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# HARNESSING ENTERPRISE AND ENTREPRENEURSHIP IN THE UNDERGROUND ECONOMY

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## Abstract

*The starting point of this paper is a recognition that the current deterrence approach towards underground work fails to recognize either the potential asset that enterprise and entrepreneurship in the underground economy represents in western economies or the desire of governments to transfer this work into the formal economy rather than simply eradicate it. Responding to this emerging understanding of such underground enterprise and entrepreneurship as an asset, as well as recognizing the desire of governments to formalize such endeavor, the aim of this paper is to propose a more enabling approach towards the underground economy that supplements the current push (deterrence) initiatives with measures to pull this endeavor into the formal economy. A variety of pull (enabling) initiatives that might be used by this emergent approach to transfer underground enterprise and entrepreneurship into the formal economy are then set out.*

## Introduction

How many self-employed and businesses start-up conducting either a portion or all of their trade in the underground economy? For those who do start-up in this manner and for those who continue to engage in off-the-books trade once they are established, what should be done about them? Should governments adopt ever more punitive measures to eradicate such enterprises? Or should more enabling measures be adopted that seek to facilitate those currently conducting a portion or all of their trade in the underground economy to formalize their business ventures?

These questions provide the starting point of this paper. Throughout western economies, public policy towards the underground economy has predominantly pursued a deterrence approach that seeks to increase the probability of detection rates and level of punishments so as to change the cost-benefit calculation for participants (e.g., Allingham and Sandmo, 1972; European Commission, 1998, 2003; Falkinger, 1988; Grabiner, 2000; Hasseldine and Zhuhong, 1999; International Labor Office, 1996, 2002; Milliron and Toy, 1988; Sandford, 1999). The result has been that most western countries have pursued the following deterrence measures: increasing sanctions for employers and employees; stepping up controls; increasing the level of punishments; increasing co-operation and data exchange between authorities; installation of cooperation networks; field checks; introducing fraud hotlines; increasing registration and identification requirements; arranging house visits or appointments with benefit claimants unannounced and/or during regular working hours; strict immigration policy; border controls and excluding businesses having made use of underground workers from business tenders.

Recently, however, a shift in thought has started to occur on the issue of how to tackle the underground economy. A deterrence approach would be appropriate if governments simply wished to eradicate underground work. However, this is not the case. Increasingly, they also want to shift this work into the formal economy, not least so as to move closer to fuller-employment. As Anna Diamantopoulou, Commissioner for Employment and Social Affairs in the European Commission so clearly puts it,

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

There is a growing appreciation, in consequence, that deterrence measures are necessary but insufficient. To transfer such work into the formal economy, the emerging recognition is that deterrence needs to be coupled with initiatives to help those currently operating in the underground economy to formalize their operations.

Why have governments started to change their approach towards the underground economy? That is, how can the shift from an eradication approach using deterrence measures towards a desire to transfer such work into the formal economy be explained? Such a change of emphasis is here considered to be in part, the result of an emerging recognition that a large proportion of the underground economy is a form of self-employment and entrepreneurial endeavor (see Williams and Windebank 2004 in this volume) and in other part, a direct consequence of the growing appreciation that this entrepreneurship and enterprise in the underground economy represents a potential asset that needs to be harnessed (rather than simply deterred) if fuller-employment is to be achieved. There is now a growing recognition, for example, that many fledgling business ventures perhaps start out in the underground economy and as such, that this sphere might be a breeding ground for self-employment and the enterprise system (e.g., Evans et al, 2004; Global Employment Forum, 2001; International Labor Office, 2002; Leonard, 1998; Small Business Council, 2004; Tabak, 2000; Vaknin, 2000; Williams, 2004a,c).

The outcome is that a fundamental rethinking of public policy towards the underground economy is beginning to occur. Until now, however, few have considered in any depth how such a goal of transferring this endeavor from the underground economy to the legitimate sphere might be achieved. In this paper, in consequence, a public policy approach that reflects this emergent objective is set out. As will become apparent, although this retains the current raft of deterrence measures to 'push' enterprise and entrepreneurship out of the underground economy, it seeks to supplement these push measures with a range of 'pull' initiatives that help such businesses make the transition from the underground to the formal economy.

To display what types of initiative might be used to help enterprise transfer from the underground to the legitimate realm, the aim of this paper is to review and evaluate a range of experiments that are taking place throughout the advanced market economies that are seeking to firstly, develop demand-side measures to enable the transfer of such work into the formal economy, secondly, formulate supply-side measures to facilitate the transfer of underground enterprise and entrepreneurship into the legitimate realm, thirdly, raise awareness and provide information to persuade people about the benefits of

working formally, and fourth and finally, promote greater co-ordination of government thought and action on this subject. The outcome of this paper is that not only will the diverse range of 'pull' initiatives available be set but also a state-of-the-art evaluation will be provided of these initiatives that seek to help enterprise transfer from the underground economy to the legitimate realm. In sum, until now, many governments, despite seeking to pursue enabling initiatives, have had little idea of the full range of choices available to them when pursuing such a strategy. This paper fills that gap by providing an evaluation of the multiplicity of options available to them in this regard.

Before commencing, however, it is necessary to define what is being discussed in this paper. Here, and akin to the vast majority of literature on the underground economy, it is defined as the paid production and sale of goods and services that are unregistered by, or hidden from the state for tax and/or welfare purposes but which are legal in all other respects (European Commission, 1998; Feige, 1999; Portes, 1994; Thomas, 1992; Williams and Windebank, 1998, 2001a,b). As shown by another paper in this symposium of the International Journal of Economic Development, however, many different forms of underground work can be identified (Williams and Windebank, 2004). These range from organized underground work conducted by off-the-books employees, through off-the-books self-employment to paid favors. In this paper, the focus is upon off-the-books self-employment and public policy related to this endeavor. This is because this type of underground work not only represents about three-quarters of the underground economy (Williams and Windebank, 2004) but is also the chief type of off-the-books enterprise and entrepreneurship that governments wish to transfer from the underground to the formal economy. Although many of the policy initiatives discussed below might well be also applicable to enabling the transfer of either organized underground work and/or paid favors into the legitimate realm, such underground endeavor is not the principal focus here.

### **Harnessing Underground Enterprise: Demand-Side Initiatives**

What measures could be used to encourage customers to reduce their use of underground labor and instead employ formal labor? Here, three types of enabling measure are

evaluated.

### **Value Added Tax Changes**

One potential means of encouraging businesses and consumers to use formal rather than underground production in many western economies is to reduce Value Added Tax (VAT) on specific goods and services where the underground economy is rife (e.g., household maintenance and repair). Such a strategy has been used in various countries. In France, according to a directive of May 25 1999, VAT was reduced on both services and goods related to the improvement, transformation and organization of household maintenance work. In Italy, similarly, the 2000 Finance Act decreased the VAT rate from 20 per cent to 10 per cent on services related to the rebuilding and restructuring of residential buildings, including ordinary and extraordinary household repairs. The introduction of the new regulation is due to a European Directive 99/85.

Whether VAT reductions lead to a formalization of underground enterprise and entrepreneurship, however, is open to debate. Firstly, there are no known contemporary evaluations of whether VAT reductions result in a formalization of underground work. Secondly, such an approach of stripping away taxes so as to tackle the underground economy has the dangerous consequence of kick-starting a 'race to the bottom'. Third and finally, such an approach is grounded in the mistaken mono-causal explanation that higher taxation always leads to a growth in the underground economy, and vice versa, that lower taxation always reduces it size. There is no evidence that this is always the case. For these reasons, in consequence, a cautious approach towards the use of VAT reductions is required.

### **Targeted Income Tax Measures**

To encourage consumers to employ formal rather than underground labor, a diverse range of income tax measures can be used. Although some might argue for general reductions in income tax rates in order to decrease the size of the underground economy, more targeted strategies are here evaluated that directly target the underground economy.

As Pedersen (2003) has revealed, the vast majority of the

underground economy is concentrated in firstly, the home maintenance and improvement sector and secondly, other domestic services (e.g., household cleaning, gardening, child-care). It is thus here proposed that any tax measures developed should target these two economic sectors that Pedersen (2003) estimates to cover some three-quarters of all underground work. One option is to give straightforward income tax relief, via claims on tax returns, to customers using formal labor to do specific household tasks (e.g., roof maintenance, outside painting, household cleaning). Other options are more targeted initiatives.

In the household maintenance and repair sphere, for example, numerous targeted tax measures (e.g., the Home Services Scheme in Denmark; tax rebates on home maintenance expenses and the purchase of large equipment such as heating systems and elevators in France since 2000; and tax reductions for house repairs in Italy and Luxembourg) appear to have been successful. As the European Commission (1998, p. 14) conclude,

‘tax-deductions and subsidies for refurbishing and improvements of houses have been particularly successful in encouraging more people to use the opportunity to repair their houses legally, and had the effect of moving work which might have been done informally to the formal and registered sector’.

In relation to other domestic services, meanwhile, similar tax measures have been introduced in countries such as Denmark, Finland and Germany in order to encourage household work (e.g., cleaning, gardening) to be carried out in the formal rather than undeclared sector.

Here, in consequence, a number of possible targeted tax measures that might be introduced in advanced market economies are outlined. All have been already recommended as ‘good practice’ in the most recent European Commission report (Renooy et al, 2004).

### **The ‘Rich Aunt Agatha Arrangement’ (Netherlands)**

To make it easier for people to start their own business in the Netherlands, the Tant Agaath-Regeling (‘Rich Aunt Agatha Arrangement’) was introduced which is intended for fledgling

entrepreneurs who need starting capital and receive a personal loan from family and friends (Aunt Agatha). These private moneylenders are then exempt from some taxes. An intention behind this is that such loans are often made on an informal basis and if formalized, this might help the business to start-off on a more formal basis rather than see itself as engaged in informal arrangements, which might well carry over into everyday trading practices (Renooy et al, 2004; Williams, 2004c).

### **Home Service Scheme (Denmark)**

The Danish Home Service Scheme began in 1994 as a pilot and was made permanent three years later in 1997. Its aim was to firstly, compete with the underground economy, secondly, promote the development of enterprises that provide household services and third and finally, offer job opportunities for low-skilled jobseekers. Once businesses register with the Danish Commerce and Companies Agency (DCCA) to participate in the scheme, they can provide services to households (e.g., cleaning, small jobs around the home, gardening) for which the government reimburses 40 per cent of the cost (only on labor costs; expenses for materials are not reimbursed). The company submits the claim to the DCCA.

In 1998, 3,506 companies were registered, 91 per cent of which were one-person businesses. Household find information on the companies they can hire within the scheme at the town hall and are allowed to spend a maximum of 7,000 on such services per annum. In 1998, one in eight Danish households used the Home Service Scheme, an average of five times per year. Almost 90 per cent of consumers were very satisfied with the company and its services. In 1997 alone, more than 2,000 jobs were created; by 2000, it had grown to 3,700 full-time equivalent jobs (Renooy et al, 2004).

### **Melkert Initiative (Netherlands)**

According to a 1995 survey in the Netherlands, one family in three needs more help at home, especially with cleaning as well as washing and ironing clothes (Cancedda, 2001). Under the Melkert Plan, a programme was implemented in 1998 to subsidize the wages of declared domestic cleaners so that they could compete with underground domestic workers. Under this Cleaning Services for

Private Persons Arrangement (RSO, Regeling Schoonmaakdiensten Particulieren), a subsidy of not more than 19,000 NLG was granted for every long-term unemployed person hired by a private cleaning company. The government, in effect, was paying the difference between formal and underground wage rates for domestic cleaners. The government therefore paid a subsidy to firms to hire formal domestic cleaners rather than benefits to the unemployed. In 1997, however, only 250 jobs were created. In 1998, however, changes were made to the scheme and it now functions better. Cleaning companies, however, have had trouble finding workers since the potential workers are required to have been unemployed for at least one year, which excludes many women who would like such work but have not been registered unemployed (Renooy et al, 2004).

The Melkert Plan also created subsidized jobs in other spheres of domestic services beyond cleaning, including home help services and child-care. In the realm of home help, the finding was that some of these jobs were replacing regular formal jobs. Moreover, some 1,700 Melkert jobs were created in the sphere of child-care by the end of 1998 (Cancedda, 2001). These Melkert schemes were thus not as successful as originally expected.

### **Formalization Vouchers**

Another demand-side initiative to encourage employers/customers to use formal rather than underground labor, that is proving very popular in many European nations, is the use of 'vouchers'. In Belgium, for example, there has been heavy investment by government in both Local Employment Agencies and subsequently the Service Vouchers Scheme. In France, similarly, there are Cheque Emploi Service and Titre Emploi Service schemes. All have been recently recommended by a European Commission report as 'good practice' in stemming the underground economy by attacking the demand-side of the equation (Renooy et al, 2004). Here, these initiatives are not evaluated in any depth. Instead, the reader is referred to Windebank (2004) in this symposium of the journal for a detailed evaluation of these initiatives. This paper reveals that such initiatives appear to have been effective in reducing the size of the underground economy in these countries and that the feasibility of transferring such initiatives to other advanced market economies now requires careful consideration.



## **Harnessing Underground Enterprise: Supply-Side Initiatives**

Besides reducing demand for underground labor by providing incentives to employers/customers to use the formal economy, supply-side measures that seek to help underground businesses to formalize their activity have been developed in some advanced market economies.

### **Simplifying Formalization Procedures**

One relatively straightforward measure to encourage underground businesses to formalize is to simplify the administrative procedures associated with establishing a formal business. To make it easier for micro- and small enterprises to start up, grow and adopt 'high road' strategies that enhance productivity and provide decent jobs, the business regulation framework must seek to lower the costs of establishing and operating a small business (easier registration procedures, reasonable and fair taxation) and increase the potential benefits of legal registration (access to commercial buyers in the formal economy, more favorable credit markets, legal protection). This will encourage businesses to start-up formally and help lever micro- and small businesses into the formal economy.

Indeed, comparing the costs associated with firstly, taxes and secondly, administrative procedures, the ILO (2002) conclude that the available research suggests that it is the latter which are often more burdensome. Legal and administrative requirements such as registration and licensing can become an obstacle to micro- and small businesses, where the transaction costs or costs of compliance per worker are higher than in larger firms. Where the costs of full administrative compliance are prohibitive, compliance tends to be low (ILO, 2002). Further attention, in consequence, needs to be given to the administrative aspects of formalizing a business and how help can be provided to micro-enterprise in this regard.

Until now, in many advanced market economies, the focus has been on providing information to help people start-up a business within the existing rules and regulations. There is now perhaps a case for a

review to simplify existing formalization procedures. Such a review might consider whether it is feasible to offer exemptions (perhaps on a temporary or graduated basis) with respect to some areas of business regulatory compliance. Running alongside this is a need to evaluate the extent to which regulation hinders formalization since this is to a major extent unknown. For the moment, in consequence, some caution is advocated with regard to adopting this measure due to the lack of evidence of its impact.

### **Targeted Tax Measures**

To reduce the supply of underground labor, there are also targeted tax measures which are recommended as 'good practice' by the most recent European Commission report on tackling the underground economy (Renooy et al, 2004). Here, an initiative recently introduced in Germany, namely the formal recognition of 'mini jobs' is evaluated.

### **Mini Jobs (Germany)**

For many years, the German government effectively ignored the fact that people occasionally undertook small jobs that they did not declare. The creation of a 'mini jobs' category of employment was a move to encourage people to legitimize such small underground jobs. In many other advanced market economies, it is similarly the case that people often feel that they have no other option than to conduct such small jobs on an underground basis due to the perceived problems in declaring such work. Creating a mini-jobs category of employment might thus represent a significant breakthrough in some advanced market economies, especially with regard to those in formal employment who conduct small jobs 'on the side' on an occasional basis.

Until 1999 in Germany, 'minor employment' was allowed up to a certain income level (DM 630) and with a weekly working time cap of 15 hours. Such work was exempt from social security payment for employers and employees. Employers had to pay a lump sum tax of 23 per cent; employees had to pay no tax at all. This minor employment could be combined with normal employment and still be exempt from tax and social security contributions. At the start of 1999, there were over 6.5 million minor jobs, representing almost 70 per cent of all jobs in catering and 60 per cent of all jobs in cleaning. In 1999, the government reformed the minor jobs scheme, with the intention of

limiting its growth. In 2002, moreover, the German government introduced three types of mini job category.

Firstly, there were 400 euro jobs, raising the income limit of the former DM630 jobs. These mini-jobs enjoyed reduced social security contributions of 23 per cent (12 per cent for the pension insurance system and 11 per cent for the health insurance system) and a lump-sum tax of 2 per cent. However, the 15 hours per week limit was lifted. Secondly, a new category of 'mini jobs in the household sector' was introduced to fight underground work in this sphere. The employer had to pay a levy of 12 per cent and can deduct a certain amount from the payment of taxes. Third and finally, 'midi jobs' were introduced. This was intended to ease the transfer from minor to normal employment. A transition zone ranging between 400-800 euros was thus introduced, with social security contributions from the employee rising gradually from around 4 per cent to the full 21 per cent.

With the introduction of this new scheme, around 600,000 changed their side-jobs from the underground to the formal economy (Bauman and Wienges, 2003). Compared with 4.1 million employees in minor employment in September 2002, there were 5.5 million at the end of April 2003, one month after the introduction of mini-jobs. This represents a rise of 1.36 million. Some 1.21 million are people already in a formal job, about 550,000 of whom are estimated to have transferred their add-on job from the underground into the formal economy (Baumann and Wienges, 2003).

### **Society-Wide Amnesties**

In many advanced market economies, society-wide amnesties have been used not only to tackle the underground economy but also many other social issues (e.g., parking fines). Here, and in order to evaluate critically the use of such society-wide amnesties to combat the underground economy, the study by Grabiner (2000) on this issue is reviewed.

For Grabiner (2000), the use of amnesties was rejected because firstly, there is the practical difficulty of defining the amnesty precisely enough to make it workable and secondly, there is the question of whether to treat all kinds of underground work in the same manner (e.g., benefit fraud is normatively seen as worse than tax fraud in many

advanced market economies and an amnesty on VAT fraud would be problematic since it has already been collected from customers). Grabiner (2000) also suggests that the evidence from advanced market economies is that amnesties are not effective in practice. For example, in the 1980s, several states in the USA used them as well as France, Italy and Ireland. They were perceived as unfair, as a free lunch for those who had not met their responsibilities at the expense of the honest taxpayers. Holding an amnesty, moreover, tended to create an expectation of future amnesties that in turn reduced the incentive for tax-evaders to come forward immediately. These factors were thus seen to undermine public confidence in the system, and even encourage honest taxpayers to become more fraudulent.

Finally, the revenue generated by amnesties was argued by Grabiner (2000) to be exaggerated. The net return (i.e., the revenue that would not have been collected without an amnesty, less the costs of operating the amnesty) was asserted to be low. One reason for this is because amnesties appear to be more effective when they are accompanied by tougher enforcement measures. It is thus likely that much of the revenue collected and attributed to amnesties would have been collected by enforcement alone. Amnesties, in consequence, have been highly contested as a measure. What Grabiner (2000) perhaps does not shed light on, however, is the fact that it is precisely due to the use of amnesties that push or enforcement measures can be toughened up. Having offered an amnesty, governments can then proceed to increase punishments for those failing to disclose their activities. As such, it is not the case simply that amnesties work best when accompanied by tougher enforcement measures but, rather, that amnesties enable tougher enforcement measures to be then introduced. Amnesties, in consequence, should not necessarily be written-off as a measure that can be used to encourage underground workers to move into the formal economy. They do, however, need to be used in conjunction with other push and pull measures in order to be most effective.

### **Individual-Level Voluntary Disclosures**

Rather than use society-wide amnesties, another option is to use individual-level voluntary disclosure in order to facilitate the transition from the underground to the formal economy. To explore this more person-centered approach towards encouraging compliance, two

initiatives are here explored. The first is the Italian regularization approach and the second is the 'offer in compromise' system used in the USA.

### **Regularization Campaign, 2001-2003 (Italy)**

In October 2001, the Italian government implemented a law known as the Regularization Campaign (L.383/01) that ended in February 2003. This allowed employers and workers who declared that they had operated on an underground basis to regularize their situation with respect to tax, labor safety, social security contributions, land use irregularities and so forth. In exchange, employers paid reduced sanctions and reduced taxes and social contributions for three years, so as to enable them to adapt to the increased (labor) costs. The workers involved could pay reduced pension contributions for the past and would have to regularize their own tax situation.

Employers and employees involved in underground work were thus given two options. On the one hand, they could declare at once, in which case the entrepreneur and his/her workers would declare the irregularities and pay immediately all (reduced) taxes and contributions to be paid. On the other hand, they had the option of gradual regularization, in which the entrepreneur submitted a regularization plan, including deadlines to solve an irregularity, to an ad hoc committee. If the deadline was then not followed, the entrepreneur would be penalized by having to pay 100 per cent of the tax and contributions owed rather than the reduced amount.

In total, this campaign produced some 1,029 declarations and 3,854 new regularized workers. This outcome was viewed as disappointing by the Italian government, in part perhaps due to its focus solely upon labor costs when this is not the sole reason for working on an underground basis.

### **Offer in Compromise (USA)**

In the USA, if taxpayers are unable to pay a tax debt in full, and an installment agreement is not an option, then they may be able to take advantage of the offer in compromise (OIC) program. Generally, the OIC is seen as a last resort after taxpayers have explored all other

available payment options. The IRS has the authority to settle, or 'compromise' federal tax liabilities by accepting less than full payment under certain circumstances. A tax debt can be legally compromised where there is either: doubt as to liability; doubt as to feasibility of being able to collect the debt; or for effective tax administration purposes. The objective of the OIC program is to accept a compromise when it is in the best interests of both the taxpayer and the government, and it promotes voluntary compliance with all future payment and filing requirements.

Such a system can be used as an incentive to come clean about past misdemeanors and to facilitate voluntary compliance in the future. If a person comes forward who has been working on an underground basis, an OIC could be in some circumstances offered. Encouraging voluntary disclosure using such a person-centered OIC system is one way forward in other advanced market economies. Indeed, according to Bajada (2002), when Revenue Canada introduced a voluntary disclosure policy, this resulted in voluntary disclosures quadrupling. Again, and similar to society-wide amnesties, however, it is perhaps the case that the OIC program would work most effectively at enabling formalization if it is used in conjunction with other enabling programs. With this in mind, attention turns toward the use of advisory and support services as a means of facilitating formalization.

### **Advisory and Support Services**

Another means of enticing those currently working underground to formalize their work is to provide transition advice and support. In order to move from the underground to the formal economy, micro-entrepreneurs and businesses require help and support on issues such as tax and benefit rules, insurance, credit, loans, book-keeping, marketing, regulations and so forth. At present, however, such support and advice is generally not available in most advanced market economies (ILO, 2002). As Copisarow and Barbour (2004) highlight in the UK context, for example, there is currently a significant gap between the advice and support available to formal businesses and to those who operate underground.

Indeed, the kind of business advice and support required by people seeking to transfer their business ventures into the formal economy is very different to the advice and support required by start-up

or growth businesses who wish to go through a formal business planning process. There is thus a need to tailor business advisory and support services to the needs of these underground micro-entrepreneurs and businesses than is currently the case. Two examples of attempts to do this in the advanced market economies are firstly, the Naples CUORE initiative in Italy and secondly, Street (UK) in the United Kingdom.

### **The Naples CUORE Initiative**

CUORE (Centri Operativi per la Riqualificazione Economica) started in 1998 with an agreement between the municipality of Naples and the University Federico II to research the local business environment. This research revealed that the labor market problem was not unemployment but the underground economy. Today, CUORE (the acronym CUORE reads like 'cuore', the Italian word for heart, courage and passion) project consists of a network of neighborhood service centers for entrepreneurs and would-be entrepreneurs. Each local CUORE center services a low-income neighborhood and their target group is small and micro-sized entrepreneurs with the potential for growth. Once identified, CUORE centers offer information and advice for formalization, support by designing business development strategies and enterprise creation.

Regularization services are a distinctive innovation of this initiative. On the request of the entrepreneur, CUORE operators devise custom-made regularization and development paths. The project workers closely monitor each step in the process to make sure that the entrepreneur follows the agreed path towards regularization and that the path still suits the entrepreneurs' needs. Project workers tend to be familiar with the neighborhood.

Since this Naples experiment, this initiative has started to be replicated elsewhere in Italy, especially the idea of out-reach workers who work in neighborhoods and identify such underground entrepreneurs and enterprises.

### **Street (UK)**

Street (UK) was set up in 2000 to offer loans, advice and business support to self-employed people and micro-enterprises,

especially those wishing to formalize their business. The project has around 200 clients and they fall into two main categories. On the one hand, they include people claiming benefits, such as disability benefit. On the other hand, they include those not claiming benefit but who are either not declaring or under-declaring income from their enterprise activity.

Street (UK)'s approach is to provide them with the tools necessary to make the transition into the formal economy. Their activities cover three areas: providing tailored financial services and business development support tools; offering a back-office loan administration and system support service for other community loan funds; and undertaking research, policy recommendation and advocacy work.

A range of case studies of specific individuals who have been helped can be found both on their web site ([www.street-uk.com](http://www.street-uk.com)) and in a recent report on this organization (Copisarow and Barbour, 2004). What is important to highlight here is the strategy that Street (UK) adopts. Since Street UK clients include a wide variety of people at different stages of development of their enterprises, the approach is to monitor progression of clients in each of the following areas twelve areas:

Moving from part-time to full-time work;

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/or opening a separate business bank account

Obtaining the required licenses and permits to operate the business (e.g., health and safety inspection certificates, driver instructor license)

Graduating of all non-work benefits

Graduating from majority cash revenues to majority invoiced revenues

Incurring formal business tax liability

Becoming VAT registered

This third sector community-based business, finance, support and advisory service thus represents one model for developing a 'transition



service' infrastructure.

The CUORE initiative in Italy and Street (UK) thus represent two options of how a specialized 'transition service' could be provided (for which public funding can be made available and targets set). A fuller range of potential options might include either developing such independent third sector community-based business support networks, using Street (UK) or CUORE as exemplars, or embedding such a transition service within the public sector. In the UK, for example, this might occur by extending the Inland Revenue's Small Business Support Teams, establishing a separate offshoot of Business Links or extending the remit of Jobcentre Plus advisors.

An independent third sector transition service might attract more clients, however, than a transition service embedded within state institutions, due to such a service being seen as relatively detached from the state. Whichever mode of delivering this transition service is adopted, nevertheless, full consideration might be given to the establishment of 'one stop formalization shops' for the provision of business support and finance as well as legal, tax, debt and benefit advisory services that would take a business through each and every step from the underground to the legitimate realm.

Indeed, such a transition service could well be set up in conjunction with an individual-level voluntary disclosure initiative along the lines of the OIC system discussed above. If this partnership working between the state (e.g., IRS in the USA and Inland Revenue in the UK) and this third sector transition service were adopted, then it would provide a key incentive for underground businesses approaching such a transition service. It might be the case, for example, that businesses approaching the transition service and agreeing to follow a plan to move from the underground to the legitimate realm might be offered an offer in compromise concerning their tax liabilities so long as they continue to keep to the tailor-made formalization plan constructed for the business by the transition service.

With regard to transition services, furthermore, the notion of creating 'formalization incubators' might be considered. These could be co-operatives where there is joint-ownership of marketing services, secretarial support and so forth. Another option might be to have an

overarching formal company under whose umbrella underground entrepreneurs continue to conduct their businesses and move towards formality.

#### Formalization Mentors

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

This has been used in Italy. Here, a network of regional tutors has been established to support companies who want to leave the underground economy by providing help and support. These tutors are independent professionals with backgrounds in socio-economic disciplines, such as lawyers and economists, and who understand the labor market situation in the region. Set up under the auspices of the Comitato per l'emersione del lavoro non regolare (Committee for the Exposure of Underground Work), the national committee temporarily hires them on a freelance basis. These tutors tend to have no central office where the underground entrepreneur goes for information. Instead, they directly approach entrepreneurs by visiting companies.

In other advanced market economies, such formalization mentors/tutors could be developed as an extension of existing volunteering initiatives, or alternatively, the 'business mentoring' systems that exist in many countries could be extended to incorporate such a function. In the UK, for example, there is a national mentoring system operated by the Business Volunteer Mentor Association, which is led by the National Federation of Enterprise Agencies. The Prince's Trust has demonstrated that there is a market of available mentors and that having a mentor assist start-up businesses has a direct impact on its longevity and success (Meager et al, 2001; Westall et al, 2000). Extending this mentoring system to cover formalization mentoring is thus one way forward, especially when it is used in conjunction with the development of transition services and an OIC-type program.

#### **Smoothing the Transition from Unemployment to Self-**

## **Employment**

One of the most active public policy areas so far as tackling the underground economy is concerned is the issue of dealing with the unemployed who are working on an underground basis. Throughout the advanced economies, many initiatives exist even though the contemporary research reveals that this group represent only a very small portion of the whole underground economy (Williams, 2004a,b,c). In recent years, for example, based on the assumption that there are many registered unemployed who probably work on a self-employed basis whilst claiming social security benefits, many advanced market economies have attempted to firstly recognize that this is the case in its policy formulation and secondly, tailor policies so that those who are unemployed can make a smooth transition from benefits to self-employment. In this section, just a few of the initiatives that have sought to smooth this transition are evaluated.

### **‘Test trading’ (UK)**

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

Although there have been evaluations of this initiative (Kellard et al, 2002), until now, these evaluations have not considered its success at transferring enterprise from the underground to the formal economy. Put another way, whether this initiative does anything to reduce participation in the underground economy has not been evaluated. Those involved with clients ‘on the ground’, nevertheless, widely believe

that this is the case (see Williams, 2004c). For the test trading initiative to become more effective, the feasibility of the following needs to be evaluated:

Reducing the eligibility period (currently 18 months);

Elongating the current 26 weeks test-trading period to up to three years; and

Developing a graduated withdrawal from benefits (e.g., 100 per cent guaranteed in the first six months; 70 per cent in the next 12 months and 40 per cent in the last 12 months), and a parallel graduated release of money earned by the business that is currently stored in a special bank account until test-trading has ended.

### **Back to Work Bonus (UK)**

The 'back to work bonus' was introduced in October 1996 in the United Kingdom with the aim of encouraging individuals and where relevant their partners to 'keep in touch' with the labor market by undertaking small amounts of work whilst still claiming Income Support (IS) or Jobseekers Allowance (JSA). The rationale was that this would provide an incentive for claimants to move from unemployment into paid work. In effect, it became a measure to condone underground work. It works in a complex way by the accrual of a bonus if the claimant's earnings from part-time work reduce the amount of JSA or IS they are paid. They can then claim the Bonus (a tax-free lump sum of up to £1,000) if and when they move off benefits and into work proper. The bonus is accumulated from 50 per cent of the declared earnings above the 'earnings disregard' (normally £5) but this can only commence after 91 days of being on JSA/IS. It also has to be claimed within 12 weeks of leaving benefit (otherwise it is lost) and it can only be paid if the claimant starts work within two weeks of leaving benefits. It cannot be accrued by people over 60 claiming IS although men aged 60-64 on JSA can join the scheme. If a claimant is on IS, the earnings of the claimants' partner are taken into account in the calculation of the bonus, but this is not the case for claimants on JSA.

Evaluations of the scheme have been carried out, albeit not directly in relation to its effectiveness at reducing the underground economy (Thomas et al, 1999; Ashworth and Youngs, 2000). Research is required with participants on whether this initiative facilitates a shift of work from the underground economy to the formal economy.

### **‘Twin track’ initiative (UK)**

‘Twin track’ is a pilot initiative running in two Government Office regions (Wales and the North West) in the United Kingdom, whereby under certain conditions a lighter touch is taken with people working on an underground basis whilst claiming benefits in an effort to get them into formal employment via contact with a personal advisor. This is one way in which a level of tolerance in government policy has been displayed in the UK towards those attempting to make the transition from benefits to employment via the underground economy. Until now, however, no public results have been made available of any evaluation of this scheme. Given that the unemployed provide only a small proportion of all underground work, however, it is unlikely that this initiative alone would have a significant impact on the size of the underground economy. It is, nevertheless, potentially useful as one initiative in a barrage of measures that could be used to tackle the underground economy.

### **‘Me-PLC’ (Germany)**

In Germany, a new business entity has been introduced in an attempt to smooth the transition from benefits to self-employment, namely ‘Me-PLC’. This is intended to help the unemployed wishing to start up their own self-employed business venture and enables them to receive a subsidy for the first three years equivalent to a maximum of 50 per cent of unemployment benefits.

Following a recommendation of the Hartz Committee in 2002 that sought to improve the functioning of the inflexible German labor market, in 2003, Ich A.G.’s (here called ‘Me-PLCs’) were introduced. This is a new legal entity. Where unemployed people want to start up a one-person business (ich-AG) or a family business (familien AG), they receive a monthly subsidy for three years. In the first year, they receive 50 per cent of the average unemployment benefit level, 30 per cent in the second year and 20 per cent in the third and final year. A start-up monitor shows that in 2003, over 93,000 long-term unemployed started a small business using this Ich-AG scheme. The German government expected around 20,000 start-ups (Renooy et al, 2004).

Variants of such schemes to smooth the transition from benefits to self-employment are found in other advanced market economies. In

the Netherlands, for example, the Bbz (Besluit Bijstandverlening Zelfstandigen), meaning ‘Decision Social Security Self-Employed’, allows people who want to start their own business and self-employed people who want to temporarily earn less than the annual standard amount a person on social security receives, to apply for social security benefit whilst running their own business (Renooy et al, 2004).

In sum, such initiatives to smooth the transition from unemployment to self-employment are popular in many advanced market economies. It needs to be recognized, however, that since the registered unemployed constitute only a very small proportion of those working underground, such initiatives will have only a relatively small impact on the overall size of the underground economy.

### **Awareness Raising and Information Campaigns**

Besides developing demand- or supply-side measures, awareness raising and information campaigns are required to encourage the transition from the underground to the formal economy. If a share of the population is willing to take a chance on evasion when the perceived benefits outweigh the risks of disclosure and punishment, making clear both the risks and costs of participation in the underground economy, as well as the benefits of using formal labor, becomes essential to underground workers and the users of such labor. Publicity is naturally a key factor in this process.

Awareness campaigns, recommended by the ILO (2002) as good practice, may be about the costs of underground work (e.g., the lack of advice, finance and opportunities), the benefits of working formally and/or they may focus upon enhancing the feeling of belonging to a common society from which everybody receives and to which everybody should contribute. Such awareness raising and information campaigns can do some and/or all of the following:

Inform underground workers of the costs and risks;

Inform underground workers of the benefits of being

Inform potential users of underground labor of the risks and costs;  
and/or

Inform potential users of the benefits of employing formal labor.

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

Publicity has the double effect of highlighting the risks involved in underground work and the benefits of formality, as well as strengthening trust in the system by taxpayers. Both effects are essential, since compliant taxpayers must be confident in the capability of the state to prevent tax evasion, while underground workers must recognize the risks involved and benefits of formalization. Indeed, there is absolutely no point in developing all of the above initiatives if participants are not informed of their existence and the possibilities offered by them.

Here, it is considered that such awareness raising and information campaigns should perhaps emphasize the benefits of working formally rather than the costs of working on an underground basis. Indeed, Thurman et al (1984) caution against adopting approaches that publicize the adverse consequences of working on an underground basis because the individual may neutralize their guilt about working underground in one of the following ways:

*Denial of responsibility.* The individual will regard the adverse consequences arising from the underground economy to be the result of others, who could even possibly be big players in the underground economy. It is not a product of their actions;

*Denial of injury.* The individual disagrees that their activity could have adverse consequences on others. In fact, the person may rationalize their actions by arguing that without their activities and endeavor, the community may pay a higher price or even be unable to get such services provided;

*Denial of victim.* The individual accepts the adverse consequences their actions may have on the community but believes that the victims deserved it;

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

*Appeal to higher loyalties.* The individual justifies their action as the result of 'non conventional social order'. The person believes that

similar and across the board behavior justifies their actions;

*Metaphor of the ledger.* The individual contemplating evasion believes that their actions, although they may be bad, are not reflective of their true and good nature. The person regards these as temporary deviations from otherwise good behavior;

*Defense of necessity.* The individual justifies their actions to be the result of personal circumstances that have led to non-compliance.

In sum, awareness campaigns should preferably be about the benefits of formal work rather than the risks and costs of underground work, and can be targeted at either employers or suppliers of underground work, and be either of a general national variety or targeted at specific sectors where the underground economy dominates.

### **Coordinating Government Actions**

Besides demand- and supply-side measures, and awareness raising and information campaigns of the benefits of going formal, the co-ordination of government actions on this issue is required if underground endeavor is to be transferred into the legitimate realm. In advanced market economies, a large number of government institutions and agencies are involved in various aspects of tackling this problem. The outcome is that initiatives are often not 'joined up', leading not only to what sometimes appear to be confusing messages coming out of government but also a lack of co-operation across departments.

In some nations, in consequence, national, regional and /or local agencies to provide coordinated action for tackling the underground economy have been established. Here, how this has been achieved in France and Italy is analyzed.

### **Délegation Interministérielle à la Lutte Contre le Travail Illégal (France)**

In France, since 1997, the *Délegation Interministérielle à la Lutte Contre le Travail Illégal* (DILTI) has coordinated the fight against underground work and set up institutions in each department. It is located under the authority of the Ministry of Employment and Solidarity, and consists of officials and civil servants of the ministry,



magistrates, military personnel, officials, and civil servants of other ministries and bodies concerned with the fight against underground work.

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

At the local level, DILTI have been created in each department who are responsible for establishing annual reports of the situation in their domain of competence that includes proposals for action.

### **Comitato per l'Emersione del Lavoro No Regolare (Italy)**

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

At a national level, its function is to analyze and co-ordinate all relevant initiatives such as:

Information and awareness campaigns through the media and schools;  
Periodical evaluation of the local control commissions' activities; and  
Examination of possible proposals for the exposure of underground work.

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

Regional analysis;  
Promotion of team work and agreement with the state authorities  
Support to enterprises; and  
Arrangement of social areas dedicated to the execution of wage alignment agreements.

Such coordinating institutions to encourage joined up thought and action on the underground economy could be introduced in many other nations.

## **Conclusions**

In order to advance understanding of how to combat the underground economy in advanced economies, this paper has built upon the emergent recognition that public policy should seek to transfer enterprise and entrepreneurship in the underground economy into the formal economy rather than simply seek to eradicate it. This shift in thinking towards underground work is in part, the result of a recognition of the heterogeneity of underground work and that much is conducted on an autonomous basis and in other part, a direct consequence of the growing appreciation that the endeavor prevalent in the underground economy represents a potential asset to be harnessed (e.g. Evans et al, 2004; Global Employment Forum, 2001; International Labor Office, 2002; Leonard, 1998; Tabak, 2000; Vaknin, 2000; Williams, 2004a,b,c).

Given this emergent recognition, a deterrence approach cannot continue. Governments pursuing such an approach will with each new initiative to eradicate underground work destroy the self-employment and entrepreneurial endeavor that other spheres of public policy are seeking to develop. In this paper, in consequence, a range of pull initiatives that complement the current raft of deterrence (push) measures by enabling underground workers to make the transition to the legitimate realm have been outlined that have been used in various advanced market economies. Ranging from demand-side measures that encourage consumers to employ formal labor through supply-side initiatives that help underground workers transfer their endeavor into the formal realm to awareness raising campaigns and ways of coordinating government action, taken together, these measures represent a public policy tool-kit for harnessing enterprise and entrepreneurship in the underground economy.

Until now, despite the emergent view that underground work needs to be transferred into the legitimate realm, few have attempted to show how this might occur. This paper thus begins to shine a light on the way forward. If greater attention now starts to be paid to evaluating these enabling initiatives and considering their transferability to other countries than has so far been the case, then this paper will have achieved its objective.

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