TACKLING ENTERPRISE IN THE INFORMAL ECONOMY: AN INTRODUCTORY OVERVIEW

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Abstract

This paper introduces this special issue by providing an overview of the various policy options and approaches available for tackling enterprise in the informal economy. It firstly reviews four possible hypothetical policy options, namely doing nothing, eradicating informal sector enterprise, moving formal enterprises into the informal economy, or formalizing enterprise in the informal economy. Displaying that formalizing informal sector enterprise is the most viable and most commonly adopted approach, it then reviews the two approaches of using either direct
controls, which increase the costs of operating informally and/or the benefits of operating formally, or indirect controls that seek greater self-regulation. Following this, the ways in which these approaches can be combined is then reviewed. The outcome is a comprehensive introductory overview and conceptual framework for contextualizing the arguments of the papers in this special issue.

Keywords: Entrepreneurship; enterprise development; enterprise culture; informal sector; shadow economy; small business; public policy.

Introduction

Since the turn of the millennium, a burgeoning literature has emerged on enterprise in the informal economy (Achua and Lussier, 2014; Aidis et al., 2006; Bruton et al., 2012; Bureau and Fendt, 2011; Kus, 2014; Mróz, 2012; Welter and Smallbone, 2011; Williams, 2006; Williams and Nadin, 2010a). This scholarship has analysed not only its magnitude, including the prevalence of enterprise in the informal economy (Autio and Fu, 2015; Williams, 2013) and the determinants of its variable prevalence (Dau and Cuervo-Cazurra, 2014; Siqueira et al., 2014; Thai and Turkina, 2014), but also its characteristics, including who participates (Thai and Turkina, 2014; Williams, 2007; Williams and Martinez-Perez, 2014; Williams and Nadin, 2010b; Williams and Round, 2007, 2008; Williams and Youssef, 2014) and their motivations for doing so, such as whether they are necessity- and/or
opportunity-driven (Adom, 2014; Adom and Williams, 2012; Maloney, 2004; Perry et al., 2007; Williams and Gurtoo, 2011). Until now however, and despite the growing understanding of the magnitude, characteristics and rationales underpinning informal entrepreneurship, relatively little attention has been paid to tackling enterprise in the informal economy. This introductory overview begins to redress this gap in scholarship.

To achieve this, Section 2 reviews the hypothetical policy options available for tackling enterprise in the informal economy. Identifying that the overwhelming consensus is that there should be a formalisation of enterprise in the informal economy, Section 3 then provides a heuristic framework for comprehending the potential policy approaches for doing so, followed by a review of the “hard” direct controls in Section 4 and the “soft” indirect controls in Section 5. Section 6 then demonstrates the various ways of combining these direct and indirect controls when tackling enterprise in the informal economy, namely the responsive regulation and slippery slope approaches, whilst Section 7 draws some conclusions. The outcome will be a comprehensive introductory overview and conceptual framework for understanding the arguments of the papers in this special issue.

At the outset nevertheless, enterprise in the informal economy needs to be defined. Here, and reflecting the strong consensus, the informal economy is defined as monetary transactions not declared to the state for tax, benefit and/or labour law purposes when they should be declared but which are legal in all other respects (Williams and Nadin, 2010a). Enterprise in the informal economy therefore refers to business ventures that engage in transactions not declared to the state for tax, benefit and/or labour law purposes when they should be declared but which are legal in all other
respects. The only illicit aspect of such enterprise in consequence, is that when trading licit goods and/or services, some or all of their monetary transactions are not declared. Enterprises trading illicit goods and services (e.g., drug trafficking, gun-running) are not deemed informal enterprises, but part of the separate criminal economy (Smith and McElwee, 2013).

**Policy Options**

Considering the full range of possible options towards enterprises in the informal economy, policy makers might either: do nothing; eradicate enterprise in the informal economy; move formal enterprises into the informal economy, or formalize enterprises in the informal economy. Here, each is reviewed in turn.

**Laissez faire**

A first option is for governments to adopt a laissez-faire approach. Rationales for taking no action include that it is a breeding ground for the micro-enterprise system, a seed-bed for new venture creation and test-bed for fledgling enterprises. Indeed, a 2012 survey of 595 small business owners in the UK reveals that 20 per cent traded in the informal economy when starting up their enterprise, with 64 per cent stating that the main reason for doing so was to test the viability of their venture (Williams and Martinez, 2014a,b). However, the problem with this approach is that it has significant deleterious implications for formal enterprises (e.g., unfair competition), informal enterprises (e.g., pressure to enter exploitative relationships with the formal economy), customers (e.g., lack of legal
recourse if a poor job is done) and governments (e.g., reduced public revenue) (for a review, see OECD, 2015; Williams, 2014a, 2015a). Until now however, no rigorous evaluations have been conducted. This is a significant gap to be filled in future studies. Despite this lack of an evidence-base however, the strong consensus is that on balance, the deleterious impacts outweigh any beneficial impacts. As such, taking no action is not seen as a feasible option. Interventions are instead viewed as required. What form of intervention is therefore required?

**Move formal enterprise into the informal economy**

A second possibility is to shift formal enterprise into the informal economy. Although not explicitly argued by any commentators, some advocate a deregulation of the formal economy to tackle informal enterprise based on the belief that informal enterprise result from over-regulation of the market (Sauvy, 1984; De Soto, 1989, 2001). The intention is therefore to de-regulate the formal economy so that all activities take place in a manner akin to what is currently the informal economy, although they would not be engaged in informal enterprise since they would be conforming to the regulations that remain. This is based on the view that deregulation reduces the informal enterprise. However, there is growing evidence that decreasing the level of state intervention results not in formalization but quite the opposite, greater levels of informal enterprise (Kus, 2010, 2014; Williams, 2013b, 2014a,b). In consequence, this way forward is not perhaps viable. Indeed, few currently advocate such an option.
Eradicate informal enterprise

Another option is to eradicate informal enterprise. However, there is a major issue of whether eradication is desirable. If informal enterprises are a breeding ground for the micro-enterprise system and a seedbed for enterprise culture, this realm is a potential asset that needs to be harnessed (e.g., Williams, 2006). Pursuing its eradication would therefore eliminate precisely the entrepreneurship and enterprise culture governments are seeking to foster. The resultant challenge for governments is thus to “join-up” their policy approach toward informal enterprise with their agendas to foster enterprise culture and entrepreneurship. Unless this is achieved, each new initiative to eradicate informal enterprise will result in governments destroying precisely the entrepreneurship and enterprise culture they wish to nurture.

Formalize informal enterprise

Rather than take no action, transfer formal enterprise into the informal economy or eradicate informal enterprise, a fourth and final possibility is to formalize informal enterprise (Aliyev, 2015; Dekker et al., 2010; European Commission, 2007, Renooy et al., 2004; Small Business Council, 2004, Williams, 2006; Williams and Nadin, 2012a,b, 2013, 2014; Williams and Renooy, 2013).

So far as formal enterprises are concerned, this would stop the unfair competitive advantage of informal enterprises over those playing by the rules (Khan and Quaddus, 2015; Evans et al., 2006; Renooy et al., 2004). It would also enable a “high road” rather than “low road” approach by shifting toward greater regulatory standards on working conditions such as health and safety and labour standards (Grabiner, 2000; Renooy et al., 2004; Williams and Windebank, 1998). Meanwhile, for
informal enterprises, the key benefits are that they escape the pressure to enter exploitative
technology (Gallin, 2001; Williams and Windebank, 1998) and achieve the same levels of legal protection as formal enterprises (Boels, 2014; Bruns et al., 2011; ILO, 2014; Morris and Polese, 2014). They are also able to secure formal intellectual property rights for their products and processes (De Beer et al., 2013) and overcome the structural impediments that prevent them growing, such as their lack of access to advice and support as well as capital (ILO, 2014). For customers, the advantages are that they benefit from legal recourse if a poor job is done, have access to insurance cover, enjoy guarantees regarding the work conducted, and have more certainty that health and safety regulations are being followed (Williams and Martinez, 2014c). Finally, for governments, the benefits are that it improves the level of public revenue (Williams and Windebank, 1998) and joins up the policy approach toward informal enterprise with the more general policy approach toward harnessing entrepreneurship and enterprise culture (Dekker et al., 2010; European Commission, 2007; Small Business Council, 2004).

Therefore, formalizing informal enterprise has been widely adopted by governments as the most viable policy choice. How, therefore, can this be achieved?

**Policy approaches: hard direct versus soft indirect measures**

Table 1 provides a summary of the different approaches towards tackling enterprise in the informal economy. This distinguishes two contrasting approaches. On the one hand, there is a “hard” direct controls approach. This treats enterprise owners as rational economic actors and seeks compliance by
ensuring that the costs of operating in the informal economy are outweighed by the benefits of operating in the formal economy. This is accomplished either by increasing the costs of non-compliance (‘sticks’) and/or by making the conduct of work in the formal economy more beneficial and easier (‘carrots’). On the other hand, the soft indirect controls approach shifts away from using ‘sticks’ and ‘carrots’ to elicit behaviour change and instead focuses upon developing the social contract between the state and enterprise owners by nurturing a high trust high commitment culture. Here therefore, we review each approach in turn.

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“Hard” direct controls approach

To tackle enterprise in the informal economy, a first way of doing so views entrepreneurs as rational economic actors and seeks to change the costs of operating in the informal economy and benefits of operating formally. To outline this approach, firstly, the direct control measures it uses to detect and punish non-compliant (“bad”) behaviour is reviewed followed secondly, by its use of “bribes” or incentives to reward compliant (“good”) behaviour.

Deterrents: detecting and punishing non-compliance

During the early 1970s, Allingham and Sandmo (1972) argued that the non-compliant, such as owners of enterprises in the informal economy, are rational economic actors who evade tax when the pay-off is greater than the expected cost. Therefore, the objective is to change the cost/benefit ratio facing those participating or considering participation (e.g., Grabiner, 2000; Hasseldine and Li, 1999; Job et al., 2007; Richardson and Sawyer, 2001). When using deterrents, this is to be achieved by focusing on the cost side and increasing the actual and perceived risks and costs associated with participation firstly, by raising the perceived or actual likelihood of detection and/or secondly, increasing the penalties and sanctions. This “negative reinforcement” approach thus uses “sticks” to punish non-compliant (“bad”) behaviour.

However, the effectiveness of this approach can be questioned. Although some reveal that improving detection and/or penalties reduces informality (De Juan et al., 1994; Slemerod et al.,
2001), others identify that informality increases (Bergman and Nevarez, 2006; Murphy, 2005) and thus that “it is not sensible to penalize illicit work with intensified controls and higher fines” (Schneider and Enste, 2002). This is because penalizing such endeavour alienates owners of informal enterprises, reducing their willingness to comply and reduces their belief in the fairness of the system (Murphy, 2005). Another reason for adopting a cautionary approach to the use of deterrence measures is that they have a range of unintended and unwanted broader impacts. As already mentioned, they lead to one hand of government deterring precisely the entrepreneurial endeavour and enterprise culture that other hands of government wish to foster. When this is combined with the recognition that punishing non-compliant (“bad”) actions is not necessarily the most effective means of changing behaviour, the result has been that many have begun to question the value of such measures. New measures have thus emerged.

**Incentives**

With the growing recognition across governments that the goal is to formalize informal enterprise, rather than simply eradicate it, a shift has begun to take place away from deterrence measures and towards providing incentives to encourage owners of informal enterprises to formalize (Small Business Council, 2004; Williams, 2006). In other words, rather than punish non-compliant (“bad”) behaviour, measures have been sought that reward compliant (“good”) behaviour, rather than taking it as given. When tackling enterprise in the informal economy, and as displayed in Table 1, these measures take two forms.
On the one hand, incentives can be provided to entrepreneurs at the business start-up stage to establish their ventures on a formal basis. These can include the simplification of compliance so as to make it easy to start-up formally, the use of direct and indirect tax incentives to make it beneficial to do so, and the provision of support and advice to entrepreneurs about how to start-up formally. On the other hand, incentives can be provided to help enterprises in the informal economy to make the transition to formality. Firstly, supply-side measures can be used to “bribe” owners of informal enterprises to make the transition to formality such as the use of society-wide amnesties, voluntary disclosure schemes and the introduction of schemes that facilitate them to undergo a smooth transition to legitimacy. Secondly, demand-side measures can be used to “bribe” customers to use formal rather than informal enterprises when sourcing goods and services, such as service vouchers and targeted direct and indirect tax incentives (see Williams, 2015a).

“Soft” indirect controls approach

The problem with using “hard” direct controls to alter the cost/benefit ratio confronting informal enterprises is that they are expensive and also often ineffective (Alm, 2011). Rather than “bribe” somebody to be compliant for example, a more effective approach is to encourage self-regulation by engendering a willing or voluntary commitment to compliant behaviour (Kirchler, 2007; Torgler, 2007, 2011). To understand this approach, it is first necessary to recognize that there exists an institutional incongruity between the laws, codes and regulations of formal institutions and the norms, beliefs and values of informal institutions (North, 1990; Webb et al., 2009, 2013). Enterprises
operate in the informal economy when the norms, values and beliefs (informal institutions) differ to
the laws and regulations (formal institutions), resulting in what formal institutions deem to be illegal
activities being seen as socially legitimate in terms of the norms, values and beliefs of entrepreneurs
(Williams and Shahid, 2015). Therefore, to tackle enterprises in the informal economy, there is a
need to reduce this asymmetry between the formal and informal institutions. This can be achieved
either by changing the informal institutions and/or the formal institutions.

**Changing informal institutions**

To change this institutional asymmetry, one approach is to change the norms, values and beliefs of
potential and existing entrepreneurs regarding the acceptability of operating in the informal economy
so that these are in symmetry with the laws, regulations and codes of formal institutions. This can be
achieved by improving tax knowledge using awareness raising campaigns about the costs of
operating enterprises in the informal economy and benefits of operating formal enterprises.

Educating entrepreneurs about the benefits of formality is important if the norms, values and
beliefs are to be in symmetry with the codified laws and regulations of formal institutions. To do
this, two types of education are required. First, there is the need to educate entrepreneurs about what
the current system requires of them, providing information regarding their responsibilities. A
significant portion of tax evasion is unintentional, resulting from a lack of knowledge,
misunderstandings and a false interpretation of their responsibilities (Hasseldine and Li, 1999;
Natrah, 2013). A solution is to provide greater information to entrepreneurs (Internal Revenue
Secondly, and more broadly, entrepreneurs also need educating about the value and benefits of paying taxes to prevent intentional evasion by developing their intrinsic motivation to comply. Consequently, a solution to reduce intentional evasion is to educate entrepreneurs about where their taxes are spent. This can be done by informing them of the current and potential public goods and services they receive (Bird et al., 2006; Saeed and Shah, 2011), such as by using signs such as “your taxes are paying for this” in hospitals, schools and medical centres.

A further way of changing attitudes toward compliance is to raise awareness by informing either: entrepreneurs of the costs and risks of operating in the informal economy; potential customers of the risks and costs; entrepreneurs of the benefits of formality, or potential customers of the benefits of using the formal economy.

**Changing formal institutions**

Besides changing the norms, values and beliefs of entrepreneurs, formal institutions can also be altered to align with informal institutions. This is particularly important in societies in which there is a lack of trust in government, such as because of public sector corruption (European Commission, 2014) or in societies where entrepreneurs do not believe they receive back from government what they expect. Two types of change are necessary.

On the one hand, there is a need to change internal processes in the formal institutions to improve the perception among entrepreneurs that there is procedural justice and fairness, and redistributive justice. Firstly, procedural justice refers to the extent to which entrepreneurs perceive
the government to treat them in a respectful, impartial and responsible manner (Braithwaite and Reinhart, 2000, Murphy, 2005; Taylor, 2005; Tyler, 1997, Wenzel, 2002). As Wenzel (2006) finds, compliance was significantly higher among taxpayers perceiving there to be interactional fairness. Being treated politely, with dignity and respect, being given a say and having genuine respect shown for one’s rights and social status all enhance compliance (Alm et al., 1993; Feld and Frey, 2002; Gangl et al., 2013; Hartner et al., 2008; Murphy, 2005; Tyler, 1997, 2006; Wenzel, 2002).

Secondly, procedural fairness refers to the extent to which entrepreneurs believe they are paying their fair share compared with others (Kinsey and Gramsick, 1993; Wenzel, 2004a,b). Entrepreneurs receiving procedurally fair treatment are more likely to trust the authorities, accept its decisions and follow its directions (Murphy, 2005). Conversely, where there are grievances among entrepreneurs that they are not receiving fair treatment, non-compliance increases (Bird et al., 2006). Thirdly, redistributive justice refers to whether entrepreneurs believe they receive the goods and services they deserve given the taxes they pay (Kinsey and Gramsick, 1993; Kinsey et al., 1991; Richardson and Sawyer, 2001; Thurman et al., 1984). Taxes are the prices paid for the goods and services provided by government. If entrepreneurs do not receive the goods and services they believe they deserve given the taxes they pay, then non-compliance increases (McGee, 2005). Therefore, there is a need for government to explain how taxes are spent and to elicit agreement regarding the public goods and services provided by government.

On the other hand, there is often a need to change the products of formal institutions by pursuing wider economic and social developments. Recent studies have revealed that fewer enterprises operate in the informal economy in in wealthier economies with stable high quality
government bureaucracies and those with lower poverty levels, more equality, greater levels of social protection, more effective redistribution through social transfers and greater state intervention in the labour market to protect vulnerable groups (Vanderseypen et al., 2013; Williams, 2013a, 2014a,b,c,d, 2015b,c).

**Combining the hard direct and soft indirect control approaches**

To tackle enterprise in the informal economy, it is not an either/or choice between these two approaches. Although the focus of most national governments until now has been upon the use of the hard direct controls, especially punitive measures that increase the costs of operating informally by raising the risks of detection and levels of punishment (see OECD, 2015; Williams, 2015a), the solution is not to shift toward either “bribes” or indirect controls.

These approaches and measures are not mutually exclusive. Indeed, even if indirect controls are useful to formalize informal enterprise (Williams, 2014a; Williams and Renooy, 2013), they are insufficient on their own. Direct controls are also required. For example, governments may seek to change the culture of government departments, such as tax offices, toward a more customer-oriented approach and introduce public campaigns to elicit greater self-regulation, while simplifying regulatory compliance for business start-ups and introducing incentives for established informal enterprises to formalise (e.g., amnesties, tax deductions). However, and at the same time, and in relation to those who fail to comply, they may also need to pursue improvements in the probability of detection and tougher sanctions for those subsequently caught.
Therefore, the discussion is not about whether to use direct or indirect controls. The emergent consensus is that both are required. Rather, the major issue is determining the most effective way of combining and sequencing these approaches to engender effective compliance. For example, measures to improve detection through inspections are currently often combined with campaigns to raise awareness. Furthermore, tougher sanctions often follow amnesties and voluntary disclosure schemes. However, whether these are the most effective combinations and sequences are not known. Despite this, two particular approaches have come to the fore in recent years in the literature that provide ways of combining these policy approaches in particular sequences.

Firstly, a responsive regulation approach starts out by openly engaging entrepreneurs to consider their obligations and take responsibility for regulating themselves in a manner consistent with the law rather than to be regulated by external rules. This facilitating of self-regulated compliance is then followed by persuasion through incentives and only as a last resort for the small minority refusing to be compliant does it use punitive measures (Braithwaite, 2009; Job et al., 2007).

A second approach is the “slippery slope framework” (Kirchler et al., 2008) which pursues both voluntary and enforced compliance concurrently by developing both greater trust in authorities and the greater power of authorities (Kogler et al., 2015; Muehlbacher et al., 2011; Wahl et al., 2010). Until now however, there has been little comparative evaluation of which sequencing and/or combination is the most appropriate and/or effective means of harnessing this sphere.

Conclusions
This introductory overview has discussed what might be done to tackle enterprise in the informal economy. This has reviewed four possible policy options, namely laissez-faire, eradicating informal enterprise, informalizing formal enterprise and formalizing informal enterprise, showing that formalizing informal enterprise is the widely viewed as the most viable option.

To review how this might be achieved, a conceptual framework has been provided showing how either hard direct controls or soft indirect controls can be employed. This has revealed that the currently dominant approach of using direct controls that seek to improve detection and increase punishment is a rather limited approach and that the toolbox available to policy-makers has a much wider range of tools in it which might also be more effective than the narrow range of blunt instruments currently used. Furthermore, it has revealed that the use of these diverse tools is not mutually exclusive and can be combined, as exemplified by the responsive regulation approach and slippery slope framework. The outcome is that a comprehensive review has been provided of the various policy options and approaches available to policy makers along with some suggestions regarding how they can be combined.

If this introductory overview helps readers contextualize the papers in this special issue, it will have achieved its main objective. However and perhaps more importantly, if it encourages governments to explore a wider array of measures for tackling enterprise in the informal economy, then it will have achieved its intention.

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