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## **Do small business start-ups test-trade in the informal economy? Evidence from a UK survey**

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**Abstract:** The aim is to evaluate critically whether small businesses start-up in the informal economy and whether they do so to test-trade the viability of their businesses. Reporting a 2012 survey of 595 small business owners in the UK, 20% report trading informally when starting their business, 64% of whom asserted a main reason was to test its viability. Some 13% of all small businesses therefore start-up test-trading in the informal economy, although multivariate analysis shows that businesses started by men, with low current annual turnovers in particular sectors are significantly more likely to do so. Regional variations are not significant. The outcome is a call for not only similar studies in other countries to determine the proportion of enterprises that start up test-trading in the informal economy but also a discussion of the policy implications of this finding.

**Keywords:** informal economy; underground sector; shadow economy; nascent entrepreneurship; business start-up; venture creation; enterprise development; UK.

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## **1 Introduction**

Over the last decade or so, a view has taken hold in western economies and well beyond that many small businesses start-up trading in the informal economy so as to test-trade the viability of their business (Copisarow and Barbour, 2004; Dellot, 2012; European Commission, 2007; Katungi et al., 2006; OECD, 2012). This view has had a major influence on public policy. The conventional deterrence approach of tax administrations that sought to eradicate informal sector entrepreneurship is now widely believed to result in one hand of government, namely tax administrations, eliminating precisely the entrepreneurship that other hands of governments so desperately wish to nurture (Small Business Council, 2004). The resultant outcome has been that tax administrations in western economies have since the turn of the millennium begun to shift towards an enabling approach that seeks to facilitate the formalisation of such ventures (Dana, 2013; Dekker et al., 2010; OECD, 2012; Williams and Nadin, 2012a; Williams and Renooy, 2013). The starting point of this paper, however, is that few, if any, empirical studies have evaluated whether small businesses start-up trading in the informal economy and do so to test-trade the viability of their business venture. The aim of this paper is to begin to fill that gap. To achieve this, evidence will be reported from a 2012 survey of 595 owners of small businesses in the UK.

In the first section of this paper, therefore, a brief literature review of the informal sector entrepreneurship literature is undertaken so as to reveal that despite the emerging consensus that many entrepreneurs start-up their ventures in the informal economy in order to test-trade its viability, evaluations of whether this is the case are notable by their absence. To begin to fill this gap, the second section will then introduce a UK panel survey of 595 small business owners and the methodology employed to analyse this data, and the third section will evaluate the findings. The concluding section will then discuss the implications for theorising the relationship between the informal economy and small business start-ups and the consequent policy implications of the findings.

Before commencing, however, the informal economy must be defined. Reviewing the extensive literature, at least 45 different adjectives have been employed to describe informality, including 'atypical', 'cash-in-hand', 'hidden', 'irregular', 'non-visible', 'shadow', 'undeclared', 'underground' and 'unregulated'. Nearly all describe what is insufficient or missing relative to the formal economy. Despite these diverse terms, however, a strong consensus is that what is missing or absent is that this remunerated production and sale of goods and services is legitimate in all respects besides the fact that it is unregistered by, or hidden from the state for tax and/or benefit purposes (European Commission, 1998; Evans et al., 2006; Katungi et al., 2006; Marcelli et al., 1999; OECD, 2000, 2002; Renooy et al., 2004; Portes, 1994).

## **2 Business start-ups and the informal economy: a review of the literature**

Reviewing the conventional literature on entrepreneurship, entrepreneurs were revered as ‘economic heroes’ (Cannon, 1991), even ‘super heroes’ [Burns, (2001), p.24] who always play by the rulebook (Burns, 2001; Cannon, 1991). In other words, an ‘ideal type’ depiction of entrepreneurs was adopted which represented them as objects of desire (Berglund and Johansson, 2007; Jones and Spicer, 2005; Williams, 2008a, 2008b). The result was that forms of entrepreneurship not conforming to this ideal-type were either ignored, portrayed as temporary or transient forms of entrepreneurship, or simply delineated as not being ‘proper’ entrepreneurship.

Over the past few decades, nevertheless, this ideal-type depiction of entrepreneurs has started to be contested. Following in the path of the classic study of entrepreneurs as people who do not always play by the rulebook (Collins et al., 1964), an emergent literature has begun to reveal the dark side of entrepreneurship. This has revealed how entrepreneurs sometimes not only participate in illegitimate activities (Armstrong, 2005; Fournier, 1998; Gottschalk, 2010; Gottschalk and Smith, 2011; Rehn and Taalas, 2004; Sköld and Rehn, 2007) but also how many engaged in criminal or illegitimate activity possess entrepreneurial attributes, such as drug-dealers (Bouchard and Dion, 2009; Frith and McElwee, 2008), prostitutes and pimps (Smith and Christou, 2009).

Within this rapidly growing ‘dark side’ literature, a burgeoning sub-stream has emerged arguing that entrepreneurs often operate partially or wholly in the informal economy (Adom and Williams, 2012; Aidis et al., 2006; Antonopoulos and Mitra, 2009; Dana, 2010, 2013; Gurtoo and Williams, 2010; Hudson et al., 2012; Ram et al., 2007; Small Business Council, 2004; Valenzuela, 2001; Webb et al., 2009; Williams, 2007, 2008, 2010; Williams and Gurtoo, 2013; Williams et al., 2012a, 2012b, 2013a, 2013b). Indeed, it is argued that many businesses start-ups trade in the informal economy in order to test-trade the viability of their business before moving towards formalisation (Community Links and the Refugee Council, 2011; Copisarow, 2004; Copisarow and Barbour, 2004; Katungi et al., 2006; Llanes and Barbour, 2007; Small Business Council, 2004; Williams et al., 2011, 2012a, 2012b).

Based on this belief that a large number of businesses start-up in the informal economy to test-trade their business, a view has taken hold that the conventional deterrence approach of tax administrations that seeks to stamp out informal sector entrepreneurship results in governments eradicating with one hand precisely the entrepreneurship that other hands of governments are so desperately seeking to nurture (Dellot, 2012; Small Business Council, 2004; Williams et al., 2012a, 2012b). The resultant outcome has been that tax administrations throughout the western world have since the turn of the millennium begun to move away from their conventional approach of seeking to eliminate such endeavour and instead shifted towards an enabling approach that has sought to develop policy measures to facilitate the formalisation of such ventures (Dekker et al., 2010; European Commission, 2013; OECD, 2012; Williams and Nadin, 2012a, 2012b; Williams and Renooy, 2013).

This has resulted in the conventional deterrence measures that seek to increase the likelihood of detection and penalties being complemented by a raft of enabling policy measures. Firstly, preventative measures have been adopted to stop non-compliance from the outset. Such measures have included: simplifying regulatory compliance; introducing new categories of legitimate work; the provision of business support and advice, as well as direct and indirect tax incentives, and the development of initiatives to smooth the

transition to self-employment. Secondly, incentives have been used to help those already participating in the informal economy to become legitimate. These curative measures have included: offering amnesties on either a societal or individual level to those who put their affairs in order; offering business advisory and support services to those seeking to formalise their endeavours, and providing a range of targeted direct or indirect tax incentives encouraging customers to engage in formal rather than informal transactions with traders. Thirdly, commitment measures have been adopted that seek to encourage an allegiance to tax morality. Such measures include tax education and awareness raising about the benefits of formal transactions, peer surveillance, and the pursuit of perceived tax fairness, procedural justice and redistributive justice (for a review, see Williams and Renooy, 2013).

Until now, however, despite the widespread belief that many business start-ups test-trade in the informal economy and the consequent shift in the policy of tax administrations towards an enabling formalisation approach, few studies have evaluated the proportion of businesses that start-up in the informal economy. One of the few studies to have done so is a survey of three countries, namely Russia, Ukraine and England which finds that 100%, 90% and 77% respectively, of nascent entrepreneurs trade in the informal economy (Williams, 2008a) and that such a tendency is not evenly distributed across space. Reporting the results of face-to-face interviews conducted in affluent and deprived urban and rural English localities with 91 early-stage entrepreneurs, Williams (2010) reveals that their preponderance to trade informally is greater in deprived and rural localities. In affluent urban and rural areas, that is, some 58% and 62% of early-stage entrepreneurs, respectively, trade informally, but 84% and 87% in deprived urban and rural localities. Until now, no larger scale survey has been conducted. This is a major gap that needs to be filled. Below, in consequence, one of the first studies to start to bridge this gap is reported.

### **3 Data, variables and methods**

To evaluate whether the informal economy is a test-bed for small business start-ups and the influence of various socio-demographic, firm-level and spatial factors on the propensity to trade informally, in August 2012, funded by the Royal Society of the Arts (RSA), YouGov Plc GB were commissioned to conduct an online interview with a sample of the 350,000+ individuals on their survey participant database. Here, the results are reported of several questions posed only to the panel survey participants who were small business owners responsible for setting up their businesses. The responding sample has been weighted to the profile of the sample definition to provide a representative reporting sample. The profile is normally derived from census data or, if not available from the census, from industry accepted data.

Here, the results are reported of the responses of 595 small business owners responsible for setting up their business to questions on whether the informal economy is a test-bed for small business start-ups. This survey investigated two issues, each of which are here treated as dependent variables:

- 1 The first dependent variable is dichotomous with value 1 for those who answer yes to the following question: *When starting any of your businesses, were there any periods, however brief, where you traded informally (where you were not fully registered as a business)* and value 0 otherwise.
- 2 The second dependent variable asked to those answered affirmatively to trading informally, is “*which three, if any, of the following were the main reasons for this (Please tick up to three options): I wanted to see if the business would be viable first; I was unaware that I had to register my business; I wanted to earn extra income that would otherwise have been taxed; It gave me the breathing space before I had the capacity to register my business; I didn’t know who to go to about registering my business; other reasons*”.

Given the categorical nature of the dependent variables, for the empirical analyses we use discrete choice models, namely an ordered logit model for the dependent variables.

The multivariate analyses for each dependent variable presented in the next section are based on a series of additive models. Model 1 only includes the small business owners’ socio-demographic characteristics, model 2 adds firm-level characteristics and model 3 the regional location of the business. In order to allow comparisons across the models both within and between the three dependent variables, the analysed results are presented using estimated probabilities for the occurrence of each of the outcomes of interest for those independent variables that reach the standard levels of statistical significance.<sup>1</sup> The measure of the magnitude of the effect of the significant variables is obtained by comparing them with the average predicted probability for each model where all variables are placed at their sample means.

The independent variables used in the additive models discussed above are as follows:

- a *Socio-demographic variables*: a dummy variable for the small business owners gender with value 1 for female and 0 for male; a categorical variable for the age of the entrepreneur with value 1 for those aged 18 to 34 years old, value 2 for those between 35 and 44, value 3 for those aged 45 to 54, and value 4 for those over 55 years old; and a continuous variable counting the number of decision-making tasks in which the entrepreneur is involved in the firm. The variable ranges from 0 to 28, the maximum of tasks included in the survey.
- b *Firm-level variables*: a categorical variable for the number of employees with value 1 for self-employed entrepreneurs with no employees, value 2 for those up to two employees, value 3 for those between three and five employees, value 4 for firms with six to nine employees, and value 5 for firms with ten to 49 employees; a categorical variable for the annual turnover of the firm with value 0 for those who do not report the amount, value 1 for firms which are in the first year of trading, value 2 for those reporting less than £25,000, value 3 for those between £25,000 to £49,999, value 4 for those with an annual turnover between £50,000 to £99,999, value 5 for those between £100,000 to £249,999, value 6 for those reporting between £250,000 to £499,999, value 7 for those with an annual turnover between £500,000 to £999,999, and value for those firms reporting between £1 million to £19,99 million; and a categorical variable for the industrial sector of the firm with value 1 for accountancy firms, value 2 for construction, value 3 for education, value 4 for firms in the financial sector, value 5 for those in the hospitality and leisure sector, value 6

for IT and telecommunications, value 7 for firms in the legal services sector, value 8 for manufacturing firms, value 9 for media, marketing and advertising firms, value 10 for medical and health services firms, value 11 for firms in a default category other, value 12 for real estate firms, value 13 for retail firms, and value 14 for firms in the transport and distribution sector.

- c *Regional location variable*: a categorical variable for the region in which the firm is located with value 1 for the East region, value 2 for the London area, value 3 for the midlands, value 4 for the North region, value 5 for Scotland, value 6 for the South region, and value 7 for Wales.

## 4 Results

To analyse the results, we firstly examine whether small business owners started-up their business in the informal economy and secondly, whether they did so in order to see if their business was viable.

### 4.1 Do small business owners trade informally when starting up?

To examine whether small business owners had themselves traded informally when starting-up their business, participants were asked ‘When starting any of your businesses, were there any periods, however brief, where you traded informally?’. Some 20% asserted that this was the case. However, this tendency to trade informally when starting-up a business was unevenly distributed. To analyse the socio-demographic, firm-level and regional determinants of whether they did so, Table 1 reports the logit regressions for the odds of engagement in informal trading amongst small business owners when starting-up their business.

**Table 1** Logit regressions for the odds of the engagement into informal economy practices among UK’s small size entrepreneurs

<i>Variables</i>	<i>(1) model</i>	<i>(2) model</i>	<i>(3) model</i>
Female	<b>-0.648** (0.281)</b>	<b>-0.750** (0.313)</b>	<b>-0.751** (0.317)</b>
<i>Age</i> (RC:18 to 34 years old):			
35 to 44	-0.711 (0.530)	-0.634 (0.533)	-0.625 (0.538)
45 to 54	<b>-0.800* (0.488)</b>	<b>-0.824* (0.495)</b>	<b>-0.806* (0.499)</b>
55+	-0.517 (0.466)	-0.502 (0.474)	-0.522 (0.480)
Decision-making index	-0.011 (0.013)	-0.004 (0.014)	-0.002 (0.014)
<i>Number of employees</i> (RC: no employees):			
1 to 2		-0.462 (0.311)	-0.432 (0.316)
3 to 5		0.447 (0.359)	0.500 (0.367)
6 to 9		0.735 (0.576)	0.804 (0.590)
10 to 49		1.118 (0.727)	<b>1.150* (0.709)</b>

Notes: Robust standard errors in parentheses

\*\*\*p < 0.01, \*\*p < 0.05, \*p < 0.1

Source: RSA Untapped Enterprise dataset

**Table 1** Logit regressions for the odds of the engagement into informal economy practices among UK's small size entrepreneurs (continued)

<i>Variables</i>	<i>(1) Model</i>	<i>(2) Model</i>	<i>(3) Model</i>
<i>Annual turnover</i> (RC: not reported)			
First year of trading		0.978 (0.607)	0.966 (0.608)
Less than £25,000		<b>0.926*** (0.346)</b>	<b>0.973*** (0.349)</b>
£25,000 to £49,999		<b>0.682* (0.368)</b>	<b>0.757** (0.369)</b>
£50,000 to £99,999		0.237 (0.381)	0.234 (0.382)
£100,000 to £249,999		-0.447 (0.450)	-0.450 (0.460)
£250,000 to £499,999		-1.071 (0.701)	-1.106 (0.718)
£500,000 to £999,999		-0.566 (0.819)	-0.583 (0.825)
£1 million to £19.99 million		-0.024 (0.712)	0.010 (0.702)
<i>Industrial sector</i> (RC: accountancy)			
Construction		1.061 (0.686)	0.964 (0.691)
Education		<b>1.676** (0.753)</b>	<b>1.673** (0.766)</b>
Financial services		1.209 (0.793)	1.163 (0.796)
Hospitality and leisure		0.274 (0.813)	0.374 (0.811)
IT and telecoms		0.946 (0.662)	0.950 (0.662)
Legal		-0.492 (1.209)	-0.405 (1.171)
Manufacturing		<b>1.218* (0.746)</b>	1.171 (0.747)
Media/marketing/advertising/PR and sales		1.033 (0.696)	0.977 (0.694)
Medical and health services		<b>1.655** (0.800)</b>	<b>1.598** (0.800)</b>
Other		0.826 (0.651)	0.775 (0.660)
Real estate		0.970 (0.779)	0.953 (0.788)
Retail		0.694 (0.698)	0.699 (0.705)
Transportation and distribution		0.768 (1.076)	0.672 (1.084)
<i>Region</i> (RC: East)			
London			0.229 (0.490)
Midlands			-0.004 (0.473)
North			0.029 (0.452)
Scotland			0.491 (0.499)
South			0.010 (0.424)
Wales			-1.197 (0.827)
Constant	-0.503 (0.470)	-1.806** (0.768)	-1.863** (0.869)
N	577	577	577
Pseudo R <sup>2</sup>	0.018	0.089	0.098
Log likelihood	-288.33	-267.51	-264.81
$\chi^2$	9.60	43.28	48.97
p>	0.0875	0.055	0.073

Notes: Robust standard errors in parentheses

\*\*\*p &lt; 0.01, \*\*p &lt; 0.05, \*p &lt; 0.1

Source: RSA Untapped Enterprise dataset

This reveals that women business owners were less likely when starting-up their business to have engaged in informal trading compared with men. This result remains significant in model 3 after controlling for firm-type and regional location. Another consistent pattern is that middle age small business owners were less likely to rely on informal trading when starting their business compared with younger owners. Involvement in decision-making activities is negative meaning that the more involved the business owner is taking decisions in the firm, the less likely it is that the business traded informally during the start-up phase. Nevertheless, this effect does not reach the standard significant levels in any of the models.

Turning to firm-level determinants, model 3 provides evidence that small business owners with larger numbers of employees were more likely to have engaged in informal trading during the start-up phase even when controlling for socio-demographic and regional location. It appears, therefore, that successful small businesses measured in terms of the number of people they employ, engaged in informal trading during their start-up phase. This is an important finding if confirmed in future studies. It intimates that the larger more successful small firms were more likely to have started-up trading in the informal economy, providing strong support for tax administrations continuing to pursue an enabling formalisation policy approach rather a deterrence approach.

Examining engagement in informal trading at start-up by the current turnover of the business, however, a rather different finding emerges. Businesses with relatively low annual turnovers up to £49,999 as reported in models 2 and 3 are more likely to have traded informally during start-up. Turning to sectors, the finding is that informal trading during start-up is concentrated in some sectors more than others. The results of the last two additive models reveal that businesses operating in the educational sector and in medical and health services are more prone to informal trading during start-up than others. The same applies to business start-ups in the manufacturing sector, although this effect disappears after controlling for regional location.

Finally, and examining whether the tendency of businesses to start-up trading informally varies regionally, this is not found to have any significant effect on the likelihood of engagement in informal trading during start-up. As the goodness of fit measures reported at the bottom of Table 1 reveal, overall, socio-demographic and particularly firm-level characteristics are the key determinants of the odds of trading informally during start-up.

To enable ease of interpretation of the salience of different determinants on the decision to trade informally during the start-up phase, Table 2 displays the predicted probabilities of trading informally during start-up for the significant variables found in the multivariate logit models in Table 1. The predicted odds of trading informally during the start-up phase are presented in percentage points. Overall, the average odds of trading informally range from 17 to 20%. This is the benchmark estimated probability with which to compare the effect of the characteristics deemed to significant effect the likelihood of trading informally during start-up.

Being a woman small business owner reduces the odds of trading informally during the start-up phase to 9%, with an average predicted probability ranging from 8 to nearly 11% across the three models which control for other variables. This is nearly half of the average predicted probability of trading informally for the whole sample. Similarly, the predicted probability of trading informally for middle age entrepreneurs is again just under 10% and the estimated probability remains below 10% across all three models. Turning to the significant firm-level characteristics identified, the finding is that the

estimated probability that firms now with 10–49 employees traded informally during the start-up phase is nearly 40%, over 22 percentage points higher than the average odds. Similarly, the odds that firms now with an annual turnover between £25,000 and £49,000 traded informally during the start-up phase ranges from 30 to nearly 40% across the models. The most important determinant that increases the odds of engagement in informal trading during start-up, however, is the sector once one controls for other variables. The odds that small businesses in the education as well as medical and health services traded informally during start-up are over 50%, and for manufacturing sector small businesses it is slightly over 40%. The strong intimation, therefore, once the various variables are controlled for, is that firm-level characteristics are key determinants of the odds that small businesses traded informally during start-up, although socio-demographic characteristics do also appear to play a significant role. The region in which a small business starts-up, however, is not an important determinant of whether a business traded informally during the start-up phase.

**Table 2** Predicted odds of small business owners trading informally in the start-up phase<sup>a</sup> (%)

Variables	Model 1		Model 2		Model 3	
	Pr( $y = 1$ )	$\Delta$	Pr( $y = 1$ )	$\Delta$	Pr( $y = 1$ )	$\Delta$
Female	10.64	-9.40	7.99	-9.65	7.81	-9.50
Age: 45 to 54	8.49	-11.55	6.94	-10.70	6.98	-10.33
Employees: 10 to 49					39.44	22.13
Turnover: less than £25,000			33.54	15.90	33.94	16.63
Turnover: £25,000 to £49,999			29.16	11.52	30.13	12.82
Sector: education			52.69	35.05	52.03	34.72
Sector: manufacturing			41.31	23.67		
Sector: medical and health services			52.29	34.65	50.31	33.00
Pr( $\bar{x}$ )	20.04		17.64		17.31	

Notes: <sup>a</sup>Predicted probabilities of significant variables in models of Table 2

Source: RSA Untapped Enterprise dataset

#### 4.2 Do small businesses trade informally during start-up to test the viability of the venture?

Is trading in the informal economy used by business start-ups to test the viability of their venture? Or are there other reasons for trading informally? To answer this, the 119 owners of small businesses who reported trading informally during start-up were asked ‘You said when you were starting any of your businesses there were periods where you traded informally, which three, if any, of the following were the main reasons for this? [Please tick up to three options]’. Some 64% stated ‘I wanted to see if the business would be viable first’, 40% that ‘It gave me the breathing space before I had the capacity to register my business’, 14% that ‘I was unaware that I had to register my business’, 12% that ‘I didn’t know who to go to about registering my business’, 9% that ‘I wanted to earn extra income that would otherwise have been taxed’ and 17% other reasons, including in terms of the frequency of statement, that they wanted to test the market, it was a hobby and that they delayed registration for various reasons.

**Table 3** Logit regressions for the odds of business start-ups trading informally to test-trade the viability of their business

<i>Variables</i>	<i>(1) model</i>	<i>(2) model</i>	<i>(3) model</i>
Female	<b>-1.074*** (0.380)</b>	<b>-1.254*** (0.436)</b>	<b>-1.251*** (0.448)</b>
<i>Age (RC: 18 to 34 years old)</i>			
35 to 44	-0.116 (0.698)	0.019 (0.671)	0.006 (0.660)
45 to 54	-0.276 (0.662)	-0.320 (0.647)	-0.320 (0.638)
55+	-0.259 (0.646)	-0.259 (0.634)	-0.266 (0.626)
Decision-making index	-0.015 (0.016)	-0.007 (0.017)	-0.007 (0.017)
<i>Number of employees (RC: no employees)</i>			
1 to 2		<b>-0.629* (0.383)</b>	-0.614 (0.385)
3 to 5		0.524 (0.418)	0.543 (0.430)
6 to 9		0.504 (0.675)	0.540 (0.679)
10 to 49		1.207 (0.838)	1.252 (0.831)
<i>Annual turnover (RC: not reported)</i>			
First year of trading		1.123 (0.778)	1.102 (0.788)
Less than £25,000		<b>0.904** (0.416)</b>	<b>0.909** (0.416)</b>
£25,000 to £49,999		0.503 (0.454)	0.524 (0.457)
£50,000 to £99,999		0.316 (0.452)	0.320 (0.449)
£100,000 to £249,999		-0.402 (0.533)	-0.388 (0.538)
£250,000 to £499,999		-0.559 (0.758)	-0.582 (0.779)
£500,000 to £999,999		-0.501 (0.955)	-0.573 (0.950)
£1 million to £19.99 million		0.111 (0.850)	0.100 (0.840)
<i>Industrial sector (RC: accountancy)</i>			
Construction		0.670 (0.719)	0.624 (0.727)
Education		1.156 (0.850)	1.093 (0.864)
Financial services		0.780 (0.824)	0.730 (0.826)
Hospitality and leisure		-1.260 (1.122)	-1.181 (1.117)
IT and telecoms		0.382 (0.696)	0.352 (0.698)
Legal		-0.459 (1.172)	-0.429 (1.143)
Manufacturing		0.868 (0.776)	0.792 (0.780)
Media/marketing/advertising/PR and sales		0.194 (0.757)	0.147 (0.758)
Medical and health services		<b>1.696** (0.821)</b>	<b>1.661** (0.825)</b>
Other		0.378 (0.686)	0.335 (0.702)

Notes: Robust standard errors in parentheses

\*\*\*p &lt; 0.01, \*\*p &lt; 0.05, \*p &lt; 0.1

Source: RSA Untapped Enterprise dataset

**Table 3** Logit regressions for the odds of business start-ups trading informally to test-trade the viability of their business (continued)

<i>Variables</i>	<i>(1) Model</i>	<i>(2) Model</i>	<i>(3) Model</i>
<i>Industrial sector</i> (RC: accountancy)			
Real estate		0.140 (0.878)	0.082 (0.901)
Retail		0.308 (0.732)	0.285 (0.739)
Transportation and distribution		0.036 (1.332)	-0.028 (1.321)
<i>Region (RC: East)</i>	535	535	535
London	0.024	0.099	0.102
Midlands	-215.056	-198.686	-198.050
North	8.769	40.486	42.968
Scotland	0.119	0.096	0.197
South	535	535	535
Wales	0.024	0.099	0.102
Constant	-215.056	-198.686	-198.050
N	535	535	535
Pseudo R <sup>2</sup>	0.024	0.099	0.102
Log likelihood	-215.056	-198.686	-198.050
$\chi^2$	8.769	40.486	42.968
p>	0.119	0.096	0.197

Notes: Robust standard errors in parentheses

\*\*\*p &lt; 0.01, \*\*p &lt; 0.05, \*p &lt; 0.1

Source: RSA Untapped Enterprise dataset

Nearly two-thirds (64%) of owners of small businesses who reported trading informally when setting out, therefore, did so in order to test whether it was viable as a business venture. This strongly intimates that this is a major reason for trading informally when starting-up a business venture. Again, however, such a response is not evenly distributed. As Table 3 displays, women small business owners are less likely to cite that they trade informally in order to test the viability of the business than men and this is significant even when controlling for other characteristics. The age of the business owner and their involvement in decision-making processes within the business, however, are not significant determinants of whether they traded informally in order to test the viability of the venture. The current firm size, however, is a significant determinant. Model 2 reveals that those currently with 1–2 employees who traded informally at the outset were more likely to do so in order to test the viability of the business, although this effect disappears after controlling for regional location. This is not the case, however, when examining businesses currently with a low annual turnover of under £25,000 per annum, who were significantly more likely to have traded informally in order to test the viability of the venture than businesses now with higher turnovers. This remains the case even when controlling for other characteristics, including regional location. It is also the case that small business owners operating in the medical and health services sector who traded informally at the outset are also significantly more likely to have done so in order to test

the viability of their venture, even when other characteristics are controlled for. The implication, therefore, is that small business owners who traded informally during start-up are significantly more likely than others to have done so to test the viability of their venture when they are men, currently with an annual turnover of less than £25,000 and in the medical and health services sector.

Table 4 displays the predicted probabilities that testing the viability of the business was the reason for trading informally during start-up for those variables found to be significant in the multivariate logit regression models in Table 3. Overall, the average odds that a small business will trade informally during start-up to test the viability of the business range from 11 to 13%. The odds of a women small business owner trading informally at start-up to test the viability of her business are well below the average predicted odds, ranging between a 1 and 3% probability. Similarly, the odds of a small business owner who currently employs 1–2 employees trading informally at start-up to test the viability of the business is 5% in model 2. Firm-level characteristics, however, have a stronger effect. Small business owners currently with a turnover of less than £25,000 have a probability of around 22% that they traded informally during the start-up phase to test the viability of their business and small business owners in the medical and health services sector have a 40% probability that they did so.

**Table 4** Predicted odds of small business start-ups trading informally to test-trade the viability of their business (%)<sup>a</sup>

<i>Variables</i>	<i>Model 1</i>		<i>Model 2</i>		<i>Model 3</i>	
	<i>Pr(y = 1)<sup>b</sup></i>	<i>Δ</i>	<i>Pr(y = 1)</i>	<i>Δ</i>	<i>Pr(y = 1)</i>	<i>Δ</i>
Female	3.09	-10.44	1.20	-10.01	1.20	-9.95
<i>Employees: 1–2</i>			5.58	-5.63		
<i>Turnover: less than £25,000</i>			22.40	11.19	22.37	11.22
<i>Sector: medical and health services</i>			39.92	28.73	38.99	27.84
<i>Pr(<math>\bar{x}</math>)</i>	<i>13.53</i>		<i>11.21</i>		<i>11.15</i>	

Notes: <sup>a</sup>Predicted probabilities of significant variables in models of Table 4

<sup>b</sup> $y = 1$ : self-declared informal economy practices: business viable before registering

*Source:* RSA Untapped Enterprise dataset

## 5 Conclusions

This paper has evaluated critically whether small businesses start-up trading in the informal economy so as to test-trade their business. The reason this is important is because this has been one of the main reasons for the recent shift in the policy of tax administrations away from a deterrence approach which seeks to detect and punish those caught trading informally and towards an enabling formalisation approach. The assumption has been that unless this is done, then government will with one hand stifle precisely the entrepreneurship that is being nurtured with other hands. Reporting a 2012 survey of 595 small business owners in the UK, the finding is that of the 20% of all small business owners who reported trading informally with their own business when it was starting-up, 64% asserted that a main reason was to test the viability of their business.

Some 13% of all small businesses, therefore, trade informally during start-up to test the viability of the business.

Some small business owners, however, are more likely to have started-up trading informally and to have done so to test the viability of their business. Using multivariate analysis to examine how these propensities vary across socio-demographic groups, business types and regional locations, the finding is that those significantly less likely to have traded informally during start-up are women and middle-aged groups aged 45–54, whilst businesses currently with turnovers below £50,000 and those operating in the education and medical and health services are significantly more likely to have done so. Similarly, women are significantly less likely and businesses currently with one to two employees, those with annual turnovers below £25,000 and those operating in medical and health services significantly more likely to have done so in order to test the viability of their business.

The outcome, therefore, is that for the first time tentative estimates have been produced of not only the degree to which small businesses start-up trading informally in order to test the viability of their business and also what type of small business owner does so and what the businesses eventually become. With some 20% of all small businesses trading in the informal economy during their start-up phase and some 13% of all small businesses doing so in order to test the viability of their business, it can be tentatively seen that the shift in the policy of tax administrations away from deterrence and towards enabling formalisation approach has been a worthwhile exercise. Unless pursued, then government will be stifling one-fifth of all business start-ups in the UK.

However, whether this policy approach should be universal or more targeted needs to be addressed. This relatively small survey reveals that the tendency to start-up trading informally in order to test the viability of the venture is largely concentrated amongst businesses started by men which now have one to two employees and/or turnovers less than £25,000, it appears at first glance that any return to an eradication approach might not do much harm to the overall economy. Those starting-up in this manner do not appear to become high-turnover businesses with large numbers of employees.

However, caution is urged in reaching this conclusion. It might well be the case that businesses that start-up trading in the informal economy end up as small businesses with low turnovers and few employees precisely because they cannot openly advertise their wares and gain access to capital to expand because of their informal trading. In other words, informality during start-up may cause them to end up having lower turnovers and fewer employees. This suggests that policy measures to prevent business start-ups entering the informal economy in the first place might have fruitful repercussions in the future. Such preventative measures, however, need to be targeted at those sectors and business types where this has been shown to be prevalent and might include: measures to simplify regulatory compliance; the provision of business support and advice regarding formalisation, as well as direct and indirect tax incentives, and the development of initiatives to smooth the transition to self-employment (see Williams and Nadin, 2012a; Williams and Renooy, 2013; Williams et al., 2013a). It might also include re-evaluating whether a test-trading period should be allowed from the first transaction until one needs to register the business and if so, the length of time. These, however, are issues for future research.

In sum, this paper has for the first time provided an estimate of the proportion of businesses that start-up trading in the informal economy in order to test-trade their business. Given that this is a relatively small sample in just one country, not only is more

extensive survey now required in the UK but also similar studies in other countries to evaluate whether the findings are the same or different. What is certain, however, is that studies of business start-ups need to recognise this facet of nascent entrepreneurship. So too do tax administrations need to further understand this practice in order to target those doing so and in an appropriate manner. If this paper thus stimulates both further research on business start-ups test-trading in the informal economy as well as greater consideration of the policy implications, then this paper will have fulfilled its objective.

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## Notes

- 1 The estimated probabilities are obtained using the Spost command version 9 developed by Long and Fresse for categorical dependent variables models using Stata SE 11 (Version of the Spost ado July 2012).