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## Tackling Europe's Informal Economy: A Critical Evaluation of the Neo-liberal De-regulatory Perspective

**Colin C Williams** *University of Sheffield*

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## Abstract

Since the turn of the millennium, there has been widespread recognition that the informal economy is a sizeable and growing feature in the global economy. To explain this, neo-liberals have contended that the informal economy is a direct result of over-regulation, high taxes and state interference in the free market. Their remedy, therefore, is de-regulation, tax reductions and minimal state intervention. This article evaluates critically this neo-liberal perspective towards the informal economy. Reviewing cross-national comparative data from the 27 member states of the European Union, the finding is that few people explain their own and others' participation in the informal economy using such rationales, that higher tax rates are not correlated with larger informal economies, and that lower levels of state intervention are correlated with larger (not smaller) informal economies. The article concludes by refuting the neo-liberal approach as a remedy and calling for more, rather than less, regulation of the economy.

## Keywords

Shadow economy; hidden economy; informal sector; informal employment; Europe

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For much of the twentieth century, the belief was that the informal economy was simply a residue from some past regime of accumulation and that it was gradually disappearing from view (Geertz 1963; Lewis 1959). In the new millennium, however, there has been recognition that the informal economy is an extensive and persistent feature of the global economic landscape (Williams and Nadin 2012a, 2012b). Indeed, of the global workforce of three billion, the OECD estimates that the majority (1.8 billion) works in the informal economy (Jütting and Laiglesia 2009). To explain this, neo-liberals have argued that its persistence and growth results from high taxes, over-regulation and state interference in the free market and that the solution is therefore to pursue tax reductions, de-regulation and to minimise state interference in the market (Nwabuzor 2005; Becker 2004; London and Hart 2004; De Soto 2001, 1989). The aim of this article is to evaluate critically this neo-liberal explanation of the informal economy as well as its resultant remedies.

To commence, therefore, the first section reviews the increasingly dominant neo-liberal explanation for the persistence and growth of the informal economy that views it to result from high taxes, over-regulation and too much state interference in the working of the market. To start to evaluate critically the validity of this neo-liberal explanation, attention turns in the second section to an evaluation of whether the cross-national variations in the size of informal economy in the 27 member states of the European Union can be explained in such terms. This evaluates not only whether participants explain their own and others' participation in the informal economy in such neo-liberal terms but also whether the size of the informal economy is smaller in member states in which there are lower taxes and less state interference. The concluding section then evaluates critically the validity of this neo-liberal perspective and calls for an alternative approach based on more, rather than less, regulation of the economy.

Before commencing, however, this sphere in which nearly two-thirds of all global jobs are found needs to be defined. Reviewing the extensive literature, it becomes quickly apparent that at least 45 different adjectives have been so far used to denote this endeavour, such as 'unregulated', 'non-visible', 'a-typical', 'irregular', 'hidden', 'shadow', 'informal', 'cash-in-hand' and 'undeclared'. Nearly all describe what is absent, insufficient or missing from work in the informal economy relative to work in the formal economy. Despite the array of terms used, there is a strong consensus regarding what is missing, insufficient or absent. The informal economy is widely taken to include remunerated

activity which is not declared to the state for tax, social security and labour law purposes when it should be declared, but is legal in all other respects (Williams 2010, 2007, 2004, 2001; European Commission 2007b, 1998; Sepulveda and Syrett 2007; Williams and Windebank 2006, 1998, 1994; Renooy et al. 2004). Consequently, if economic activity possesses other absences or insufficiencies, such as that the good and/or service traded is illegal, or that no money changes hands, then it is not part of the informal economy but instead part of the 'criminal' economy or unpaid economy respectively. However, there are of course blurred edges to this definition such as when gifts or in-kind labour are exchanged in lieu of money (White 2009). For the purposes of this article, nevertheless, only monetary transactions are here deemed as the informal economy.

## **LITERATURE REVIEW: EXPLAINING THE PERSISTENCE OF THE INFORMAL ECONOMY**

For much of the twentieth century, a widespread belief was that the modern formal economy was colonising every nook and cranny of the economic landscape and that the informal economy was merely a residue or remnant from some past regime of accumulation that was gradually waning and disappearing (Geertz 1963; Lewis 1959; Boeke 1942). From this perspective, therefore, there was little reason to pay much attention to the informal economy. The belief was that it was wholly appropriate for the study of the economy to focus upon the apparently ever more dominant modern formal economy.

Over the past few decades, however, this has begun to be questioned with the recognition that the informal economy is widespread, persistent and even growing relative to the formal economy in many global regions (Buehn and Schneider 2012; Feld and Schneider 2010; Schneider et al. 2010; Jütting and Laiglesia 2009; Rodgers and Williams 2009; ILO 2002a, 2002b; OECD 2002). Indeed, given that the informal economy on a global level has been estimated to be equivalent to 33 per cent of global GDP (Schneider 2011) and some 60 per cent of all jobs worldwide are asserted to be in the informal economy (Jütting and Laiglesia 2009), it can no longer be depicted as some leftover, residue or remnant. The result is that new explanations for its persistence and growth have emerged.

At first, it was a structuralist view that tended to be the dominant explanation for the persistence and growth of the informal economy. This viewed the informal economy not as separate from, but an inherent component of, contemporary capitalism, providing businesses with a channel to attain flexible production, profit and cost reduction. The informal economy was thus seen as a key component of the new downsizing, sub-contracting and outsourcing arrangements emerging under de-regulated global capitalism, as well as a receptacle into which surplus labour is cast to eke out a survival in the absence of alternative means of livelihood (Slavnic 2010; Davis 2006; Gallin 2001; Sassen 1996; Castells and Portes 1989). Viewed through this structuralist lens, informal work was seen to be a result of under-regulation and composed almost entirely of 'sweatshop-like' dependent employment and/or 'false' self-employment, with informal workers viewed as unfortunate and unwilling pawns in an exploitative global system working in this realm out of necessity (Ghezzi 2010; Ahmad 2008; Geetz and O'Grady 2002).

Over the past few decades, however, it has been widely recognised that the vast majority of work in the informal economy is conducted on a self-employed basis and often as a matter of choice rather than due to a lack of choice (OECD 2012; Williams and Nadin 2012a, 2012b; Williams et al. 2012, 2011; Williams 2011, 2010, 2006, 2003; Neuwirth 2011; Williams and Round 2010, 2008; Venkatesh 2008; Cross and Morales 2007; Small Business Council 2004; Snyder 2004; ILO 2002b; De Soto 2001, 1989; Cross 2000). Based on this recognition, a neo-liberal explanation has come to the

fore that reads the informal economy to be a result of over-regulation rather than under-regulation (Nwabuzor 2005; Becker 2004; London and Hart 2004; Small Business Council 2004; De Soto 2001, 1989). Seen through this lens, informal workers have become widely depicted as micro-entrepreneurs voluntarily choosing to operate in the informal economy on a self-employed basis and heralded as heroes casting off the shackles of state over-regulation (e.g., De Soto 1989; Sauvy 1984). As Nwabuzor (2005: 126) asserts: 'Informality is a response to burdensome controls, and an attempt to circumvent them', or as Becker (2004: 10) puts it, 'informal work arrangements are a rational response by micro-entrepreneurs to over-regulation by government bureaucracies'. Informal workers are thus seen to be only breaking unfair rules and regulations imposed by an excessively intrusive state. The informal economy is consequently construed as a form of popular resistance to state over-regulation and informal workers viewed as a political movement that can generate both true democracy and a rational competitive market economy (De Soto 1989). For neo-liberals, the persistence and growth of the informal economy is therefore a direct result of high taxes, over-regulation and state interference in the free market. Their resultant policy approach is to pursue tax reductions, de-regulation and minimal state intervention.

However, although neo-liberals heap praise on informal entrepreneurs, their intention is not to promote such work. That is a popular misreading. Rather, their desire was and is to eradicate informal work as much as the structuralists discussed above. For neo-liberals, nevertheless, this is to be achieved by reducing taxes and state regulations so as to unshackle formal employment from the constraints that force up labour costs and prevent flexibility, and remove the constraints that act as a disincentive to those seeking formal jobs. With fewer regulations, the notion is that the distinction between formal and informal work will wither away so that the formal and informal spheres become inseparable since all activities would be performed in the manner now called 'informal work', although such activity would be 'formal' since it would not be breaking any rules.

The neo-liberal project, in consequence, is to de-regulate the formal economy and give the market free rein by preventing state interference in the working of the free market, and also to reduce state welfare provision. Neo-liberals view the welfare state and the economy as adversaries in that one is usually seen as the root cause of problems in the other. The difference is that whilst structuralists largely favour the welfare state and view free market capitalism as hindering social equality, neo-liberals support the free market and dislike any structure that constrains it. Structuralists therefore read intervention in the economy and social protection as necessary for the functioning of modern capitalism and indeed, a pre-requisite for efficiency and growth as well as individual self-realisation. Neo-liberals, in marked contrast, read state interference in the economy and state provision of social protection as interfering with individual freedoms and the ability of the market to optimise the efficient allocation of scarce resources. Although debates exist within neo-liberalism over the degree to which social protection should be provided (see Williams 2004), this should not mask the fact that neo-liberal commentators are largely negative about social protection and social transfers due to their deleterious influence on economic performance. For them, competitive self-regulatory markets are superior allocation mechanisms from the viewpoint of both efficiency and justice. Thus it follows that government interference in allocation processes (aside from marginal cases of imperfections, externalities or market failure) risks generating crowding-out effects, maldistribution and inefficiency with the inevitable end result that the economy will produce less aggregate wealth than if a *laissez-faire* approach were adopted (Lindbeck 1981; Okun 1975).

For neo-liberals, in sum, the persistence and growth of the informal economy is a direct result of high taxes, over-regulation and state interference in the free market. To evaluate critically the validity of this neo-liberal explanation, therefore, several hypotheses can be tested. These are:

- that people view themselves and others as engaging in the informal economy due to high tax rates and the burdensome bureaucracy/red tape involved in working formally;
- that countries with higher tax rates have larger informal economies;
- and that countries with greater levels of state interference in the workings of the free market have larger informal economies.

Here, the intention is to evaluate critically these hypotheses in relation to the 27 member states of the European Union (EU-27) so as to begin to explore the validity of the neo-liberal explanation.

### **METHODOLOGY: EXAMINING NEO-LIBERAL EXPLANATIONS FOR EUROPE'S INFORMAL ECONOMY**

To evaluate whether people view themselves and others as working in the informal economy for the reasons neo-liberals assert, namely high tax rates and the over-burdensome bureaucracy/red tape involved in working in the formal economy, data is reported from the 2007 Eurobarometer survey of participation in the informal economy conducted in the 27 member states of the European Union (European Commission 2007a; TNS Infratest et al. 2006). This involved 26,659 face-to-face interviews, 500 in the smaller nations and 1,500 interviews in the larger EU countries, based on a multi-stage random (probability) sampling method with sampling points drawn with probability proportional to population size and population density according to the Eurostat's NUTS II (or equivalent) and the distribution of the resident population in terms of metropolitan, urban and rural areas. Further addresses (every *n*th address) were subsequently selected by standard 'random route' procedures from the initial address. Within each household surveyed, furthermore, the respondent was chosen using the 'closest birthday rule'. The interviews were conducted face-to-face in their homes and in the appropriate national language with adults aged 15 years and over. The interview schedule firstly asked respondents for their opinions regarding the informal economy and then moved onto questions regarding their purchase of goods and services from the informal economy, followed by their supply of work in the informal economy, including the type of work conducted, for whom and their reasons. Here, the focus is be upon the results regarding their opinions about why people engage in informal work and the reasons given by informal workers for doing so.

To analyse whether EU countries with higher tax rates have larger informal economies, meanwhile, the size of the informal economy is here derived from a European Commission-funded evaluation of the magnitude of the informal economy in the EU-27 using indirect measurement methods (GHK and Fondazione Brodolini 2009). Indirect measurement methods either seek statistical traces of such work in non-monetary indicators (e.g. discrepancies in labour supply figures, electricity demand), monetary indicators collected for other purposes (e.g. currency demand) or investigate the discrepancies between income and expenditure levels either at the aggregate or household level. Here, the mean estimate resulting from all the indirect measurement methods that have been used over the past decade in each country is used to estimate the size of informal economy. Although this is not a perfect measure, it does nevertheless avoid over-reliance on one method. Examining the measurement methods used over the past decade in the EU-27, the monetary currency demand method has been most frequently used (in 39 instances across 27 member states), followed by the income/expenditure discrepancy method (28 sources) and labour input variances (27

sources). The number of estimates produced also varies across countries, with the highest number in Spain (14), followed by Slovenia (10), Hungary and Croatia (9 each), and Netherlands, Poland and Turkey (8 sources in each country). For the UK, GHK and Fondazione Brodolini (2009) found no estimates, so the result produced by Schneider (2011) using a dynamic multiple variables method is here used. For Malta and Luxembourg no results are available so these countries are not included.

The varying tax rates across the EU-27, meanwhile, are taken from the official publications of the European Statistical Office (Eurostat 2011, 2007). Firstly, the implicit tax rates on employed labour in the EU-27 are evaluated, which is the sum of all direct and indirect taxes and employees' and employers' social contributions levied on employed labour income divided by the total compensation of employees working in the economic territory. Secondly, the total tax revenue (excluding social contributions) as a percentage of GDP in each member state is analysed. Total tax revenue here includes all taxes on production and imports (e.g. taxes enterprises incur such as for professional licences, taxes on land and building and payroll taxes), all current taxes on income and wealth (including both direct and indirect taxes) and all capital taxes (Eurostat 2007).

To evaluate the relationship between the size of the informal economy and levels of state interference in the workings of the free market, meanwhile, three indicators are used. Firstly, the level of spending on state labour market interventions as a proportion of GDP (Eurostat 2011), secondly, the level of state social protection expenditure (excluding old age benefits) as a proportion of GDP (European Commission 2011) and third and finally, the impact of state redistribution via social transfers (European Commission 2011), are analysed. Each is discussed in more detail below.

## **FINDINGS: EVALUATING CRITICALLY NEO-LIBERAL EXPLANATIONS FOR EUROPE'S INFORMAL ECONOMY**

*Hypothesis 1: People participate in the informal economy due to high tax rates and the burdensome bureaucracy/red tape involved in working legitimately*

To evaluate this hypothesis, the 2007 Eurobarometer survey evaluates firstly, respondents' opinions of why people participate in the informal economy and secondly, the reasons informal workers themselves give for participating in the informal economy. According to neo-liberal thought, the reasons for engaging in such endeavours are less to do with economic necessity (e.g. the inability to find a regular job, the fact that customers insist on non-declaration) as structuralists argue, and more to do with voluntary choice such as to avoid paying high taxes, and due to the burdensome bureaucracy/red tape involved in working formally. As Table 1 displays, however, just 16.7 per cent of the 26,659 respondents are of the opinion that high taxes and/or social contributions are the primary reason for people working in the informal economy and just 7.8 per cent say that the primary reason is because the bureaucracy and red tape involved in carrying out legitimate work is too complicated. Instead, many respondents are of the opinion that structural issues are the primary reason for people operating in the informal economy, such as the low salaries in the formal economy, the lack of regular jobs and the lack of any alternative. As such, popular opinion does not provide any resounding support for the neo-liberal assertion that informal work is due to high taxes and a burdensome bureaucratic state; less than a quarter of the population believes these are the primary reasons for participating in the informal economy.

*Table 1: What in your opinion is the reason for working in the informal economy?*

Reason:	% of respondents
Salaries in the regular businesses are too low	26.1
Taxes and/or social contributions are too high	16.7
Lack of control by authorities	12.0
Lack of regular jobs on the labour market	10.4
In certain sectors or regions there is no alternative	7.4
Bureaucracy/red tape to carry out a regular economic activity is too complicated	7.4
Sanctions are too weak	5.3
The state does not do anything for people, so why should they pay taxes	3.3
Nobody would buy these goods or services at normal market prices	2.4
Don't know/refusal/other	9.0

Source: data from 2007 Eurobarometer survey No. 284 on undeclared work

These, however, are simply the opinions of the population about why people work in the informal economy. They are not the reasons informal workers give for why they do so. To evaluate informal workers' motives, Table 2 reports the results of asking informal workers whether they agreed or not with a range of statements about reasons for working in the informal economy. Respondents could tick all relevant reasons. The finding is that just 12.9 per cent of the informal workers surveyed state that one of their reasons is the high levels of tax and/or social contributions and 7.8 per cent that it is the bureaucracy and/or red tape involved in conducting work on a formal basis. As such, only a small minority of informal workers explain their work in the informal economy as being due to high taxes and social contributions, and a burdensome state apparatus.

*Table 2: Among the following, what were your reasons for doing this activity in the informal economy?*

Reason	% of informal workers
Both parties benefited from it	46.7
You could not find a regular job	22.7
Working undeclared is common practice in this region/sector so there is no real alternative	15.6
It is just seasonal work so not worth declaring it	15.5
Taxes and/or social contributions are too high	12.9
The person who acquired it insisted on its non-declaration	11.9
Bureaucracy/red tape to carry out a regular economic activity is too complicated	7.8
The state does not do anything for you, so why should you pay taxes	5.5
You were able to ask for a higher fee for your work	5.3

Source: data from 2007 Eurobarometer survey No. 284 on undeclared work

Instead, the reasons for informal workers engaging in the informal economy again often appear to involve structural explanations and to be borne out of necessity rather than choice. For example, many asserted that they could not find a regular job, that there was no alternative in their region/sector so there is no real alternative and that it was just seasonal work so not worth declaring it, or that the person acquiring it insisted on non-declaration.

The most common reason, namely that both parties benefited from it, moreover, is not even superficially part of any neo-liberal discourse so far promulgated. Yet it is the case that it could be interpreted as part of a neo-liberal perspective of entering the informal economy voluntarily. In many EU nations, a dual formal labour market exists where the insiders have strong protection whilst the outsiders have fewer rights and protection. For neoliberals, it is this that makes people work in the informal sector. While the insiders are highly regulated and protected by the state, the outsiders prefer working informally since this is often a better choice than working formally and paying taxes. When respondents assert that both parties benefit from informality, therefore, it could be interpreted that it is this trade-off between being temporary and having to pay taxes or being informal and not paying taxes which is being discussed. This, however, will require further qualitative research before this can be asserted with any certainty.

Nevertheless, although only a minority of informal workers explain their informal work as being because of high tax and social contribution levels, as well as burdensome bureaucracy, this neo-liberal explanation is more popular in some populations than others. As Table 3 reveals, the neo-liberal explanation that informal work is conducted because taxes and/or social contributions are too high, is statistically significantly more likely to be cited by informal workers in East-Central Europe and amongst men, middle-aged people, those with formal qualifications, on lower-incomes, employed in either very small businesses or the larger businesses, and managers, other white collar workers and the unemployed. Those statistically significantly more likely to undertake informal work because the bureaucracy/red tape involved in regular work is too complicated are those with more years in education or still studying, those working in their regular employment in larger businesses, and managers and students.

As such, the finding is that only a minority of people explain their own and others' participation in the informal economy in terms of such neo-liberal rationales. Consequently, the hypothesis that people participate in the informal economy in the EU-27 due to high tax rates and the burdensome bureaucracy/red tape involved in working legitimately is refuted. Instead, many explain their own and others' participation in terms of structural rationales.

*Hypothesis 2: EU member states with higher tax rates have larger informal economies.*

Neo-liberals commonly assume that the informal economy is a direct result of high tax rates and that the remedy is therefore to reduce taxes so as to decrease the size of the informal economy. Here, and to evaluate the relationship between the size of the informal economy and tax rates, firstly, the implicit tax rates on employed labour in the EU-27 (Eurostat 2011) are analysed. As Eurostat (2007) explain, the implicit tax rate (ITR) on employed labour is the sum of all direct and indirect taxes and employees' and employers' social contributions levied on employed labour income divided by the total compensation of employees working in the economic territory. The ITR on labour is calculated for employed labour only (so excludes the tax burden falling on social transfers, including pensions). Direct taxes are the revenue from personal income tax that can be allocated to labour income, while indirect taxes on labour income are taxes such as payroll taxes paid by the employer. Employers' contributions to social security (including imputed social contributions), as well as to private pensions and related schemes, are also included. The compensation of employees is the total remuneration, in cash or in kind, payable by an employer to an employee in return for work done.



Table 3: Who cites neo-liberal reasons for participating in informal work? By population group

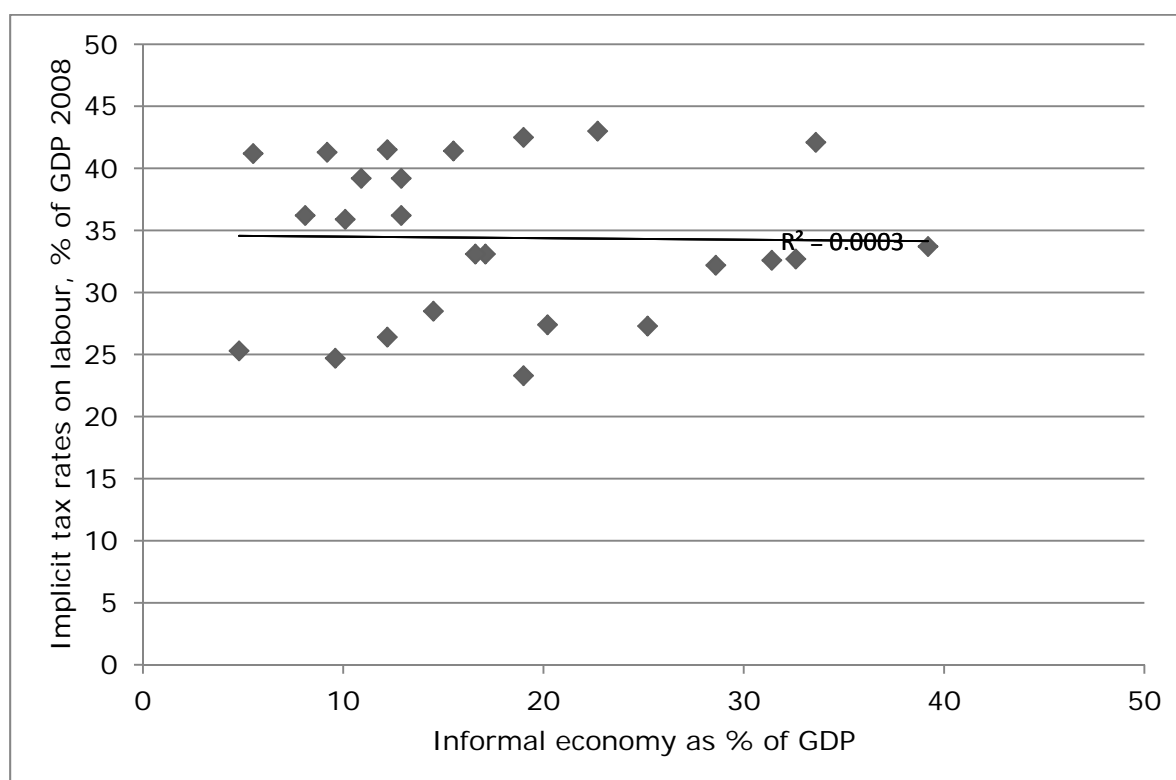
	Taxes and/or social contributions are too high (%)	Bureaucracy/red tape too complicated (%)
All	12.9	7.8
<i>EU region:</i>		
Nordic	10.3***	13.7
Western	10.3	6.9
East-Central	18.2	7.3
Southern	13.1	7.4
<i>Gender:</i>		
Men	14.8**	8.1
Women	9.6	7.2
<i>Age:</i>		
15-24	8.1***	7.8
25-39	16.3	9.5
40-54	15.0	7.5
55+	10.9	3.6
<i>Education (end of):</i>		
15	11.8***	3.6***
16-19	15.8	5.2
20+	13.3	11.6
Still studying	5.7	11.4
<i>Gross formal job income/ month (€)</i>		
<500	18.0***	7.0
500-1000	10.6	5.3
1001-2000	21.4	7.1
2001-3000	7.4	6.4
3001+	6.6	11.7
<i>Size of business in which employed:</i>		
1-20 people	17.4***	5.3***
21-50 people	5.5	5.6
51-100 people	5.9	2.0
101-500 people	22.2	7.8
501+ people	10.0	14.1
<i>Employment status:</i>		
Self-employed	10.8***	8.0***
Managers	19.0	16.7
Other white collar workers	16.3	7.8
Manual workers	13.0	5.3
House person	9.7	3.2
Unemployed	24.0	6.9
Retired	10.0	3.3
Students	5.6	11.4

Significant levels at: \*\*\* p<0.01, \*\* p<0.05, \* p<0.1. Source: data from 2007 Eurobarometer survey No. 284 on undeclared work

It is thus the gross wage from employment before any charges are withheld. The resulting ITR on labour is therefore a summary measure of the average effective tax burden on labour income.

Figure 1 displays the relationship between the size of the informal economy and the implicit tax rates on labour (i.e. the average effective tax burden on labour income) across the 27 member states of the European Union. Contrary to the neo-liberal assertion that high tax rates result in the growth of informal economies, this displays that there is no significant correlation between the implicit tax rates on labour and the size of informal economies in the EU-27. Using Spearman's rank correlation coefficient ( $r_s$ ), no statistically significant correlation is found between the size of the informal economy across the EU-27 and the implicit tax rates on labour ( $r_s = -0.011$ ). Merely 0.03 per cent of the variance in the size of the informal economy is correlated with the variance in implicit tax rates ( $R^2 = -0.0003$ ). EU member states with higher average tax burdens on labour income do not have larger informal economies, thus refuting the neo-liberal assertion that the informal economy is a direct result of high taxes and that the solution is therefore to pursue tax reductions.

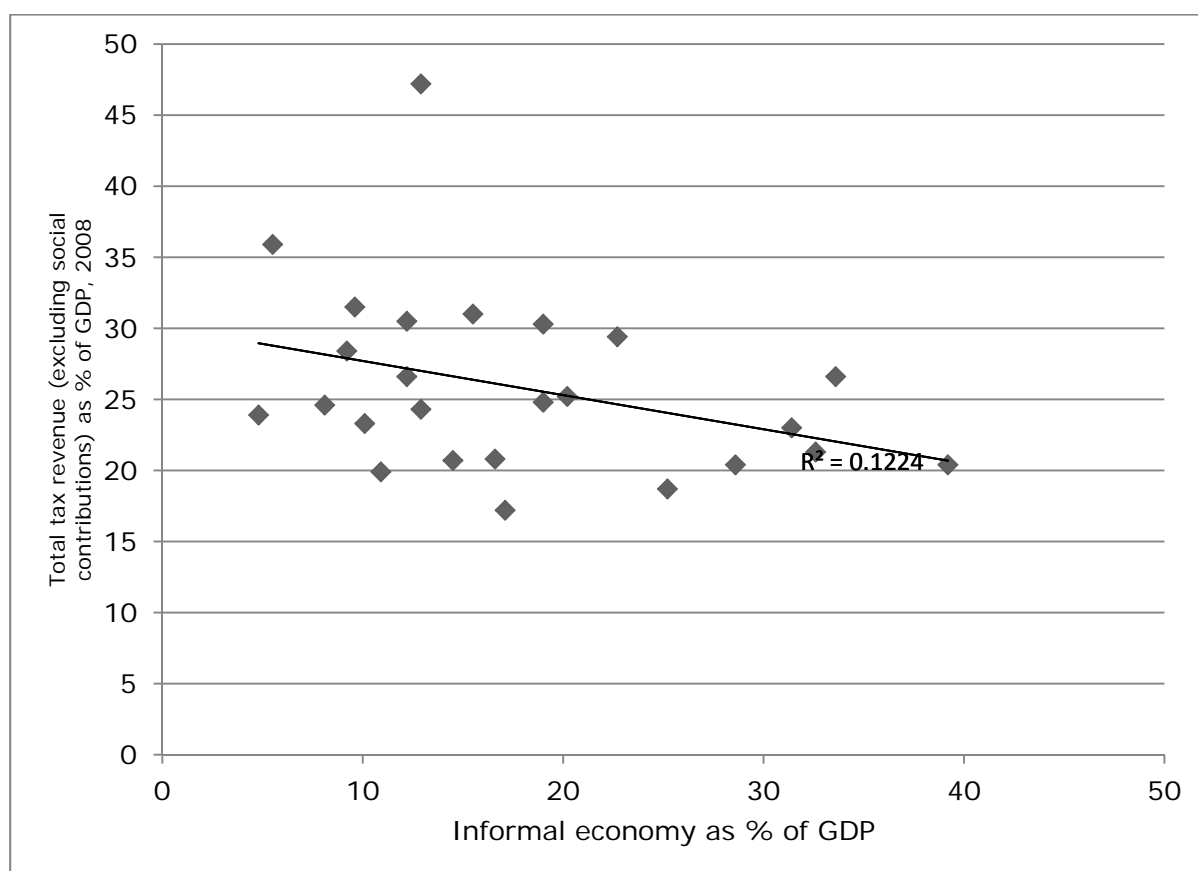
Figure 1: Relationship between magnitude of informal economy and implicit tax rates on labour



Given this, it is important to evaluate this finding a little further, especially given that the ITR on labour income does not take into account tax rates on self-employed income. Here, therefore, the relationship between the size of the informal economy and another indicator of taxation rates is used, namely total tax revenue (excluding social contributions) as a percentage of GDP. Total tax revenue here includes: all taxes on production and imports (e.g. taxes enterprises incur such as for professional licences, taxes on land and building and payroll taxes), all current taxes on income and wealth (including both direct and indirect taxes) and all capital taxes. At first glance, Figure 2

appears to support the neo-liberal assertion that higher tax rates are correlated with larger informal economies. It shows that EU member states where the total tax revenue is higher as a proportion of GDP have larger informal economies. However, this relationship is not statistically significant ( $r_s = -0.357$ ;  $R^2 = 0.1224$ ); higher total tax revenues as a proportion of GDP are not correlated with larger informal economies. In sum, whether one examines the implicit tax rates on labour (as a summary measure of the average effective tax burden on labour income) or the total tax revenue as a percentage of GDP, the hypothesis that EU member states with higher tax rates have larger informal economies is refuted. No significant statistical correlation is identified between tax rates and the size of the informal economy.

Figure 2: Relationship between magnitude of informal economy and total tax revenue, 2008



*Hypothesis 3: EU member states with greater levels of state intervention have larger informal economies.*

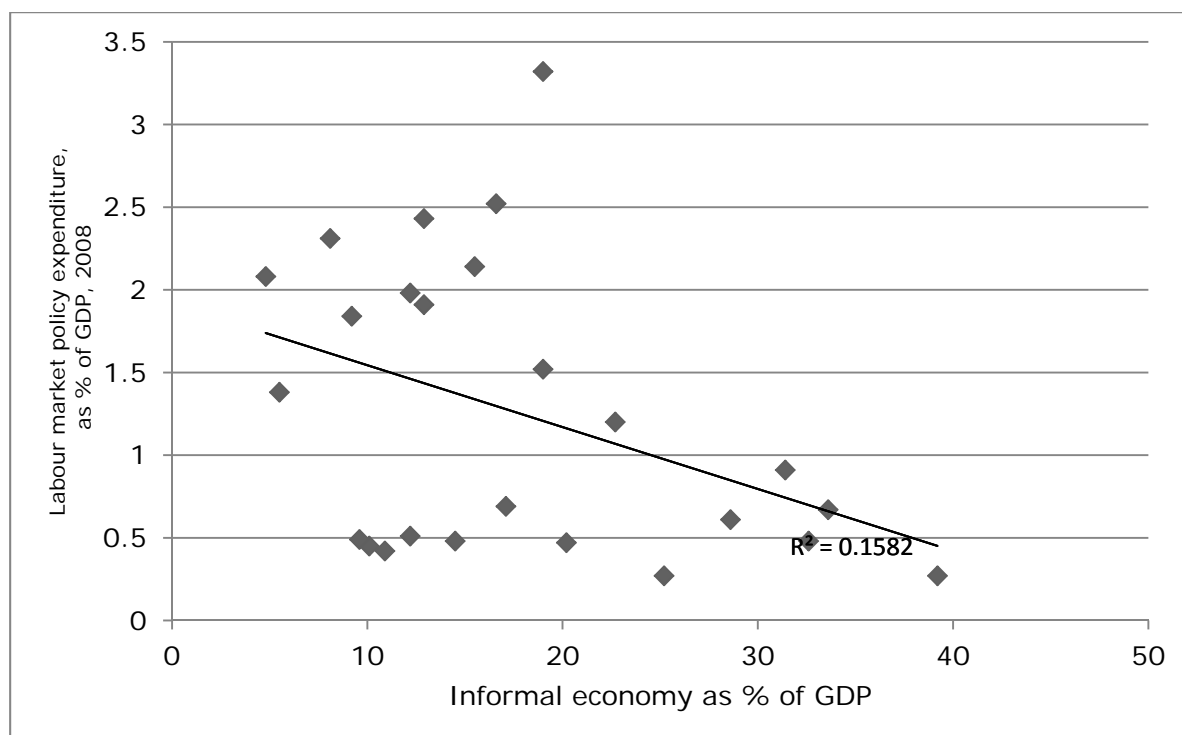
If there is no statistically significant relationship between tax rates and the informal economy, is it nevertheless the case that greater levels of state intervention are correlated with larger informal economies? To evaluate this, the correlation between the size of the informal economy and firstly, the extent of state labour market interventions as a proportion of GDP, secondly, the level of social protection expenditure as a proportion of GDP and third and finally, the impact of state redistribution, are analysed.

According to neo-liberal discourse, the size of the informal economy is a direct result of the level of state interference in the workings of the economy. As such, the greater the

level of state intervention in the labour market, the greater will be the size of the informal economy. To evaluate this, the extent of state labour market measures which can be described as public interventions in the labour market aimed at correcting disequilibria are evaluated. Public interventions refer to measures taken by general government which involve expenditure, either in the form of actual disbursements or of foregone revenue (reductions in taxes, social contributions or other charges normally payable), explicitly targeted at groups of people with difficulties in the labour market. In broad terms, this covers people who are unemployed, people in employment but at risk of involuntary job loss, and inactive persons who are currently not part of the labour force but who would like to enter the labour market and are disadvantaged in some way (Eurostat 2011).

As Figure 3 displays, there is a correlation between the proportion of GDP spent on labour market policy measures and the size of informal economies ( $r_s = -0.316$ ), and 16 per cent of the variance in the size of the informal economy is correlated with the variance in the proportion spent on social protection ( $R^2 = 0.1582$ ). However, the trend is not in the direction suggested by neo-liberals. The greater the level of state expenditure on labour market interventions, the smaller (not larger) is the informal economy. Nevertheless, this is not a statistically significant correlation. Once again, therefore, and akin to tax rates, there is no support for the neo-liberal thesis that greater state interference in the labour market is correlated with larger informal economies. There is no statistically significant relationship across the EU-27 between the level of state labour market policy expenditure and the size of informal economies.

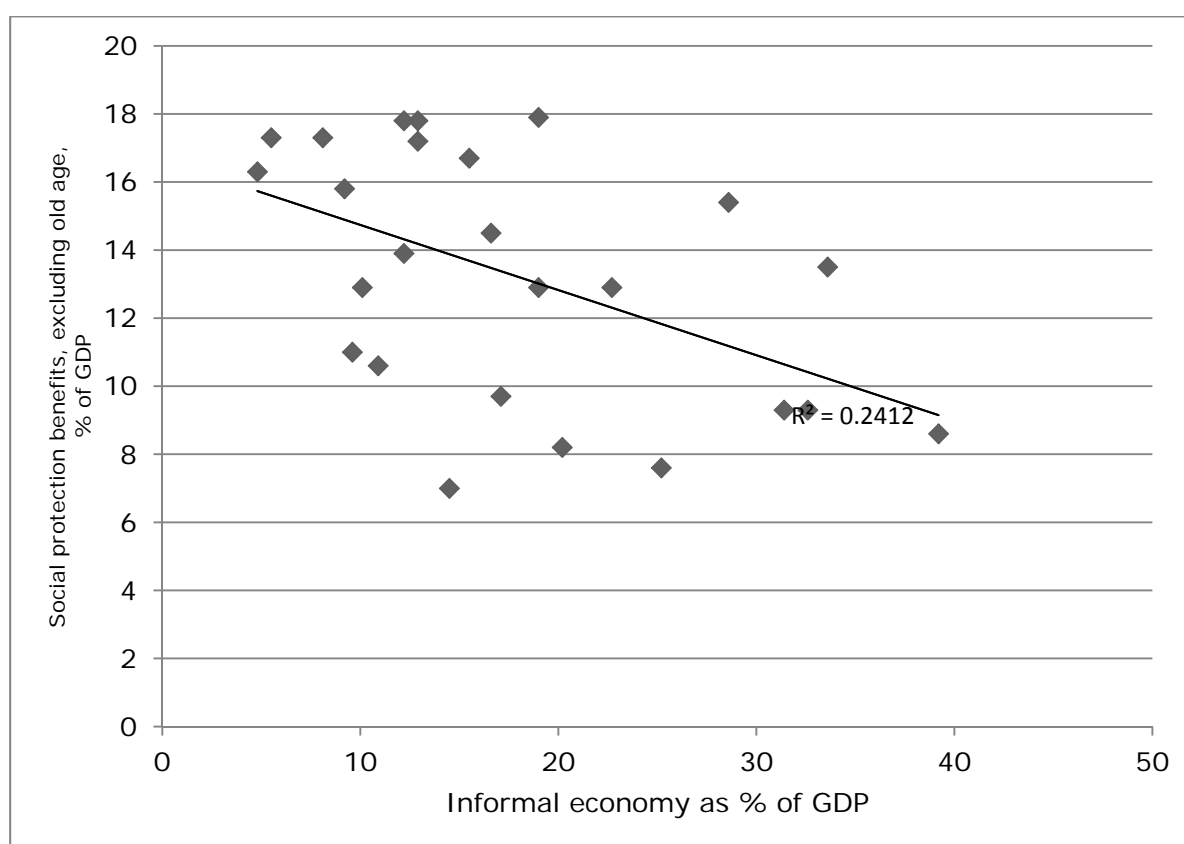
Figure 3: Relationship between magnitude of informal economy and labour market policy expenditure



If the size of the informal economy is not correlated with state intervention in the labour market, is it nevertheless the case that state interference in the realm of social provision leads to a growth of the informal economy? To evaluate this, here an evaluation is

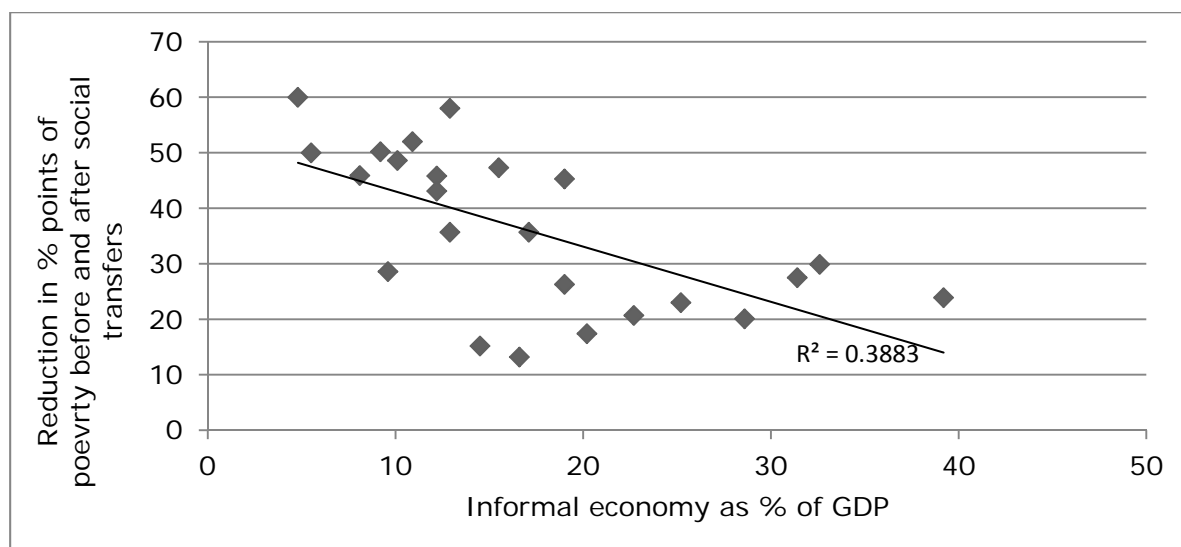
conducted of the relationship between the size of the informal economy and the proportion of GDP spent on social protection benefits, excluding old age benefits (European Commission 2011: Table 3). As Figure 4 displays, there is a statistically significant correlation between the proportion of GDP spent on social protection benefits (excluding old age benefits) and the size of informal economies ( $r_s = -0.480^{**}$ ), and 24 per cent of the variance in the size of the informal economy is correlated with the variance in the proportion spent on social protection ( $R^2 = 0.2412$ ). Hence, a clear substitutive effect is apparent. However, it is not a substitutive effect in the direction suggested by neo-liberal discourse. Member states where a higher proportion of GDP is spent on social protection have smaller informal economies. Put another way, a higher level of state intervention in the form of social protection is correlated with a decrease in the magnitude of the informal economy, not an increase as suggested by neo-liberals.

Figure 4: Relationship between magnitude of informal economy and social protection benefits



This correlation between greater state intervention and smaller (rather than larger) informal economies is further reinforced when the redistributive impacts of state intervention are evaluated. Analysing the reduction in percentage points of poverty before and after social transfers, with poverty defined as the proportion of people with an income below 60 per cent of the national median income (European Commission 2011: Table 3), Figure 5 shows that member states where social transfers have a greater impact on reducing poverty have smaller informal economies, not larger informal economies as neo-liberals intimate. This is a strong statistically significant correlation ( $r_s = -.691^{**}$ ,  $R^2 = 0.3883$ ).

Figure 5: Relationship between magnitude of informal economy and impacts of state redistribution



Consequently, evaluating the correlation between the size of the informal economy and firstly, state labour market interventions as a proportion of GDP, secondly, the level of social protection expenditure as a proportion of GDP and thirdly, the impact of state redistribution, the repeated finding is that the hypothesis that EU member states with greater levels of state intervention have larger informal economies is refuted.

## CONCLUSIONS

This article has evaluated critically the neo-liberal explanation for the informal economy which asserts that high taxes, over-regulation and state interference, such as through labour market interventions, high levels of social protection and state redistribution via social transfers, lead to the growth of the informal economy, and therefore that the remedy is to pursue tax reductions, de-regulation and minimal state intervention (Nwabuzor 2005; Becker 2004; London and Hart 2004; De Soto 2001, 1989).

Evaluating critically this neo-liberal explanation in relation to the 27 member states of the European Union, this article has revealed firstly, that few people explain their own or others' participation in informal work to be a result of too high taxes and/or social protection levels or burdensome bureaucracy/red tape, although some population groups (e.g. East-Central Europeans, men) do cite such rationales to a greater extent than others. Secondly, it has evaluated critically the relationship between the size of informal economies and tax rates. Whether one examines the implicit tax rates on labour (as a summary measure of the average effective tax burden on labour income) or the total tax revenue as a percentage of GDP, no correlation is identified between tax rates and the size of the informal economy.

Thirdly, the relationship between the size of informal economies and the level of state intervention in the economy and welfare provision has been evaluated. This has revealed no statistically significant correlation across the EU-27 between the level of state labour market policy expenditure and the size of informal economies. Meanwhile, although a statistically significant correlation has been identified between the proportion of GDP spent on social protection benefits (excluding old age benefits) and the size of informal economies, it is not in the direction suggested by neo-liberal discourse. A higher level of

state intervention in the form of social protection is correlated with a decrease in the magnitude of the informal economy, not an increase as suggested by neo-liberals. Similarly, the greater the level of state redistribution via social transfers in member states, the smaller (not larger) is the informal economy.

In consequence, decreasing the degree of state intervention is not correlated with a reduction in the size of the informal economy. Instead, the informal economy tends to be largest in those European Union member states where the degree of intervention is lower and least effective in redistributing wealth. These findings thus raise grave doubts about whether de-regulation, tax reductions and minimal state intervention constitute the way forward if the intent is to reduce the size of informal economies in the EU-27. This does not appear to be a panacea to the ills of the informal economy, at least in the European Union.

Instead, these findings provide tentative support for the structuralist explanation which suggests that the informal economy is more a result of under-regulation in economies and that the problem is not one of over-regulation but, rather, under-regulation of economies. The finding is that the greater the proportion of GDP spent on social protection benefits (excluding old age benefits) and the greater the level of state redistribution via social transfers, the smaller is the size of the informal economy. Higher levels of state intervention, therefore, result in a decrease, rather than growth, in the size of the informal economy.

In future, nevertheless, further research is required on several issues before these conclusions can be anything but tentative. Firstly, there is a need to analyse how the variable strength of deterrence measures cross-nationally influences the extent of the informal economy, and how this influences the above findings. If it is correct that deterrence measures are indeed stronger in more regulated economies, then it may well be the case that it is deterrence measures rather than state intervention in the economy that is leading to lower levels of informal work in these countries. This needs further investigation in future research. Secondly, there is also a need to evaluate the relationship between salaries on the one hand and taxes and/or social contributions on the other hand. Taxation levels need to be seen in relation to wage levels and the cost of living in countries. It may well be the case that in countries where wages are relatively low but tax rates relatively high, more will engage in informal work. This requires further investigation.

In sum, this article, through a study of the 27 member states of the European Union, has begun to question the validity of the neo-liberal advocacy of tax reductions, de-regulation and minimal state intervention when tackling the informal economy. To take this further forward, it will now be necessary to evaluate whether this critique of the neo-liberal explanation is more widely valid. If this article therefore stimulates the wider evaluation of these neo-liberal assumptions in other global regions (see, for example, Kus 2010), then it will have fulfilled one of its intentions. If it also engenders a fuller evaluation in the EU-27 and other global regions of whether higher taxes, more labour market interventions, greater social protection and more effective state redistribution via social transfers might be the way forward in tackling the informal economy, then it will have fulfilled all of its objectives.

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