



Does Trust Prevent Undeclared Work? A Policy Brief

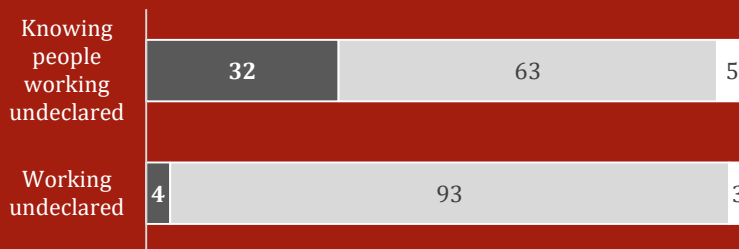
An Evaluation of the Social Actor Approach

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UNDECLARED WORK:

1 in 3 Europeans (32%) know persons engaged in undeclared work

1 in 25 Europeans (4%) are engaged in undeclared work



EU-28: Yes No Refusal & Don't know

Source: Eurobarometer 79.2 (2013)

What's the ISSUE?

In recent decades, a burgeoning literature has brought out of the shadows the magnitude of the undeclared economy. This reveals that the undeclared economy is a persistent feature of contemporary economies. With the equivalent of 17.9 per cent of GDP not declared to the authorities in the European Union in 2016 [1], undeclared work representing 14.3 per cent of gross value added in the private sector in 2013 [2] and 4 per cent of EU28 citizens conducting undeclared work [3], tackling the undeclared economy is not some minor issue. Addressing this practice is important. This is not only because of the income lost by governments which could otherwise pay for improving the countries' structural conditions. The undeclared economy also results in poorer quality working conditions for employees and causes unfair competition for legitimate businesses.

What measures, therefore, can be used to tackle undeclared work? Surveying the policy measures used by governments, two approaches are identified, namely a **rational economic actor** approach that aims to tackle undeclared work by ensuring that the cost of undeclared work is higher than its benefits, and a **social actor** approach which aims to tackle undeclared work by building trust between the citizens and between the citizens and government.

The purpose of this policy brief is to review the policies that can help EU Member States reduce the share of undeclared work and focuses on **evaluating the effectiveness of the social actor approach**.

KEY POINTS

- Undeclared work is more common in the Member States where the citizens share a lower horizontal trust (i.e., they believe that undeclared work is widespread in their country and/ or personally know others engaged in undeclared work) and a lower level of vertical trust (i.e., a low tax morale, meaning a lack of trust in government and the rule of law).
- Citizens in European Union member states deem it more unacceptable for firms than individuals to operate in the undeclared economy.
- A shift away from focusing upon deterrents that seek to detect and punish undeclared work towards measures that aim to build trust, both between citizens and between citizens and government, is required.

What is UNDECLARED WORK?

Undeclared work is defined by the European Commission as ‘any paid activities that are lawful as regards their nature but not declared to public authorities, taking into account differences in the regulatory systems of the Member States’. Thus, if the activities differ to declared work in any additional ways, then this activity is not undeclared work. For example, if the goods and/or services traded are illegal (e.g. illegal drugs), then it is part of the wider criminal economy rather than undeclared economy.

TACKLING UNDECLARED WORK: An Evaluation of the Social Actor Approach

The dominant policy approach adopted by governments has been a deterrence one which, grounded in a **rational economic actor approach**, views participation in undeclared work as occurring when the pay-off from working undeclared is greater than the expected cost of being caught and punished [4]. In consequence, engagement in undeclared work is tackled by increasing the actual or perceived penalties and risks of detection [5-7].

However, the evidence that increasing the deterrents reduces participation in undeclared work is mixed. While some previous studies are supportive of this approach [8-10], others identify no effect or only a short-term effect of increasing the deterrents [11-13] and, yet others find that deterrents raise the level of non-compliance by breaking down the trust between the state and its citizens [14-17].

What is the RATIONAL ECONOMIC ACTOR APPROACH?

The view that undeclared work arises when people perceive the benefits of undeclared work higher than its costs. According to this view, by increasing the cost of undeclared work, this practice will reduce.

Policy measures related with this approach focus on disincentives and aim to:

- Increase the actual and/or perceived **level of detection**.
- Increase the actual and/or perceived **penalties**.

Indeed, analysing the most recent survey on undeclared work conducted at EU28 level (i.e., the Eurobarometer 79.2 conducted in 2013), the results on country level aggregate data display that the association between the participation in undeclared work and the perceived level of detection or the perceived penalty is very weak and not significant¹.

Table 1. Relationship between the share of people engaged in undeclared work and the variables related with social actor approach and the rational economic actor approach, EU28 country level aggregates

SOCIAL ACTOR APPROACH	
▪ Horizontal trust (personally knowing people engaged in undeclared work)	Positive ***
▪ Vertical trust (tax morality)	Negative *
RATIONAL ECONOMIC ACTOR APPROACH	
▪ The perceived risk of detection of undeclared work	Negative
▪ The perceived sanction for engaging in undeclared work	Negative

Strong
 Weak
 Very weak

Note: Significant at: *** p<0.01, ** p<0.05, * p<0.1
 Source: Abridged form of the results presented in [18]

Meanwhile, as Table 1 displays, across the member states of the European Union, horizontal and the vertical trust, which are the key determinants of undeclared work in the **social actor approach**, are both associated with the level of participation in undeclared work. Similarly, analysing the individual level results, these relationships become more pronounced.

¹ For more details about the effectiveness of the rational actor approach on tackling undeclared work, please see Horodnic, I.A. and Williams, C.C. (2018). Do Deterrents Prevent Undeclared Work? An Evaluation of the Rational Economic Actor Approach. Available at SSRN: <http://dx.doi.org/10.2139/ssrn.3108375>.

Comparing the views and behaviour of EU28 citizens in 2013 and 2007, the findings show that the association between participation in undeclared work and the perceived level of deterrents (i.e., penalties and risk of detection) has become weaker while the association between participation in undeclared work and the level of trust (i.e., horizontal and vertical) has become stronger [18]. Moreover, analysing data collected in 2015 from two EU member states and one EU candidate country (i.e., Bulgaria, Croatia and FYR of Macedonia)², which were selected because their high share of undeclared work, the results are the same. There are small or no differences between the perceived sanction or the perceived risk of detection of those engaged in undeclared work and those not engaged in undeclared work. Meanwhile, twice as many of those engaged in undeclared work know others engaged in undeclared work (low horizontal trust) and those engaged in undeclared work display a higher asymmetry between their norms and beliefs and the legal environment (low vertical trust) (please see [18] for further details).

The tentative finding is therefore, akin to previous studies which only partially support the rational actor approach [19-21] that, at a very minimum, the rational actor approach needs to be complemented by measures related with the social actor approach.

What is the SOCIAL ACTOR APPROACH?

This views undeclared work as arising due to low levels of both vertical and horizontal trust. According to this view, by implementing measures aimed at fostering trust, undeclared work will be reduced.

- **Horizontal trust** refers to the degree to which citizens trust other citizens regarding their level of compliance. People are more likely to engage in undeclared work if they do not have trust in other citizens and perceive that a large share of people are engaged in undeclared work (e.g., they personally know others – e.g.,

family members, friends, colleagues, acquaintances – engaged in undeclared work).

- **Vertical trust** refers to the degree to which citizens trust the government. It displays the symmetry between the formal and informal institutions. People are more likely to engage in undeclared work when the formal and informal institutions are not in symmetry (i.e., a low tax morale, meaning that there is a lack of trust in government and the rule of law).
- **Formal institutions** represent the codified laws and regulations of a society that define the legal rules of the game.
- **Informal institutions** represent the norms, values and beliefs of citizens which produce shared unwritten rules and understandings within a society.

Policy measures in this approach focus on fostering trust and aim to:

- Alter the **formal institutions** by modernising governance through three reforms, namely:
 - ✓ improved *procedural justice*, which refers to authorities shifting away from a ‘cops and robbers’ approach and treating citizens in a respectful, impartial and responsible manner;
 - ✓ improved *procedural fairness*, which refers to citizens believing that they pay a fair share compared with other citizens;
 - ✓ improved *redistributive justice*, which refers to citizens believing that they receive the goods and services they deserve given the taxes they pay.
- Alter the **informal institutions** regarding the acceptability of undeclared work through tax education (e.g., about the benefits of declared work) and awareness raising campaigns (e.g., by linking the taxes with the public goods and services).

² GREY data (European Commission’s Framework 7 Industry-Academia Partnerships Programme (IAPP) grant no. 611259 entitled ‘Out of the shadows: developing capacities and capabilities for tackling undeclared work in Bulgaria, Croatia and FYR Macedonia’).

To evaluate the effectiveness of the social actor approach, the relationship between cross-country variations in the share of undeclared work and variations in the level of vertical and horizontal trust can be analysed.

Table 2 provides a 'league table' of the relative position of member states ranked according to the prevalence of undeclared work (as percent of gross value added in the private sector), and then denotes the relative position of each member

state on various measures of *horizontal* and *vertical trust*. We use a traffic light system composed of dark red where a member state is in the 'bottom quartile' on an indicator (i.e., large share of shadow economy, large share of citizens knowing others working undeclared, low tax morality, low trust in state authorities), light red where it is in the 'lower middle' quartile, light green when it is in the 'upper middle' quartile and dark green when it is in the 'upper quartile'.

Table 2. Undeclared work and various indicators displaying horizontal and vertical trust: ranking of the EU28

Country	Undeclared Work (% of GVA in the private sector) ^[2]	Shadow Economy MIMIC ^[22]	Tax morality ^[23]	Knowing people working undeclared ^[23]	Trust in Government ^[24]	Trust in Parliament ^[24]	Trust in regional or local public authorities ^[24]
Poland	27.3	17	24	6	18	17	15
Romania	26.2	22	14	2	20	24	19
Lithuania	25.2	15	27	15	16	24	22
Hungary	23.2	19	21	8	10	11	9
Greece	22.5	27	7	26	25	21	25
Latvia	22.3	13	28	24	15	17	13
Estonia	21.3	14	23	11	8	10	9
Bulgaria	19.2	20	16	11	16	20	23
Cyprus	17.9	28	1	20	13	15	20
Spain	17.9	23	7	11	28	27	26
Italy	17.2	24	15	18	25	26	28
Croatia	17.1	25	11	23	20	21	27
Czech Republic	16.9	8	26	11	20	21	15
Slovenia	16.4	21	13	25	25	28	24
Portugal	15.5	18	19	6	23	19	17
Belgium	15.4	16	20	22	5	6	4
Slovakia	14.7	7	25	17	12	12	18
Denmark	14.3	12	5	28	7	2	2
Ireland	13.0	6	17	4	19	15	20
Netherlands	11.9	1	21	27	10	8	8
Finland	11.8	11	4	9	3	2	4
France	11.0	10	9	19	24	14	12
Austria	10.0	2	18	10	3	4	2
Sweden	9.7	9	3	20	1	1	7
United Kingdom	9.5	4	6	1	14	13	13
Luxembourg	9.1	5	12	15	2	8	1
Germany	7.1	3	9	5	8	7	4
Malta	N.A.	26	2	2	5	5	11

Notes: Ranks based on indicators values in 2013.

 Upper Quartile
  Upper middle Quartile
  Lower middle Quartile
  Lower Quartile

Sources: authors' own work based on [2, 22-24]

Table 2 shows that, in those countries with a low estimated share of undeclared work, and a low share of estimated shadow economy, positioned at the bottom of the table (i.e., Germany, Luxembourg, UK, Sweden), citizens have a high tax morality (i.e., low asymmetry between their norms and beliefs and the legal environment), have fewer acquaintances working undeclared, and greater trust in state institutions. In contrast, in the countries with the highest estimated share of undeclared work and large share of shadow economy (i.e., Poland, Romania, Lithuania), citizens share a rather low tax morale and lack trust in government, parliament or regional and local authorities. Furthermore, in the case of Lithuania and other countries ranked by the share of undeclared work, a large share know of others working undeclared. These results further display that the engagement in undeclared work is related with the citizens' trust in other citizens and in their state authorities.

Therefore, when citizens have a low level of **vertical trust** (i.e., there is a large gap between the formal and informal institutions, and lack of trust in state institutions) and a **low horizontal trust** (i.e., they know other persons engaged in undeclared work, and think that undeclared work is a widespread practice in their society) they will be more likely to view undeclared work as an acceptable practice and, in consequence, to work undeclared.

How widespread is perceived to be undeclared work, therefore, by the European Union's citizens? And is undeclared work perceived as acceptable?

According to the last available data at EU28 level (Eurobarometer 79.2), one in three citizens (32 per cent) of the EU member states personally know people engaged in undeclared work. Indeed, as Figure 1 displays, close social networks play an important role in the sphere of undeclared work. Those who report they engage in undeclared work, representing 4 per cent of the respondents, provide their services to their friends, colleagues or acquaintances (51 per cent). Similarly, those who report that they

purchase undeclared goods and services, representing 11 per cent of the respondents, buy to a greater extent from their friends, colleagues or acquaintances (43 per cent) rather than other sources. Most undeclared work in the EU, therefore, is provided by, and purchased from, close social relations, such as kin, neighbours, friends, colleagues and acquaintances.

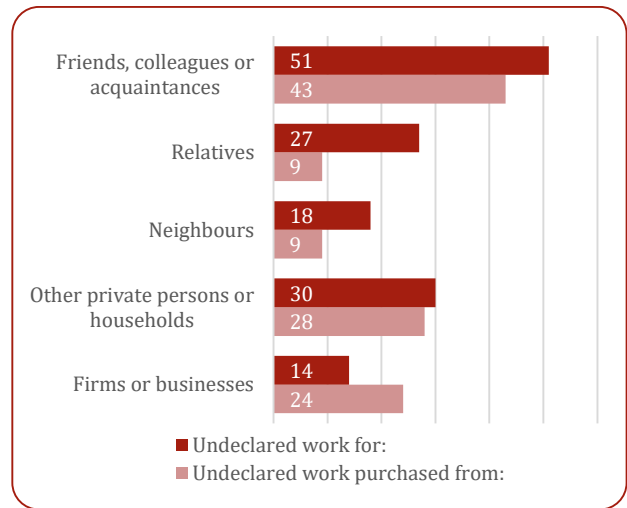


Figure 1. Suppliers and customers of undeclared work in EU28 (%)
 Source: authors' own work based on Eurobarometer 79.2 data (2013)

The social acceptability of participating in undeclared work varies according to the type of undeclared work considered.

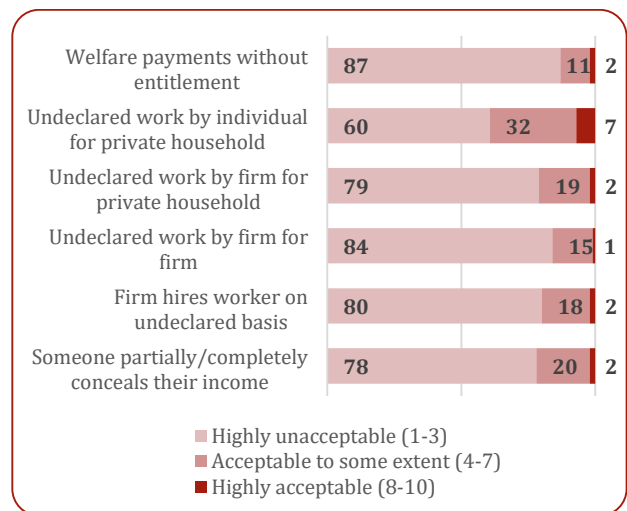


Figure 2. Acceptability of different types of undeclared work in EU28 (%)
 Source: authors' own work based on Eurobarometer 79.2 data (2013)

As Figure 2 reveals, although just 60 per cent of the EU population find it highly unacceptable for an individual to engage in undeclared work for a

private household, the acceptability of the other forms of undeclared work is lower. As such, 78 per cent of the population finds it highly unacceptable for someone to partially or completely conceal their income, 79 per cent for a firm to do undeclared work for a private household, 80 per cent for a firm to hire a worker on an undeclared basis and 84 per cent for a firm to do undeclared work for another firm. The most unacceptable of all behaviours is claiming benefits without entitlement, such as whilst working undeclared, doubtless because such individuals are viewed as ‘taking our money’

rather than seeking to ‘keep their own money’ [25]. Therefore, the overall finding is that the citizens in the European Union member states deem it more unacceptable for firms than individuals to operate in the undeclared economy (with the exception of claiming welfare payments without entitlement).

To enable each member state to assess where the norms, values and beliefs of their citizens differ most from the formal rules, Figure 3 reveals how widespread is the acceptability of each type of undeclared work for every individual country.



Figure 3. Acceptability of different types of undeclared work in EU28, by country (% highly unacceptable)
 Source: authors' own work based on Eurobarometer 79.2 data (2013)

Similar patterns exist across all 28 member states of the European Union regarding the relative social acceptability of the different types of undeclared work. There are very few exceptions. For example, in Austria, Finland, Germany, Greece and Spain, citizens find it more unacceptable for a firm to conduct undeclared work for another firm than an individual to claim welfare payments without entitlement.

Turning to the business environment, and using data from a 2015 representative survey involving 1,430 face-to-face interviews with owners or managers in Croatia, Bulgaria and FYR Macedonia (countries with a large share of undeclared work), the finding is again, a low level of horizontal and vertical trust.

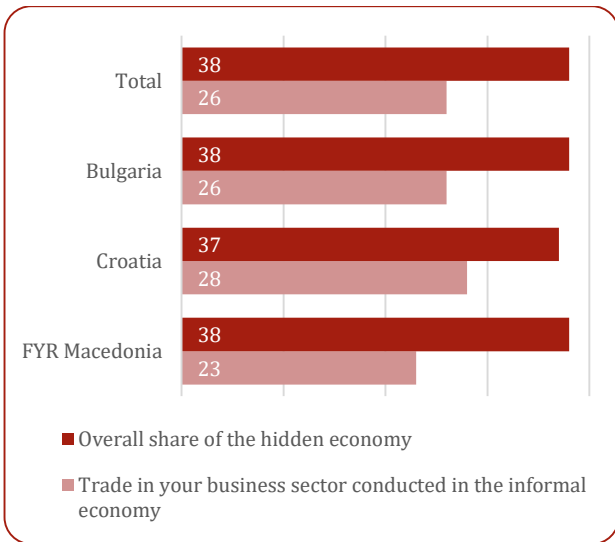


Figure 4. Horizontal trust, businesses, by country (mean %)
 Source: authors' own work based on GREY data

As Figure 4 displays, the entrepreneurs in these three South-Eastern European countries estimate that more than one quarter of the trade in their sector is conducted undeclared (26 per cent) and that, overall, the undeclared economy is even higher (around 38 per cent).

Figures 5-7 provide a more nuanced investigation of which types of undeclared work are perceived by the entrepreneurs as more prevalent in their competitors' activity. Eight different types of undeclared work potentially employed by businesses are analysed.

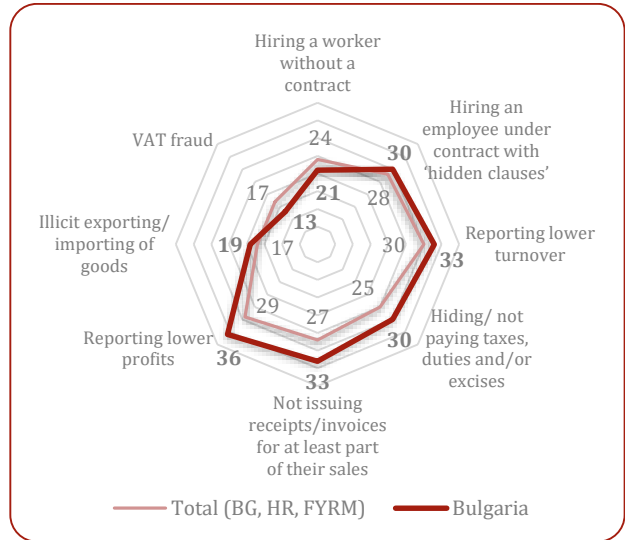


Figure 5. Informal practices in Bulgaria occurring within direct competitor businesses (%)
 Source: authors' own work based on GREY data

Overall, as Figures 5 to 7 display, a low level of horizontal trust is displayed, with 17 to 30 per cent of the entrepreneurs reporting that their competitors use always or almost always these undeclared practices. The most common undeclared practice they report to be used by competitors is the reporting of a lower turnover (30 per cent), the reporting of lower profits (29 per cent) and hiring employees under contracts with hidden causes such as paying the social insurance and contributions based on a minimum wage, whilst the rest of the wage is paid undeclared, without a payslip (28 per cent).

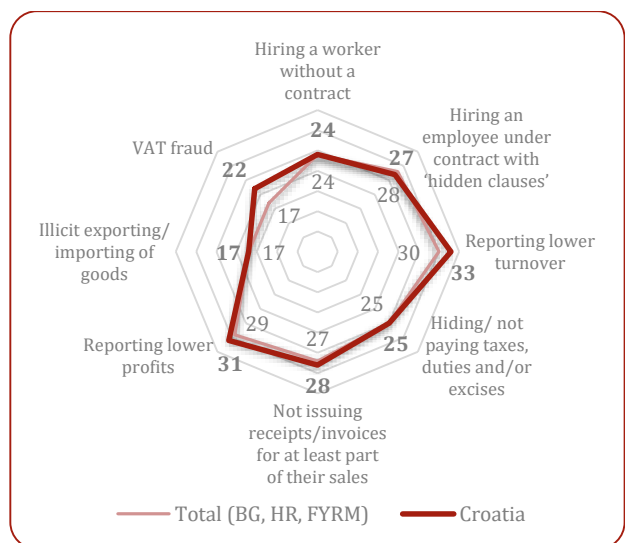


Figure 6. Informal practices in Croatia occurring within direct competitor businesses (%)
 Source: authors' own work based on GREY data

However, there are some differences between countries. In FYR Macedonia the entrepreneurs display a higher level of horizontal trust compared with Bulgaria and Croatia. While in FYR Macedonia the most prevalent undeclared practices are related with under-reporting the number of employees or their wages (i.e., 26 per cent hiring workers without a contract and 27 per cent hiring employees under contracts with hidden clauses), in Croatia and Bulgaria the most prevalent practices are perceived as related to financial under-reporting (i.e., 36 per cent reporting lower profits and 33 per cent reporting lower turnover or not issuing invoices or receipts for at least part of their sales in Bulgaria and 33 per cent reporting lower turnover and 31 per cent reporting lower profits in Croatia).

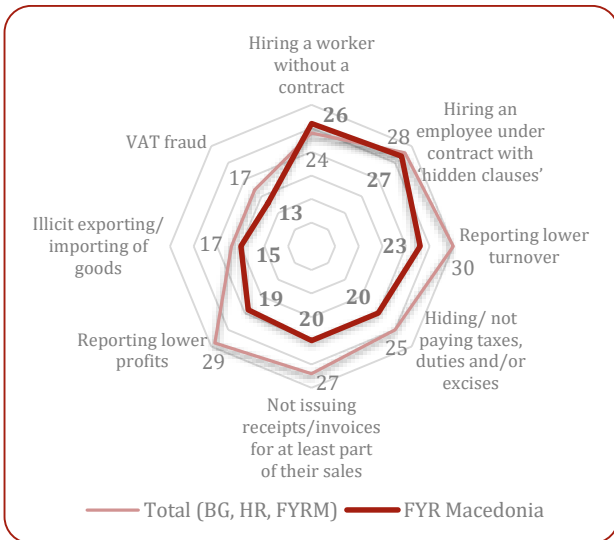


Figure 7. Informal practices in FYR Macedonia occurring within direct competitor businesses (%)
 Source: authors' own work based on GREY data

How acceptable are the undeclared work practices perceived by the entrepreneurs in these South-East European countries? Using a 10-point scale, where 1 means completely disagree and 10 means completely agree, just 68 per cent of the entrepreneurs in Croatia and FYR Macedonia and less than half of the entrepreneurs in Bulgaria find it unacceptable to underreport the annual revenue or turnover to evade taxes. Even lower percentages are reported for the necessity of such practices. For example, in FYR Macedonia, although 68 per cent of the entrepreneurs find it

completely unacceptable to underreport in order to evade taxes, just 28 per cent disagree with the necessity of doing so in order to ensure the company survival. This suggest that entrepreneurs in these three countries feel pressure to use undeclared practices. This might be generated by the low level horizontal trust, considering that they believe that their competitors employ undeclared practices and gain competitive advantages (as displayed in Figures 4-7), or by a low level of vertical trust.

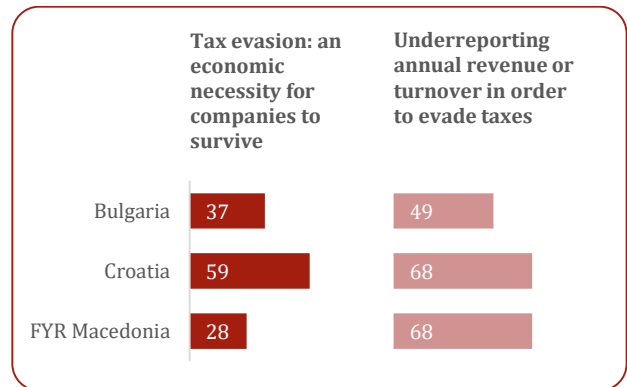


Figure 8. Vertical trust (acceptability of undeclared work), businesses, by country (% scored 1 to 3, completely unacceptable/high disagreement)
 Source: authors' own work based on GREY data

In sum, using multiple data sets and various measures of undeclared work (Eurobarometer surveys, GREY data, estimates based on labour force surveys, and shadow economy measured using MIMIC methodology), the evidence in this paper shows that there is a close relationship between the engagement in undeclared work and the level of horizontal and vertical trust, supporting the social actor approach.

However, deterrents remain the most common policy approach used by the governments in the European Union and even more, the importance attributed to this deterrence approach has increased over time. The results of two surveys conducted amongst policy-makers in 2010 and 2017 show that in 2017 the top two most effective policy measures for tackling undeclared work are perceived to be the deterrence measures related to the *rational economic actor* approach. Meanwhile, curative measures, preventive measures and measures aimed to

foster commitment to declared work, related to the *social actor* approach are viewed as less effective than in 2010 by the policy makers [26, 27]. However, the 2017 survey also reveals that the governments seldom use ex-ante and ex-post evaluation of these policy measures [27]. As such,

Conclusions and Policy Recommendations

For tackling undeclared work, across the European Union member states, governments use mostly deterrence measures related with the *rational economic* approach. Despite little ex-ante and ex-post evaluation being undertaken by governments, the view is that such measures are the most effective and this view has increased over time [27]. However, numerous academic studies question the effectiveness of deterrent measures [11-17]. Using a wide range of data sets and measurements of undeclared work, the evidence reported in this paper shows that there is a close relationship between engagement in undeclared work and the level of horizontal and vertical trust, supporting the *social actor* approach. Indeed, undeclared work is more prevalent in those countries where the trust among citizens and towards the authorities is low, providing an excellent breeding ground for non-compliant behaviour. So long as individuals perceive that declared work does not represent the social norm, they will not comply. The more people who deviate from the formal rules (i.e., declaring their work in this case), the weaker will become adherence, which will generate in turn even fewer people adhering. Indeed, two field experiments, one conducted in the UK [28] and one in Austria [29] confirmed that tax compliance is influenced by the information regarding the level of compliance of the other citizens. Thus, individuals' behaviour is conditionally cooperative; they are willing to comply conditioned by the behaviour of the other members of the society [30].

Similarly, a low level of trust in institutions and the rule of law is associated with higher participation to undeclared work. Thus, for tackling undeclared work more effectively, a shift away from focusing upon deterrents that seek to

it seems that the policy makers' views on what is most effective to tackle undeclared work do not reflect the behaviour of the individuals and the variables that influence their decision to engage in undeclared work.

detect and punish undeclared work, and towards measures that aim to build trust both between citizens and between citizens and government, is necessary. Therefore, deterrence measures need to be complemented with measures aiming to improve trust between citizens, and between citizens and the state. This requires an alignment of the formal and informal institutions.

What tools, therefore, can be used to achieve this?

To alter the informal institutions regarding the acceptability of undeclared work, tax education and awareness raising campaigns (i.e., information about the benefits of undeclared work, linking the taxes with the public goods and services received) are required. Also, the government should avoid sending the message that non-compliance is accepted in some cases (i.e., by providing tax amnesties) [31] and be careful to not over-publicize high levels of non-compliance because this might cause a negative effect on other citizens who honestly declare their work [32].

On the other hand, however, formal institutions need to be altered, particularly in nations in which there is a lack of trust in government. In this regard, measures are required to change both the country-level conditions that lead to lower tax morale, such as the quality of governance [33] but also the way in which the formal institutions operate in terms of improving procedural justice, procedural fairness and redistributive justice are required.

By using these preventive and commitment measures in order to increase the level of horizontal and vertical trust, the gap between what is currently used to tackle undeclared work, and what is most effective will be reduced.

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