



# Tackling undeclared work in the European Union

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# Executive summary

This overview report provides a typology of the potential approaches to and measures for tackling undeclared work. Such a resource could be used to provide a baseline against which the current approaches and measures used in the current 27 Member States of the European Union (EU27) can be assessed (see Table 1 on page 4). The report looks specifically at the effectiveness of the policy measures used in five countries – Belgium, Denmark, Italy, Poland and the United Kingdom (UK). The central finding is that EU countries currently remain heavily embedded in a ‘deterrence approach’, which seeks to increase the actual or perceived likelihood of detection and penalties. However, there has also been a noticeable increase in the use of more enabling approaches and measures, particularly prevention measures, since **Employment Policy Guideline No. 9 on transforming undeclared work into regular work**<sup>1</sup> was published in 2003. Nonetheless, up until now, the take-up of initiatives to engender commitment to ‘tax morality’ has been relatively slow.

To evaluate whether the most effective and efficient approaches and measures are being used to tackle undeclared work, the report provides a comprehensive and up-to-date evaluation of the different policy measures. The analysis reveals that it is currently difficult to determine what is effective and what is not. This is due to the fact that, up until now, no knowledge bank has been available to:

- identify what has been tried and tested elsewhere;
- assess the relative effectiveness of different approaches and measures;
- evaluate their transferability across countries, sectors and occupations.

The development of such a knowledge bank – one that addresses the effectiveness of different measures – is therefore an important step forward in tackling undeclared work.

Another advantage of such a resource is that, as it develops, it will quickly reveal areas where further analysis is required to fill the gaps in understanding on the effectiveness of specific approaches and measures. The comprehensive analysis of the five countries earmarked in this report represents a first step towards developing such a knowledge bank. Nonetheless, although there are some comprehensive evaluations of specific measures, which provide a solid evidence base for Member States to make decisions on whether to test the initiative in their own country, many other measures have not been subject to rigorous evaluation. Thus, one emerging finding of this attempt to create a knowledge bank is the somewhat patchy nature of the evidence base. The examples of measures used in the five countries are available in an online database collection at: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/search.php>

If this initial overview report facilitates the further development of a knowledge bank on the feasibility, effectiveness and transferability of different approaches and measures – as well as encouraging all of the social partners involved in tackling undeclared work to share their experiences – then it will have begun to achieve its objective.

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<sup>1</sup> [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003G1029\(01\):EN:NOT](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003G1029(01):EN:NOT)

# Introduction

Across the 27 Member States of the European Union (EU27), a great deal of effort is being invested into developing and testing policy measures that aim to tackle undeclared work. Although a number of previous attempts have been made to describe the array of measures used in different countries (EIRO, 2005; European Employment Observatory, 2004; Renooy et al, 2004), a ‘knowledge bank’ is currently lacking where one can identify what measures work and what do not. Recognising this, in 2007, the European Foundation for the Improvement of Living and Working Conditions (hereafter ‘the Foundation’) took the first step towards developing such a resource by commissioning a review of the effectiveness of the policy measures adopted in five countries – Belgium, Denmark, Italy, Poland and the United Kingdom (UK). If further countries were added, this could result in a learning hub for knowledge sharing on the different approaches as well as on the effectiveness of specific policy measures and their transferability.

The aim of this report is to provide a comprehensive and up-to-date overview of the range of approaches and measures available for tackling undeclared work and the direction of change in the EU Member States. In addition, the report provides an overarching evaluation of the effectiveness and transferability of particular policy approaches and measures. The first chapter of the report sets out a typology of potential policy approaches and measures for tackling undeclared work, which can be used to provide a baseline against which the current approaches and measures used in the EU27 can be assessed. The second chapter examines current policy approaches and the direction of change in EU Member States. Chapter three reviews what is known about the effectiveness and transferability of different policy approaches and measures.

Among the central findings of the report is that the EU countries currently remain heavily embedded in a ‘deterrence approach’ to undeclared work, which seeks to increase the actual or perceived likelihood of detection and penalties. However, there has also been a noticeable increase in the use of more enabling approaches and measures, particularly prevention measures, since Employment Policy Guideline No. 9 on transforming undeclared work into regular employment was published in 2003. At the same time, up until now, the take-up of initiatives to engender adherence to tax regulations has been relatively slow.

## Defining undeclared work

Before embarking on an overview of this policy field, it is necessary to first define what undeclared work is. To date, three contrasting types of definition have been used – namely, an enterprise-based definition, a jobs-based definition and an activities-based definition. Although in a third world context, an enterprise-based definition has been replaced by a jobs-based definition (Husmanns, 2005; ILO, 2002 a–c, 2007), in Europe in particular and advanced economies more generally, the widespread consensus is that an activities-based definition should be used (European Commission, 1998; OECD, 2002; Renooy, 1990; Renooy et al, 2004; Sepulveda and Syrett, 2007; Thomas, 1992; Williams, 2006; Williams and Windebank, 1998). In other words, rather than distinguishing between undeclared and declared enterprises or jobs, the tendency has been to differentiate between activities that are declared and undeclared.

Although different activities-based definitions exist and there is no official definition of undeclared work, there is broad consensus on what should be included and excluded. In this report, such consensus is taken into account by defining undeclared work as ‘productive activities that are lawful as regards their nature but are not declared to the public authorities, taking into account the differences in the regulatory systems between Member States’ (Renooy et al, 2004, p. 95). In this context, the only deficiency in relation to undeclared work compared with declared work is that it is not declared to the authorities for tax, social security and/or labour law purposes.

As with any definition, there are of course blurred edges between the different distinctions. Some definitions of undeclared work include work recompensed in kind or involving gifts, while others do not, often reflecting the different regulatory systems across countries. On the whole, however, this definition reflects the widespread agreement on what

is to be included and excluded when discussing undeclared work. In this report, all activities which are remunerated – either with money or in kind – are included. As such, the barter and exchange of services are included since these are supposed to be declared, albeit usually only above a certain threshold. Indeed, including these activities is particularly important in those countries where the subsistence economy is still widespread and where payment in kind is considered a normal practice and an important element of social cohesion.

For analytical and policy reasons, it is important to distinguish between several types of undeclared work. The following distinction can be used:

- undeclared work within a formal enterprise – ‘off the books’, envelope wages;
- undeclared work for a formal enterprise – the ‘gang-master’;
- undeclared work in delivering goods and services directly to the consumer – ‘doing odd jobs’.

If activities possess additional deficiencies, they are generally not defined as undeclared work. For instance, if an activity involves illegal goods and/or services – such as in the case of drug trafficking – they are separately defined as ‘criminal’ activities. Alternatively, if the productive activities are unpaid, they are defined as ‘unpaid community work’ if a household member undertakes these unpaid productive activities for a member of a household other than their own; if the household member engages in these unpaid productive activities for themselves or another member of their household, these may be defined as ‘self provision’ activities.

However, the question may be asked: why does Europe adopt an activities-based rather than an enterprise-based or jobs-based definition of undeclared work? One significant reason is that such an approach allows for the inclusion of forms of undeclared work that are popular in Europe and which are excluded in enterprise-based or jobs-based definitions. Prominent examples include the underreporting of income by self-employed people and formal businesses, which are excluded in an enterprise-based definition, and ‘envelope wages’ – whereby a formal employee receives part of their wage on a declared basis and the remainder on an undeclared basis; both jobs-based and enterprise-based definitions omit these forms of undeclared work, since the worker is in a formal job and the work takes place in a registered company (Husmanns, 2005).

# 1

## Policy approaches to tackling undeclared work

This chapter presents a typology of possible policy approaches, providing a lens through which the range of practices currently adopted by EU Member States can be evaluated. Most literature on tackling undeclared work distinguishes between two broad approaches: the dominant deterrence approach that seeks to detect and punish non-compliance and an emergent approach focused on encouraging compliant behaviour. These have been labelled respectively in different ways as: an ‘economic deterrence’ approach versus a ‘fiscal psychology’ approach (Hasseldine and Li, 1999); a ‘chauvinistic’ versus ‘softy’ approach (Cullis and Lewis, 1997); a ‘deterrence model’ versus an ‘accommodative model’ (Murphy, 2005); a ‘deterrence’ versus a ‘tax morale’ approach (Ahmed and Braithwaite, 2005); a ‘command and control’ versus ‘responsive regulation’ approach (Commonwealth Association of Tax Administrators, 2006); a ‘stick’ versus ‘carrot’ approach (SBC, 2004); or a ‘deterrence’ versus ‘enabling’ approach (Williams, 2006).

As Table 1 shows, while the conventional deterrence approach seeks to engender compliance by detecting and punishing non-compliance, the emergent approach aims to encourage compliance by either preventing businesses or people from engaging in undeclared work from the outset, enabling the transfer of undeclared work into the declared realm, or by facilitating a commitment to ‘tax morality’ (see, for example, Mateman and Renooy, 2001).

Table 1: *Policy approaches for tackling undeclared work, EU27*

This table outlines the main types of approaches used for tackling undeclared work in the EU27.

Approach	Method	Measures
<b>Deterrence</b>	Improve detection	Data matching and sharing Joining up strategy Joining up operations
	Penalties	Increase penalties for evasion
<b>Enabling compliance</b>	Prevention	Simplification of compliance Direct and indirect tax incentives Smooth transition into self-employment Introducing new categories of work Micro-enterprise development
	Legitimising undeclared work	Employer incentives: <ul style="list-style-type: none"> <li>• service vouchers</li> <li>• targeted direct taxes</li> <li>• targeted indirect taxes</li> </ul> Worker incentives: <ul style="list-style-type: none"> <li>• society-wide amnesties</li> <li>• voluntary disclosure</li> <li>• business advisory and support services</li> </ul>
	Changing attitudes	Promoting benefits of declared work Education Peer-to-peer surveillance Tax fairness Procedural justice Redistributive justice

## Deterrence

Efforts to tackle undeclared work have been traditionally dominated by a deterrence approach that seeks to elicit a change in behaviour by detecting and punishing non-compliance. Based on the understanding that those who are non-compliant are ‘rational economic actors’ who will evade tax as long as the pay-off from evasion is greater than the expected cost of being caught and punished (Allingham and Sandmo, 1972), the goal is to deter engagement by changing the cost/benefit ratio confronting those who are engaged or thinking about participating in undeclared work (see, for example, Grabiner, 2000; Gramsick and Bursik, 1990; Hasseldine and Li, 1999; Lewis, 1982; Milliron and Toy, 1988; Richardson and Sawyer, 2001; Sandford, 1999). This is achieved by increasing the actual and perceived risks and costs associated with participation by:

- firstly, raising the perceived or actual likelihood of detection – not least by improving the coordination of strategy, operations and data sharing;
- secondly, raising the penalties and sanctions for those caught.

This, therefore, constitutes a ‘negative reinforcement’ approach that seeks to elicit a change in behaviour using a ‘stick’ to punish those engaged in non-compliant or ‘bad’ behaviour so that they will ultimately change their actions.

## Enabling compliance

In recent decades, however, calls for a more enabling approach towards undeclared work have emerged (Hite, 1989; Renooy et al, 2004; SBC, 2004; Slemrod, 1992; Williams, 2006a). Such an approach seeks to bring about a change in behaviour by encouraging ‘good’ behaviour – that is, tax and benefit compliance – rather than taking it as given. It is grounded in a belief that punishing people for doing something wrong – in other words, negative reinforcement – is relatively ineffective compared with positive reinforcement of good behaviour. In the realm of undeclared work, a positive reinforcement approach can take at least three different forms.

Firstly, prevention measures can be adopted to prevent non-compliance from the outset. Such measures could include: simplifying regulatory compliance; introducing new categories of legitimate work; providing business support and advice, as well as direct and indirect tax incentives; and developing initiatives to ensure a smoother transition into self-employment.

Secondly, incentives can be used to help those already participating in undeclared work to transfer into the declared work realm. These include: offering amnesties on either a societal or individual level to those who are willing to 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 use declared rather than undeclared work.

Thirdly, commitment measures can be adopted that seek to encourage an allegiance to tax morality (Alm et al, 1995; Andreoni et al, 1998; Cullis and Lewis, 1997; Smith and Kinsey, 1987; Torgler, 2003; Weigel et al, 1987; Wenzel, 2002). Such measures include not only some of the incentives discussed above to engage in legitimate endeavours, but also tax education and awareness raising about the benefits of declared work, peer surveillance, and the pursuit of perceived tax fairness, procedural justice and redistributive justice.

Of course, these contrasting approaches to tackling undeclared work are not necessarily mutually exclusive. For example, governments might simplify regulatory compliance as well as introduce incentives, such as amnesties, enabling people to enter the legitimate realm; at the same time, in relation to those who fail to comply, they may implement tougher sanctions for those subsequently caught, while also introducing campaigns to elicit greater commitment among the public to tax morality. As such, these approaches are better represented as a continuum of possible policy approaches that in theory can be used alongside each other. The issue is, of course, whether this is indeed the case. In other words, do Member States employ all of these approaches or do they tend to place greater emphasis on one approach or set of measures, while only paying lip-service to other approaches and measures? To answer this question, the report will seek to evaluate the nature and direction of policy in the EU Member States in the next chapter.



# Policy measures adopted in individual EU Member States

A number of questions arise in relation to the issue of tackling undeclared work in the EU. For instance, how is undeclared work being tackled in the EU? Do EU Member States use deterrence measures that seek to punish non-compliance? If so, is this their sole strategy? Or do they also seek to enable compliance and, if so, do they adopt the full range of measures? Moreover, what is the direction of change?

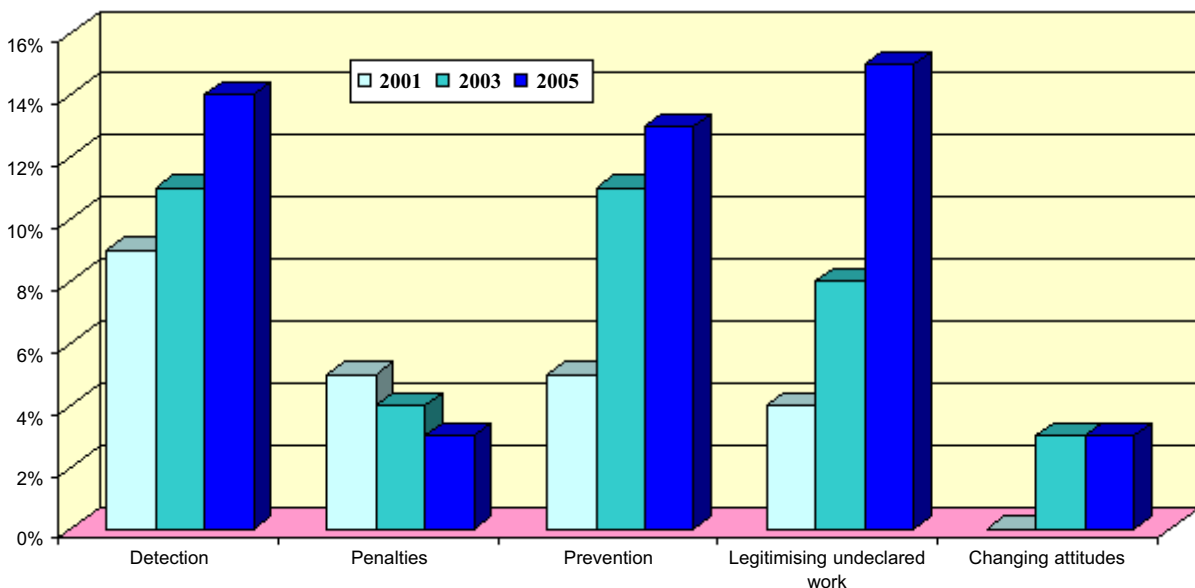
The European Commission's Employment Guideline No. 9 on undeclared work, adopted on 22 July 2003, is quite explicit in terms of the approach that should be adopted. Accordingly:

*Member states should develop and implement broad actions and measures to eliminate undeclared work, which combine simplification of the business environment, removing disincentives and providing appropriate incentives in the tax and benefits system, improved law enforcement and the application of sanctions.*

In other words, tackling undeclared work requires not only the punishment of non-compliance in the form of 'improved law enforcement and the application of sanctions', but also a range of initiatives to facilitate compliance, namely: a 'simplification of the business environment', 'removing disincentives' and offering 'appropriate incentives in the tax and benefits system' (European Commission, 2003b). The recommendation is therefore that EU Member States should combine deterrence measures with incentive measures to enable compliance. The only major set of policy measures not covered in this guidance is that which facilitates greater commitment to tax morality. The implications of this will be addressed later on in this report.

Before doing this, however, it is necessary to evaluate the extent to which EU Member States have adopted the European Commission's recommendation. Several data sources are examined here. Firstly, the 2001 and 2003 National Action Plans (NAPs) for Employment and the National Reform Programmes (NRPs) 2005–2008 of each Member State are analysed (Figure 1). Secondly, and to complement these, several international reviews of the initiatives being pursued in different countries are analysed, namely those conducted by the European Employment Observatory in the autumn of 2004 and the survey of undeclared work carried out by the European Industrial Relations Observatory (EIRO) in 2005.

Figure 1: *Approaches used for tackling undeclared work in the EU27*



Source: *National Reform Programmes, 2001–2005*

Table 2 summarises the findings. Examining the approach most commonly adopted in 2001, prior to the introduction of Employment Guideline No. 9, the most widespread one was that punishing non-compliance – mostly through improved detection rather than penalties. Moreover, in a few countries, there was a tendency to adopt prevention measures. However, following the publication of Employment Guideline No. 9 in 2003, not only have measures punishing non-compliance and prevention measures become more commonplace, so too have those enabling greater compliance – as observed in a wider array of Member States.

Table 2: *Measures used to tackle undeclared work in the EU25, 2001–2005*

This table shows the different type of deterrence and enabling approaches used in the EU25 countries in 2001, 2003 and 2005.

Country	Deterrence						Enabling compliance								
	Improve detection			Penalties			Prevention			Legitimising undeclared work			Changing attitudes		
	2001	2003	2005	2001	2003	2005	2001	2003	2005	2001	2003	2005	2001	2003	2005
AT	●	●	○			●	●	●				●			
BE	●	●	○					●	○	●	●	●○			
CY									○						
CZ															
DE	●	●		●	●	○	●		○	●	●	○		●	
DK	●	●	●			●		●			●	○			●
EE			●○						○						
EL	●	●		●			●	●	○			●			
ES		●	●					●	●○			●			
FI	●			●				●	○		●	○			
FR	●							●	○		●	○		●	
HU			●						●			●			
IE	●	●		●	●		●								
IT									○	●	●				
LT			●○						●○			●			
LU															
LV			●						●			●			
MT															
NL	●	●	○	●	●		●	●		●		●○			
PL															
PT		●	●					●			●				
SE		●	●					●	●○						●○
SI			●												
SK			●○						●○						
UK		●	○		●	○		●	○		●	○		●	●
<b>Total (●)</b>	9	11	10	5	4	2	5	11	6	4	8	8		3	3
<b>Total (○)</b>			7			2			13			7			1

Note: ● = Mentioned in the 2001 or 2003 NAP, and the 2005 NRP.

○ = Mentioned in the European Employment Observatory (Autumn 2004) and in EIRO (2005).

Nevertheless, some marked differences emerge across various regions of the EU in terms of the sets of measures and combinations used. Measures enabling compliance, with one or two exceptions, appeared to be mostly confined to the northern EU Member States in 2001 and 2003; however, by 2005, a wider range of Member States were starting to adopt such measures, albeit mostly only countries from among the original 15 EU Member States (EU15). The new Member States have, on the other hand, shown a preference for measures aimed at detecting and punishing non-compliance. Where such countries have adopted measures to enable compliance, these have tended to be mostly confined to the prevention type measures. A common trend across most EU countries is the notable absence of measures that aim to engender greater commitment to tax morality.

It seems that policies targeting undeclared work in the different EU Member States are strongly related to the socioeconomic context and structural position of such work in these economies. When undeclared work is strongly intertwined with the formal part of the economy, in the sense that there is a level of interdependency between the two, a broad and comprehensive approach like that observed in Italy is needed. In cases where this form of work is largely confined to undeclared work carried out by private persons for private individuals, such as those doing odd jobs, as seen in Denmark, targeted measures are advisable.

However, great care must be taken in interpreting these conclusions about the nature and direction of approaches to undeclared work across the EU. The results in Table 3 simply note whether different initiatives are mentioned in relation to each Member State in the aforementioned documents. One problem with this approach is that small-scale and piecemeal pilot experiments are given the same importance as large-scale mainstream initiatives. Therefore, there is no way of qualitatively evaluating the emphasis placed in each country on the different sets of measures. As a result, the degree to which there has been a shift away from punishing non-compliance using ‘stick’ type measures, and towards pull or ‘carrot’ type measures that seek to enable compliance when tackling undeclared work, may well be exaggerated in this type of analysis. Nonetheless, even if this is the case, the analysis reveals that punishing non-compliance – in other words, the deterrence approach – is no longer solely used to tackle undeclared work and that there is a significant shift taking place in the EU Member States towards enabling compliance.

It is important, however, to recognise the consequences of tax commitment measures being omitted from Employment Guideline No. 9 as a prescription for the way forward. Few Member States have, as a result, adopted such an approach. Given that, at the time, the issue of tax morality only constituted a small body of thought in policy-oriented literature on undeclared work – which despite its growing popularity in recent years still only covers some 10% of all literature published on this topic (Kirchler, 2007) – its omission is not necessarily a surprise. However, such an omission has had a significant impact on the breadth of policy approaches adopted in EU countries. If measures to improve tax morality had been highlighted, it seems likely – based on the above findings showing how Member States have followed the recommendations – that these measures would have been promoted more strongly to facilitate greater commitment to tax morality across society. Thus, such measures will need to be given greater prominence in future recommendations and policies targeting undeclared work.

# 3 Towards ‘good practice’ – evaluating the effectiveness of policy measures

This chapter presents the diverse range of measures available for tackling undeclared work and evaluates the effectiveness of different policy measures where data are available. It will in turn:

- review and evaluate deterrence measures;
- assess prevention measures;
- examine measures aimed at legitimising undeclared work;
- look at measures that aim to change attitudes and engender commitment to the payment of tax.

## Deterrence measures

Deterrence measures seek to force people to move from undeclared into declared work using ‘stick’ type measures. Such measures aim to change the cost/benefit ratio for those engaged in undeclared work or contemplating participation. To achieve this, attempts are made, on the one hand, to increase the perceived or actual likelihood of detection; on the other hand, penalties are used to ensure that the expected cost of being caught and punished is greater than the economic benefit of engagement (see, for example, Allingham and Sandmo, 1972; Falkinger, 1988; Hasseldine and Li, 1999; Milliron and Toy, 1988; Sandford, 1999). This chapter, therefore, evaluates the range of measures available for improving detection and, secondly, reviews and evaluates the impact of increasing penalties.

### Detection

Measures to improve the perceived or actual likelihood of detection have focused on three issues:

- joining up strategy;
- joining up operations;
- data matching and sharing – either at national or cross-national level.

The assumption is that by increasing the probability of detection in general, and by joining up strategy, operations and data sharing more specifically, undeclared work will be tackled more effectively – as the following example implies.

#### Text box 1: *Crossroads Bank in Belgium*

Measures to improve detection have been at the core of Belgium’s policy for tackling undeclared work since the 1990s. E-government is an integral part of the government’s strategy in this respect. An important step was the establishment of the so-called Crossroads Bank for Social Security in 1991. This bank constitutes the central hub in an electronic network integrating the back offices of all social security institutions in Belgium and thus facilitates initiatives targeting undeclared work. Some of the main e-government initiatives targeting undeclared work include: the Social Identity Card (1991), which made undeclared work harder to perform; the Immediate Declaration system (*Déclaration Immédiate/ONmiddellijke Aangifte*, Dimona) (2003), which requires employers to electronically inform social security services as soon as an employee joins or leaves the company; and the International Migration Information system (*Landenoverschrijdend Informatiesysteem Migratie Onderzoek Sociaal Administratief*, Limosa) (2006), which requires the electronic and immediate registration of any activity by foreign workers in Belgium. Dimona and Limosa have further increased the likelihood of detection, although both measures have yet to be evaluated.

Despite the interest in detection measures, evaluations are far from conclusive as to whether such measures have proved effective. Some studies have found that increasing the probability of detection reduces participation in undeclared work for some income groups at least (Beron et al, 1992; Dubin and Wilde 1988; Dubin et al, 1987; Slemmerod et al, 2001). However, others find that it actually leads to a growth in undeclared work (Bergman and Nevarez, 2006; Elffers et al, 1987; Friedland, 1982; Spicer and Lunstedt, 1976; Varma and Doob, 1998; Webley and Halstead, 1986).

Evidence is also lacking at this point to show that joining up strategy and operations, and increasing data sharing, results in a more effective approach. An example can be seen in the case of France. Since 1997, a highly coordinated approach to data, strategy and operations has been pursued at national, regional and local government levels, with a wide array of social partners included at all spatial levels (ACOSS, 2004; DILTI, 2002, 2004 a,b). However, it is not evident whether detection has improved since 1997. There have been no known evaluations of the relative cost of detection before and after 1997 nor any evaluation of the marginal net benefits in terms of improved tax recovery of such a joined-up approach. Similarly, in countries such as the UK, no evaluations have been conducted to show that cross-departmental joined-up operations are any more effective than pursuing detection in conventional departmental structures (Williams, 2007). Despite the widespread assumption across tax administrations that improving detection through the aforementioned measures leads to a more effective approach, little evidence currently exists that this is actually the case. Thus, caution is urged in using such a measure for tackling undeclared work, until it is shown to be an effective way forward.

### Penalties

Given the high costs involved in raising detection measures, it is sometimes decided to impose higher penalties for engaging in undeclared work. Nevertheless, the findings are by no means clearcut when evaluating the impact of increasing penalties on reducing the incidence of undeclared work. While some analyses find that increasing fines reduces undeclared work (de Juan et al, 1994; Friedland et al, 1978; Klepper and Nagin, 1989; Schwartz and Orleans, 1967), others conclude that increased penalties, in fact, lead to a growth in such work (Elffers et al, 1987; Friedland, 1982; Murphy, 2005; Spicer and Lunstedt, 1976; Varma and Doob, 1998; Webley and Halstead, 1986). Indeed, some studies have even concluded that 'it is not sensible to penalise illicit work with intensified controls and higher fines' (Schneider and Enste, 2002, p. 192).

Thus, increasing penalties does not always have the intended impact. One principal reason for raising penalties is to increase the amount of tax revenue to be collected. In practice, however, this may not occur, as a reduction in undeclared work does not always lead to increased tax revenue. A Danish study hypothesised that if the 200 million hours of undeclared work provided in 1984 in Denmark were converted into jobs for unemployed people, some 110,000 new full-time jobs could be created, thus lowering the unemployment rate in 1984 from 10.8% to 7.8% (Mogensen, 1985). The study concluded that this could only be achieved if the price differentials between declared and undeclared labour supply were abolished. However, in this particular study, the purchasers of undeclared work stated that they would prefer to resort to 'do-it-yourself' activities (34%) or to simply not consume the services (30%) rather than pay the official formal price. Hence, nearly two-thirds of undeclared work would not be converted into formal jobs. This applies not only to penalties but all types of policy measures aimed at tackling undeclared work.

Another potential unintended impact of increasing penalties, as well as detection measures, is that it may cause a reduction in tax morality and therefore an unintended growth in undeclared work. For instance, an analysis of the 1987 American Taxpayer Opinion Survey (Smith, 1992) reveals that perceived procedural fairness and responsiveness in providing a service emerged as positive incentives that increased taxpayers' commitment to paying taxes. Meanwhile, Kinsey (1992) found that while detection and punishment attempt to force people to comply, these processes also alienate taxpayers and reduce voluntary compliance. An increase in the perceived severity of punishment and likelihood of detection may therefore amplify rather than lower tax evasion by reducing respect for the system's fairness; this is also confirmed by the findings of Murphy (2005).

Indeed, Wenzel (2004a) in a survey of 1,406 Australian citizens, finds that increased penalties only work where individual ethics are weak. In cases where social norms are strongly in favour of tax honesty, stricter penalties may only serve to increase tax evasion. Thus, harsh penalties and tax morality do not always work well together. However, this does not mean that they cannot be used in sequence. For example, Davis et al (2003) finds that harsh enforcement increases compliance among previously non-compliant taxpayers, but that returning to the previous more lax system does not necessarily cause these people to return to their former behaviour. This finding suggests that harsh penalties followed by their reduction and a shift towards more enabling measures could be an effective means of encouraging ongoing compliance, since those who were previously outside would be then within the compliance system.

A final but important finding regarding the effectiveness of deterrents is that many people engaging in undeclared work, geared directly at the consumer, are not rational economic actors swayed by the potential cost/benefit ratio. Analysing the relationship between customers and suppliers of undeclared work, a growing number of studies reveals that much undeclared work is conducted for and by family, neighbours, friends and acquaintances for reasons other than making or saving money (Cornuel and Duriez, 1985; Persson and Malmer, 2006; Williams, 2004a). In Sweden, for example, Persson and Malmer (2006, p. 64) cite a 2005 survey conducted for the Swedish Tax Agency (Skatteverket), which finds that over half of undeclared work performed for households was conducted by family and neighbours. If work colleagues and acquaintances are added to this proportion, the figure rises to over 80%. Only 10% of the work is done by people who have no close connection with members of the household. Similarly, in half of cases where undeclared work was conducted for companies, the worker knew the company owner in a private capacity or was related to them. In a quarter of cases, the worker was either currently or had previously been employed by the company.

In the UK, Williams (2004a) also finds that of all the undeclared work reportedly carried out directly for the customer, 7% was conducted by household members, 30% by family members living outside of the household, 33% by friends or neighbours and just 30% by people who were previously unknown to the customer. Contrary to the assumption that consumers and suppliers are 'rational economic actors' engaging in such work to save or make money – which in turn leads to a deterrence approach being pursued to alter the cost/benefit ratio for consumers and suppliers – Williams (2004a) finds that, in just 31% of cases, the primary reason for sourcing undeclared work was to save money. The main reason why consumers used this form of work was to either maintain or cement social networks or to help others out. Similarly, when suppliers' motives were analysed, just 50% engaged in this form of work to make money; some 22% of people took part in undeclared work primarily to help the customer and 28% to cement or build social capital. These studies have important implications for tackling undeclared work. It can no longer be assumed that all participants are rational economic actors seeking to make or save money and that undeclared work can therefore be tackled by changing the potential cost/benefit ratio.

To summarise, the evidence that improving detection and increasing penalties improves compliance is less than conclusive. Not surprisingly, therefore, other approaches and measures are beginning to be used.

### Prevention measures

To enable people to start work in a legitimate manner from the outset, at least five broad policy measures can be adopted, namely:

- simplifying compliance;
- introducing new categories of legitimate economic activity to enable people to make the transition from undeclared work to regular work;
- providing direct and/or indirect tax incentives to encourage people to engage in regular employment;

- offering micro-enterprise development programmes to help businesses set up and develop in a formal manner;
- introducing initiatives to ensure a smoother transition into self-employment.

### **Simplifying compliance**

At present, some activities may not – either intentionally or unintentionally – fully adhere to the regulations that apply to them. For example, people may deliberately ignore regulations in order to cut costs, or they may unintentionally break the rules, not realising that they are failing to comply. For both groups, one option is to provide better advice on how to formalise their activities within the existing rules and regulations. Another option is to simplify the regulatory compliance framework itself. Such options include simplifying the administrative framework by lowering the costs of establishing and operating a small business – for instance, through easier registration procedures, and reasonable and fair taxation. Moreover, the potential benefits of legal registration could be increased – for example, through access to commercial buyers in the formal economy, more favourable credit markets and legal protection.

Legal and administrative requirements, such as registration and licensing, can pose an obstacle to small companies. This is particularly evident in cases where the transaction costs or costs of compliance per worker are higher than in larger firms due to smaller companies' lack of internal resources – such as time, money and specialist expertise – to cope with regulations and their inability to spread the costs of compliance across large-scale operations (Chittenden et al, 2002, 2003; Hansford et al, 2003; Hart et al, 2005; Michaelis et al, 2001; OECD, 2000). Where the costs of full administrative compliance are prohibitive, compliance is found to be low (see Adams and Webley, 2001; ILO, 2002; Matthews and Lloyd-Williams, 2001). Examples of administrative costs associated with regulatory compliance include the filling out of forms, inspection rather than advice, inconsistent application of the rules by different regulators or even different inspectors within the same regulator, and duplication of information requirements from different regulators. Indeed, in an analysis of some 45 countries, Richardson (2006) revealed that non-economic determinants have the strongest impact on tax non-compliance. Specifically, he shows that complexity is the most significant determinant of non-compliance; this is followed by level of education, income source, fairness and tax morale. Overall, Richardson's regression results show that the lower the level of complexity – and the higher the level of education, fairness and tax morale – the lower the level of tax non-compliance.

Thus, a potential way forward is to reduce administrative costs and complexity. Such efforts could include simplifying tax administration for small businesses – for example, by reducing the number of tax forms and returns, and pursuing an integrated approach to auditing with only a single visit required to inspect records rather than separate inspections for different taxes. Moreover, support and education could be enhanced to improve companies' capacity to comply with regulations.

Simplifying regulatory compliance, however, need not solely involve relatively minor administrative changes. Measures could also include more fundamental overhauls of the tax administration system, such as introducing a standard deduction for expenses for self-employed people on their tax returns (Elffers and Hessing, 1997).

### Text box 2: *The CUORE initiative in Naples*

The Operative Urban Centre for Economic Upgrading (*Centri Operativi per la Riqualificazione Economica*, CUORE) was established in 1999 based on an agreement between the municipality of Naples and the University Federico II to research the local business environment. This research revealed that the principal local labour market problem in Naples was not unemployment but rather the 'hidden economy'. Today, CUORE consists of a network of neighbourhood service centres for entrepreneurs and aspiring entrepreneurs. Each local CUORE centre offers services to a low-income neighbourhood and their target group is small and micro-sized 'hidden' entrepreneurs with the potential for growth. Once identified, CUORE centres offer information and advice to aid formalisation (Bàculo, 2001, 2002, 2005).

Following a request for services by an undeclared worker, CUORE operators devise custom-made regularisation and development paths. The project workers closely monitor each step in the process to ensure that the enterprise follows the agreed path towards regularisation and that the path still suits the needs of the enterprise. Project workers tend to be familiar with the neighbourhood. In total, according to Bàculo (2005), some 1,280 hidden enterprises have received advisory services and 326 problems have been solved.

Besides providing advice and support, attempts have also been made to offer incentives for businesses to do the same. As a result, business consortia have been established to provide promotional aid and training, arrange trade fairs, help protect the originality of their labels and offer assistance with the internationalisation of their markets. This creates further incentives for companies or individuals to legitimise their business, allowing them to compete on grounds other than labour costs and in turn reduce the necessity for hidden practices. The initiative has resulted in new opportunities for businesses to join these clusters and counteract their perceived need to continue on a hidden basis (Comitato per l'emersione del lavoro no regolare, 2003).

Since its success in Naples, the initiative has started to be replicated elsewhere in Italy.

### **Introducing new categories of legitimate work**

Another possible method for encouraging people and businesses to engage in legitimate activities is to introduce new categories of legitimate work, enabling those involved in undeclared work, often by necessity, to move into the declared realm. For many years, like other Member States, the German government effectively shut its eyes to the fact that people undertake small jobs that they do not declare. Unlike other countries, however, the German government decided to address this situation, creating a new 'mini jobs' category of employment, which encourages people to legitimise these small jobs (see Text box 3).

Similarly, in many other advanced economies, people often feel they have no option but to conduct such small jobs as undeclared work due to the perceived problems involved in declaring this work. Creating a 'mini jobs' category might thus represent a way forward, especially as those engaged in formal employment who conduct small jobs 'on the side' on an occasional basis probably represent the vast bulk of undeclared workers.



Text box 3: *'Mini jobs' in Germany*

Until 1999, 'minor employment' was allowed up to a certain income level of about €325 and with a weekly working time cap of 15 hours. This work was exempt from social security payments for both employers and employees. Employers had to pay a lump-sum tax rate of 23%, while employees were not obliged to pay any tax whatsoever. This minor employment could be combined with normal employment and still remain exempt from tax and social security contributions. At the start of 1999, over 6.5 million minor jobs existed, representing almost 70% of all jobs in the catering industry and 60% of jobs in the cleaning industry. In 1999, the government reformed the minor employment scheme, in an effort to limit its growth. This drove much of this work into the undeclared sphere. As a result, in 2002, the government introduced a new initiative providing for three new types of 'mini job':

- Jobs with a €400 earning threshold – the former €325 income limit was raised to €400. Within this income limit, mini jobs also became subject to reduced social security contributions of 23% (12% for pension insurance and 11% for health insurance contributions) and a lump-sum tax rate of 2%. Moreover, the 15 hours weekly working time cap was abolished.
- Mini jobs in the household sector – introduced to combat undeclared work in this sphere. Accordingly, the employer pays a levy of 12% and can deduct a certain amount from their tax payments.
- 'Midi jobs' – in order to ease the transfer from minor to normal employment, a transition zone was introduced allowing for earnings ranging between €400 and €800, with social security contributions for the employee gradually rising from about 4% to the full 21%.

Compared with the 4.1 million employees in minor employment in September 2002, some 5.5 million employees were recorded at the end of April 2003, one month after the introduction of the mini jobs initiative; this therefore amounted to a rise of around 1.4 million people in minor employment. By 2004, the number of employees in minor employment grew to seven million people. However, some 1.21 million of these were people already in a formal job, about 580,000 of whom are estimated to have transferred their add-on job from the undeclared to the declared realm (Baumann and Wienges, 2003).

**Direct and indirect tax incentives**

A popular assumption is that the most basic way to eradicate undeclared work is by reducing overall tax rates. However, the problem with using general tax reforms to deal with undeclared work is that they have much broader impacts. For this reason, more targeted measures are often developed – as demonstrated by an initiative introduced in the Netherlands (Text box 4).

Text box 4: *Rich Aunt Agatha scheme in the Netherlands*

It is well known that many people starting up in business secure their venture capital not from formal but from informal sources – such as family, friends and acquaintances. A resulting problem is that these loans are often made on a relatively informal basis, which may contribute to an attitude from the outset that informal practices are part of the culture of the enterprise that is being established. In the Netherlands, it was formally recognised that this is how many entrepreneurs receive their venture capital. As a result, a scheme called the Rich Aunt Agatha Arrangement (*Tante Agaath-Regeling*) was introduced as an incentive to those giving loans, and in doing so to help those using personal loans obtained from family and friends (Aunt Agatha) to start off on the right footing. By exempting these private moneylenders from certain taxes, such loans are deliberately put on the radar of the tax authorities. At the same time, the initiative helps to encourage businesses to start off on a more formal basis rather than seeing themselves as being engaged in informal arrangements, which might carry over to their everyday trading practices (Renooy et al, 2004; Williams, 2004d). As of yet, however, no formal evaluation of this initiative appears to have been conducted.

### Micro-enterprise development programmes

Another way of encouraging legitimate start-ups is through the development of micro-enterprise development programmes (MDPs). These programmes provide micro-credit, advice, training and/or support to start-up ventures (Jurik, 2005). Although some MDPs are lending-oriented, others are more training or advice-oriented. Evaluations of MDPs in advanced economies have found them to be effective in promoting business growth, creating jobs and increasing clients' incomes, self-esteem and community involvement (Anthony, 1997; Auawal and Singhal, 1992; Balkin 1989; Edgcomb et al, 1996; Himes and Servon, 1998; Light and Pham, 1998; Servon, 1999). At the same time, they can help to ensure a smoother transition from unemployment to self-employment (Balkin, 1989).

Nevertheless, it is largely unknown whether MDPs are effective in helping fledgling micro-enterprises to start up legitimately. By providing formal loans, MDPs may well help businesses to launch their operations on a formal footing. If such formal loans are also coupled with advice, support and training measures, the likelihood of such ventures starting off on a formal footing could be further enhanced. At this point, however, this initiative has not been evaluated.

### Smoothing the transition to self-employment

Unemployed people often represent only a small proportion of all persons engaged in undeclared work (see, for example, Jensen et al, 1995; Leonard, 1998; Pahl, 1984; Renooy, 1990; Williams, 2004 a–c). Despite this finding, one of the most dynamic areas of public policy aimed at tackling undeclared work, reflecting the shift towards active welfare policies, has entailed easing the transition from unemployment to self-employment. One such initiative is the Ich AG scheme in Germany (see Text box 5).

To date, measures that aim to smoothen the transition to self-employment have focused on helping unemployed people move into self-employment in a legitimate manner. Less attention has been paid to easing the transition from employment to self-employment, despite the evidence that the vast majority of newly self-employed people have previously been employees in employment rather than unemployed persons (SBS, 2003). This is a major gap that needs to be addressed.

#### Text box 5: *Ich AG scheme in Germany*

In Germany, a new business entity was introduced to help ease the transition from unemployment to self-employment, namely the Ich AG scheme. This initiative aims to help unemployed people start up their own business venture as a self-employed person. Individuals receive a monthly subsidy for three years. In the first year, they receive 50% of the average unemployment benefit level; this is reduced to 30% in the second year and to 20% in the third and final year. A start-up monitor shows that, in 2003, over 93,000 long-term unemployed people launched a small business with the assistance of the Ich AG scheme. The German government expected around 20,000 start-ups to be launched (Renooy et al, 2004). Few reliable sources exist on recent figures regarding the results of the initiative. Nonetheless, in December 2005, the German newspaper *Handelsblatt* cited several research institutes, counting 356,000 Ich AGs in November 2005 (Renooy, 2007).

## Legitimising undeclared work

Besides using measures to prevent people from engaging in undeclared work in the first place, measures also exist to enable those already participating in undeclared work to legitimise their activities. Such measures fall into two categories: measures designed to help undeclared workers make the transition to the declared realm; and measures which aim to encourage customers and employers to use declared rather than undeclared labour.

In relation to undeclared workers, at least three types of measures can be pursued:

- society-wide amnesties;
- voluntary disclosure;
- tailored business support and advisory services to help unregistered enterprises make the transition to the formal economy.

On the other hand, measures that aim to encourage customers and employers to acquire goods and services on a declared rather than undeclared basis include:

- targeted indirect tax measures;
- targeted direct tax measures;
- wage cost subsidies, including voucher schemes;
- wage realignment contracts.

### Society-wide amnesties

Society-wide tax amnesties have been used to tackle undeclared work in many countries (see, for example, Hasseldine, 1998; López-Laborda and Rodrigo, 2003; Torgler and Schaltegger, 2005). In Italy, for instance, a six-month amnesty in 2001 generated €1.4 billion in additional tax revenue, constituting 0.4% of total tax revenue (Torgler and Schaltegger, 2005). A further amnesty in 2003 resulted in some 703,000 illegal immigrants coming forward, 48.6% of whom were women employed in undeclared work as domestic workers and carers (Ghezzi, 2006). Indeed, since 1982, more than 60 amnesty programmes have been conducted in the United States (US), with strong variations in the revenue repatriated across the different states (Torgler and Schaltegger, 2005). In a comprehensive review of 43 of these tax amnesties pursued in 35 US states between 1982 and 1997, Hasseldine (1998) shows that the collection rate ranged from between 0.008% and 2.6% of total tax revenue.

### Voluntary disclosure

Another measure involves offering amnesties on an individual basis to those who voluntarily disclose that they have been working on an undeclared basis, as the following example shows (Text box 6).

### Text box 6: *Regularisation campaign in Italy*

In October 2001, the Italian government implemented a law known as the Regularisation Campaign (Law 383/2001), which eventually ceased in February 2003. This allowed hidden workers and enterprises to regularise their situation with respect to issues such as tax, labour, safety, social security contributions and land use irregularities. In exchange, they paid reduced taxes and social contributions for three years, as well as reduced pension contributions for the previous years, to enable them to adapt. Hidden workers were given two options: to declare their irregularities and immediately pay all (reduced) taxes and contributions owing, or to engage in gradual 'regularisation'; the latter entailed submitting a regularisation plan, which included deadlines for solving irregularities, to an ad hoc committee. If the plan was not followed and the deadlines not met, the workers would be penalised by having to pay 100% of the tax and contributions owing, rather than the reduced amount.

In total, this campaign produced some 1,794 declarations and 3,854 new regularised workers (Meldolesi, 2003). On a superficial level, this might imply that the campaign was unsuccessful, as the Italian government expected a much higher level of declarations. However, as Meldolesi (2003) points out, although it failed to reach its targets, the initiative resulted in a process of 'indirect' or 'silent' regularisation. Between October 2001 and October 2002, which was a period of economic stagnation, 385,000 additional workers registered nationally. This is largely because small businesses – although they were reluctant to submit the regularisation form as it was generally perceived as a precarious form of self-incrimination – did regularise indirectly resulting in a process of 'silent' formalisation (Meldolesi, 2003). Thus, evaluated in terms of the indirect formalisation that ensued, this regularisation campaign was more effective than if it was solely evaluated in terms of direct formalisation.

### Advisory and support services

The development of a local advisory and support service tailored specifically for businesses seeking to formalise their operations has been widely discussed in public policy circles both in Italy (see, for example, Bàculo, 2005; Caianello and Voltura, 2003; Meldolesi and Ruvolo, 2003) and the UK (see Evans et al, 2006; SBS, 2004; Williams, 2005). The issue has also been discussed in Europe more generally (Mateman and Renooy, 2001; Renooy et al, 2004) as well as in the US (see, for example, Jurik, 2005).

It is now widely recognised that the type of business advice and support required by those seeking to legitimise their business ventures differs from that which is required by start-up or growth businesses wishing to go through a formal business planning process (Caianello and Voltura, 2003; Copisarow, 2004; Copisarow and Barbour, 2004; ILO, 2002; Meldolesi and Ruvolo, 2003; SBC, 2004; Williams, 2005). It is also acknowledged that support and advice is generally not widely available to these businesses about how they might resolve their situation (Copisarow and Barbour, 2004; ILO, 2002; SBC, 2004; Williams, 2005). The development of a 'formalisation service' is one way forward. The CUORE initiative (see Text box 2) is one such measure which sought to provide enterprises with help and advice on formalisation, much like other measures encompassed in the broader Italian initiative aimed at targeting the hidden economy.

### Targeting consumers with indirect tax measures

One way of encouraging consumers and businesses to use declared rather than undeclared work is to reduce value-added tax (VAT) on specific goods and services where undeclared work is widespread; this could include areas such as the household repair, maintenance and improvement (RMI) sector (see Capital Economics, 2003). However, whether VAT reductions might lead to the increased formalisation of undeclared work is open to debate. Although early academic research argued that the introduction of VAT had little effect on the extent of undeclared work (Bhattacharyya, 1990; Feige, 1990; Frey and Weck, 1983; Macafee, 1980), few contemporary evaluations have analysed whether this is actually the case.

### Targeting consumers with direct tax measures and wage cost subsidies

Although general reductions in income tax rates might be used as a measure, this has very wide societal implications. More targeted strategies, however, are available. One option is to give straightforward income tax relief, claimed on self-assessed tax returns, to customers using declared labour for specific household tasks – such as roof maintenance, outside painting and household cleaning. In the RMI sphere, for example, tax rebates on home maintenance expenses have been available in France since 2000, along with tax reductions for household repairs in Italy and Luxembourg. As the European Commission (1998, p. 14) concludes with regard to such initiatives:

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

In relation to other domestic services – for instance, household cleaning and gardening – similar targeted direct tax measures have been introduced in countries such as Finland and Germany; such measures encourage this type of household work to be carried out in the formal rather than the hidden sector. The following case gives an example of a more tailored measure directed at lowering wage costs for certain types of activities (Text box 7).

#### Text box 7: Home Service Scheme in Denmark

The Danish Home Service Scheme (*Hjemmeserviceordningen*) was launched in 1994 as a pilot project and made permanent in 1997. Its aims were to: firstly, compete with undeclared work; secondly, promote the development of formal enterprises that provide household services; and thirdly, offer job opportunities to low-skilled jobseekers. Under this scheme, businesses registered with the Danish Commerce and Companies Agency (*Erhvervs-og Selskabsstyrelsen*) to provide services to households, for which the government reimbursed a portion of the cost. In 1998, one in eight Danish households used the Home Service Scheme on average five times a year. Almost 90% of consumers were highly satisfied with the company and its services. In 1997 alone, more than 2,000 jobs were created; by 2000, this increased to 3,700 full-time equivalent jobs (Renooy et al, 2004). Analysing the impact of the Home Service Scheme on undeclared work, it has been estimated that the extent of this work has diminished by 10% in Denmark since the introduction of the Home Service Scheme (Platzer, 2002; Sundbo, 1997). The initiative shows how it is wholly feasible to use measures targeting service users to transfer hidden work into the formal realm on a large society-wide scale. However, Larsen (2006) states that the cessation of the Home Service Scheme for all persons other than elderly people has resulted in more people buying their cleaning services as undeclared work, thus creating a new market for undeclared cleaning activities.

### Wage realignment

The objective of wage realignment strategies is to reduce the tax and social contribution burden to help encourage greater compliance and less tax evasion, as the following example shows (Text box 8).

### Text box 8: *Realignment contracts in Italy*

In 1990, wage realignment contracts were adopted in Italy. Accordingly, trade unions and business associations located in a specific area in southern Italy were allowed to determine a minimum wage at local level. This wage could be no less than 25% of the minimum wage established in the national labour contract and had to be adjusted within three years to 100% of the national contract wage. The initiative had the twin objective of reducing the tax and social contribution burden for that time and condoning past non-compliance in terms of tax evasion, safety in the workplace, and welfare. The idea behind this policy is that labour costs are the central reason driving companies to avoid national labour contracts. The three-year period and allowances granted were considered sufficient to enforce regulation.

An analysis of the realignment contracts (Bàculo, 2003) performed in the provinces of Lecce (Puglia region) and Avellino (Campania region) shows that different results were obtained; this was attributed to initial differences in labour conditions and levels of unionisation.

A few years later, realignment contracts were totally abandoned following a decision by the EU, which opposed interventions favouring individual areas of a country – in this case southern Italy.

### Voucher schemes

One specific method for lowering wage costs in certain service sectors is the use of vouchers. Using voucher schemes to encourage customers to employ declared rather than undeclared labour has been a popular measure across the EU (see Text box 9). Nevertheless, the success of service voucher schemes has been variable in the EU Member States.

One such initiative which has proved successful is the Chèque Emploi Service Universel (CESU) scheme, which was introduced in France to simplify the process of hiring and paying a domestic worker. The worker's salary is paid using a system of cheques, which can be purchased at the local bank. The benefit to the customer is that they can claim an income tax reduction amounting to 50% of the sum spent on purchasing the cheques. For the supplier, meanwhile, the salary cannot fall below the national minimum wage, and a 10% indemnity is also given for paid leave. By 2002, the number of households legally using domestic service workers amounted to 765,411 households, while just under 88,000 full-time equivalent jobs were created (Adjerad, 2003). By 2002, some 53% of all formal employers of domestic workers used the CESU scheme (ibid). An estimated 20% of those previously working in the hidden economy are now officially employed (le Feuvre, 2000).

### Text box 9: Service vouchers in Belgium

Service vouchers are a means of paying for everyday personal services. Each voucher costs €6.70 and this pays for an hour of work from certified companies that hire unemployed people. At first, the unemployed person can be hired by the company on a part-time, temporary basis. After six months, the company has to offer the worker a permanent employment contract for at least half-time employment if the person was registered as unemployed. An employee of a certified company can carry out the following activities: housecleaning, washing and ironing, sewing, running errands and preparing meals. The household pays using the vouchers, the cost price of which was €21 in 2005; the difference is paid to the company by the government. The household can recover 30% of the price of the voucher in their tax returns. This effectively means the cost of one hour's work to the customer is €4.69. The Belgian government intended to create 25,000 jobs by the end of 2005.

According to Gevers et al (2005), by the end of 2005, some 28,933 people had been employed through this service voucher scheme. The workers were employed by 792 companies, 41% of which were temporary employment agencies, 25% private not-for-profit enterprises and 18% public companies. The majority (90%) of the workers were employed in part-time jobs, although most work more than half of the time. The 28,933 people in jobs represent 17,360 full-time

equivalent jobs, a 70% increase compared with the number employed in 2004. However, 49% of those employed had already held a job before joining the service voucher scheme. Thus, the net effect on job creation was some 9,000 jobs. By the end of 2005, two thirds of the employees were employed on permanent contracts.

During the two-and-a-half years that the scheme has been in operation, almost 200,000 households have used the voucher scheme. Although early studies found that customers previously sourced some 44% of the work now conducted using service vouchers from the undeclared economy (de Sutter, 2000), the most recent evaluation finds that only 25% reported that it would have been conducted in the undeclared economy if there had been no vouchers. One interpretation is that, in its early days, the scheme acted as a tool for transferring undeclared work into the formal economy, but is now becoming more of a means for moving unpaid self-provisioning activities into the formal economy.

Gross costs for the service voucher schemes are estimated at €303.2 million, encompassing the government subsidy for the jobs, staffing costs and the cost of tax deduction. The additional jobs, however, also generate returns for the government, because they result in savings in unemployment benefits, as well as surpluses in social contributions and personal income tax. These returns are estimated at €93.1 million, which brings the net costs to €210 million in 2005. The outcome is that every full-time equivalent job created through this service voucher scheme has cost in the region of €12,500.

Not all countries, however, have had such a positive experience of service voucher schemes. In Finland, in the late 1990s, only 24,000 households used a service voucher scheme; the low take-up was mainly due to the fact that the subsidy was insufficient to make formal domestic services less costly than hidden economy services (Cancedda, 2001, p. 29). This proves that, unless the incentive is sufficient, such demand-side experiments will be ineffective. It also raises a key issue for tax administrations: the tendency will be to keep costs to a minimum by providing as low an incentive as possible; however, as seen in the case of Finland, the incentive offered can sometimes be too low to encourage consumers to make the transition.

Moreover, until now, voucher schemes have focused on a relatively narrow range of domestic services. It might be useful in the future, therefore, if the range of activities included was expanded to other areas where undeclared work is widespread – such as home improvement and maintenance work.

### Changing attitudes – tax morality

A wealth of research shows that low tax morality leads to higher levels of undeclared work (Alm et al, 1995; Alm and Torgler, 2006; Riahi-Belkaoui, 2004; Richardson, 2006). Therefore, measures to improve people's commitment to paying taxes are important when tackling undeclared work. Indeed, beliefs and attitudes towards undeclared work correlate more strongly with compliance than deterrence factors (Carroll, 1987; Etzioni, 1988; Roth et al, 1989; Smith, 1990). In an analysis of 30 countries, Riahi-Belkaoui (2004) identifies that tax compliance is strongly correlated with high moral norms, as does Richardson (2006) in his comparison of 45 countries. Similarly, Alm et al (1995) and Alm and Torgler (2006) compare the extent of undeclared work and level of tax morality across various countries and find strong evidence that societal attitudes towards tax compliance exert a measurable and significant impact on individual behaviour.

### Campaigns

How, therefore, can the level of tax morality be raised? One tactic for achieving this could be to pursue awareness-raising and information campaigns. Such campaigns could either:

- inform undeclared workers of the costs and risks involved in such work;
- inform potential users of undeclared labour of the risks and costs;
- inform undeclared workers of the benefits of moving to formal work;
- inform potential users of undeclared work of the benefits of formal labour.

Until now, most publicity campaigns have focused on the costs of participating in undeclared work. As Thurman et al (1984) highlight, this approach is ineffective because individuals tend to neutralise their guilt about engaging in undeclared work – for instance, by perceiving the adverse consequences of such work to be the result of others, who could even possibly be big players, rather than their own actions, or by disagreeing that their activity could have adverse consequences for others. As such, awareness raising and information campaigns should perhaps focus on the benefits of formal work, rather than the risks and costs of undeclared work.

### Appeals

The question of whether normative appeals are more effective at eliciting compliant behaviour is open to debate. Although Blumenthal et al (2001) reveal that normative appeals in the US state of Minnesota only affected some groups of taxpayers, and Chung and Trivedi (2003) find that friendly persuasion is effective, it depends on the nature of the appeal made. Hasseldine et al (2007) examined 7,300 sole proprietors in the UK. Comparing the effect of five different letters –ranging from a simple offer of assistance to a letter advising that the person’s tax return had been pre-selected for audit – they find that tax compliance appeals resulted in greater compliance, particularly among those who do not use a paid accounts person. Sanction appeals, however, were found to be more effective than normative appeals.

The effectiveness of appeals, nonetheless, depends not only on the nature of the appeal; it is also influenced by the individuals addressed and their perceptions of the social norms, the fairness of the tax system and whether there is perceived procedural justice in the tax administration. In relation to the individuals addressed and their perceptions of the social norms, Wenzel (2005a) finds that: tax ethics causally affected tax compliance and also that tax ethics are themselves affected by compliance levels; that perceived social norms causally affect personally held tax ethics, but only for respondents who identified strongly with their respective group; and that perceived social norms causally affect tax compliance. Wenzel (2005b) also reveals that misperceptions of social norms can have a significant impact on tax compliance. If undeclared work is viewed as extensive, tax compliance declines. In addition, Wenzel (2004b) finds that, in Australia, when taxpayers strongly identify with the group to whom social norms (ethics and morality attributed to other taxpayers) are attached, they internalise the social norms and act accordingly. If tax morality is perceived as high, they thus engage in tax compliant behaviour. In contrast, if morality is seen as low, non-compliance increases.

These findings have major implications when considering the effectiveness of peer surveillance as a tool for tackling undeclared work. To be effective, there must be an overall high degree of tax morality in the population in general. Thus, there is a case to be made for positive publicity campaigns on the benefits of declared work in conjunction with telephone support lines.



### **Perceived fairness and justice of tax system**

The perceived fairness and justice of the tax system and administration also has a significant impact on tax morality and compliance (Wenzel, 2002). ‘Fairness’ refers to the extent to which individuals believe that they are paying their fair share of tax compared with others (Kinsey and Gramsick, 1993; Wenzel, 2004b); ‘justice’ relates to whether citizens receive the goods and services they believe they deserve, given the taxes they pay (Kinsey and Gramsick, 1993; Kinsey et al, 1991; Mason and Calvin, 1984; Richardson and Sawyer, 2001; Scholz and Lubell, 1998; Thurman et al, 1984); ‘procedural justice’ refers to the degree to which people believe that the tax authority has treated them in a respectful, impartial and responsible manner (Braithwaite and Reinhart, 2000; Murphy, 2005; Tyler, 1997; Wenzel, 2002). As Murphy (2005) finds, people who feel that they have been treated in a procedurally fair manner by an organisation will be more likely to trust that organisation and more inclined to accept its decisions and follow its directions.

### **Tax knowledge**

Given that tax morality is found to be highly correlated with the level of tax knowledge (Eriksen and Fallan, 1996; Lewis, 1982), one potential way of improving tax morality – and therefore compliance – is to improve tax knowledge. As Eriksen and Fallan (1996, p. 399) conclude, ‘a successful means of preventing tax evasion is to provide more tax knowledge to larger segments of society, in order to improve tax ethics and people’s conception of the fairness of the tax system’.

To evaluate the approaches and measures used in the EU27 when tackling undeclared work, a typology of the potential approaches and measures was provided as a baseline against which the strategies employed in the EU Member States can be assessed, along with the direction of change. This has revealed that although the approach towards targeting undeclared work in the EU remains heavily embedded in a deterrence approach, which seeks to increase the actual or perceived likelihood of detection and penalties, there has also been a noticeable increase in the use of a more enabling approach and measures across Member States – particularly, in the use of prevention measures, since Employment Policy Guideline No. 9 was published in 2003. So far, however, the take-up of legitimising measures and initiatives to engender commitment to tax morality has been much slower. As such, since Employment Guideline No. 9 was published, a diversification of approaches and measures appears to have emerged when tackling undeclared work.

Nevertheless, it is still open to debate whether the most effective approaches and measures are now being used and which measures are suitable for the particular context – that is, national, regional or local. Until now, there has been no knowledge bank available enabling policymakers to:

- determine what has been tried and tested elsewhere, and in which context;
- assess the relative effectiveness of different approaches and measures;
- evaluate the transferability of different approaches and measures across countries, sectors and occupations.

The development of a knowledge bank that addresses the effectiveness of different measures is therefore an important step forward in tackling undeclared work. Unless such a resource is further developed, Member States will be unable to quickly learn from each other about what works and what does not, and may well continue to make the same mistakes.

The additional value of such a knowledge bank is that, as it develops, it will quickly reveal where further evaluative work is required to fill the gaps in understanding on the effectiveness of specific approaches and measures. As a first step towards developing this knowledge bank, this report examines in detail the measures and approaches of five countries in relation to tackling undeclared work. From this analysis, it has become evident that although there are some comprehensive evaluations of specific measures which provide a solid evidence base for Member States to decide whether to test the initiative in their own country, many other measures have not been subject to rigorous analysis. One outcome of this attempt to create a knowledge bank, therefore, is the emerging patchy nature of the evidence base.

If this initial overview report facilitates the further development of such a knowledge bank on the feasibility, effectiveness and transferability of different approaches and measures – and starts to encourage all of the social partners involved in the fight against undeclared work to share their experiences – then it will have begun to achieve its objective.

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