



# UNTAPPED ENTERPRISE

LEARNING TO LIVE WITH  
THE INFORMAL ECONOMY

BENEDICT DELLOT  
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RSA  
Action and Research Centre

# About this report

This report attempts to breathe fresh air into the longstanding policy challenge of the informal economy. Despite being a fundamental activity underlying our economy and society, undeclared work has for many years remained sidelined by policymakers, journalists and other social commentators. The result is that the UK has arguably been left with a stale, outdated approach to combating informal activity. This report seeks to address this learning gap by critically reappraising government policy and by highlighting an alternative means of framing and dealing with undeclared work that would benefit hidden entrepreneurs and the wider communities in which they operate.

The RSA is well suited to this task. We are an organisation that has been a source of ideas, innovation and civic enterprise for over 250 years. In the light of new challenges and opportunities for the human race our purpose is to encourage the development of a principled, prosperous society by identifying and releasing human potential. This is reflected in the organisation's recent commitment to the pursuit of what it calls 21st century enlightenment.

The RSA is reviving its tradition of encouraging enterprising responses to today's challenges through the new Enterprise programme, a central strand of which is exploring how we can enhance employability in tough economic times. By this we mean improving people's ability to find and sustain high quality employment throughout their working lives. The Untapped Enterprise project is the latest in a series of new projects that are attempting to take us closer to this goal.

In writing this report, the RSA has been supported by Community Links. Community Links is an innovative east London charity working with more than 25,000 people every year. Early action has been at the heart of their strategy for 35 years. Their national research and policy work – such as The Early Action Task Force – is rooted in the knowledge gained through a wide range of practical projects and services delivered locally, offering support to all age groups and across a wide range of issues. Through a network of community projects and social enterprises, Community Links help disadvantaged children, teenagers, adults and older people, empowering them to fulfill their potential and build a brighter future together.

Community Links will publish two reports on the informal economy this autumn: "Journeys to Formalisation – a delivery model for legalising informal trading", with support from the Joseph Rowntree Foundation; and "Enabling Enterprise: Tackling the Barriers to Formalisation", co-authored with the University of Sheffield and supported by The Institute of Small Business and Entrepreneurship's RAKE fund.

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# Methodology

The arguments and findings presented within this report are drawn from desk research and interviews with expert stakeholders. As part of the desk research, we sought to synthesise the wealth of existing research undertaken by Community Links and marry this with other relevant insights drawn from academic journals and grey literature. This includes reports produced by research organisations, government departments, independent authors and international bodies, for example the World Bank and the ILO. The purpose of this research synthesis was to bring to light the current state of informal activity in the UK, piece together the key factors that compel or encourage hidden entrepreneurs to work informally, and critically review how undeclared work has been tackled in the UK to date. As part of the desk research, we also sought to pull together a series of international case studies that would showcase alternative models for addressing informality. These were chosen on the basis of how innovative they were and the extent to which they might inform efforts in the UK. We owe particular thanks to the OECD and Eurofound for being able to use many of the case studies they had previously compiled.

In an attempt to substantiate the findings from the desk research and tap into current debates on this issue, we subsequently held semi-structured interviews with 16 key stakeholders, among them academics, civil servants, experts from international organisations and representatives from business groups. Interviewees were asked about a range of issues relating to informal work, namely what they felt the underlying reasons were for the success or otherwise of policy interventions both in the UK and abroad.

Finally, alongside the desk research and interviews we commissioned YouGov to survey nearly 600 small business owners to find out more about their experiences of and attitudes towards the informal economy. For a round-up of the findings, please see the executive summary.

While this report attempts to breathe fresh air into a longstanding issue, it is important to note that it is not intended to provide an all-encompassing account of the issues relating to the informal economy, such is the ‘messy’ nature of this phenomenon.

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# Foreword

For many people, the term ‘informal economy’ is surrounded by negative connotations, conjuring up images of exploitation, hardship and excessive greed. This report by the RSA and Community Links seeks to change the tone of the debate. It adds its voice to a growing chorus of practitioners, economists and social commentators who are now calling for the informal economy to be recognised as a potential hotbed of entrepreneurialism that needs to be harnessed, rather than solely a clandestine activity to be beaten into submission.

Not everyone who takes part in undeclared work does so for good reason. There are no doubt many who are seeking to make an extra buck by not paying their fair share of taxes. But for all those in the informal sphere who are there for calculated self-interest, there are others for whom formalisation and business registration is simply out of reach. As this report argues, burdensome taxes, complex benefits, a lack of business advice, sparse financial credit and a dearth of other support mechanisms often serve to push hard working people looking to create their own future out of the formal economy.

Yes, formalisation should be the goal for entrepreneurs whatever their background or difficulties – it is where firms can more readily expand their operations, maximise their profits and reach a wider audience – but it is time to recognise the various hurdles that prevent people from realising this dream. We need to acknowledge that formalisation can be a long and arduous road for some, rather than a position that can be achieved through a quick and simple decision.

This notion of formalisation as a journey is one that I know resonates with many, now highly successful entrepreneurs. The volume and expanse of red tape means that most business owners have at some time or another probably been in breach of some regulation. Starting and growing a business is a steep learning curve and one that doesn’t always afford the time to be au fait with every rule and regulation, however well-meaning people’s intentions.

The ‘stepping-stone’ model of formalisation advocated by the RSA and Community Links must be part of any future consideration of a policy response to the informal economy. Here, government, business and civil society each have a role to play in helping entrepreneurs make the transition to the formal economy through a gradual step-by-step process. This would be a marked improvement on the UK’s historic policy approach which, with its emphasis on punitive measures such as penalties and inspections, risks stifling much of the dynamism and resourcefulness that the country’s hidden entrepreneurs harbour.

Although the recommendations and questions raised by this report may prove politically hard for policymakers to swallow – few will feel comfortable acknowledging informality as a legitimate temporary state for entrepreneurs – without confronting this issue head on we are likely

to continue disregarding or even diminishing the valuable entrepreneurial talent of hidden entrepreneurs which the country is clearly in desperate need of.

**Duncan Cheatle FRSA**  
Founder of Prelude Group

# Executive Summary

The informal economy is perceived as a significant challenge for the UK. It reportedly undermines the country's tax base, creates unfair competition for fully compliant businesses, and leaves many informal workers insecure and vulnerable in times of hardship. Above all, by forcing firms to stay at a suboptimal size, informality prevents some hidden entrepreneurs from achieving their full potential. Formalisation would help to address this problem and provide a channel through which the entrepreneurial assets of hidden entrepreneurs – their work ethic, skills, ideas and connections – could bear greater fruit, creating benefits for themselves, their communities and their local economies.

While formalisation is now a commonly held objective, this report argues that the UK's historic approach to achieving this goal through punitive measures has been ineffective and possibly even counterproductive. The fundamental problem with the blanket use of deterrence measures is that it assumes informal activity to be borne out of excessive greed. This may be true of some individuals, yet the evidence suggests large numbers of hidden entrepreneurs engage in undeclared work due to a complex array of factors that relate more to an 'exclusion' from the formal sphere rather than a decision to 'exit' it. For instance, of the 1 in 5 small business owners we surveyed who said they had engaged in informal trading when setting up one of their businesses, 40 per cent reported doing so because it gave them the breathing space before they had the capacity to register their business. Only 9 per cent said they did it to earn extra income (see the box below for more information on our survey findings). In short, the route to business registration is for many a long term journey complete with various individual, structural and cultural hurdles that need to be cleared along the way.

If we rely too heavily on deterrence measures, we run the risk of derailing this journey and preventing the entrepreneurial potential of thousands of hidden entrepreneurs from being realised. Against the backdrop of an enduring financial crisis and sluggish growth rates, this is something the UK can ill afford to lose. We welcome recent efforts by the likes of HMRC to move away from a reliance on deterrence measures, but we would like to see more significant changes made in future years. We therefore advocate an alternative approach to formalisation based on the 'stepping-stone' model devised and used by Community Links. This involves guiding individuals along the path towards business registration; from becoming aware of their obligations, to setting up a bank account for their transactions, to finally becoming VAT registered. The role of government, tax authorities, public bodies and increasingly business and civil society should be to aid this journey and make it as seamless as possible.

More broadly, the government should begin to treat the informal economy as a 'wicked' issue rather than a 'tame' one. Undeclared work has to be seen as something that arises as a result of a number of competing and interrelated drivers, rather than just one or two discreet causes, for

*If an overreliance on deterrence measures continues, we run the risk of derailing this journey and preventing the entrepreneurial potential of thousands of hidden entrepreneurs from being realised*

example calculated self-interest. In practice, this means devising a ‘clumsy’ approach to addressing the informal economy that combines interventions cutting across different ‘cultural understandings’, namely the hierarchical (an emphasis on establishing rules), egalitarian (a focus on nurturing social norms) and individualist forms (a concentration on incentives and support structures). This stands in contrast to the UK’s historic approach, which has often been to rely heavily upon hierarchical measures. A central part of this shift will involve weaning ourselves off ‘elegant’ solutions; initiatives that may be politically pleasing but which are detrimental in the long-term.

Based on the arguments and findings noted in this report, we propose the following recommendations and principles to guide future UK efforts in this area. Many of these are informed from the interventions that have been applied elsewhere in the world (see chapter 4 for more detail). It is worth noting that HMRC is now taking significant steps to develop a more nuanced approach to addressing the hidden economy, and is already considering a number of these proposals (particularly around prevention).

### **Build an overarching strategy for addressing undeclared work**

- Draw up an overarching strategy for dealing with informal activity which covers the actions of local and national bodies, including key government departments such as HMRC, DWP and BIS.
- Create a single Hidden Economy National Committee which draws together key stakeholders to share information and data, and to devise new interventions.
- Incorporate within relevant government policy papers some discussion of informal activity and the potential impact, positive or negative, that non-related interventions could have.

### **Nurture tax morality and social norms, and make the state relevant**

- Replace negative advertising campaigns for positive ones that showcase the benefits of formal work and which demonstrate that declaring income is the norm adhered to by the vast majority of the population.
- Consider creating personal ‘lifecycle accounts’ that chart and project people’s contributions and benefits over their lifetime.<sup>1</sup>

### **Simplify formalisation procedures**

- Consider creating a programme where businesses can be established in a very short timeframe (1-2 hours) face-to-face.
- Undertake an assessment of formalisation procedures to identify any instances where ‘accidental non-compliance’ may occur.

### **Prioritise early intervention**

- Work with schools and colleges to design a set of early intervention schemes targeted at groups of young people who are at risk of entering informal self-employment.

1. This tool has already been proposed by the 2020 Public Services Hub at the RSA. See 2020 Public Services Trust (2010) *2020 Welfare: Life, work, locality*. London: 2020PST.

- In the long term, consider extending the New Enterprise Allowance scheme so that its support package is available to unemployed people as soon as they begin claiming Job Seekers Allowance, rather than the 6 months which is the current minimum.
- Explore the potential of waiving the taxes on personal loans provided by friends and family as a means of encouraging people to declare them with the authorities and begin on a formal footing.

### **Target consumers as well as producers**

- Design information campaigns that target consumers, as well as producers, of undeclared work.
- Explore further the potential for minimising the use of large cash transactions so as to encourage sizeable informal enterprises to formalise their operations. This could involve transferring the responsibility for tax evasion from the producer to the consumer when any large cash payments take place.

### **Draw upon business and civil society to address informality**

- Establish a new initiative for the Work Programme whereby private and third sector contractors are paid on a case-by-case basis for helping hidden entrepreneurs to formalise their operations.
- Wherever possible, seek to recruit and train ‘formalisation champions’ from the community where targeted interventions are underway, thereby giving the authorities greater leverage to change local behaviours.
- Initiate a system whereby a written guarantee is given to any hidden entrepreneur seeking assistance. This would state that none of the information collected in their dialogue would be used against them in another interaction.
- Create an investment fund to kick-start new initiatives which help self-employed people and micro-entrepreneurs establish their own businesses and remain operating in the formal sphere.
- Encourage organisations supporting start-up entrepreneurs (e.g. StartUp Britain) to direct a portion of their efforts towards helping informal entrepreneurs.

This report finishes by asking a fundamental question that we have yet to fully consider: can we learn to live with the informal economy? If the government is to acknowledge that formalisation is for many a journey to complete rather than a simple decision to be made, this also means accepting informality as a legitimate, albeit temporary, state for some hidden entrepreneurs making their way to the formal sphere also means accepting informality as a legitimate, albeit temporary state for hidden entrepreneurs to operate in as they make their way to the formal sphere. As our survey findings show, nearly half of all small business owners think that informal trading activity is often a necessary step as part of the journey towards becoming a successful entrepreneur.

To acknowledge this publicly would pose many challenges for policymakers, chiefly how to determine who is genuinely on the route to formalisation and who is residing in informality for their own calculated

self-interest. Nevertheless, we hope that this report kick-starts a valuable debate on the viability of legitimising informal activity, and that others begin to explore this question in more detail within future research.

### **Box 1: Summary of the YouGov survey findings on the informal economy**

During August 2012, the RSA commissioned YouGov to conduct an online survey of business owners who were responsible for establishing or co-founding their firm. 595 respondents completed our survey and answered several questions relating to their experiences of and attitudes towards the informal economy. The top line findings include:

- 1 in 5 respondents said they had traded informally on at least one occasion when starting one of their businesses.
- Of the respondents who had traded informally, the two most popular reasons given for doing so was that they first wanted to see if their business would be viable (64%) and that it gave them the breathing space before they had the capacity to register their business (40%).
- Only 9% of those who had traded informally said they did so because they wanted to earn extra income that would have otherwise been taxed.
- Burdensome red tape and high business and personal taxes are still a clear issue, with 48% and 34% of all survey respondents citing these as some of the biggest individual factors that encourage or compel entrepreneurs to trade informally.
- 47% of respondents agreed and 39% disagreed with the statement, “Engaging in informal trading activity is often a necessary step as part of the journey towards becoming a successful entrepreneur.”

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# 1 Understanding the informal economy

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“The informal economy is both deceptively simple and extraordinarily complex, trivial in its everyday manifestations and capable of subverting the economic and political order of a nation”

Portes and Haller.<sup>2</sup>

## The contours of the informal economy

Against the backdrop of an enduring financial crisis, there is a strong perception among policymakers and other social commentators that we will need to begin reappraising every aspect of our economy and tax base if the UK is to prosper in the years ahead. Of particular importance will be revisiting old challenges that have yet to be fully addressed, but whose consequences are as significant for the economy and wider society as other issues which currently enjoy much greater limelight from policymakers and the media.<sup>3</sup> One such challenge is that of the country’s informal economy. In the UK, it has been reported that 1 in 10 people have consumed goods and services with an informal element,<sup>4</sup> and the most recent figures suggest that as much as 10.1 per cent of the nation’s GDP – equivalent to over £200 billion – arises from and is spent on informal, undeclared work (although more conservative estimates do exist, such as ONS’s figure of 1.5%).<sup>5</sup>

Indeed, most of us are party to informal activity on a surprisingly regular basis, albeit often unknowingly. The cash-in-hand gardening jobs which are done between neighbours and friends may never be recorded on the books; the food that is bought at the supermarket may contain ingredients farmed using labourers paid under the minimum wage; and clothes purchased online may be from regular eBay traders who fail to declare their earnings to the tax authorities. While informality may be difficult to describe in abstract – not least because ‘formal’ and ‘informal’ work coexist along a continuum with several linkages<sup>6</sup> – it is much easier

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As much as  
**£200bn**  
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on undeclared work  
every year in the UK

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2. Portes, A. and Haller, W. (2005) ‘The Informal Economy’ in N. Smelser and R. Swedberg (eds.) *Handbook of Economic Sociology*, 2<sup>nd</sup> edition. New York: Russell Sage Foundation.

3. See, for example, the extensive news coverage relating to SME bank lending, tax avoidance by very high earners, and excessive remuneration packages paid to bankers.

4. European Commission. (2007) *Undeclared Work in the European Union* (Eurobarometer survey). EC.

5. Schneider, F. (2011) *Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2012: Some New Facts*.

6. International Labour Organisation. (2002) *Decent Work and the Informal Economy*. ILO; and Chambwera, M., MacGregor, J. and Baker, A. (2011) *The Informal Economy*. London: International Institute for Environment and Development.

*The informal sector is like an elephant: we may not be able to define it precisely, but we know it when we see it*

to distinguish when presented in reality. As the economist Hernando de Soto put it, “the informal sector is like an elephant: we may not be able to define it precisely, but we know it when we see it.”<sup>7</sup>

Regardless of the contentions over its definition, for the purposes of this report we will use the description of informal activity that has been deployed by the likes of the Small Business Council, Community Links and the European Commission. This states that informal work involves “the paid production and sale of goods or services which are unregistered by or hidden from the state for tax, benefit and/or labour law purposes, but which are legal in all other respects.”<sup>8</sup> Exchanges of criminal goods and services, for instance prostitution, drug dealing and counterfeit production, are therefore excluded from this picture.

Under this banner of the informal economy sit a wide variety of activities. However, it is clear that undeclared work is more prevalent in, although certainly not limited to, industries that are labour-intensive and low skilled.<sup>9</sup> This includes construction, catering, care assistance, cleaning, hairdressing, child minding, gardening services and mini-cab driving, among others.<sup>10</sup> Types of informal activity can be grouped into three main categories<sup>11</sup>: (i) informal *wage-workers* who are employed by firms and who do all or part of their job undeclared; (ii) *self-employed individuals* who operate alone as own-account workers and whose operations are completely or partially informal; and (iii) *informal production by firms* who are doing all or part of their business “off the books”.

Our interest in this report is on those informal entrepreneurs who are in self-employment and who operate entirely below the radar. This is widely recognised as the largest category of informal activity in the UK, with one study suggesting that up to 70 per cent of undeclared work occurs in this space, whether for friends and family or for commercial reasons.<sup>12</sup>

## The grey economy?

Although perceptions of the informal economy have undergone several shifts since the economic anthropologist Keith Hart first documented it in the 1970s, for the most part it has been viewed as an unwelcome activity with detrimental consequences for government, businesses, society and the individuals who are involved. First and foremost, a prevalence of undeclared work has a direct impact on the government tax base. HMRC have calculated that the tax gap of the hidden economy equated to some £4bn in 2010 alone.<sup>13</sup> The cumulative impact of this tax loss is that the state has less

7. Hernando de Soto cited in Parlevliet, J., Jütting, J. and Xenogiani, T. (2008) *Informal Employment: Can We Tame the Beast?* OECD.

8. Katungi, D., Neale, E. and Barbour, A. (2006) *People in Low-Paid Informal Work*. London: JRF; and Community Links and the Refugee Council (2011) *Understanding the Informal Economic Activity of Refugees in London*. London: Community Links and the Refugee Council.

9. Capp, J., Elstrodt, H. P., and Jones, W. B. Jr. (2005) *Reining in Brazil's Informal Economy*. McKinsey Quarterly.

10. National Audit Office and RAND Europe. (2008) *Comparing How Some Tax Authorities Tackle The Hidden Economy*. London: NAO and RAND; and International Labour Organisation. (2011) Op cit.

11. Chen, M. (2005) *Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment*. Research paper No. 2005/10. Expert Group on Development Issues and the World Institute for Development Economics Research.

12. Williams, C. C. and Renooy, P. (2009) *Measures to Tackle Undeclared Work in the European Union*. European Foundation for the Improvement of Living and Working Conditions.

13. HMRC. (2011) *Measuring Tax Gaps 2011: An official statistics release*. London: HMRC

to spend on the public services that can alleviate poverty and improve social outcomes. As a result, the integrity of public institutions diminishes and the social contract holding society together becomes more strained.<sup>14</sup>

At the level of individual businesses, the informal economy can create unfair competition and skew incentives for innovation. Since hidden entrepreneurs do not pay taxes or comply with costly regulation, their costs of production are lower and therefore their goods and services are more likely to be cheaper, thus drawing away customers from formal firms.<sup>15</sup> Likewise, hidden entrepreneurs are prone to circumvent rules on intellectual property rights and draw upon whatever product and service innovations they see as beneficial to their business.<sup>16</sup> This in turn diminishes the incentives for formal firms to invest in R&D. Viewed through a macro lens, the informal economy – or what McKinsey terms the “grey economy” – is therefore often perceived as a free rider haven creating a drag on the economy’s productivity and growth.<sup>17</sup>

Informality can also serve to create several serious hazards for hidden entrepreneurs themselves, not least because they lack legal recognition, regulation and protection.<sup>18</sup> Remaining under the radar may help entrepreneurs avoid costly interactions with the state, but it also means they forego many of the social security benefits that could support them during long periods out of work or in times of acute unforeseen difficulty, such as a financial crisis or illness.<sup>19</sup> Since many are relying on the minimum state pension, informal entrepreneurs face the all too realistic prospect of poverty when they enter old age.<sup>20</sup> Moreover, beyond issues of social protection and out of work support, informal entrepreneurs also face difficulties within work, including a notable absence of opportunities to enhance their skills and gain new competencies through training, something typically enjoyed by formal wage-workers.<sup>21</sup> Given that women account for the majority of informal activity, these risks can also serve to amplify existing gender imbalances.<sup>22</sup>

### **The silver linings of a political economy**

Notwithstanding the difficulties that informal activity can impose on institutions, businesses and individuals alike, it would be mistaken to assume that it is inherently immoral or solely problematic. For hidden entrepreneurs, informal employment can enable them to find work and earn a living where

14. World Bank. (2007) *The Informal Sector: What Is It, Why Do We Care, and How Do We Measure It?* World Bank; and Andrews, D., Caldera Sanchez, A. and Johansson, A. (2011) *Towards a Better Understanding of the Informal Economy*. OECD.

15. Llanes, M. and Barbour, A. (2007) *Self-Employed and Micro-Entrepreneurs: Informal Trading and the Journey Towards Formalisation*. London: Community Links.

16. OECD. (2009) *Policy Roundtables, Competition Policy and the Informal Economy*. Paris: OECD cited in Andrews, D., Caldera Sanchez, A. and Johansson, A. (2011) Op cit.

17. A-M Ovideo 2009; and Capp, J., Elstrodt, H. P., and Jones, W. B. Jr. (2005) Op cit.

18. Chen, M. (2005) Op cit.

19. Oviedo, A-M. (2009) *Economic Informality: Causes, Costs and Policies. A Literature Survey of International Experience*. Background paper for Country Economic Memorandum (CEM). World Bank; and Jütting, J, Parlevliet, J. and Xenogiani, T. (2008) *Informal Employment Re-loaded*. OECD Development Centre working paper 266. OECD cited in Jonasson, E. (2011) “Informal Employment and the Role of Regional Governance” in *Review of Development Economics*, Vol. 15 (3).

20. Andrews, D., Caldera Sanchez, A. and Johansson, A. (2011) Op cit.

21. International Labour Organisation. (2002) Op cit.; and Parlevliet, J, Jütting, J. and Xenogiani, T. (2008) Op cit.

22. Heintz, J. and Pollin, R. (2003) *Informalisation, Economic Growth and the Challenge of Creating Viable Labour Standards in Developing Countries*. PERI Working Paper No. 60.

*The term “informal” does not mean that there are no rules or norms regulating the activities of workers or enterprises. People engaged in informal activities have their own “political economy” – their own informal or group rules, arrangements, institutions and structures for mutual help*

– The International Labour Organisation

they would have otherwise found it difficult, if not impossible, in the formal sphere. Indeed, in periods of economic downturns, the informal economy can quickly soak up entrepreneurs from the shrinking formal sphere and create an outlet for their entrepreneurial talent that would otherwise go to waste.<sup>23</sup> For example, this could be a recently laid off factory electrician undertaking small jobs for local businesses, or a redundant teacher operating as a tutor for the children of friends and family. By continuing to work and harness their skills, hidden entrepreneurs avoid some of the “scarring” effects which are such a common feature of long-term unemployment.

Informal activity is also a means of creating social and economic value for the wider community. Since their goods and services are often cheaper than those provided in the formal economy, hidden entrepreneurs can offer a welcome alternative to residents in more deprived areas where competition among formal providers is sparse and where prices are high.<sup>24</sup> For families paying what Save the Children call the “poverty premium”<sup>25</sup> – the extra amount poorer people pay for goods and services when higher levels of interest and travel distances are taken into account – this can be a lifeline. What is more, research suggests that in multicultural areas, informal activities can more readily cater to the ‘specific socio-cultural habits’ of local residents than can formal markets.<sup>26</sup>

Hidden entrepreneurs could therefore be viewed as an integral part of the wider community and its development. Informal activity both nurtures community support networks – for instance, as hidden entrepreneurs make and weave connections between neighbours – and thrives as a result of doing so – since a more cohesive community wants to help out those who are in need of work.<sup>27</sup> The International Labour Organisation (ILO) has described the complex reciprocal interactions that fall out of these informal economic relationships as a “political economy”:

The term “informal” does not mean that there are no rules or norms regulating the activities of workers or enterprises. People engaged in informal activities have their own “political economy” – their own informal or group rules, arrangements, institutions and structures for mutual help and trust, providing loans, organizing training, transferring technology and skills, trading and market access, [and] enforcing obligations.<sup>28</sup>

### **Harnessing entrepreneurial assets through formalisation**

While it is necessary to recognise the social and moral roots of informal economic activity and to acknowledge the benefits that hidden entrepreneurs afford to their wider community, this may not be sufficient to

23. Loayza, V., Servén, L. and Sugawara, N. (2010) *Informality in Latin America and the Caribbean*. Policy Research Working Paper Series cited in Andrews, D., Caldera Sanchez, A. and Johansson, A. (2011) Op cit.

24. Copisarow, R. and Barbour, A. (2004) *Self-employed People in the Informal Economy – Cheats or Contributors?* London: Community Links.

25. For more information see <http://www.savethechildren.org.uk/get-involved/join-our-campaigns/the-uk-poverty-rip-off>

26. Masurel, E. et al. (2002) ‘Motivations and Performance Conditions for Ethnic Entrepreneurship’ in *Growth and Change*, 33(2), pp.238-160 cited in Llanes, M. and Barbour, A. (2007) Op cit.

27. Pfau-Effinger, B. (2003) ‘Development of informal work in Europe: causal factors, problems, approaches to solutions’, Paper presented at EU Workshop ‘Informal/ undeclared work: research on its changing nature and policy strategies in an enlarged Europe’, Brussels, 21 May cited in Katungi, D., Neale, E. and Barbour, A. (2006) Op cit.

28. International Labour Organisation. (2002) Op cit.

justify undeclared work; in part because of the aforementioned social and economic ramifications arising from informality, but equally because of the entrepreneurial potential of individuals wasted as a result of not formalising their paid activities.

Many experts and social commentators now agree that the assets of hidden entrepreneurs, including their entrepreneurial spirit, skills, ideas, connections and work ethic, would bear greater fruit in the formal sector.<sup>29</sup> Research by Community Links, for instance, found that business registration often preceded an increase in income and a “new phase in business development.”<sup>30</sup> Formalisation enabled the entrepreneurs to secure credibility for their business, open up new markets (advertising no longer had to be via word of mouth) and achieve peace of mind.<sup>31</sup> This confirms the findings of other research that suggests informal entrepreneurs would benefit strongly from the features of formality, including having legal ownership of their place of business, enforceable commercial contracts and access to new sources of capital.<sup>32</sup> Conversely, as a result of needing to stay small to avoid regulation and detection, informality keeps many firms at a suboptimal size and provides few incentives to innovate.<sup>33</sup>

By harnessing the capabilities of hidden entrepreneurs, formalisation offers a clear route to closing what the RSA has termed the ‘social aspiration gap’; that gap between the world in which we aspire to live in and the one we are creating through our current ways of thinking and acting. It is through gainful employment that people can learn new skills, fashion an identity for themselves and more readily achieve a sense of self-efficacy and wellbeing. As the sociologist Richard Sennett wrote, “work is the road to the unification of the self”.

### **Reappraising interventions for a new economic era**

For these reasons the government should consider formalisation to be a key policy objective. The concern, however, is that our current model for addressing informality has not yet had a major impact in curtailing the hidden economy, which remains persistently high. Moreover, there are wider structural changes underfoot which may serve to boost levels of undeclared work. First, the impact of the economic downturn, although still unknown, could lead to greater numbers of people engaging in informal activity since it provides a welcome ‘cushion’ to those recently made unemployed.<sup>34</sup> There is a strong possibility that many of these will be tempted to stay in this sphere long after the economy begins to grow again. Second, the trend towards flexibilisation in employment patterns, particularly with regard to self-employment, part-time work and temporary agency contracts, may create more opportunities for people to enter

29. See for example Social Exclusion Unit. (2004) *Stimulating jobs and enterprise in deprived communities*. London: The Stationery Office cited in Katungi, D., Neale, E. and Barbour, A. (2006) *Op cit.*; and Williams, C. C. and Renooy, P. (2009) *Op cit.*

30. Llanes, M. and Barbour, A. (2007) *Op cit.*

31. *Ibid.*

32. Chen, M. (2005) *Op cit.*

33. Oviedo, A-M. (2009) *Op cit.*; and World Bank. (2007) *Op cit.*

34. Williams, C. C. and Renooy, P. (2009) *Op cit.*; and Tokman, V. (1978) ‘An Exploration into the Nature of the Informal-Formal Sector Relationship’ in *World Development*, Vol. 6 (9/10) cited in Chen, M. (2005) *Op cit.*

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Nearly a third of the

**5.9m**

businesses which are  
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into informality.<sup>35</sup> 14 per cent of the workforce are now self-employed, the highest figure ever recorded,<sup>36</sup> and nearly a third of the 5.9 million businesses which are based in people's homes were set up in the last 2 years alone.<sup>37</sup>

Against this backdrop, it is clear that we need to reappraise the toolkit of policy interventions we use to surface hidden entrepreneurs. Indeed, it is important to reconsider our whole relationship to the informal economy, including whether it is something that can be accepted as a legitimate, albeit temporary, state for entrepreneurs to operate within. Before going on to explore these issues in more detail, the next section will first summarise the key factors that encourage or compel entrepreneurs to operate in the informal economy.

35. Schuetze, H. J, and Bruce, D. (2004) "Tax Policy and Entrepreneurship" in Swedish Economic Policy Review, Vol. 11 cited in OECD. (2008) *Declaring Work or Staying Underground: Informal Employment in Seven OECD Countries*. OECD.

36. McRae, H. (2012) *Within the Jobless Data, Some Fascinating Stories of Change*. The Independent, 19<sup>th</sup> April 2012. Available: <http://www.independent.co.uk/news/business/comment/hamish-mcrae/hamish-mcrae-within-the-jobless-data-some-fascinating-stories-of-change-7658131.html>

37. For more information see <http://news.sky.com/home/business/article/16004896>

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# 2 The drivers of informality

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## A theoretical introduction

Discussions about the informal economy go back several decades. A number of key theories have emerged that seek to shed light on this phenomenon and explain why it continues to persist and even grow. The four most predominant schools of thought can be grouped into two camps: one that sees informal activity as resulting from ‘exclusion’ from the formal sphere; and another which considers informal activity to arise from a voluntary decision to ‘exit’ conventional markets.<sup>38</sup> These are explained in brief below:

- **The dualist school** sees informal activities emerging when there are too few employment opportunities in the formal sphere and when those that do exist are inappropriate for individuals seeking employment, in part because of a mismatch in skills. The excess labour that is not accommodated in the formal economy is soaked up by the informal economy.<sup>39</sup>
- **The structuralist school** argues that informal activity exists to serve the needs of larger firms by supplying cheaper goods and services. This view seeks to highlight the plight of informal workers as marginalised and exploited individuals.
- **The legalist school** suggests that informal activity represents the overflow of entrepreneurialism that is stifled in the formal sphere due to cumbersome regulation and bureaucracy. The school’s main proponent, Hernando de Soto, argues that formality, not informality, is the problem that needs to be addressed.
- **The voluntarist school** considers informality to be the result of a simple cost-benefit decision on the part of informal workers. Where the benefits of informality (for example, the avoidance of taxation and regulation) exceed the probability and cost of getting caught, entrepreneurs will seek to remain below the radar.<sup>40</sup>

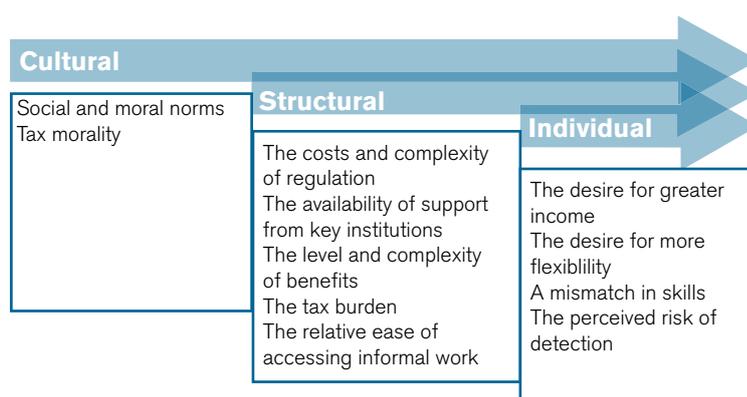
38. For more information see WIEGO’s ‘Holistic Framework’ on the informal economy. Available: <http://wiego.org/informal-economy/wiego-network-holistic-framework>. See also WIEGO’s overview of the policies and programmes in this area. Available: <http://wiego.org/informal-economy/policies-programmes>

39. International Labour Organisation. (2002) Op cit.

40. Capp, J., Elstrodt, H. P., and Jones, W. B. Jr. (2005) Op cit.

While these theoretical discussions of informality broadly map the different motivations at play, it is important to recognise that undeclared work sits on a continuum between ‘exit’ on the one hand and ‘exclusion’ on the other.<sup>41</sup> Some entrepreneurs are driven to informality by exit and some by exclusion, but more likely it is a combination of both depending on their circumstances.<sup>42</sup> In order to better understand informal activity and generate effective interventions, it is necessary to drill down into the specific factors – cultural, structural and individual – that compel or encourage entrepreneurs to become and remain hidden.

**Figure 1: The drivers of informality**



### Individual drivers

The individual level drivers refer to the skills and desires of workers.

#### The desire for greater income

The desire to earn extra income is one of the central determinants of undeclared work.<sup>43</sup> Occasionally this is borne out of an aspiration to consume more luxury goods and achieve a better quality of life – the ‘life strategy’ – while in other cases it is to rise out of poverty and achieve a minimum decent standard of living – the ‘survival strategy’.<sup>44</sup> Participants in one Community Links study saw no way of earning a living and supporting themselves through low-paid formal work and thus turned to the informal sphere to get by.<sup>45</sup> The high costs of housing and childcare have been identified as key factors pushing people into informal work.<sup>46</sup> Self-interest, however, is still a significant driver of informality. 36 per cent of our survey respondents identified greed as one of the main reasons why people engage in informal activity.

#### The desire for more flexibility

For individuals who have recurring bouts of illnesses and intermittent difficulties in securing childcare, informal work can offer the necessary

41. Williams, C. C. and Round, J. (2011) “Beyond Competing Theories of the Hidden Economy: Some Lessons from Moscow” in *Journal of Economic Studies*, Vol. 38 (2).

42. Ibid.

43. International Labour Organisation. (2002) Op cit.

44. Engbersen, G. (2001) *Controlling a new migration world*. London/New York: Routledge cited in Katungi, D., Neale, E. and Barbour, A. (2006) Op cit.

45. Katungi, D., Neale, E. and Barbour, A. (2006) Op cit.

46. Ibid.

flexibility to decide their own hours of employment, something that is not often found in more formal wage-work within organisations. Interviews undertaken by Community Links with informal workers found that they were frustrated by the failure of formal employers to adjust to their particular health needs. In addition, there are many entrepreneurs who work in the informal sphere to enjoy the freedom of being their own boss.<sup>47</sup>

### **A mismatch in skills**

Individuals are often known to set up their own informal enterprises because of an absence of suitable job opportunities in the formal sphere. In many cases hidden entrepreneurs lack the necessary qualifications required by formal employers, as well as the know-how to find relevant job opportunities or the self-esteem to apply.<sup>48</sup> This is particularly true of individuals coming from overseas, many of whom are unfamiliar with the UK job market, face a language barriers with employers and have degrees and training not recognised in the UK.<sup>49</sup>

### **The perceived risk of detection**

While the desire for greater income, more flexibility and the opportunity to make better use of available skills make informal activity seem more attractive, this is offset to an extent by the perceived risk of undeclared work being detected by the authorities. Where this is high, people will be reticent to move into the informal economy.<sup>50</sup> According to the most recent Eurobarometer survey into public perceptions of informal activity across Europe, more than half of the respondents considered the risk of being detected undertaking undeclared work to be fairly or very small (although responses in the UK were in the higher ranges).<sup>51</sup>

### **Structural drivers**

The structural level drivers are those that emerge as a result of actions taken by the state or because of the nature of the employment market.

### **The costs and complexity of regulation and registration**

There is widespread agreement that costly regulation and registration procedures create significant incentives to engage in undeclared work.<sup>52</sup> As the economist Eric Friedman notes, “the relationship is unambiguous: more over-regulation is correlated with a large unofficial economy.”<sup>53</sup> Such regulation includes obtaining a license to start a business, adhering to health and safety regulations, and spending time and effort managing company records. Each of these activities may require training and therefore upfront

47. Smith, D. (2005) *On the margins of inclusion: Changing labour markets and social exclusion in London*. Bristol: The Policy Press cited in Katungi, D., Neale, E. and Barbour, A. (2006) Op cit.

48. Katungi, D., Neale, E. and Barbour, A. (2006) Op cit.

49. Community Links and the Refugee Council (2011) Op cit.

50. Andreoni, J., Erard, B. and Feldstein, J. (1998) “Tax Compliance” in *Journal of Economic Literature*, Vol. 36 (2) cited in Andrews, D., Caldera Sanchez, A. and Johansson, A. (2011) Op cit.

51. National Audit Office and RAND Europe. (2008) Op cit.

52. See for example Llanes, M. and Barbour, A. (2007) Op cit.; Chambwera, M., MacGregor, J. and Baker, A. (2011) Op cit.; and International Labour Organisation. (2002) Op cit.

53. Friedman, E., Johnson, S., Kaufman, D. and Zoido-Lobaton, P. (2000) “Dodging the Grabbing Hand: the determinants of unofficial activity in 69 countries” in *Journal of Public Economics*, Vol. 76 (3) cited in OECD. (2004) *Informal Employment and Promoting the Transition to a Salaried Economy*. OECD.

*More than half of people consider the risk of being detected undertaking undeclared work to be fairly or very small*

expenses, some of which are likely to exceed the budgets of microentrepreneurs who do not enjoy economies of scale.<sup>54</sup> Likewise, burdensome complexity can have the same impact.<sup>55</sup> There is either a reluctance or an inability on the part of some to deal with the ample paperwork that accompanies running a formal enterprise. Burdensome red tape was the most significant driver of informal activity identified by our survey respondents, with 48 per cent agreeing that it is an issue.

### **The availability of support and finance from mainstream institutions**

The ability of public institutions to support micro entrepreneurs, whether through advice or finance, will have a direct impact on levels of informal activity.<sup>56</sup> For many of the hidden entrepreneurs interviewed in one Community Links study, there was a general sense that mainstream services were ill-equipped to help less affluent individuals set up their own enterprises.<sup>57</sup> Jobcentre Plus staff, for instance, were too fixated on directing aspiring micro-entrepreneurs towards paid employment within firms rather than helping them to become self-employed. A similar problem encountered by budding entrepreneurs is that it is often difficult to secure start-up capital at reasonable rates from mainstream institutions.<sup>58</sup> For this reason many people acquire loans from friends or family and as a result begin their enterprise on an informal footing.<sup>59</sup> The lack of financial assistance from the government and mainstream banks was identified as a driver of informality by 1 in 5 of the entrepreneurs we surveyed.

### **The levels and complexity of benefit entitlements**

Where benefit levels are too low, many people find themselves in the unfortunate position of having to choose between incurring debt, cutting back on essentials or taking up informal paid work.<sup>60</sup> Many people naturally opt for the latter rather than attempt to get by on meagre benefits. Should they try to engage in formal employment instead, they may risk losing a large degree of their entitlement to their existing benefits, for example Working Tax Credits or the Carers Allowance.<sup>61</sup> Anyone already operating as a hidden entrepreneur may be reluctant to enter into the ‘unknown’ and leave their ‘safety-net’ of benefits behind, in part because of the difficulty in re-establishing their entitlements should things go wrong in the formal sphere.<sup>62</sup> The hope is that the Universal Credit may alleviate some of these issues, although some in HMRC believe that it may actually serve to increase the size of the hidden economy.

54. OECD. (2004) Op cit.

55. Richardson, G. (2006) “Determinants of tax evasion: A cross-country investigation” in *Journal of International Accounting, Auditing and Taxation*, Vol. 15 (2) cited in Williams, C. C. and Renooy, P. (2009) Op cit.

56. See for example Andrews, D., Caldera Sanchez, A. and Johansson, A. (2011) Op cit.; and OECD. (2008) Op cit.

57. Copisarow, R. and Barbour, A. (2004) Op cit.

58. See the World Bank’s online toolkit on the informal economy. Available: [http://info.worldbank.org/etools/docs/library/166856/UCMP/UCMP/index\\_informaleconomy.html](http://info.worldbank.org/etools/docs/library/166856/UCMP/UCMP/index_informaleconomy.html)

59. Copisarow, R. and Barbour, A. (2004) Op cit.

60. Kempson, E. (1996) *Life on a low income*. York: Joseph Rowntree Foundation cited in Katungi, D., Neale, E. and Barbour, A. (2006) Op cit.

61. Llanes, M. and Barbour, A. (2007) Op cit.

62. Department for Work and Pensions. (2006) *A new deal for welfare: Empowering people to work* [Welfare Reform Green Paper]. London: DWP cited in Katungi, D., Neale, E. and Barbour, A. (2006) Op cit.

### The tax burden

High levels of income tax and low thresholds can dissuade people from entering into formal wage employment. Likewise, high levels of VAT, corporation tax and National Insurance create clear financial disincentives for hidden entrepreneurs to register their 34% of the small business owners we surveyed said that high business and personal taxes are key drivers of informal behaviour.<sup>63</sup> While this makes intuitive sense, it is important to recognise that the impact of this driver is not the same across all countries. For instance, some studies show high tax rates are correlated with lower informal activity; something witnessed most visibly in Germany and the Scandinavian countries.<sup>64</sup>

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66%

of people who buy goods and services from informal enterprises do so because prices are lower

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### The relative ease of accessing informal employment

Searching for formal employment through typical avenues can prove prohibitively expensive for people on low incomes due to the costs of travel, suitable work clothes, internet access, attending interviews and obtaining CRB checks.<sup>65</sup> In addition, a record of criminal behaviour can create a significant barrier to formal work. Conversely, informal paid work is often more readily available, for instance through friends, family and neighbours. This might include looking after the neighbours' children or doing handyman jobs for personal acquaintances in the local area.<sup>66</sup> More broadly, demand from consumers is often greater for informal goods and services than for their formal equivalents. It has been reported that 66 per cent of people who buy goods and services from informal enterprises do so because prices are lower and 21 per cent because it is a faster service.<sup>67</sup>

### Cultural drivers

The cultural level drivers refer to the norms, attitudes and values that condition our perception of informal work and set the parameters for the kind of work we see as justifiable.

### Social and moral norms

Social and moral norms are the standards and customs that people expect themselves and others to live by and are therefore a key part of what shapes people's behaviour.<sup>68</sup> Where individuals and the wider community consider informal economic activity to be normal and justifiable, it is much more likely that they will engage in undeclared work.<sup>69</sup> The EU Commission reports that across Europe informal activity is often per-

63. Copisarow, R. and Barbour, A. (2004) Op cit.; and OECD (2008) "Declaring Work or Staying Underground: Informal Employment in Seven OECD Countries" in *OECD Employment Outlook*, Chapter 2. Paris: OECD cited in Andrews, D., Caldera Sanchez, A. and Johansson, A. (2011)

64. Friedman, E., Johnson, S., Kaufman, D. and Zoido-Lobaton, P. (2000) Op cit.

65. Katungi, D., Neale, E. and Barbour, A. (2006) Op cit.

66. Lister, R. (2005) *Poverty*, Cambridge: Polity Press cited in Katungi, D., Neale, E. and Barbour, A. (2006) Op cit.

67. European Commission. (2007) Op cit.

68. See for example Dolan, P. et al. (2010) *MINDSPACE: Influencing behaviour through public policy*. London: Institute for Government; and Grist, M. *Steer: Mastering our Behaviour through Instinct, Environment and Reason*. London: RSA.

69. National Audit Office and RAND Europe. (2008) Op cit.; and Riahi-Belkaoui, A. (2004) "Relationship between tax compliance internationally and selected determinants of tax morale" in *Journal of International Accounting, Auditing and Taxation*, 13(2) cited in Williams, C. C., Horlings, E. and Renooy, P. (2008) *Tackling Undeclared Work in the European Union*. European Foundation for the Improvement of Living and Working Conditions.

ceived as a casual exchange of services that does not need to be declared,<sup>70</sup> while at home in the UK informal entrepreneurs interviewed by Community Links stated clearly that they were able to operate informally because their community accepted it as a benign activity.<sup>71</sup> Interestingly, these respondents were keen to create a moral distinction between their activities and those of ‘benefit scroungers’.

### **Tax morality**

Tax morality refers to the specific attitude that people have towards the tax regime of the state. Tax morality broadly takes two forms. The first is a perception that everybody is being treated fairly by the tax authorities.<sup>72</sup> This includes clear impartiality, no unwarranted demands and adequate customer service support. The second is a sense that people are getting enough ‘out’ of the state relative to what they are putting ‘in’. Entrepreneurs are more likely to formalise their operations when they can see a clear link between contributions and benefits, particularly pension entitlements.<sup>73</sup> It is now widely reported that low levels of tax morality are strongly correlated with high levels of undeclared work.<sup>74</sup> It is some concern then that tax morality may be dipping slightly in the UK.<sup>75</sup> As one of our interviewees, Keith Hart, put it in conversation, “[people] have long ago lost the sense that what goes on in government is for them”. This sentiment may be amplified by a growing feeling that the more affluent are not pulling their weight in the tax system. Nearly a third of the small business owners who answered our survey said that a culture of tax avoidance created by high earners was a key factor encouraging people to engage in informal activity.

### **A journey towards formality**

The many drivers of informality outlined above illustrate the complexity of this issue and the sheer number of forces that need to be contended with in any efforts to address undeclared work. However, it is also important to recognise that these different factors vary over time. Informality, in short, is temporal and dynamic.

The clearest indication of this is the reportedly large number of hidden entrepreneurs who aspire to formalise but cannot yet do so because their firm is not yet at the appropriate stage of development. Community Links have identified two clear phases that occur in the growth of informal enterprises: ‘getting by’ and ‘getting ahead’.<sup>76</sup> Getting by refers to the stage where entrepreneurs are operating with difficulty to make ends meet. Getting ahead is the next stage on where they are making a steady profit and have the wherewithal to expand and eventually register their operations. One of the key factors determining whether or not entrepreneurs fall into the latter camp is the size of their firm. Once their

70. International Labour Organisation. (2002) Op cit.

71. Copisarow, R. and Barbour, A. (2004) Op cit.

72. See for example House of Commons Treasury Select Committee. (2012) Op cit.

73. Andrews, D., Caldera Sanchez, A. and Johansson, A. (2011) Op cit. and Williams, C. C., Horlings, E. and Renooy, P. (2008) Op cit.

74. Richardson, 2006 and others in 135. And Torgler and Schneider (2009) in Jonasson 2011

75. This observation was raised at a meeting with representatives from HMRC. Their research suggests that levels of tax morality may be reducing, albeit marginally.

76. Llanes, M. and Barbour, A. (2007) Op cit.

operations reach a certain size they attain the economies of scale needed to cover formal transaction costs.<sup>77</sup>

This suggests that informality may be the necessary incubation period protecting fledgling entrepreneurs from an unforgiving business environment that would otherwise hamper their development or sink their business entirely.<sup>78</sup> This experience has been documented not only in small micro-enterprises in the UK but also in the tech start-ups of Silicon Valley and elsewhere.<sup>79</sup> Although every individual is different, it is striking to find that of those registered micro-entrepreneurs who were interviewed in the aforementioned Community Links study, all had operated at one point under the radar.<sup>80</sup> What is more, the majority of those who had not yet registered expressed their willingness to do so once they were generating enough income.<sup>81</sup> This also bears out within our own surveying of small business owners (see Table 1 below). Of the 1 in 5 respondents who had traded informally at one point in the past, the two most popular reasons given for doing so was that they first wanted to see if their business would be viable (64%), and that it gave them the ‘breathing space’ before they had the capacity to register their business (40%).

What follows is that formalisation can be viewed as a gradual journey, with each hidden entrepreneur following their own path towards registration. Enterprises may start off on an informal footing but through a steady process of growth and a careful navigation of the individual, structural and cultural drivers of informality, there is a strong possibility that many will eventually have the wherewithal to make the transition to the formal economy. Of course, there exist many capable hidden entrepreneurs who are unwilling to make the move towards the formal economy for reasons of self-interest, but this should not distract us from the large numbers who do aspire to one day register their business.

In the next section we will provide an overview of the UK’s current policy approach to addressing informal activity. As we shall see, this notion of formalisation as a journey does not appear to have strongly informed UK efforts to date.

**Table 1: Reasons for trading informally**

I was unaware that I had to register my business	14%
I wanted to earn extra income that would otherwise have been taxed	9%
It gave me the necessary breathing space before I had the capacity to register my business	40%
I wanted to see if the business would be viable first	64%
I didn't know who to go to about registering my business	12%
Other	17%
Can't recall/ Prefer not to say	2%

77. Heintz, J. and Pollin, R. (2003) Op cit.

78. See for example Global Employment Forum. (2001) “Informal Economy: formalizing the hidden potential and raising standards”, Session III-C, Global Employment Forum, Geneva, 1-3 November; and Small Business Council (2004) *Small Businesses in the Informal Economy*. London: Small Business Council; both cited in Williams, C. C. and Windebank, J. (2006) “Harnessing the Hidden Enterprise Culture of Advanced Economies” in *International Journal of Manpower*, Vol. 27 (6).

79. Portes, A. and Haller, W. (2005) Op cit.

80. Llanes, M. and Barbour, A. (2007) Op cit.

81. Ibid.

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# 3 Tackling informality in the UK

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## A commitment to deterrence

The publication of Lord Grabiner's report in 2000 marked the beginning of the government's efforts to tackle informal activity in the UK.<sup>82</sup> Prior to this, few government authorities had recognised undeclared work as a major policy challenge. Among the proposals outlined in the report were that government and relevant agencies should:<sup>83</sup>

*The clear message from the Grabiner report was that deterrence – that is, detection and punishment – had to be the central feature of the policy landscape addressing informal activity in the UK*

- Substantially increase levels of detection, aided by more resources and greater cross-sector partnership working. New rules on data sharing were recommended, including allowing tax authorities access to private sector resources such as bank records and utility directories
- Establish clear and significant punishments for those who engage in informal activity. Suggestions were to force suspected informal workers to visit the Job Centre more frequently and at unpredictable times, and to stop the benefits of people proven to be repeat offenders

The clear message from the Grabiner report was that deterrence – that is, detection and punishment – had to be the central feature of the policy landscape addressing informal activity in the UK. For Grabiner and for the government as a whole, the informal economy was thought to be a surreptitious activity occurring when people calculate that the benefits of tax avoidance are higher than the chance and costs of being caught.<sup>84</sup> This meant that the most effective way for the authorities to reduce the size of the informal economy was to increase the 'cost' side of the equation through better detection methods and harsher penalties. These include raising fines for those caught, increasing the number of field checks and inspectors, coordinating unannounced house visits for suspected informal entrepreneurs, and establishing greater data exchange and cooperation between public bodies at both a local and national level.<sup>85</sup>

82. Grabiner, A. (2000) *The Informal Economy*. London: HM Treasury.

83. OECD. (2004) Op cit.

84. Williams, C. C. and Windebank, J. (2006) Op cit.

85. Ibid.

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HMRC has a  
**600**  
-strong team of agents  
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informality

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## Key interventions

Following Grabiner's report, deterrence became the dominant thread running through government interventions. The most notable approaches that have been pursued by the government over the past ten years include:

- **The tax fraud hotline** – set up shortly after the Grabiner report to allow people to report others they suspect of operating in the hidden economy.<sup>86</sup>
- **Advertising** – HMRC have commissioned a number of advertising campaigns to build people's awareness of their tax obligations. The largest of these was the series of campaigns running from June 2005 to March 2007 that targeted self-employed workers. According to the National Audit Office, this generated £38 million in tax receipts over 3 years.<sup>87</sup> Advertising has also been used to encourage people to come forward and report others they believe are engaging in undeclared work.
- **Voluntary disclosure schemes** – Like Belgium and Australia, the UK currently operates a programme of voluntary disclosure schemes that attempt to encourage hidden entrepreneurs to come forward and disclose their operations, past and present.<sup>88</sup> Voluntary disclosure schemes allow those engaging in informality activity to come forward and declare their tax liabilities without paying the full penalties. These are different to amnesties in that they do not wipe clean any of the tax liability and are normally targeted towards specific individuals or groups through 'offers in compromise'.<sup>89</sup> The most recent use of a voluntary disclosure scheme was for prolific eBay traders.<sup>90</sup> Sellers who came forward before the deadline were offered a penalty reduction of between 80 and 90 per cent.
- **Hidden economy agents** – HMRC has a 600-strong team of officers that work on the ground to inspect firms exhibiting signs of informality. This risk-based approach involves internally analysing their own information or that provided by third parties in order to work up cases which are then given to visiting officers.

Though not specifically targeted at informal entrepreneurs, there are various start-up enterprise programmes that stop informality in its tracks at an early stage by offering help to individuals who wish to kick-start their own business in the formal sphere. The **New Enterprise Allowance**, for instance, assists unemployed people to create their own enterprise.<sup>91</sup> Participants with a promising business proposition are provided both guidance to develop a business plan and financial assistance in the form of a weekly allowance and start-up loan. DWP

86. National Audit Office and RAND Europe. (2008) Op cit.

87. Ibid.

88. National Audit Office and RAND Europe. (2008) Op cit.

89. Ibid.

90. See Jones, R. (2012) *Ebay Traders Under the Spotlight*. The Guardian, Tuesday 1<sup>st</sup> May 2012. Available: <http://www.guardian.co.uk/money/2012/may/01/ebay-traders-hmrc-tax-spotlight>

91. For more information, see <http://www.dwp.gov.uk/adviser/updates/new-enterprise-allowance/>

estimates that the package of support amounts to more than £2000 for each person taking part.

Other organisations such as **StartUp Britain** help to coordinate support services for budding entrepreneurs. Since their launch in 2011, they have helped to establish StartUp Loans, a service offering young people small amounts of finance to start a business, and have worked with organisations like The Supper Club to match entrepreneurs with expert mentors. Other government initiatives seek to open up more finance for prospective entrepreneurs. The new **National Loan Guarantee Scheme (NLGS)**, for instance, will commit banks to pass on new government funding to their small business customers at reduced loan rates.

It is worth noting that in recent years, HMRC has attempted to pursue a far more nuanced approach to addressing the hidden economy, driven in part by their own extensive research with customers and participants of undeclared work. They have, for instance, attempted to complement compliance activities with earlier, and more effective, interventions which help people towards formalisation. Despite these and other promising changes in direction, it is still early days and there is arguably more to be done in recognising that formalisation is for many entrepreneurs (although not all) a gradual journey. Before exploring this issue in more detail, the next section will map out the range of innovative interventions that have been applied elsewhere in the world to address the informal economy.

### **Box 2: Competing agendas across government**

The majority of recent interventions are testament to the impact that the Grabiner report has had on steering government policy towards a focus on deterrence. However, such an approach has not been universally endorsed or practiced across Whitehall. Attitudes concerning the best way of tackling informality appear to vary both between different government departments and within them.<sup>92</sup>

It is not uncommon for departments to differ in outlook. But the lack of strategic vision uniting all relevant bodies across Whitehall is thought by many academics, policymakers and civil servants alike to be a considerable barrier towards more effective collaboration in addressing undeclared work. This is an opinion which came out strongly within our own interviews. One senior stakeholder commented that HMRC and BIS seldom work together and are “constantly at loggerheads”. Another said there is “next to no collaboration” between government departments. That there is no longer an Informal Economy Steering Group (IESG) to bring these departments together was broadly agreed among those we interviewed to be a key contributing factor in the government’s disjointed response to informal activity.

92. Llanes, M. and Barbour, A. (2007) Op cit.

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# 4 International efforts to surface hidden entrepreneurs

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## The learning gap

This section outlines examples of policy efforts, overarching strategic approaches and non-governmental initiatives that have been used to reduce, or lessen the impact of, informal activity in other countries. Learning from what is happening elsewhere will serve to highlight specific interventions that could be deployed in the UK, as well as indicative principles that could help to inform policy efforts more broadly. While we appreciate that it is unwise to assume interventions can be imported directly from other countries where the context will differ considerably to that of our own, looking at what is happening elsewhere is a fundamental part of any attempt to bring fresh thinking to bear on a challenge.

## Policy interventions

To explore these international case studies, a typology will be used to frame policy interventions and divide them into three main camps.<sup>93</sup> These are (i) deterrence measures that increase the punishments for, and likelihood of, being caught by the authorities; (ii) incentive and prevention measures that make the formal sphere more attractive and easier to join; and (iii) attitudinal measures that are geared towards embedding social norms and improving levels of tax morality. Below we lay out a set of international case studies under each of these three policy types. This is not intended to be a comprehensive list of interventions but rather a sample of some of what we consider to be the most thought-provoking.

## Deterrence, inspection and monitoring

### National Committee for the Formalisation of Irregular Work, Italy<sup>94</sup>

In 1998, Italy established a National Committee to tackle informal work. Its aim was to begin to collect quantitative and qualitative data about informal activity across the country, and to table a series of policy

93. This typology is an adaptation of the one used by Colin Williams and Piet Nerooy in their research on undeclared work in the European Union. See Williams, C. C. and Renooy, P. (2009) *Op cit.*

94. Eurofound. (2008) *National Committee for the Formalisation of Irregular Work, Italy*. Available: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/ito07.htm>

interventions based on this data and the experiences and expertise of all those on the Committee. This body provided a place where a disparate set of stakeholders come together and address informality with a single coherent voice. The agencies participating in the Committee include the Italian Financial Police and the Labour Inspectorate. The experience of the Committee to date suggests that it has been useful in collecting information about the characteristics of the country's informal economy, coordinating responses at a local and national level, and creating a collective forum from which more joined-up interventions, informed by the views of all relevant parties, can emerge. These benefits aside, there has been some concern that the Committee's operations and impact may have been hampered by irregular funding and a reticence on the part of some organisations to cooperate and contribute data.

#### **Integral Plan of Prevention and Correction of Fraud, Spain<sup>95</sup>**

In 2010, the Spanish government approved and publicised a plan to create closer links between three main government agencies with a clear stake in tackling undeclared work: the State Agency of Tributary Administration (the national revenue body), the Inspection of Work and Social Security and the General Treasury of the Social Security. The plan seeks to align the efforts of the three agencies and make them complementary rather than conflicting, particularly in the areas of detection, enforcement and the promotion of voluntary compliance. Although a number of countries have attempted to more closely align the operations of government authorities, both local and national, Spain has taken this one step further by initiating a formalised plan which is approved by government and made widely public.

#### **Compliance incentives and prevention measures**

##### **Rich Aunt Agatha Arrangement, Holland<sup>96</sup>**

Holland has long recognised that many people who are attempting to form their own businesses tend to acquire their start-up capital from friends and family members rather than formal financial sources. This is particularly true of less affluent people who are unable to secure loans with banks due to their poor credit ratings. This is a potentially major cause of undeclared work because people who use informal capital to kick start their operations begin on an informal footing and are likely to continue on this trajectory going forward. Having identified this as a problem some years ago, Holland established its Rich Aunt Agatha scheme to bring informal loans into the formal fold. As part of the arrangement, the loans provided to entrepreneurs from friends and family are made exempt from certain taxes, thus making it more likely for people to log them with the authorities and to establish themselves as a formal outfit from the outset.

95. OECD. (2012) *Forum on Tax Administration: SME Compliance Sub-Group*. OECD.

96. Williams, C. C., Horlings, E. and Renooy, P. (2008) Op cit.

### **Simplex programme (on the spot firms), Portugal<sup>97</sup>**

The complexity and effort of registering a business can be one of the biggest factors discouraging entrepreneurs from operating in the formal economy. In a bid to ease the process of formalisation, in 2005 Portugal established the Simplex Programme to enable firms to be created in one day and using only one office. Once registered, entrepreneurs receive the necessary social security number, memorandum of association and entry into the Commercial Register which allows them to start their operations with immediate effect. The average time needed to create a business through the Simplex system is just over 1 hour and costs fewer than 400 Euros. Between 2005 and 2008, nearly 60,000 new enterprises were established, 23,500 of which were one-person companies. It is still unknown whether the Simplex programme played a role in increasing the number of registrations but the World Bank has already recognised this intervention as a success.

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Norway has proposed shifting responsibility for a worker's tax evasion onto any customers paying more than

**£2,500**

in cash for services

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### **Reducing the use of cash, Norway<sup>98</sup>**

In 2009, Norway set out a number of proposals to reduce undeclared work in the country. Two of these were geared towards addressing consumer demand for informal work by reducing the incidence of cash in transactions for home renovations. One proposal was that the home renovation deductions which consumers are entitled to should only be made available when consumers pay via a bank. The other proposal involved shifting responsibility for a worker's tax evasion onto any customers paying more than £2,500 in cash for services. By encouraging customers to move away from this method of cash payment it was expected that hidden entrepreneurs would be forced to set up a bank account and thereby formalise their business.

### **Commissioner's guarantee to new businesses, Australia<sup>99</sup>**

The Australian Tax Office (ATO) offers a range of different support to entrepreneurs to enable them to comply with the necessary regulations and paperwork. This assistance is focused primarily, although not exclusively, on start-up businesses and small firms undergoing significant transformation. The authorities visit those who contact them and provide practical help with difficult activities such as record-keeping and lodging activity statements. The support is designed to be tailored to the specific needs of the business, whatever sector they operate within. What is unique about this approach is that the ATO offers a 'Commissioner's Guarantee letter' to the businesses they visit, which means that none of the information seen by the authority is used for any other purpose. The aim is to encourage entrepreneurs on the cusp of informality to come forward and seek assistance without the fear of any immediate reprisals. It is unknown whether these proposals have yet been fully implemented.

97. Williams, C. C. and Renooy, P. (2009). Op cit.

98. OECD. (2012) Op cit.

99. Ibid.

### Box 3: Non-governmental interventions

#### **Low Income Food Entrepreneurs programme (LIFE), East Harlem, United States<sup>100</sup>**

Alongside the City Council and the Economic Development Corporation, a not-for-profit bakery in East Harlem runs a business incubator facility offering immigrant and minority women access to modern facilities, food-handling training and English language courses. These services typically cost between \$2,000 and £5,000, meaning that micro-entrepreneurs sometimes have to choose between registering their business and purchasing the training needed to expand their operations. By providing these services at 80 per cent less than the normal price, the Low Income Food Entrepreneurs programme (LIFE) at the Hot Bread Kitchen Bakery is helping those on low incomes to grow their businesses within the formal sphere.

#### **Freelancers Union, United States<sup>101</sup>**

Independent workers make up around 30 per cent of the US workforce and are faced with greater insecurities compared to conventional wage-workers employed by organisations. Freelancers Union assists the interests of these workers through advocacy, education and membership services. This includes offering insurance services and retirement plans at a cut-price group rate, offering resources like contract templates, and running campaigns such as that to end unpaid wage practices. Although not specifically designed to address informal activity, this 'New Mutualism' association is providing individuals with the services and resources that will enable them to remain in formal working patterns.

## Changing attitudes

#### **The Trade School Initiative, Canada<sup>102</sup>**

As part of its prevention efforts, the Canadian government initiated the 'Trade School Initiative' to target students and apprentices who could be at risk of engaging in informal activity once they enter the world of work. The TSI sought to help young people become familiar with their tax obligations, inculcate within them a sense that registering their business and paying taxes is the norm, and explain the variety of benefits that they would experience from doing so. Since an in class session was not deemed appropriate, students were instead engaged via a website specifically designed for trade students, an information card and a lunch and learn session. An in-depth evaluation of the Trade School Initiative suggests that it may have improved participants' perception and understanding of tax matters.<sup>103</sup>

#### **Changing consumer attitudes about informal goods and services, Canada<sup>104</sup>**

A recent campaign was initiated in 4 Canadian states to change the attitudes of consumers to informal work. Radio, television, websites, posters and various other communication vehicles were used to highlight the risks that customers face when paying for undeclared work and the detrimental

100. For more information see <http://www.dnainfo.com/20120413/harlem/non-profit-aims-lower-barriers-low-income-entrepreneurs>

101. For more information see <http://www.freelancersunion.org/>

102. OECD. (2012) Op cit.

103. Ibid.

104. Ibid.

effect that such informal activity has on the provision of government services and benefits. In organising this campaign, the Canadian authorities worked closely with a diverse set of stakeholders to identify the groups most at risk, including homebuilders associations and various retailers.

#### **The Cash Economy Communications Strategy, Australia<sup>105</sup>**

Through a comprehensive set of messages, Australia's 'Cash Economy Communications Strategy' seeks to build people's awareness of the disadvantages of the informal economy and dissuade them from being party to any undeclared work. Communications attempt to describe what undeclared work is, explain why it is a problem for both individuals and wider society, highlight what the government is doing to tackle this kind of activity, and suggests how people and businesses can play their own part in reigning in informal activity in their area. These messages are directed at both potential consumers of undeclared goods and services, as well as entrepreneurs who may be at risk of engaging in informal activity. Australia's Communications Strategy differs from those of other countries in that it systematically answers the breadth of questions around undeclared work – from what it is, to why it is a problem, to what people can do about it – and reaches out to all actors who are potentially affected by it.

*The Hot Bread Kitchen Bakery helps entrepreneurs operate in the formal economy by offering training services at 80 per cent less than the normal asking price*

#### **Overarching strategies for addressing informal activity**

Many of these interventions will be appealing to governments who are struggling to address informality and who are willing to experiment with new approaches that have been tried and tested elsewhere. However, identifying the most appropriate interventions is only one part of the problem-solving picture. Equally important is developing an overarching strategy which pulls these disparate measures together and creates a coherent process for addressing the informal economy. Without a clear strategy, a jumble of individual measures may lead to competing approaches or unnecessary replication of efforts.

A number of countries have recognised the importance of having an overarching strategy and created their own systematic, cross-departmental processes for dealing with informal activity. The two figures below show the approach taken by Canada and Australia.<sup>106</sup> In each of these cases, there are three familiar components:

- **Leadership, coordination and research** – Outlining how efforts to tackle informality will be managed, including which governmental and non-governmental parties are involved, the frequency of advisory group and task force meetings, the type and scope of research taking place (e.g. surveys and qualitative interviews), and the various findings that are being collected.
- **Interventions** – Laying out the type of interventions that will be used, including which messages will be communicated to the public and businesses, how those messages will be promoted, the form of outreach activities that should be undertaken, the type of education delivered, and the 'toolkit' of responses that

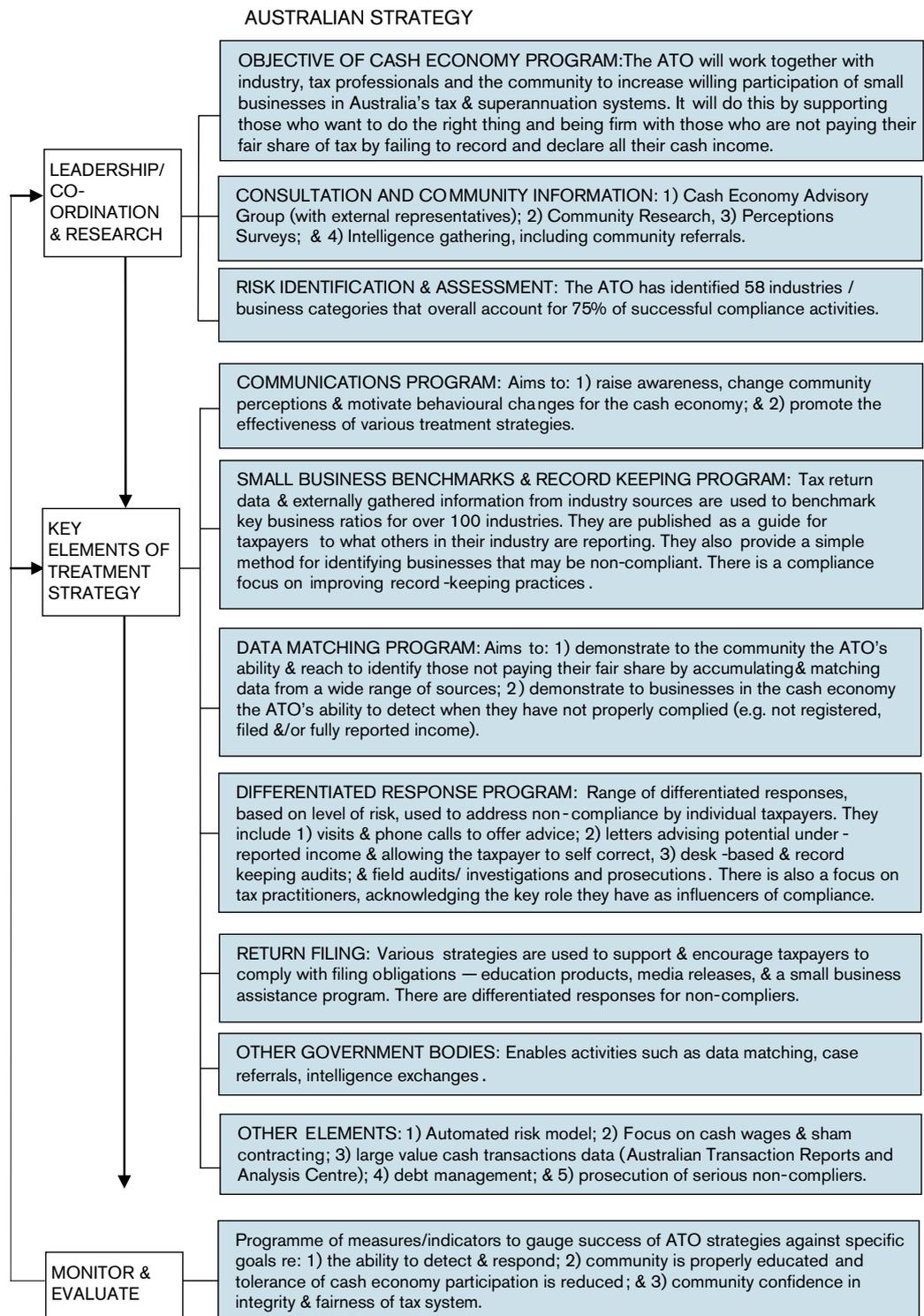
<sup>105</sup>. Ibid.

<sup>106</sup>. Ibid.

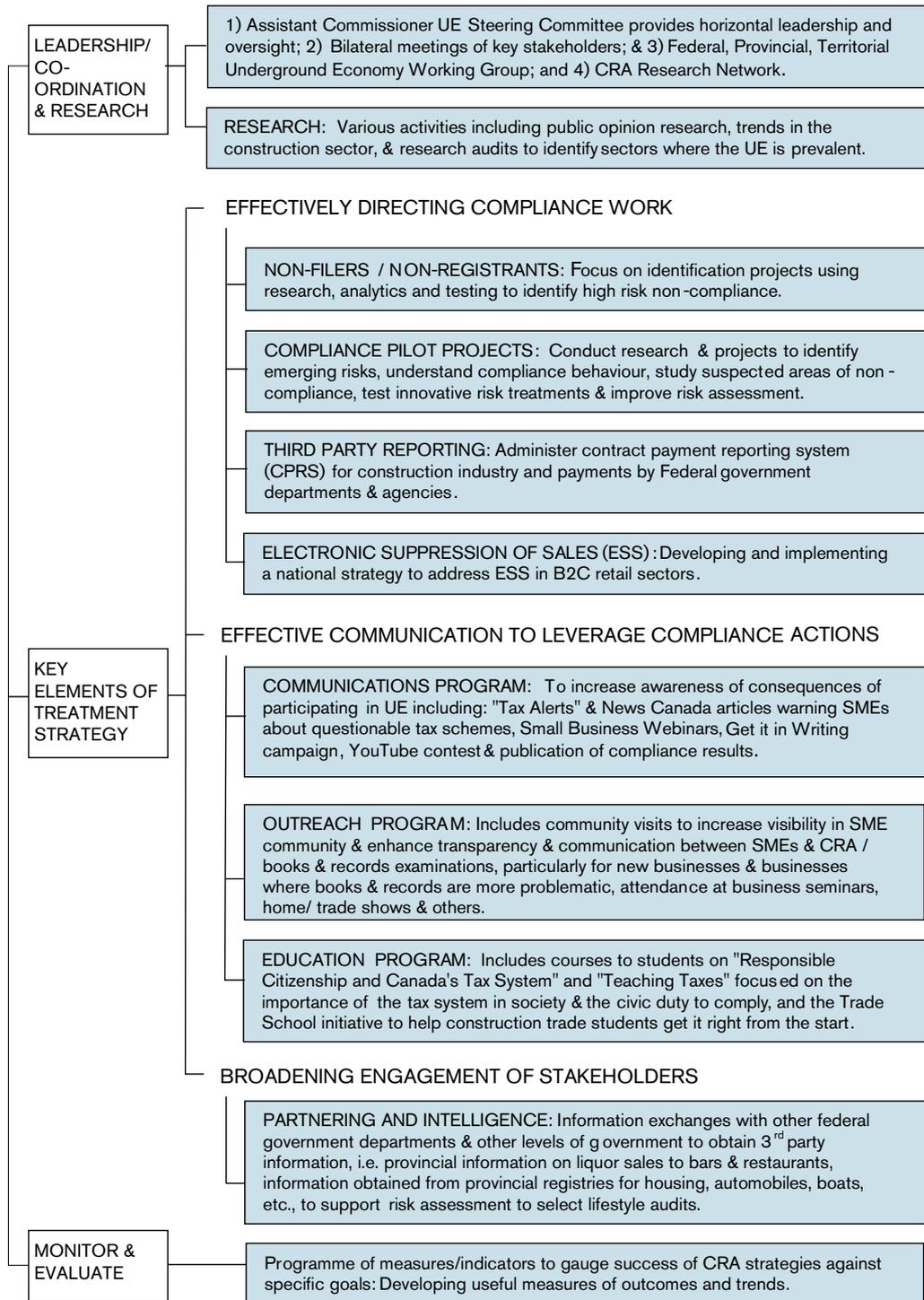
can be used (e.g. field visits, warning letters and phone calls offering advice).

- **Monitoring and evaluation** – Gauging the success of interventions against a set of clear goals (e.g. improving levels of tax morality), and measuring trends of informal activity over time.

**Figure 2: ‘The Australian Tax Office’s (ATO) and Canadian Revenue Agency’s (CRA) overarching strategies for addressing informality**



CANADIAN STRATEGY



The next section will consolidate the learning derived from these international approaches – both individual interventions and overarching strategies – and consider what these lessons might mean for how we can better surface hidden entrepreneurs in the UK.

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# 5 A new approach for the UK

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## The downsides of deterrence

Informal activity is perceived as a significant challenge for the UK. It diminishes the country's tax revenues, creates unfair competition for the businesses that are fully compliant, and leaves informal workers vulnerable to hardship since they have little social protection. Formalisation would address these issues and create a channel through which the entrepreneurial assets of hidden entrepreneurs could bear greater fruit.

As we have seen, formalisation to date has been primarily pursued in the UK through a deterrence approach. Sanctions, penalties and extensive data sharing between authorities have been regularly drawn upon in a bid to root out hidden entrepreneurs and make informal activity undesirable. While this has had some notable achievements, a reliance on punitive measures to address informality is increasingly being called into question. Deterrence interventions may damage tax morality by alienating taxpayers and creating an “us and them” culture between the state and citizens.<sup>107</sup> Indeed, research suggests that it may even encourage greater numbers of people to engage in undeclared work and embolden those who already do.<sup>108</sup>

More importantly, deterrence measures are symptomatic of a system that fails to recognise the many and varied factors driving entrepreneurs below the radar. Informality is not always the result of a simple cost-benefit calculation on the part of rational actors but rather a combination of factors – for instance, poverty or the prohibitive costs of business registration – that put formalisation out of reach.<sup>109</sup> Nor is informal activity a wholly clandestine activity, which deterrence implies. It exists within a ‘political economy’ of mutual support that emerges when a community is attempting to help one another in times of need.

Formalisation should therefore not always be seen as a simple decision to be made but rather a journey with numerous individual, structural and cultural hurdles that need to be cleared along the way. Since a deterrence approach does not appreciate that registration is an aspiration for many hidden entrepreneurs, it risks stopping this process in its tracks and stamping out the kind of entrepreneurial spirit that the country is calling out for. As two of the leading experts in this field, Colin Williams

107. Portes, A. and Haller, W. (2005)

108. OECD. (2012) Op cit. and Murphy, K. (2005) “Regulating more effectively: The relationship between procedural justice, legitimacy and tax noncompliance” in *Journal of Law and Society*, 32(4) cited in Williams, C. C., Horlings, E. and Renooy, P. (2008) Op cit.

109. Williams, C. C. and Windebank, J. (2006) Op cit.; and Williams, C. C., Horlings, E. and Renooy, P. (2008) Op cit.

and Jan Windebank, put it, “If a deterrence approach continues, then western governments will with each step that they take to deter informal employment destroy with one hand precisely the self-employment and entrepreneurial behaviour that they are so desperately seeking to nurture with another hand.”<sup>110</sup>

### **Towards a stepping-stone model of formalisation**

Higher levels of formalisation could be more readily achieved by employing a model that assists informal entrepreneurs along the path to business registration and which addresses the various obstacles along the way. The organisation Street UK perceives this journey as involving a number of distinct steps to be achieved gradually over a period of several years.<sup>111</sup> Steps range from purchasing liability insurance, to using a bank account for transactions, to finally becoming VAT registered.

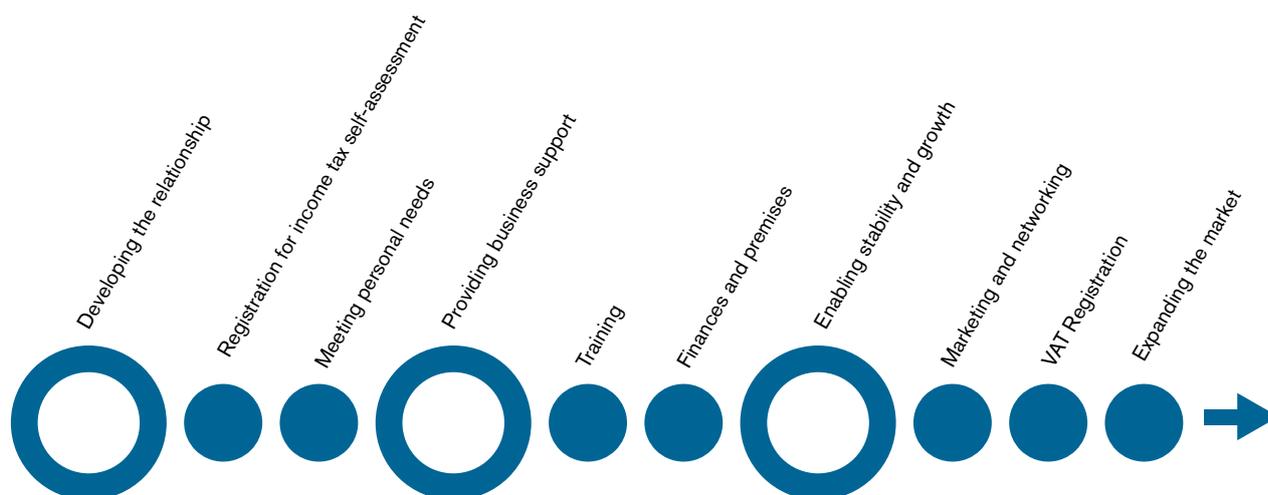
As has been noted, the obstacles preventing such a step-by-step process are likely to be diverse in nature, vary from person to person and differ at each point along the way. Tax authorities and other agencies should therefore tailor their efforts to meet the circumstances of different individuals and groups. Where a decision to engage in undeclared work is born out of ‘exclusion’ – individuals prevented from engaging in formal activity where they otherwise would have – it may be more appropriate to use ‘carrot’ measures to overcome barriers. Conversely, where informality is being driven by a conscious desire to ‘exit’ the formal system that could easily accommodate the entrepreneur, this may warrant more ‘stick’ measures. For example, for a fledging entrepreneur starting off on an informal footing it may prove more beneficial to deploy light-touch advice and educational materials, whereas somebody closer to registration may need hands-on practical assistance, new lines of financial credit, or, if they are avoiding any progression towards formality, personalized sanctions. One key civil servant we interviewed describes the perfect process of formalisation as being like “a nice gentle tunnel” rather than one which “makes you feel as though you’re sucked into a huge bureaucratic vortex”.

Figure 5 below illustrates an adapted version of the formalisation process devised and used by Community Links. This shows how different measures could be applied along the journey depending on the individual circumstances of hidden entrepreneurs. Once the entrepreneurs have registered for income tax self-assessment at the early stages of their journey, they will then be made identifiable to HMRC and can enjoy access to additional support.

110. Williams, C. C. and Windebank, J. (2006) Op cit.

111. These steps include: moving from home to business premises; keeping basic level records; keeping higher-level accounts; purchasing public liability and employers liability insurance; hiring employees on a PAYE basis; using a bank account for their business transactions and opening a separate business bank account; obtaining the required licences and permits to operate the business (e.g. health and safety inspection certificates, driver instructor licence); graduating off all non-work state benefits; graduating from majority cash revenues to majority invoiced revenues; incurring a formal business tax liability; and becoming VAT registered. Cited in Williams, C. C. and Windebank, J. (2006) Op cit.

**Figure 3: Community Links’s Stepping-Stone Formalisation Process**



**Box 3: Treating the informal economy as a ‘wicked problem’**

As is true of many of today’s major challenges, our attempts to address the informal economy have been beset by a tendency to frame it in terms of what Horst Rittel and Melvin Webber call a ‘tame’ problem, as opposed to a ‘wicked’ one.<sup>112</sup> Tame problems are those that may be complicated but are easily solved, often with a discreet response that can be replicated time and again. Conversely, wicked problems are complex rather than complicated and emerge as a result of a number of interrelated drivers, each of which cannot be tackled without having a knock-on impact on the other drivers. The academic Keith Grint uses the example of the Greek financial crisis, where no action can be taken without causing ripples that affect other Eurozone countries.<sup>113</sup> Wicked problems have to be tackled with ‘clumsy’ approaches rather than ‘elegant’ solutions. Proponents of ‘cultural theory’ argue that clumsy approaches work by combining interventions which cut across a variety of different cultural understandings, namely the hierarchical, egalitarian and individualist types.<sup>114</sup> Hierarchists focus on implementing stringent rules and punishments; egalitarians on cultivating the right norms and community values; and individualists on designing the best forms of incentives.

Applying this lens to the informal economy suggests that undeclared work could be best tackled not only through a deterrence approach (hierarchical) but also through, for instance, nurturing tax morality (egalitarian) and creating new incentives and support structures which make formalisation more attractive (individualist). The recommendations outlined in this section attempt to handle each of these three cultural viewpoints. Beyond these discreet initiatives, the broader challenge for government and wider society will be to remove what Grint calls the “culturally induced cataracts” that leave us “addicted” to one particular viewpoint, which in the case of the informal economy is perhaps an over-reliance on command and control hierarchical measures, most notably penalties and sanctions.<sup>115</sup>

112. Rittel, H. and Webber, M. (1973) “Dilemmas in a general theory of planning” in *Policy Sciences*, Vol. 4. cited in Grint, K. (2010) “The Cuckoo Clock Syndrome: Addicted to Command, Allergic to Leadership” in *European Management Journal*, Vol. 28 (4).

113. Grint, K. (2010) Op cit.

114. Douglas, M. (1966) *Purity and Danger*. London: Routledge cited in Grint, K. (2010)

115. Grint, K. (2010) Op cit.

## Wider principles and recommendations

### **Build an overarching strategy for addressing undeclared work**

Drawing upon the strategic approaches of Canada and Australia, the UK could improve its partnership working, deliver a clearer and more coherent message, and better plan for the long-term if it were to establish a single strategic process which encompasses and governs the actions of all relevant authorities (HMRC is already developing its own strategy). This would set out guidelines and actions under each of the three main strategic components laid out previously: (i) leadership, coordination and research; (ii) treatment and interventions; and (iii) monitoring and evaluation.

A central feature of an overarching strategy for the UK would need to be a national taskforce that pulls all relevant stakeholders together to cooperate on addressing informality, including the sharing of data and information about best-practice interventions. The experiences of the Italian and Spanish committees indicate that any such body would be more effective by being independent in nature, and may gain greater recognition if codified in a plan publicly approved by government.

Key recommendations:

- Draw up an overarching strategy for dealing with informal activity which covers the actions of local and national bodies, including key government departments such as HMRC, DWP and BIS.
- Create a single Hidden Economy National Committee which draws together key stakeholders to share information and data, and to devise new interventions that all parties agree to support.<sup>116</sup> Participants should include representatives from government, Whitehall, business, trade unions, the charity sector and academia. HMRC are already considering the possibility of reestablishing their own HE Advisory Group.
- Incorporate within relevant government policy papers some discussion of informal activity and the potential impact, positive or negative, that non-related interventions could have.

### **Nurture tax morality and social norms, and make the state relevant**

One of the most striking findings from our research and interviews is that of the impact of tax morality and social norms on undeclared work. This appears to be something that is yet to be fully recognised by policy-makers. For example, many expert commentators from the ILO to the OECD are concerned that an emphasis on negative advertising campaigns – something the UK has been known to employ heavily – may be giving the impression that non-compliance is the norm among the population,

<sup>116</sup> Alongside Community Links, Colin Williams is leading the call for a new hidden economy expert group that will facilitate joined-up government working on the informal economy. The three main aims of such a group would be to (i) develop cooperation so as to arrive at a common understanding of what needs to be done in order to address the informal economy; (ii) enhance and develop expertise and capacity in how to tackle the informal economy; and (iii) raise awareness and share information on issues relating to addressing the informal economy. In practice, one key function of the group would be to convene regular workshops on various subjects related to the informal economy. These would be used to discuss new trends, explore new policy approaches and develop good practices.

*There are signs that informality could be better addressed by making the state more relevant and tangible to those tempted by informal work*

thus diminishing the stigma that hangs over this activity. An alternative approach, is to use more positive campaigning that shows most people to be fully compliant and which highlights the vital services reliant on tax revenue from declared earnings. Such positive and comprehensive campaigns are now widely recognised to be more effective than negative, single issue-based ones.<sup>117</sup>

On a similar note, there are signs that informality could be better addressed by making the state more relevant and tangible to those tempted by informal work. As we have seen, many people choose to ‘exit’ the formal sphere because they feel that the authorities do little for them and perceive themselves as gaining very few benefits from the state relative to what they put in. One means of addressing this is to make the benefit and service entitlements people receive more visible and salient through, for instance, personal ‘lifecycle accounts’ which track contributions and benefits.<sup>118</sup> This is something that has already been mooted by the 2020 Public Services Hub at the RSA.

Recommendations:

- Replace negative advertising campaigns for positive ones that showcase the benefits of formal work and which demonstrate that declaring income is the norm adhered to by the vast majority of the population.
- Consider creating personal ‘lifecycle accounts’ that chart and project people’s contributions and benefits over their lifetime.

### **Simplify formalisation procedures**

Despite reportedly having some of the lowest business regulation procedures in the world, there is still a widely held perception that starting and running a business comes with prohibitively laborious and costly paperwork and red tape. There is little disagreement that the initial step of registering a business should be made as easy as possible, while still maintaining the necessary security checks. The case of Portugal’s Simplex Programme (on the spot firms) is a promising example of how business registration could be made easier and cheaper, and formalisation thus more attractive. The UK would benefit from following suit, learning from Portugal’s approach and considering whether registration could be achieved in 1 or 2 hours, a much shorter turnaround than the current 48 hours offered by Companies House. Thought should also be given to addressing ‘accidental non-compliance’ such as completing a form incorrectly, something recently identified as a potentially major factor in explaining the prevalence of undeclared work.<sup>119</sup>

Recommendations:

117. International Labour Organisation. (2002) Op cit. See also Renooy, P., Ivarsson, S., van der Wusten-Gritsai, O. and Meijer, R. (2004) *Undeclared Work in an Enlarged Union: An Analysis Of Undeclared Work – An In-Depth Study Of Specific Items*. Brussels: European Commission; and Thurman, Q.C., St. John, C. and Riggs, L. (1984) “Neutralisation and tax evasion: how effective would a moral appeal be in improving compliance to tax laws?” in *Law and Policy*, Vol. 6 (3); both in Williams, C. C. and Windebank, J. (2006) Op cit.

118. This tool has already been proposed by the 2020 Public Services Hub at the RSA. See 2020 Public Services Trust (2010) *2020 Welfare: Life, work, locality*. London: 2020PST.

119. OECD. (2012) Op cit.

- Consider the possibility of following in Portugal's footsteps and creating a programme where businesses can be established in a very short timeframe (1-2 hours) face-to-face.
- Undertake an assessment of the formalisation procedure to identify any instances where 'accidental non-compliance' may occur and the reasons for this happening, for instance due to the use of complex language throughout the process.

*A written guarantee should always be provided to any hidden entrepreneur seeking assistance*

#### **Prioritise early intervention**

Just like any other activity, informality can become an ingrained habit. For this reason, it is better and more cost-effective if the authorities can intervene early to prevent people from ever falling into undeclared HMRC (as said this is the type of approach they are seeking to adopt). Aside from improving general levels of tax morality, there are more practical steps that can be taken at a young age. As shown by the Trade School Initiative in Canada, targeting young people who are 'at risk' of entering informal employment with discreet training interventions may be an effective means of nipping informality in the bud. Alongside this, early intervention also means taking steps to address the lack of mainstream financial assistance for would-be entrepreneurs, a key factor pushing people out of the formal sphere. Arranging better start-up capital for entrepreneurs is a must, although it has proven a major challenge for governments to encourage banks to begin lending more freely. Another option, at least in the short-term, is to follow the example set by the Rich Aunt Agatha Arrangement in Holland and try to 'formalise' and bring into the fold the start-up capital loans which entrepreneurs source more readily from family and friends. This would make it more likely that entrepreneurs would establish their business on a formal footing from the outset.

#### Recommendations:

- Work with schools and colleges to design a set of early intervention schemes targeted at groups of young people who are at risk of entering informal self-employment, for instance trainee apprentices close to completing their studies.
- Extend the New Enterprise Allowance scheme so that its support package of mentorship, business allowance and start-up loan are available to unemployed people as soon as they begin claiming Job Seekers Allowance, rather than the 6 months which is the current minimum.

- Explore the potential of waiving the taxes on personal loans provided by friends and family as a means of encouraging people to declare them with the authorities and begin on a formal footing.

### **Target consumers as well as producers**

Like all other markets, the informal economy operates as a result of both supply and demand. Yet so far the vast majority of efforts to curb informality in the UK have been focused on the supply-side of the equation. As was noted previously in the report, the demand from consumers for informal goods and services is one of the key factors driving the informal economy. Any efforts to address informality in the UK therefore need to address the demand-side of the equation. This can either be achieved through information campaigns or financial incentives. With regard to the former, lessons may be drawn from Australia's Cash Economy Communications Strategy, which delivers a comprehensive set of messages to consumers about the informal economy, ranging from what it is, to why it's a problem to what they can do about it. In terms of using financial incentives, Norway's attempt to reduce the use of cash by transferring responsibility for tax evasion onto anybody who uses this as a form of payment could be deployed in the UK to nudge hidden entrepreneurs into formalising their operations. However, it should be made clear that reducing consumption of informal goods and services by a considerable amount runs the risk of damaging the livelihoods of those who depend upon undeclared work to make ends meet. These initiatives would need to be designed carefully to tackle only the most prolific offenders who choose to 'exit' the formal sphere.

#### Recommendations:

- Design information campaigns that target consumers, as well as producers, of undeclared work. These should attempt to give consumers a comprehensive understanding of why goods and services produced in the formal sphere are more desirable than those borne out of undeclared work.
- Attempt to minimise the use of large cash transactions and thus encourage sizeable informal enterprises to formalise their operations. This could involve transferring the responsibility for tax evasion from the producer to the consumer on any cash payments over a significant threshold, for instance £5,000.

### **Draw upon business and civil society to address informality**

A familiar theme arising from our interviews was that the ability of government, tax authorities and other key public agencies to address informality is severely limited. This is in part because they are perceived to lack the independence and impartiality that is necessary to win the trust of hidden entrepreneurs, but it is also because their efforts can only reach so far into the communities where informality is most prevalent.<sup>120</sup> To date, however, it has been state bodies that have overwhelmingly

<sup>120</sup>. Oviedo, A-M. (2009) Op cit.

led efforts to address informality in the UK, often to the detriment of key initiatives that would have fared better if led by civil society or business organisations.

The pilot ‘formalisation service’ that was trialled in Hartlepool in 2005 is a case in point.<sup>121</sup> This was intended to offer hidden entrepreneurs a confidential assessment of their existing liabilities and an opportunity to legitimise their business if they agreed to pay the reasonable settlement offered to them. Yet only one person came forward to use the service. An evaluation of the scheme found that low levels of trust between the authorities and potential users played a central part in its failure, and recommended that an independent body should have ran the system instead. In addition to helping implement government-backed initiatives, civil society and business organisations could play a more independent role in assisting entrepreneurs as they seek to grow in the formal sphere. Both the LIFE programme in New York and the Freelancers Union which operates across the US indicate how independent organisations – one a social enterprise, the other a mutual – can help entrepreneurs to start-up their own businesses and remain fully compliant in the formal sphere.

*Is the informal economy something we can conceivably live with?*

Recommendations:

- Establish a new initiative for the Work Programme whereby private and third sector contractors are paid on a case-by-case basis for helping hidden entrepreneurs to formalise their operations. To ensure that entrepreneurs are not prematurely rushed into registering their business, payments could be made at each milestone of the ‘stepping stone’ formalisation model outlined earlier.
- Wherever possible, seek to recruit and train ‘formalisation champions’ from the community where targeted interventions are underway, thereby giving the authorities greater leverage to change local behaviours. Entrepreneurs who have been through the formalisation process and who have registered their businesses would be strong advocates for registration.
- Whether or not the authorities can partner alongside non-state organisations, a written guarantee should always be provided to any hidden entrepreneur seeking assistance which states that none of the information collected in their dialogue will be used against them in another interaction. This would draw upon the model of the ‘Commissioner’s Guarantee’ initiative used in Australia.
- Create an investment fund to kick-start new initiatives which help self-employed people and micro-entrepreneurs establish their own businesses and remain operating in the formal sphere. It is envisaged that this would act as a springboard for the creation of alternative support services, for instance a Freelancers Union-type mutual, which could offer advice, sources of credit, insurance and mentorship not currently available through Business Link or the Job Centre Plus.

121. Centre for Economic and Social Inclusion, 2006 Centre for Economic and Social Inclusion. (2006) *Evaluation of the Hartlepool ‘informal to formal’ pilot*. Manchester: Centre for Economic and Social Inclusion cited in Williams, C. C. and Renooy, P. (2009) Op cit.

- Encourage organisations supporting start-up entrepreneurs (e.g. StartUp Britain) to direct a portion of their efforts towards helping informal entrepreneurs, for instance by providing information, mentorship and events that provide assistance along the lines of the stepping-stone formalisation model.

The stepping-stone formalisation model and the principles and recommendations advocated above have been chosen because they are seen to be achievable in the short-medium term. It is not intended to be a comprehensive account of all the actions that can be taken to tackle informal Add here behaviour. Nor have the proposals above been subject to rigorous cost-benefit analysis (this was beyond the remit of this short study). Most notably, considerations of tax and benefits have not been addressed here. This is for two reasons: first, there are a multitude of other debates and issues that are vying to shape the government's decisions on tax and benefit levels; and second, as has been argued, blanket level approaches like these can be perceived as taking a sledgehammer to a problem that would be better served with a scalpel.

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# 6 Learning to live with the informal economy

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Notwithstanding the moral and social roots of informality which make undeclared work more understandable, there is now widespread agreement across the political and economic spectrum that formalisation should be an end goal for all entrepreneurs. This is not least because the assets of hidden entrepreneurs, including their entrepreneurial spirit, skills, ideas, connections and work ethic, would bear greater fruit in the formal sphere, benefiting both the entrepreneurs themselves as well as the wider community in which they operate.

While formalisation is and should be a commonly held objective, this report argues that using a deterrence approach to achieve this goal is ineffective and may even exacerbate the numbers of entrepreneurs engaging in undeclared work. In short, a deterrence approach fails to appreciate that formalisation is not a simple decision to be made but rather a journey that takes time and effort to finish, complete with numerous obstacles that need to be navigated along the way.

We commend recent steps taken by the likes of HMRC to implement a more nuanced model for dealing with the informal economy, but we believe that more could be done in future years. We therefore advocate a different approach to formalisation based on the ‘stepping-stone’ model devised by Community Links. This involves guiding hidden entrepreneurs along their own route with tailored support that helps them address the various hurdles along the way. Unlike the deterrence approach, this model acknowledges that every entrepreneur has their own distinct challenges and temptations to contend with, and that these require their own attendant responses. The role of government, tax authorities, public bodies and increasingly business and civil society should be to aid this journey and make it as seamless as possible.

Alongside this step-change, drawing upon the experiences of other countries we propose a number of other policy shifts – establishing an overarching strategy, prioritising early intervention and drawing upon the assets of civil society and business, among others - which would seek to overcome the various other caveats currently hampering the UK’s efforts to address informality.

A final question this report asks is whether or not the informal economy is something we can conceivably live with. If the government is to recognise, as we have argued, that formalisation is for many a gradual journey, this also means accepting informality as a legitimate state for many entrepreneurs, albeit a temporary one. Such a viewpoint may

appear controversial, but as our own surveying indicates, the informal economy can be the perfect protective environment that many small fledgling micro entrepreneurs need as they make the transition from unemployment to the formal sphere.

In this way, it is possible to conceive of the informal economy as a fixed quantum, not to be reduced in size but to be controlled in such a way that individuals flow through it as seamlessly as possible, from jobseeker all the way through to compliant entrepreneur. Careful consideration would of course need to be given towards the impact such a declaration would have on tax morality and other key factors. However, without going some way towards accepting informality as an integral part of the economy, there is a danger of never being able to fully realise the assets of existing and would-be micro entrepreneurs who depend on this shielding environment. We hope this report kick-starts a valuable debate on the legitimacy of informality, and that others pick up this question in future research.

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