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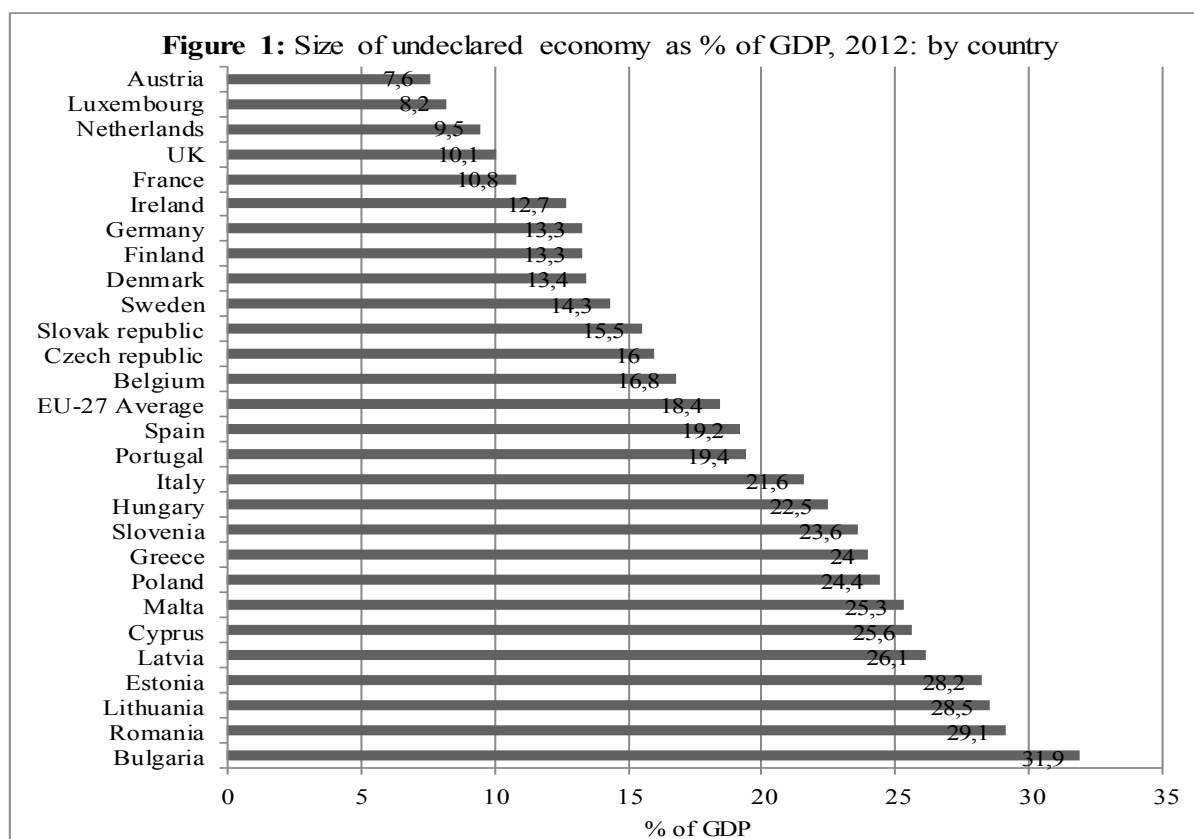
# Tackling Europe's undeclared economy

by Colin C. Williams

Across the European Union, many businesses and individuals hide some or all of their monetary transactions from the public authorities either for tax, social security and/or labour law purposes. Although they may personally benefit from doing so, there are also significant wider costs. This undeclared economy creates risks for the health and safety of workers and damages working conditions, hinders job creation, puts at greater risk the financial stability of social protection systems and causes unfair competition for legitimate business (Williams, 2014).

## How big is the undeclared economy?

Estimating the size of the undeclared economy is difficult because it is by definition hidden from view. The most widely-used measurement method – the DYMIMIC (dynamic multiple-indicators multiple-causes) technique (Schneider, 2005) - estimates the size of the undeclared economy in the European Union (EU) to be 18.4 per cent of GDP, ranging from 7.6 per cent in Austria to 31.9 per cent in Bulgaria, with a clear East-West and North-South divide (see Figure 1). No Western and Northern European countries have undeclared economies larger than the EU average and most East-Central and Southern European nations have above average undeclared economies.



Source: derived from Schneider (2013)

If all of this undeclared work was declared, European public expenditure could increase by around one-fifth, and healthcare expenditure for example could be doubled (Murphy, 2012).

### **What types of undeclared work exist?**

For a long time, the undeclared economy was viewed as composed of low-paid waged work conducted under ‘sweatshop’ conditions. However, there is a continuum of wage levels in the undeclared economy, just as in the declared economy. Although the mean wage is lower than in the declared economy, there is overlap with some undeclared waged work higher paid than declared employment (Krstić and Sanfey, 2011). There is also recognition that some declared employees sometimes receive two wages from their formal employer; an official declared salary and an additional undeclared (‘envelope’) wage.

However, much undeclared work is self-employment. At one end are profit-motivated varieties. These range from ‘bogus self-employment’, where a person works for one employer but is self-employed and pays no wage tax and has no rights (e.g., dismissal protection, vacation entitlements), through to various forms of ‘real’ self-employment. This ranges from registered traders undertaking some of their transactions off-the-books, to unregistered enterprises trading wholly off-the-books. One outcome has been a re-reading of the undeclared economy as a ‘hidden enterprise culture’. Indeed, in both OECD nations and developing countries, two-thirds of all businesses start-up unregistered in the informal economy (Autio and Fu, 2015).

Yet other undeclared self-employment is more community-oriented rather than market-like, ranging from for-profit entrepreneurs conducting jobs for social rationales (e.g., when an elderly person is charged less than the market rate) to paid favours conducted for, and by, close social relations to help each other out (e.g., paying an unemployed family member to do your decorating so as to give them money, which they would not otherwise accept because they would see it as charity).

### **How can the undeclared economy be tackled?**

There are four hypothetical policy options: do nothing; move declared work into the undeclared economy; eradicate the undeclared economy, or transfer undeclared work into the declared economy. Doing nothing is unacceptable; it leaves intact the negative impacts on formal businesses, undeclared enterprises and workers, customers and governments discussed at the outset. Deregulating the declared economy is also a non-starter because it results in a levelling down of working conditions. Eradicating undeclared work is unworkable because it would with one hand squash precisely the active citizenship and entrepreneurship that with other hands governments want to foster. Moving undeclared work into the declared economy thus appears the most viable policy option. How, therefore, can this best be done?

### **Direct versus indirect controls**

Changing the behaviour of businesses, workers and consumers is difficult. If one views participants as rational economic actors, then one can increase the costs of operating in the undeclared economy and the benefits of operating in the declared economy. As Table 2 shows, this leads to a direct controls approach which usually uses ‘sticks’ to punish non-compliant (‘bad’) behaviour (i.e., negative reinforcement), although recent years have seen the increasing use of ‘carrots’ to reward compliant (‘good’) behaviour (i.e., positive reinforcement).

Less discussed until now in EU policy circles has been an indirect controls approach which views participants as ‘social actors’ and instead focuses upon developing the social contract between the state and citizens to engender a voluntary commitment to compliant behaviour and thus greater self-regulation.

Interviewing senior government officials involved in tackling the undeclared economy in 31 European countries in 2010, 57 per cent stated that the use of ‘sticks’ (i.e., deterrence measures) is accorded the most importance in their country, 33 per cent ‘carrots’ (i.e., incentive measures) and 10 per cent indirect controls.

**Table 2:** Policy measures for tackling the undeclared economy

Approach	Method	Measures (examples)
Direct controls: deterrents	Improved detection	Data matching and sharing Joined up operations and strategy
	Increased penalties	Increased penalties for evasion
	Increase perception of risk	Advertising the penalties Advertising the effectiveness of detection
Direct controls: incentives	For businesses	Simplification of compliance Direct and indirect tax incentives Supply chain responsibility Support and advice to start-ups
	For individuals	Supply-side incentives (e.g. society-wide amnesties; voluntary disclosure; smoothing transition to formalization) Demand-side incentives (e.g. service vouchers; targeted direct and indirect taxes)
Indirect controls	Fostering culture of commitment	Promoting benefits of declared work Education and awareness raising Tax fairness Procedural fairness and justice Redistributive justice

Source: derived from Williams (2014: Table 5.2)

These different policy measures to harness this sphere however, are not mutually exclusive. Indeed, they can be combined in at least two ways. Firstly, there is a responsive regulation approach which starts out by openly engaging citizens to consider their obligations and take responsibility for regulating themselves rather than need to be regulated by external rules. This facilitating of voluntary 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 (Job *et al.*, 2007). A second approach is the ‘slippery slope framework’ (Kirchler *et al.*, 2008) which pursues both voluntary and enforced compliance concurrently, developing both greater trust in authorities and the greater power of authorities (Kogler *et al.*, 2015). Until now however, which sequencing and/or combination is the most effective approach has not been evaluated.

What is certain nevertheless, is that the currently dominant approach in the European Union of using ‘sticks’ to elicit compliant behaviour needs to change. The EU platform for tackling undeclared work being established at present by the European Parliament could facilitate this shift. Hopefully, it will do so.

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