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An institutional theory of the informal economy: some lessons from the United Kingdom

Purpose
The aim of this paper is to propose a new way of explaining participation in the informal economy as resulting from the asymmetry between the codified laws and regulations of a society's formal institutions (government morality) and the norms, values and beliefs of the population that constitute its informal institutions (societal morality). The proposition is that the greater the asymmetry between government morality and societal morality, the greater is the propensity to participate in the informal economy.

Methodology
To evaluate this institutional asymmetry theory, the results are reported of 1,306 face-to-face interviews conducted during 2013 in the United Kingdom.

Findings
The finding is a strong correlation between the degree of institutional asymmetry (measured by tax morale) and participation in the informal economy. The lower the tax morale, the greater is the propensity to participate in the informal economy. Using ordered logistic regression analysis, tax morale is not found to significantly vary by for example social class, employment status or wealth, but there are significant gender, age and spatial variations with men, younger age groups, rural areas and Scotland displaying significantly lower tax morale than women, older people, urban areas and London.

Practical Implications
Rather than continue with the current disincentives policy approach, a new policy approach that reduces the asymmetry between government morality and societal morality is advocated. This requires not only changes in societal morality regarding the acceptability of participating in the informal economy but also changes in how formal institutions operate in order for this to be achieved.

Originality/value
This paper provides a new way of explaining participation in the informal economy and reviews its consequences for understanding and tackling the informal economy in the UK.

Keywords: informal sector; shadow economy; undeclared work; tax morale; institutional theory; United Kingdom.

Introduction

In recent years, numerous studies have revealed the informal economy to be a sizeable proportion of contemporary economies. This is the case not only in the developing world (ILO, 2012; Rani et al., 2013) but also across the transition economies (Kus, 2014; Polese and Rodgers, 2011; Rodgers et al., 2008; Williams and Onoshchenko, 2014) as well as the higher-income OECD nations (Schneider, 2013; Williams, 2006, 2014b). In the UK, for example, both Schneider and Williams (2013) and Murphy (2014) estimate the UK informal economy to be equivalent to some 10 per cent of GDP. The result is not only significant tax losses which reduces the public revenue available for spending on issues such as social protection and cohesion, but just as importantly, weakened trade union and collective bargaining, poorer working conditions and unfair competition for legitimate businesses (Andrews et al., 2011; ILO, 2014; TUC, 2008).

The aim of this paper is to propose and evaluate a new way of explaining and tackling participation in this informal economy. Drawing upon institutional theory (Baumol, 1990; Baumol and Blinder, 2008; North, 1990), participation in the informal economy is here explained as resulting from the existence of an asymmetry between the codified laws and regulations of a society's formal institutions (here termed 'government morality') and the norms, values and beliefs of its informal institutions (here termed 'societal morality'). The proposition is that the greater is the asymmetry between government morality and societal morality, the higher is the likelihood of participation in the informal economy. If valid, this has consequences for how the informal economy is tackled. A policy approach based on reducing this institutional asymmetry necessitates a very different approach to that currently adopted.

To explore this, the first section briefly reviews previous explanations of the informal economy and their shortcomings along with the rapidly increasing number of empirical studies revealing a strong association between tax morale and participation in the informal economy. To marshal these empirical findings into a new theory of the informal economy, we draw on institutional theory to formulate the proposition that the greater is the asymmetry between government morality and societal morality, the greater is the propensity to participate in the informal economy. To evaluate this, the second section then introduces the methodology and data used, namely an ordered logistic regression analysis of the association between participation in the informal economy and the degree of institutional asymmetry using a 2013 UK survey involving 1,306 face-to-face interviews. The fourth section then presents the results followed in the fifth section by a discussion of the theoretical and policy implications before the sixth and final section summarises the findings along with the limitations of the study and avenues for future research.

At the outset however, the informal economy needs to be defined. Castells and Portes (1989: 15) define this as 'a specific form of income generating production… unregulated by the institutions of society in a legal and social environment in which similar activities are regulated'. Although this defines the informal economy through the lens of both the 'legal' (formal) and 'social' (informal) institutions in a society, it fails to recognise firstly, that even if unregulated by formal institutions, the informal economy is regulated by the rules of informal institutions and secondly, that even if activity is 'illegal' from the viewpoint of formal institutions it can be 'legitimate' from the viewpoint of informal institutions (Siqueira et al., 2014; Webb et al., 2009). As such, and reflecting the consensus in the literature, we here define the informal economy as socially legitimate activity which is legal in all respects other than it is not declared to the authorities for tax, social security or labour law purposes (European Commission, 2007; OECD, 2012; Williams, 2014a,b). If it is not legal and legitimate in all other respects, it is not part of the informal economy. Whilst the formal economy is legal (from the viewpoint of formal institutions) and legitimate (from the viewpoint of informal institutions), the informal economy is illegal but legitimate, unlike the criminal economy (e.g., forced labour) which is both illegal and illegitimate (Ponsaers et al., 2008).

Explaining participation in the informal economy: an institutional perspective

Since the turn of the millennium, numerous studies reveal that participation in the informal economy varies not only by global region (ILO, 2013), cross-nationally (Likic-Brobric et al., 2013; Papyrakis, 2014; Putniņš and Sauka, 2014; Schneider, 2013; Williams, 2014a,b) and locally and regionally (Kesteloot and Meert, 1999; Williams and Shahid, 2015), but also by age (Pedersen, 2003), gender (ILO, 2013; Leonard, 1994, 1998; Stănculescu, 2005), income level (Boels, 2014; Williams, 2004) and employment status (Brill, 2011; Williams et al., 2013).

To explain the informal economy, and as Williams (2014a) highlights, most studies have adopted one of three competing theoretical explanations. Firstly, 'modernisation' theory explains the informal economy in terms of the lack of economic development and modernisation of state bureaucracies (Geertz, 1969; ILO, 2013; Lewis, 1959), secondly, 'neo-liberal' theory explains the informal economy as resulting from high taxes and over-burdensome rules and regulations (De Soto, 2989, 2001; Nwabuzor, 2005) and third and finally, 'political economy' theory explains it to result from inadequate state intervention and a lack of safeguards for workers (Castells and Portes, 1989; Dau and Cuervo-Cazurra, 2014; ILO, 2014; Meagher, 2010; Slavnic, 2010). The problem with all these explanations which focus upon country-level conditions is that they are unable to take agency into account and explain why some individuals participate in the informal economy and others do not.

In recent years however, empirical studies on 'tax morale', defined as the intrinsic motivation to pay taxes owed, have begun to do so by examining how the acceptability of participation in the informal economy varies across individuals and populations (Cummings et al., 2009; McKerchar et al, 2013). The finding across a range of contexts is that usually tax morale is lower among men, single people, the unemployed and self-employed, and increases with religiosity, age, perceived social status and income but is negatively related to years spent in formal education (Alm and Torgler, 2006; Cannari and D'Alessio, 2007; Daude and Melguizo, 2010; Daude et al., 2013; Kastlunger et al., 2013; Lago-Peñas and Lago-Peñas, 2010; Martinez-Vazquez and Torgler, 2009; Williams and Martinez, 2014a,b).

These empirical studies also reveal a strong relationship between tax morale and participation in the informal economy. The lower is the level of tax morale, the higher is the level of participation in the informal economy, with Pearson r values between -0.46 and -0.66 (Alm and Torgler, 2006; Alm et al., 2006, Halla, 2010; Riahi-Belkaoui, 2004; Richardson, 2006; Torgler, 2011; Torgler and Schneider 2009). Indeed, Alm and Torgler (2006) focusing on Europe and the United States find a strong negative correlation (Pearson r = -0.460) significant at the 0.05 level. Analysing the linear relationship in a simple regression indicates that the variable tax morale can explain 20 per cent of the total variance of the size of informal economy. Similarly, Alm et al. (2006) focusing on transition countries find a strong negative correlation (r =-0.657), significant at the 0.01 level; low tax morale is related with larger informal economies, with the variable tax morale explaining more than 30 per cent of the total variance of the size of informal economy. This is also the case in developing countries. Torgler (2005) finds in Latin America a strong negative correlation (-0.511), significant at the 0.05 level.

Here, and to advance a new theorisation of the informal economy, we re-read these empirical studies through the lens of institutional theory (Baumol and Blinder, 2008; Helmke and Levitsky, 2004; North, 1990). Institutions represent 'the rules of the game'; they prescribe the norms regarding the acceptability of activities (Baumol and Blinder, 2008; Denzau and North 1994; Mathias et al., 2014; North, 1990). All societies have not only formal institutions (i.e., codified laws and regulations) that define the legal rules of the game (prescribing what we here term 'government morality') but also informal institutions which are the 'socially shared rules, usually unwritten, that are created, communicated and enforced outside of officially sanctioned channels' (Helmke and Levitsky, 2004: 727), prescribing what we here term 'societal morality'.

The norms, values and beliefs of a society's informal institutions can be either 'complementary' if they reinforce formal institutions or 'substitutive' if their rules are incompatible with those of the formal institutions (Helmke and Levitsky, 2003; North, 1990; Williams and Vorley, 2014). When there is symmetry between formal and informal institutions therefore, the informal economy will be largely absent. However, when there is asymmetry between a society's formal institutions (government morality) and its informal institutions (societal morality), such as due to a lack of trust in government, the informal economy will be larger. As Webb et al (2009: 495) put it, 'the informal economy exists because of the incongruence between what is defined as legitimate by formal and informal institutions'. When there is institutional asymmetry, the informal economy, although 'illegal' in terms of the formal rules, will be deemed socially 'legitimate' in terms of the informal institutions (Siqueira et al., 2014). The empirical studies on tax morale (i.e., the social acceptability of the informal economy) measure the extent to which societal morality aligns with government morality (i.e., degree of institutional asymmetry). To test this new institutional theory of the informal economy, the following proposition can be therefore evaluated:

> Institutional asymmetry thesis: the lower is the tax morale, the greater is the propensity to participate in the informal economy.

Data and methodology

To evaluate this institutional asymmetry thesis, data is reported from special Eurobarometer survey no. 402, which involved 1,306 face-to-face interviews conducted in 2013 in United

Kingdom. A multi-stage random (probability) sampling methodology was employed which ensured that on the issues of gender, age, region and locality size, both the UK sample as well as each level of the sample, was representative in proportion to its population size. To analyse the UK, a weighting scheme is thus used which adjusts the British and the Northern Ireland samples to their respective proportions of the UK population. For univariate analysis, therefore, we employ this sample weighting scheme as recommended in both the wider literature (Sharon and Liu, 1994; Solon et al., 2013) and the Eurobarometer methodology, to obtain meaningful descriptive results. For the multivariate analysis however, a debate exists over whether to use a weighting scheme. Reflecting the dominant viewpoint, the decision was taken not to do so (Pfefferman, 1994; Sharon and Liu, 1994; Solon et al., 2013; Winship and Radbill, 1994).

The face-to-face interviews first asked participants attitudinal questions regarding their views on the acceptability of various informal economic practices, followed by questions on whether participants had purchased from the informal economy and finally, whether they had participated in the informal economy over the past year. Here, the focus is upon firstly, the attitudinal questions on the acceptability of working in the informal economy, which measure the level of tax morale, and secondly, the questions on whether they had participated in the informal economy.

To measure the level of tax morale, participants were asked six questions that rate their views on the acceptability of participating in the informal economy on a 10-point Likert scale (where 1 means absolutely unacceptable and 10 means absolutely acceptable), namely: an individual is hired by a household for work and s/he does not declare the payment received to the tax or social security authorities even though it should be declared; a firm is hired by a household for work and it does not declare the payment received to the tax or social security authorities; a firm is hired by another firm for work and it does not declare its activities to the tax or social security authorities; a firm hires an individual and all or a part of the wages paid to him/her are not officially declared; someone receives welfare payments without entitlement, and someone evades taxes by not declaring or only partially declaring their income. An aggregate tax morale index for each individual is then created by collating participants' responses to each of the six questions. The Cronbach's Alpha coefficient is 0.9 which shows an excellent internal consistency of the scale (Kline, 2000). The index has been represented here in the 10-point Likert scale original format. The lower the index value, the higher is the tax morale.

The dependent variable is therefore the aggregate tax morale index. As the dependent variable is a 10-point Likert scale index, we here employ an ordered logistic regression analysis. To evaluate whether tax morale is associated with participation in the informal economy, we include a variable measuring this, and drawing upon the above tax morale studies above which reveal how gender, age, marital status, social class, occupation, income level and area influence tax morale, the independent variables selected are:

- Participation in the informal economy: a dummy variable with recorded value 1 for persons who answered "yes" to the question, "Have you yourself carried out any undeclared paid activities in the last 12 months?" and with recorded value 0 otherwise.
- Gender: a dummy variable with value 1 for men and 0 for women.
- Age: a numerical variable for the exact age of the respondent.
- Marital Status: a categorical variable for the marital status of the respondent with value 1 for married/ remarried individuals, value 2 for cohabiters, value 3 for singles, value 4 for those separated or divorced, and value 5 for widowed.
- Social class: a categorical variable for the respondent perception regarding social class of society to which it belongs with value 1 for working class of society, value 2 for middle class of society, and value 3 for higher class, other or none class of society.

- Household composition aged 15+: a categorical variable for people 15+ years in respondent`s household (including the respondent) with value 1 for one person, value 2 for two persons, value 3 for 3 persons, and value 4 for 4 persons or more.
- Number of children (up to 14 years old in the household): a categorical variable for number of children with value 1 for individuals with no children, value 2 for the presence of children less than 10 years old live in respondent`s household, value 3 for the presence of children aged 10 to 14 years old live in respondent`s household, and value 4 for the presence of children less than 10 years old and children aged 10 to 14 years old live in respondent`s household.
- Occupation: a categorical variable for the occupation of the respondent with value 1 for self-employed, value 2 for employed, and value 3 for not working.
- Difficulties paying bills: a dummy variable for the respondent difficulties in paying bills with value 1 for having difficulties and value 0 for not having difficulties in paying bills.
- Urban/rural area: a categorical variable for the area where the respondent lives with value 1 for rural area or village, value 2 for small or middle sized town, and value 3 for large town.
- UK region: a categorical variable for the region where the respondent lives with value 1 for North West, value 2 for Northern Ireland, value 3 for North East, value 4 for Yorkshire and The Humber, value 5 for East Midlands, value 6 for West Midlands, value 7 for East of England, value 8 for London, value 9 for South East, value 10 for South West, value 11 for Wales, and value 12 for Scotland.

To analyse the results, firstly a descriptive analysis of the level of tax morale is provided, secondly, a simple bivariate regression of the relationship between tax morale and participation in the informal economy, and third and finally, an ordered logistic regression analysis to on the one hand, test the hypothesis that there remains an association between tax morale and participation in the informal economy when other independent control variables are introduced and held constant and on the other hand, to identify whether any socio-demographic, socio-economic and spatial variables are strongly associated with lower tax morale, so as to identify potential population groups where tax morale is weak.

Findings

The mean tax morale score for the UK population regarding the acceptability of participating in the informal economy is 2.02 (where 1 is totally unacceptable and 10 totally acceptable). The codified laws and regulations of formal institutions (government morality) and the norms, values and beliefs of the informal institutions (societal morality), therefore, are not wholly aligned (i.e., the tax morale score is not 1.00).

Nevertheless, the social acceptability of participation in the informal economy varies according to whether a firm or individual participates. As Figure 1 displays, the UK population deem it more unacceptable for firms than individuals to operate in the informal economy. The mean tax morale score for a firm hiring an informal worker is 1.92 and 1.91 for a firm doing informal work for a household, and is even lower (1.79) for firms doing informal work for another firm (i.e., the lower the score, the more unacceptable is the activity). Meanwhile, the UK population are more tolerant of individuals participating in the informal economy. The acceptability of a person partially or completely concealing their income is 1.97 and 2.63 for a person who engages in informal work for a household. The exception is those claiming benefits without entitlement, such as whilst working informally. This is the most unacceptable of all behaviours, scoring 1.69, doubtless because such individuals are here viewed as ‘taking our money’ rather than seeking to ‘keep their own money’. Similar patterns regarding the relative social acceptability of these different types of informal work are replicated across not only the EU15 but also the new member states of the European Union, whose overall tax morale is lower at 2.22 and 2.75 respectively.

INSERT FIGURE 1 ABOUT HERE

Is it the case, therefore, as the institutional asymmetry thesis proposes, that there is a relationship between the level of tax morale and participation in the informal economy? To evaluate this, the first step is to test whether the tax morale of individuals participating in the informal economy is lower than the tax morale of those not participating in the informal economy. Given that the distribution of tax morale is non-parametric, a Wilcoxon Rank Sum test, also known as the Mann-Whitney two-sample statistic, is used. The finding is a strong statistically significant difference in the median tax morale of those participating in the informal economy, which is 3, compared with those not engaging in informal work, whose median score is 1. Those participating in the informal economy thus have significantly lower tax morale than those not participating in the informal economy. This provides support for the institutional asymmetry thesis.

To determine whether this association between the level of tax morale and participation in the informal economy remains significant when other characteristics are taken into account and held constant, Table 1 reports the results of an ordered logistic regression analysis. The first row in models 1-3 reveals that lower tax morale remains strongly associated with participation in the informal economy across all models, whether socio-demographic variables alone are analysed, or whether socio-economic and/or spatial characteristics are added and held constant. This positively confirms the institutional asymmetry thesis; the greater is the non-alignment of government morality and societal morality, the higher is participation in the informal economy.

INSERT TABLE 1 ABOUT HERE

This ordered logistic regression analysis also identifies the socio-demographic, socio-economic and spatial groups significantly more likely to hold lower tax morale when all other characteristics are taken into account and held constant. As model 1 in Table 1 reveals, when other socio-demographic factors are held constant, men remain significantly more likely to have lower tax morale than women, as are younger age groups and people living in households with four or more adults. Interestingly however, there are no significant variations in tax morale for instance across social class or by marital status. When socio-economic characteristics are added in model 2, the same socio-demographic variables remain significant. However, neither employment status nor whether one has difficulties paying the bills significantly influence tax morale. The unemployed and those witnessing financial difficulties, for example, are not significantly more likely to have lower tax morale than those in employment and those without financial problems. Finally, when model 3 adds the spatial characteristics, the same socio-demographic variables continue to be significant and the additional finding is that rural areas have a lower tax morale than more urban areas, suggesting that participation in the informal economy may well be higher in such areas, which is reinforced by previous UK empirical studies comparing the prevalence of the informal economy in rural and urban areas (Williams, 2004). It is also the case that regional variations exist with Scotland having significantly lower tax morale than London, displaying perhaps how Scottish people have less allegiance to the codified rules and regulations of the UK government.

Discussion

Evaluating the institutional asymmetry thesis, a strong association is found between tax morale (i.e., the asymmetry between government morality and societal morality) and the propensity to participate in the informal economy. When institutional asymmetry is higher, the likelihood of participation in the informal economy is greater and this remains strongly significant when other socio-demographic, socio-economic and spatial variables are introduced and held constant. This UK survey thus positively confirms an institutional theory of the informal economy which asserts that the likelihood of participating in the informal economy will be greater in populations where tax morale is lower. It also reveals the populations most likely to display lower tax morale, namely men, younger people, those in households with more than adults, living in rural areas and Scotland.

This re-theorisation of the informal economy as resulting from the asymmetry between government morality and societal morality, moreover, has implications for how the informal economy is tackled. According to institutional theory, two basic mechanisms exist for tackling institutional asymmetry: disincentives (sticks) to prevent socially legitimate but illegal activities, or incentives (carrots) to encourage desirable legal activities (Matthias et al., 2014; North 1990). Conventionally, governments have used disincentives to ensure that the cost of being caught and punished is greater than the pay-off from participating in the informal economy (Allingham and Sandmo, 1972). Firstly, penalties and sanctions have been raised and/or secondly, the likelihood of detection improved such as by increasing workplace inspections and by improving data sharing and matching to identify individuals engaged in informal work (e.g., Hasseldine and Li, 1999). The problem with this disincentives approach however, is that introducing tougher sanctions and improving detection reduces voluntary compliance because it undermines respect for the fairness of the system and leads to greater rather than less informality (Chang and Lai, 2004; Murphy, 2005; Murphy and Harris, 2007).

Hence, a rather different approach is required. Two options exist. Firstly, incentives to behave legally can be offered, such as direct and indirect tax incentives to either suppliers or consumers of informal work to operate in the formal economy. The problem however, is that offering incentives fails to deal with the underlying desire of people not to comply because their morality does not adhere with government morality. To tackle this, a second and rather different approach is required. Drawing inspiration from a large body of research at the organisational level where there has been a shift from 'hard' to 'soft' HRM, and from bureaucratic to post-bureaucratic management (Legge 1995; Thompson and Alvesson 2005; Watson 2003), a similar shift is here advocated at the societal level when tackling participation in the informal economy. In other words, a move is advocated away from a low commitment, low trust and adversarial 'hard' policy approach, which seeks compliance via prescribed procedures, tight rules, close supervision and monitoring and centralised structures. Instead, a high trust, high commitment 'soft' policy approach is advocated that fosters internalised commitment and self-regulation by seeking to align the norms, values and beliefs of the population ('societal morality') with the codified laws and regulations of formal institutions ('government morality'). This requires changes in the norms, values and beliefs of the UK population. If this is to occur however, it also requires changes in formal institutions.

Changing informal institutions

To change informal institutions ('societal morality'), three policy initiatives can be pursued. Firstly, tax education is required to align the beliefs, norms and values of the population with the formal rules and elicit an intrinsic motivation to comply (Saeed and Shah, 2011). This requires not only the provision of easily consumable information on their responsibilities with regard to compliance (Vossler et al., 2011) but also education about the value and benefits of paying taxes in order to elicit an intrinsic motivation to comply. For example, ‘your taxes are paying for this’ signs can be used in hospitals, on ambulances and on public construction projects, or letters informing taxpayers how their taxes have been spent, as recently adopted in the UK.

Secondly, advertising campaigns about the benefits of working in the formal rather than informal economy can be used. These can either inform: employers or employees of the risks and costs of the informal economy, or employers and/or employees of the benefits of operating in the formal economy. Indeed, the evidence is that advertising campaigns are effective and cost efficient. In the UK, an evaluation of the advertising campaigns run by Her Majesty’s Revenue and Customs (HMRC) reveals a return of 19:1 on the expenditure compared with a return of 4.5: 1 on expenditure detecting those operating in the informal economy (National Audit Office, 2008). The above analysis reveals the population groups to be targeted by such advertising campaigns, namely men, younger people, those living in households with more than four adults, in rural areas and Scotland.

And third and finally, appeals can be used. Hasseldine et al. (2007) examine 7300 sole proprietors in the UK. Comparing the effect of five different letters ranging from a simple assistance offer to a letter stating that their tax return had been pre-selected for audit, they find that appeals resulted in greater compliance. Sanction appeals however, were more effective than normative appeals.

Changing formal institutions

Improving tax morale nevertheless, does not simply require a focus upon changing societal morality. Formal institutions must also change. This requires at least three types of improvement. Firstly, procedural fairness is required, which is the extent to which citizens believe they are paying their fair share compared with others (Kirchgässner, 2011; Molero and Pujol, 2012). People who receive procedurally fair treatment are more likely to trust that organisation and will be more inclined to accept its decisions and follow its directions (Murphy, 2005). Conversely, where unfair treatment is perceived either in absolute terms (e.g., the level of taxes paid, that taxes are wasted) or in relative terms (e.g., the suspected level of others evasion or payments), non-compliance increases. The implication is that if the authorities advertise that the informal economy is rife, they elicit grievance and thus engagement in the informal economy by those who might not have done so.

Secondly, procedural justice is required, which refers to whether citizens believe that the tax authority treat them in a respectful, impartial and responsible manner (Murphy, 2005). This requires a shift from a ‘cops and robbers’ approach and towards a customer-service oriented approach (Kirchler, 2007; Murphy, 2005, 2008). Being treated with dignity and respect, politely, being given a say and having genuine respect shown for one rights and social status enhance compliance (Hartner et al., 2008; Murphy 2005; Tyler, 2006). Conversely, if citizens feel that they are treated unreasonably, this generates a lack of trust and resistance to compliance (Murphy, 2008).

Third and finally, redistributive justice is required, which refers to whether they believe that they receive the goods and services they deserve given the taxes they pay (Kirchgässner, 2011). Taxes are prices for the goods and services provided by the government. The question for the moral evaluation of taxes is whether the price corresponds to the value of these services (i.e., whether it is seen as ‘just’), namely whether there is a ‘just price’ (Kirchgässner, 2011). Citizens see themselves as more justified being non-compliant, the less they perceive the tax system as fair. If customers believe they receive what they view as appropriate public goods and services for the taxes they pay, their identification with the state increases and willingness to contribute is greater. If however, citizens do not receive the goods and services that they believe they deserve given the taxes that they pay, then non-compliance increases (McGee, 2005).

Conclusions

To explain participation in the informal economy, this paper has evaluated the relationship between the informal economy and tax morale. Viewing tax morale as a measure of the symmetry between the codified laws and regulations of formal institutions (government morality) and the unwritten socially shared rules of informal institutions (societal morality), the proposition has been tested that the lower the tax morale (i.e., the greater the asymmetry between government and societal morality), the greater is the propensity to participate in the informal economy. Using data from the UK, this paper has positively confirmed this new institutional theory of the informal economy.

This has implications for reducing participation in the informal economy. It reveals the need for a policy shift away from the use of disincentives that detect and punish those participating in the informal economy and towards fostering a high trust high commitment culture to align societal morality with government morality. On the one hand, this requires improvements in tax morale using education and awareness raising measures regarding the benefits of paying taxes. On the other hand, and to facilitate this, it also requires changes in formal institutions by developing a service-oriented approach which treats taxpayers as clients and pursues greater procedural justice, procedural fairness and redistributive justice, so as to improve tax morale and reduce participation in the informal economy.

The major limitation of this paper, nevertheless, is that although the quantitative analyses displays the importance of aligning societal morality with government morality, it has not identified the reasons for institutional asymmetry. Future qualitative research is therefore required to identify the reasons, such as whether it is due to a perception that tax rates are too high, a lack of trust in government or lack of understanding of the taxation system and how taxes are used.

In sum, this paper has outlined a new explanation for participation in the informal economy grounded in institutional theory. Whether this is valid in other European countries and global regions now requires evaluation. If this paper therefore stimulates such evaluations, it will have achieved one of its objectives. However, if governments also start viewing participation in the informal economy as resulting from lower tax morale and begin exploring policy measures for improving such morale, rather than persisting with the detection and punishment of those participating in the informal economy, then this paper will have achieved its wider intention.

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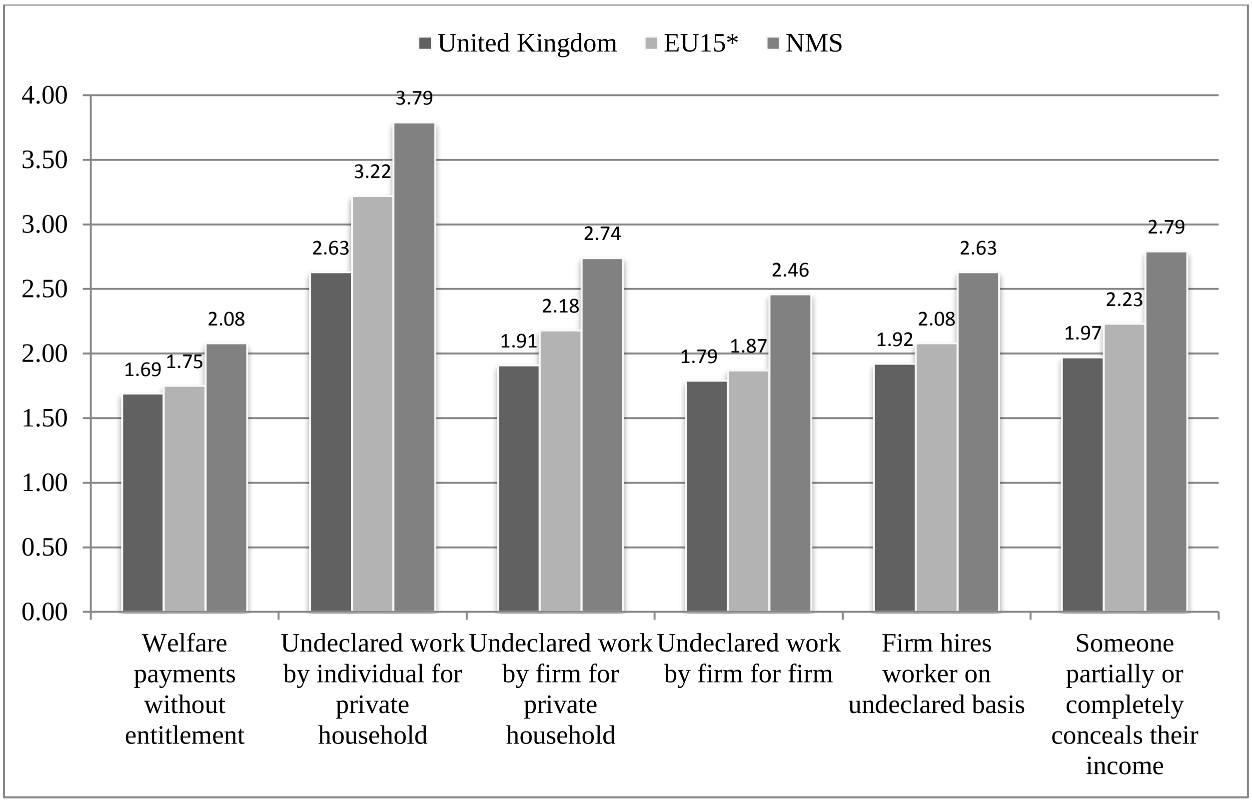
Figure 1. Social acceptability of participation in different types of informal work: UK, EU15 and new member states



Notes:
NMS – Bulgaria, the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovenia, Slovakia, Croatia
EU15 (United Kingdom excluded.) – Austria, Belgium, Denmark, Germany, Greece, Finland, France, Ireland, the Netherlands, Norway, Luxembourg, Portugal, Spain, Sweden.

Table 1. Acceptability of informal economy: ordered logistic model

	Model 1	Model 2	Model 3
Informal work (Not engaged)			
Engaged	1.738*** (0.362)	1.745*** (0.365)	1.774*** (0.379)
Gender (Women)			
Men	0.406*** (0.117)	0.406*** (0.119)	0.424*** (0.120)
Age (exact age)	-0.0130*** (0.004)	-0.0137*** (0.005)	-0.0149*** (0.005)
Marital status (Re/Married)			
Single living with partner	-0.0986 (0.201)	-0.121 (0.204)	-0.108 (0.203)
Single	-0.0610 (0.205)	-0.0716 (0.215)	-0.0572 (0.220)
Divorced or separated	0.112 (0.242)	0.102 (0.246)	0.0986 (0.255)
Widow	0.379 (0.268)	0.368 (0.273)	0.328 (0.279)
Social class (The working class of society)			
The middle class of society	0.148 (0.117)	0.135 (0.119)	0.122 (0.123)
The higher class/Other/None	-0.413 (0.301)	-0.429 (0.302)	-0.467 (0.306)
Household composition aged 15+ (One)			
Two	0.0569 (0.198)	0.0409 (0.201)	-0.0107 (0.206)
Three	0.175 (0.224)	0.196 (0.233)	0.0901 (0.238)
Four or more	0.592** (0.249)	0.573** (0.255)	0.537** (0.261)
Number of children (No children)			
Children < 10 years	-0.204 (0.183)	-0.201 (0.183)	-0.170 (0.182)
Children 10-14 years	0.267 (0.205)	0.261 (0.209)	0.241 (0.218)
One or more < 10 years and 10-14 years	-0.124 (0.265)	-0.133 (0.265)	0.000887 (0.274)
Occupation (Self-employed)			
Employed		0.0368 (0.217)	0.141 (0.225)
Not working		0.0515 (0.226)	0.0786 (0.231)
Difficulties paying bills last year (Not having difficulties)			
Having difficulties		-0.0309 (0.136)	-0.0140 (0.139)
Area respondent lives (Rural area or village)			
Small/middle town			-0.380*** (0.144)
Large town			-0.355** (0.173)
Region (London)			
Northern Ireland			0.327 (0.237)
North East			0..522 (0.368)
Yorkshire and The Humber			0.192 (0.294)
East Midlands			0.048 (0.316)
West Midlands			0.449 (0.285)
East of England			0.255 (0.283)
North West			-0.476 (0.305)
South East			0.153 (0.267)
South West			0.234 (0.333)
Wales			0.120 (0.407)
Scotland			0.718** (0.305)
Constant cut1	-0.202 (0.388)	-0.225 (0.453)	0.134 (0.494)
Constant cut2	0.750* (0.390)	0.718 (0.454)	1.092** (0.496)
Constant cut3	1.616*** (0.393)	1.595*** (0.454)	1.982*** (0.497)
Constant cut4	2.399*** (0.402)	2.372*** (0.464)	2.766*** (0.507)
Constant cut5	3.171*** (0.419)	3.131*** (0.479)	3.531*** (0.521)
Constant cut6	3.943*** (0.445)	3.903*** (0.500)	4.310*** (0.544)
Constant cut7	4.604*** (0.486)	4.565*** (0.536)	4.977*** (0.576)
Constant cut8	5.124*** (0.553)	5.084*** (0.593)	5.498*** (0.633)
Constant cut9	6.227*** (0.799)	6.188*** (0.832)	6.600*** (0.859)
N	1,169	1,155	1,155
Pseudo R^2	0.0225	0.0222	0.0303
Log likelihood	-1592.3262	-1572.7764	-1559.7738
χ^2	77.79	75.32	102.73
p>	0.0000	0.0000	0.0000

Notes: significant at *** p<0.01, ** p<0.05, * p<0.1 (robust standard errors in parentheses); All coefficients are compared to the benchmark category, shown in brackets.