-compliance increases (Bird et al., 2006).

8.3.3 Redistributive justice

This refers to whether entrepreneurs believe they are receiving the goods and services they deserve given the taxes they pay (Kinsey and Gramsick, 1993; Kinsey et al., 1991; Richardson and Sawyer, 2001; Thurman et al., 1984). 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). Entrepreneurs see themselves as more justified being non-compliant and breaking the psychological contract with the state, the less they perceive the tax system as fair. If tax compliance is to be high therefore, the tax system should be perceived as fair. If entrepreneurs do not receive the goods and services that they believe they deserve given the taxes that they pay, then non-compliance increases (McGee, 2005). The result is that governments need to educate entrepreneurs about where their taxes are spent. In situations where entrepreneurs do not know, or do not fully understand that public goods and services are due to taxes, then compliance will be lower than in situations where citizens are fully aware of the public goods and services they receive for their taxes and agree with how their taxes are spent (Lillemets, 2009). In recent years therefore, many governments have sought to explain how taxes are spent.

8.3.4 Changing the products of formal institutions: wider economic and social developments

To achieve a high-commitment culture and self-regulation amongst entrepreneurs, there is also a need to change the products of formal institutions by pursuing wider economic and social developments (Vanderseypen et al., 2013; Williams and Renooy, 2013, 2014). Until now, and as discussed above, there have been three contrasting theoretical standpoints regarding what broader economic and social developments are required.

Firstly, the ‘modernization’ thesis purports that informal entrepreneurship decreases as economies modernize and develop and therefore that economic development and growth is required to reduce such endeavour (ILO, 2012). Secondly, the ‘neo-liberal’ thesis argues that its prevalence is a direct result of high taxes, public sector corruption and state interference in the free market and therefore that tax reductions, resolving public sector corruption and reducing the regulatory burden are the ways forward (De Soto, 1989, 2001; London and Hart, 2004; Nwabuzor, 2005; Sauvy, 1984; Schneider and Williams, 2013). Third and finally, the ‘structuralist’ thesis argues that its pervasiveness is the outcome of inadequate levels of state intervention in work and welfare, meaning that workers are unprotected. The focus therefore should be less upon formalising work and more upon introducing social protection, reducing inequality and pursuing labour market interventions to help vulnerable groups (Castells and Portes, 1989; Davis, 2006; Gallin, 2001; Slavnic, 2010; Taiwo, 2013).

In recent years, there have been evaluations of which economic and social policies are associated with smaller informal sectors (Vanderseypen et al., 2013; Williams, 2013a, 2014a,b,c,d; Williams and Renooy, 2013, 2014; Williams et al., 2013a) and lower levels of informal sector entrepreneurship (Williams, 2013a). Analysing the relationship between cross-national variations in the level of informal sector entrepreneurship and cross-national variations in the various aspects of the broader economic and social environment deemed important by each of the above perspectives, Williams (2013a) calls for a synthesis of various tenets of all three theses. He finds that informal entrepreneurship is lower in wealthier economies with stable high quality government bureaucracies and those with lower poverty levels, more equality, greater levels of social protection, more effective redistribution via social transfers and greater state intervention in the labour market to protect vulnerable groups.

9. WAYS FORWARD FOR POLICY

In recent years, there has been growing recognition that indirect controls are necessary but insufficient when tackling informal entrepreneurship (Williams, 2014a; Williams and Renooy, 2013). Direct controls are also required. For example, governments might seek to change the culture of government departments towards a more customer-oriented approach and introduce public campaigns to elicit greater commitment to tax morality, whilst simplifying regulatory compliance and introducing incentives (e.g., amnesties, tax deductions) to formalise informal entrepreneurs. At the same time, and in relation to those who fail to comply, they may also pursue improvements in the probability of detection and tougher sanctions for those subsequently caught.

The current debate therefore, is not over whether to use direct or indirect controls. There is a consensus that both are required. Rather, the major issue is determining which specific policy measures in each approach are most effective and what is the most effective way of putting these measures together in various combinations and sequences to engender effective compliance. At present for example, measures to improve detection through inspections are often combined with campaigns aimed at raising awareness or warning customers that inspections are about to occur. Tougher sanctions moreover, follow amnesties and voluntary disclosure schemes. However, whether these combinations are more effective than other sequences and combinations needs evaluating. In recent years nevertheless, two particular approaches have come to the fore in the literature that provide ways of combining these policy approaches in particular sequences, namely the responsive regulation approach and the slippery slope framework.

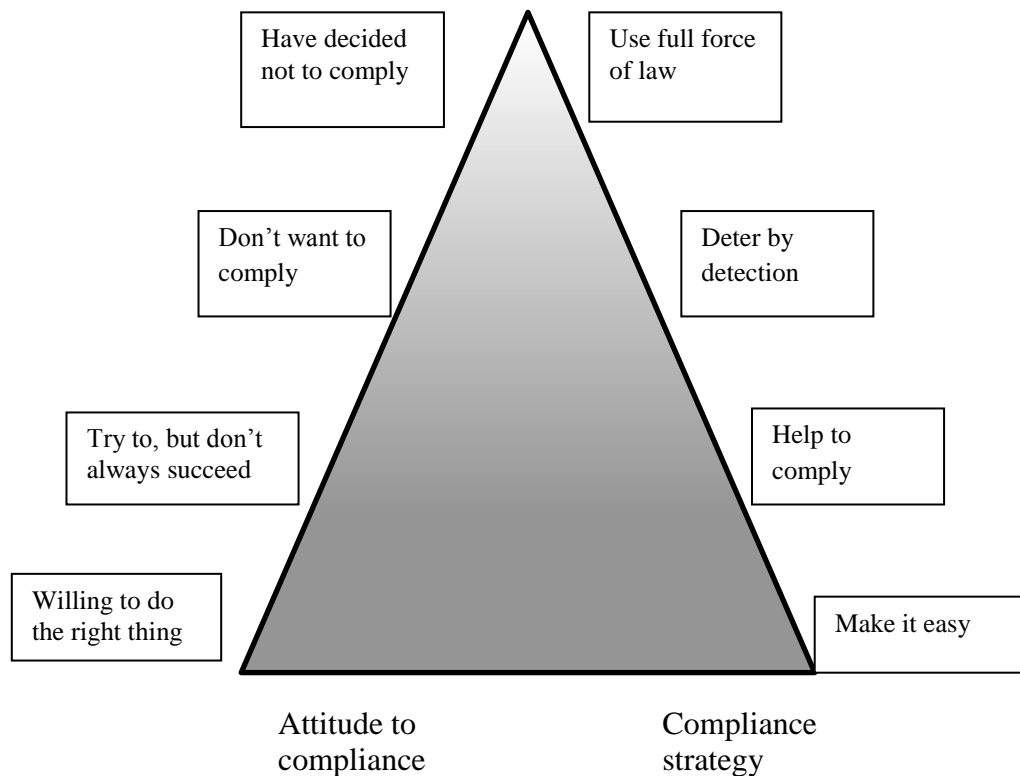
9.1 Responsive regulation

Responsive regulation openly engages entrepreneurs to think about their obligations and accept responsibility for regulating themselves in a manner consistent with the law. It is about winning their ‘hearts and minds’ so as to engender a culture of commitment to tax morality in order that they will regulate themselves rather than need to be regulated by external rules. However, although it gives primacy to the use of indirect controls, it does not exclusively confine itself to such measures (see Braithwaite, 2009).

The Australian government for example has adopted this responsive regulation approach. As Figure 3 displays, in the first instance indirect controls facilitate voluntary self-regulated compliance, followed by persuasion and only then punitive measures to tackle tax non-compliance (Braithwaite, 2009; Job et al., 2007). Put another way, this responsive regulation approach envisages a regulatory pyramid with various options that a tax authority can use to engender compliance, sequenced from the least intrusive at the bottom and used

first to the most intrusive at the top. The view is that a tax authority does not need in most cases to pursue the coercion option at the top of the pyramid to engender compliance. Instead, it can commence with the indirect control measures at the bottom of the pyramid and if these do not work with some groups, then the level of intrusiveness can escalate up the pyramid until it reaches the policy intervention that elicits the desired response. The outcome is recognition of a continuum of attitudes towards compliance and different policy responses that can be temporally sequenced starting with commitment measures and moving through to sanctions.

Figure 3 The responsive regulation approach



Whether this is the most appropriate combination and temporal sequencing of measures is open to debate. Until now, no evaluation has occurred of whether this sequencing of the policy measures used by the ATO is the most appropriate and/or effective sequencing combination to use to engender compliance. In other words, although it appears appropriate and effective, there is currently no evidence-base of whether this is the case.

9.2 Slippery slope framework

Another way of combining the direct and indirect control approaches is by adopting the 'slippery slope framework' (Kirchler et al., 2008). This distinguishes between two types of compliance, namely voluntary compliance (akin to the indirect controls approach) and enforced compliance (akin to the direct controls approach). Voluntary compliance occurs where there is trust in the authorities. Enforced compliance meanwhile, occurs where authorities have power (i.e., the ability to get citizens to do what they were before not going to do, in the way in which the authorities wish them to do it). When there is neither trust in authorities and authorities do not have power, then informal entrepreneurship will be rife.

To tackle informal entrepreneurship therefore, one can either increase the power of authorities and/or trust in the authorities. The direct controls approach tends to put the

emphasis on increasing the power of authorities, whilst the indirect controls approach places greater emphasis on increasing the trust of authorities. In practice, however, these are not mutually exclusive. It is possible to use both to engender compliance. The slippery slope framework displays that both approaches can be combined in order to elicit behaviour change.

Wahl et al. (2010) randomly presented participants with one of four different descriptions of a fictitious country, in which the authorities were depicted as either trustworthy or untrustworthy on the one hand and as either powerful or powerless on the other hand. Their results show that participants paid significantly more taxes when both power and trust were high. They also found that voluntary compliance was highest when the authorities were both trustful and powerful, while enforced compliance was highest when authorities were portrayed as powerful, but not trustworthy. This has been since further reinforced by two surveys of real-world taxpayers (Muehlbacher et al., 2011a,b). The outcome 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 pursuing both is the most effective approach.

9.3 Key policy recommendations

To facilitate the formalisation informal entrepreneurship, therefore, this background paper recommends the following:

1. There is a need to develop and share best practice between countries on the most effective ways of formalising informal entrepreneurship. The European platform on undeclared work is a key vehicle for delivering such mutual learning.
2. Few policy measures have been evaluated in terms of their effectiveness at formalising informal entrepreneurship. Further research is therefore required to evaluate the effectiveness of a range of policy measures used in different European countries. Wherever possible, common indicators should be developed and used when evaluating the effectiveness of these initiatives (e.g., cost-to-revenue ratios).
3. There is also a need to evaluate the most effective way of putting these policy measures together in various combinations and sequences to formalise informal entrepreneurship.
4. When developing strategies, consideration should be given to placing less emphasis should be put on deterrence measures and more emphasis on both incentive measures as well as indirect controls that improve the psychological contract between entrepreneurs and the state.
5. Further research is also required on the broader economic and social conditions that result in a decline in the prevalence of informal sector entrepreneurship.

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