

# **INFORMAL EMPLOYMENT: A THREAT OR AN OPPORTUNITY FOR THE UK CONSTRUCTION SECTOR?**

**Carol Jewell**

*School of Construction Management and Engineering, University of Reading, PO Box 219, Reading, RG6 6AW, UK*

There are many myths about the informal economy, its size, its growth/decline and its impact on formal employment. The validity of measuring the informal economy is criticised by many researchers because of its lack of economic theory and the unreliability of data collection (Harding and Jenkins, 1989; Williams and Winderbank, 1998). Its impact on formal employment depends on whose perspective is taken into account. The government would be concerned over the loss of tax income whilst the industry may be affected by lack of health and safety, and skills training. On the positive side, informal employment provides more flexibility and it maintains economic activity, contributing 60% of its income to the formal economy (Schneider, 2002). Construction has a high proportion of informal employment compared with other sectors, due to the nature of its work - project-based and with few barriers to entry. The Small Business Council (2005) suggests a figure of 46.7% as the proportion of construction of all informal work in the UK. There have been changes in work practice over recent years with an increasing reliance on sub-contracting with a greater likelihood of informal employment (HM Treasury, 2000). The characteristics and drivers of informal employment in the UK construction sector need to be better understood. This paper considers whether informal employment is an opportunity as a 'new' labour market or if it is a threat to the UK construction sector.

Keywords: construction, employment, informal.

## **THE AIM OF THIS PAPER**

The aim of this paper is to first define and explain informal employment and its relationship to formal employment. Secondly, to understand the different ways in which informal employment is measured, highlighting benefits and pitfalls of such exercises. Thirdly, informal employment within the construction sector will be considered and finally, conclusions are reached about the effect of informal employment on the sector.

## **INTRODUCTION**

There are many different terms used for informal employment, for example, shadow, black, hidden, non-observed, underground and so on, but one fact ties them altogether - those that work informally "are not recognized or protected under the legal and regulatory frameworks" (ILO, 2002). The use of the word economy or sector is misleading as it is not a specific industrial group but a form of employment. It changes over time according to economic, social and political pressures with many people working both formally and informally throughout their working life. For the purposes

of this paper the term “informal employment” will be used throughout except for direct quotes from other authors.

Employment patterns have changed with increasing globalization, often becoming more informal and more flexible. The rapid improvements in information and communication technologies have allowed companies to decentralize their production and create flexible and specialized units, often in low-wage economies (ILO, 2002).

The transient nature of project-based work and the range of site processes requiring changing levels in the workforce, provides an environment highly suitable to informal employment. Many construction sectors in the developed world have witnessed a rapid growth in sub-contracting and outsourcing arrangements designed to reduce overheads and bring down production costs. This has ‘informalised’ working relationships in the industry.

*“The hidden economy covers a variety of different (and often multiple) abuses of the tax and benefits systems. It includes activities which range from small-scale moonlighting to organised fraud and serious crime. Most people and businesses in the hidden economy are in low-wage, labour intensive industries where cash payment is widespread. It is impractical to measure the scale of the hidden economy accurately. This report simply assumes that it is a major problem that needs to be tackled.”*

*The informal economy, a report by Lord Grabiner, 2000*

## **WHAT IS INFORMAL EMPLOYMENT?**

There are a wide range of terms used to describe informal employment and the use of any estimates of it in economic analysis (Battacharyya 1999). Informal employment could be simply considered as all employment that is not formal, that is, employment that is not formally registered (Williams and Winderbank, 1998, p4). The two types of employment are best considered in the context of a continuum (Harding & Jenkins, 1989, p176), along which there are carrying degrees of informality/formality with many workers residing in different places along that continuum over their working lives.

Informal employment can be split into several different categories ranging from illegal activities to work for which there is no formal arrangement such as childcare and homeworking. Gershuny (1983) suggested three types of economic activity that were not easily accountable by government departments:

- Household
- Communal
- Underground

In construction terms, household activity would be do-it-yourself (DIY) projects undertaken by the homeowner and/or friends and family. The communal type of economic activity encompasses charity work, baby-sitting circles and so on. The label “underground” is a somewhat catch-all phrase that ranges from drug running and smuggling to moonlighting. Gershuny (1983) divides this last category into:

- Type A Occupational theft, tax avoidance, tax evasion
- Type B Outworker e.g. clothing industry
- Type C Direct goods/services e.g. house repairs

## MEASURING INFORMAL EMPLOYMENT

Research has shown that the transition economies, the developing world countries, and the OECD countries have all experienced significant growth in informal employment. In some countries it has doubled in the 30 years between 1970 and 2000 - from 10% of GDP to 20% in Belgium, Denmark, Italy, Norway, Spain, and Sweden. There has also been growth in those countries with a lower level of informal employment - USA doubled from 4% of GDP in 1970 to 9% in 2000. For OECD countries, the growth has been the fastest in the 1990s (Schneider & Enst 2002). Table 1 shows the size of the informal economy in OECD countries between 1989 and 2003.

**Table 1:** The size of the informal economy in OECD Countries

Size of the informal economy (in average % of GDP) using the Currency Demand and DYMIMIC Method						
	1989/90	1994/95	1997/98	1999/00	2001/02	2002/03
1. Australia	10.1	13.5	14.0	14.3	14.1	13.8
2. Belgium	19.3	21.5	22.5	22.2	22.0	21.5
3. Canada	12.8	14.8	16.2	16.0	15.8	15.4
4. Denmark	10.8	17.8	18.3	18.0	17.9	17.5
5. Germany	11.8	13.5	14.9	16.0	16.3	16.8
6. Finland	13.4	18.2	18.9	18.1	18.0	17.6
7. France	9.0	14.5	14.9	15.2	15.0	14.8
8. Greece	22.6	28.6	29.0	28.7	28.5	28.3
9. UK	9.6	12.5	13.0	12.7	12.5	12.3
10. Ireland	11.0	15.4	16.2	15.9	15.7	15.5
11. Italy	22.8	26.0	27.3	27.1	27.0	26.2
12. Japan	8.8	10.6	11.1	11.2	11.1	11.0
13. Netherlands	11.9	13.7	13.5	13.1	13.0	12.8
14. N Zealand	9.2	11.3	11.9	12.8	12.6	12.4
15. Norway	14.8	18.2	19.6	19.1	19.0	18.7
16. Austria	6.9	8.6	9.0	9.8	10.6	10.8
17. Portugal	15.9	22.1	23.1	22.7	22.5	22.3
18. Sweden	15.8	19.5	19.9	19.2	19.1	18.7
19. Switzerland	6.7	7.8	8.1	8.6	9.4	9.5
20. Spain	16.1	22.4	23.1	22.7	22.5	22.3
21. USA	6.7	8.8	8.9	8.7	8.7	8.6

Source: Schneider & Klingmair (2004)

There are four main methods used to measure the informal economy; these vary according to whether the measurement is in a developed, developing or transition economy (Hanousek 2003; Schneider & Klingmair 2004):

- 1) Direct approach
- 2) Indirect approach
- 3) Physical input (electricity)
- 4) Model approach

### Direct approach

The direct approach is undertaken either through micro surveys or voluntary replies to tax audits, and has been used extensively in Norway and Denmark. The major drawback is the robustness of the data collected as those that reply may not give accurate information, while many more may not be willing to reveal any information

at all. Another disadvantage of the approach is that it gives a measurement at one point in time rather than over a longer time horizon.

### **Indirect approach**

There are a number of indirect approaches:

- The gap between income and expenditure measures. For example in national accounting the income measure of GNP should be equal to the expenditure measure of GNP (Schnieder 2004). However, as this approach uses national statistics that include many omissions and errors, the result is questionable.
- A decline in the labour participation figures is often used as an indication of an increase in the informal economy. It is not a foolproof method as there may be other reasons for a drop in the labour participation figures.
- The transactions approach is based on the equation:  $M*V = p*T$  (where M = money, V = velocity, p = prices and T = total transactions) which assumes that there is a constant relationship over time between levels of transactions and the official GNP. This approach ignores the fact that the differences between transaction and GNP figures may not be due solely to the informal economy.
- The currency demand approach was first used in 1958 (Cagan 1958). It is based on the premise that transactions within the informal economy are undertaken using cash payments, therefore measuring the level of cash in the economy is an indicator of the level of the informal economy. Certain allowances are made for other causes of cash level increases, such as interest rates. This approach has been widely used and has been applied to many OECD countries, but it has been criticised as not all payments in the informal economy are made in cash.

### **Physical input**

Kaufmann and Kaliberda (1996) made an assumption that electricity consumption is the single best physical indicator of overall economic activity. This 'physical input' method has been criticised as not all informal economic activities use large amounts of electricity. Technical progress has produced fuel efficiencies which would affect the consumption figures, and there may be considerable differences in the elasticity of electricity/GDP.

### **Model approach**

The model approach recognises there is no single indicator of the informal economy. Production, labour and money markets can all be used to measure the informal economy. The multiple indicator and multiple causal (MIMIC) model, or dynamic multiple-indicator and multiple-causal model (DYMIMIC), uses information contained within relevant indicator and causal variables to estimate a time-path of the size of the informal economy. The model identifies the multiple causes and effects of the informal economy, rather than using a single measure. The large body of literature on the subject identifies three causes: the burden of regulation, direct and indirect taxation; and three indicators: the development of monetary indicators, the production market and the labour market (Thomas 1992; Johnson & Zoido-Lobaton 1998).

There are substantial differences between the measurements undertaken by researchers (Fleming 2000). Table 2 shows a comparison of the different approaches to measuring the informal sector and the deviation in the results.

**Table 2:** A comparison of the different methods for calculating the informal sector

Methods	Mean value* of informal sector (% of GNP)
Discrepancy between actual & official labour force.	24.4
Transactions approach ( <i>Feige</i> )	21.9
Cash-deposit ration ( <i>Gutmann</i> )	15.5
Physical input (electricity) approach	12.7
Currency demand approach	8.9
Model approach ( <i>Frey/Weck-Hanneman</i> )	7.9
Discrepancy between expenditure and income	6.4
Tax auditing	6.1
Survey method	3.1

*Source: Schneider 1998 \* Over 5 countries: Canada, Germany, Great Britain, Italy, USA (1970-90).*

Due to the nature of informal employment, it is unlikely that the direct approach will produce accurate or realistic figures. Those working informally are unlikely to want to 'own up' to their activities as many of them are avoiding taxes or costly bureaucracy and regulations. Thomas (1999) provides an example of how inaccurate interviews may be as an approach to measurement in his comments on the work of Matthews and Stoney (1987). He points out that, despite the author's claim that all interviews were conducted personally (without using a postal questionnaire or the phone), their results reveal that the interviewers failed to establish the sex of the interviewee in 6% of the cases and their marital status in 69% of cases. There is concern by the UK government over the extent of the 'informal economy' and a report was commissioned to look at its effects on the economy. Lord Grabiner, the author of the report, stated that "the very existence of the informal economy has a social cost". The fact that a significant proportion of the population is routinely engaged in illegal activity encourages a more casual attitude towards the law (Grabiner, 2000, p7).

The use of official statistics means that assumptions have to be made about their accuracy. Any anomalies in the collection of these statistics would be compounded if the data is used to estimate the size of the informal sector. There are some researchers that challenge the validity of any measurement with that is not based on economic theory and therefore questionable (Harding & Jenkins, 1989; Williams and Winderbank, 1998; Thomas, 1999). Koopmans (1947) refers to this phenomenon as 'measurement without theory'.

## INFORMAL EMPLOYMENT WITHIN THE CONSTRUCTION SECTOR

The term 'construction sector' is often used, particularly by research organisations, as if it is a homogeneous entity. Clearly it is not. The sector is made up of a number of sub-sectors, for example, design and engineering consultants, construction enterprises, manufacturers and suppliers and general service providers. There is a further sub-division within those sub-sectors, for example, 'construction enterprises' includes civil engineering, housebuilding and general contracting.

The indiscriminate use of the term 'construction sector' is very apparent in the measurement of informal employment, where figures are produced (mostly as a percentage of GDP) with no indication of which part of the sector is being measured.

Where expensive plant, equipment and other capital-intensive items are needed, for example in civil engineering, there is little opportunity for informal employment. On the other hand, the housebuilding sector gives ample opportunity for informal employment. Other examples of informality are found in parts of the supply chain, for example, within service provider organisations.

Issues such as human rights, economic activity, health and safety, and education and training are all features of informal employment that have caused some concern. Informal employment is heterogeneous, dynamic and very complex as it changes according to social, political and economic circumstances (ILO, 2002). Each of these aspects will be looked at in the following sections.

### **Social aspects**

In order to understand why informal employment exists, it is important to consider the social aspects and not just the economic reasons. According to Brown (1978, p9) an occupation gives someone a sense of purpose//belonging, a place in the “socially ordered division of labour”. A job is more about what a person is than what a person does. From this view one can see that unemployment is not just about loss of income but also a loss of social identity. This is an important driver and one that should not be ignored. The social aspect is very important in the networks formed by those in informal employment in parts of the construction sector. Contacts made in the process of formal employment often provide opportunities for informal work. For example a tradesman fitting a kitchen for a formal organisation may return to the client after work and undertake other work to supplement their income. This type of mobility is part of informal associations either between groups of workers or one or more sub-contracting firms (Bresnen *et al.*, 1985). These are semi-permanent relationships - contesting the idea that self-employment is casual. Once established, people or small organisations work informally, and rely heavily on personal contacts/networks for business, as advertising may draw attention to themselves from the authorities.

The International Labour Organisation (ILO) is worried about the growth of informal employment not only in the developing world, but also in industrialised countries. In its “Decent work and the informal economy” report (2002) it has voiced concerns saying that informal employment is unrecognised, insecure and unprotected and so people working informally are more at risk because of a lack of adherence to health and safety regulations and lack of education and training. The UK Construction Skills Certification Scheme (CSCS) has been an attempt to reduce accidents and improve quality on site, by requiring registration of site workers. Health and safety remains a significant issue for those that are informally employed. The lack of adherence to safety regulations can lead to a higher likelihood of accidents, and, even when there are accidents, informal workers and firms are less likely to report these.

People in informal employment do not have the benefits of those in formal employment such as work security, a pension and other employee benefits (ILO, 2002). This issue has been addressed by a number of countries in the developed world. For example, Japan with its National Pension System that covers a large majority of the working population, both in formal and informal employment. Another ‘solution’ is to encourage the transition for informal to formal employment where frameworks already exist to protect workers’ rights. For example, in Germany there are two schemes: Mini Jobs and Me-PLC (Small Business Council, 2005). The incentives in the Mini Jobs scheme include reduce social security contributions, which include pension and health insurance schemes. The Me-PLC scheme offers reduced taxation

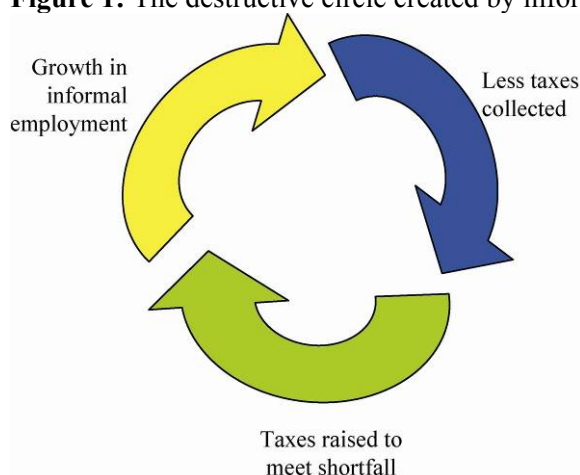
levels to ease the transition from unemployment to employment with a subsidy equivalent to 50% of unemployment benefit. A similar scheme operates in the Netherlands. In the UK there has been more of a focus on providing information and support for those starting up formal businesses but still working within the existing framework of tax and labour regulations. Street (UK) is an organisation that provides this kind of support not only in terms of finance, premises and tax issues but also public and employer's liability insurance.

## **Political**

### *Taxation*

Taxation issues dominate the reports/research commissioned by governments or undertaken by taxation experts. There is a view that informal employment is a means of not paying tax. There has been considerable discussion about the difference between tax avoidance and tax evasion, and often the two terms are used synonymously. The definition of tax avoidance used by the US government is that it is "lawful conduct" that allows somebody to avoid tax liability. They define tax evasion as an illegal activity, whereby somebody evades paying taxes that are already due. A simplistic definition of the two is that one is legal and the other is not. However, the literature on the subject is wide-ranging and complex; there are many legal and financial arguments about the rights and wrongs of the two concepts and their effects on an economy. Figure 1 illustrates how growth in informal employment is seen as creating a destructive circle: a fall in tax income leading to higher taxes, leading to further growth in informal employment and so on.

**Figure 1:** The destructive circle created by informal employment



### *Regulation*

The International Labour Office (ILO), in their report on decent work (ILO, 2002), cites excessive bureaucracy as one reason for the existence of informal employment. The British Chambers of Commerce (British Chambers of Commerce, 2005) is concerned about the number of new regulations coming in to force that "will add over £700 million to the cost of doing business in Britain". There have been a plethora of changes in regulations that impact the construction industry in recent years all adding to compliance costs. These range from Building Regulations and new health and safety rules to corporate governance and labour regulations. For example, labour regulations include the introduction of the national minimum wage, the right to paid annual leave, limits to the average working week, a reduction in the qualifying period for unfair dismissal claims, and increased 'family-friendly' rights

Some of the increased regulation is designed to protect workers in terms of remuneration or health and safety, which is very laudable, but there is a danger that investors, employers and industry professionals will, at some point, no longer absorb the associated costs.

Many government policies are based upon the national statistics, with economic activity and its growth is of prime concern in any country. However if the measurement of informal employment cannot be relied upon, this distorts the construction (or any) output figures. Tanzi (1999) points out that without accurate figures on production and the tax base, the government will have little guidance for its policy making.

### **Economic aspects**

The first time the phrase ‘informal sector’ was used was in reports on Ghana and Kenya by the ILO in the early 1970s. Since then the fixation with the economics of informal employment has led to a large amount of research on the measurement of the phenomenon, some of which was referred to earlier.

Many economists see informal employment as having a negative impact on the economy, yet Schneider (2002) noted that over 60% of the money earned in the informal sector is spent in the formal economy, representing positive economic activity. This is borne out in times of booming construction activity when formal employers rely on sub-contracting/informal workers to meet the increased need for labour. ConstructionSkills (2006), a government-initiated body estimates that building for the 2012 London Olympics will create 33,500 extra construction jobs over the next years. Meeting this target may rely heavily on those working informally.

Williams and Windebank (1998) outlined a number of economic regulators as ‘reasons’ for informal employment, namely: level of unemployment; level of affluence; duration of unemployment; industrial structure; level of sub-contracting; tax and social contributions. The level of unemployment and affluence is a ‘local’ measure and explains the varying levels of informal employment in different parts of the same country, as shown, for example in the English Localities Survey (Williams, 2004). The level of sub-contracting is particularly relevant to construction where there is an increasing reliance on this form of employment and, with it, an increased likelihood of informal employment (HM Treasury, 2000).

## **CONCLUSIONS**

Lord Grabiner (2000) referred to informal employment as a “major problem” in his report, but it should be noted that this covered all industries. This ‘major problem’ is not easy to measure and not well understood.

Those that have attempted to measure informal employment have either relied on official statistics, which themselves are flawed because of the lack of information about informal employment; or they have used direct methods, which, as they rely upon the respondents revealing all their activities, are inherently unreliable. Or thirdly, they have employed direct methods which use a number of different metrics. All of these are “measurement without theory” and should only be regarded as a guide rather than a true reflection of the extent of informal employment. It is not the measurement (economics) that is so important, if the economic and social aspects are to be properly addressed, an understanding of the drivers and the issues of informal employment is vital.



The 'problem' is not well understood, not always consistently defined, and mostly considered from an economic point of view. The social aspects are particularly important as they are often the reasons that people work informally, for example the need to have a job and a social identity. There is often a perception that there are two separate economies or sectors - the informal and the formal - whereas, in reality there is an employment continuum ranging from informal to the formal along which people place themselves, throughout their working lives, according to their economic and social circumstances, the employment market and the availability of suitable work.

Whether informal employment is a threat or an opportunity very much depends on the perspective taken. For those on a low income who can only afford the low-priced work offered by those working informally, it is an opportunity, for the government, the loss of tax is a threat. For the UK industry that is facing labour and skills shortages, especially in the run up to the 2012 Olympic Games, informal workers offer an opportunity.

This paper has considered the social, political and economic aspects of informal employment in construction. It has also shown that measurement is at best difficult and, at worst, inaccurate and misleading. Therefore, a way forward must be considered, that meets the social, political and economic problems identified. Countries in the developed and developing world are tackling the problem in different ways, either by looking at the demand issues, such as providing incentives for householders to get a tax reduction for renovation, refurbishment and extensions of residential property as in the ROT system in Sweden. Or through the supply side, with incentivisation for informal businesses to formalise in the form of subsidies for tax, social security, pensions and health insurance.

There is a need to understand more fully the different facets of informal employment which is so prevalent in the construction sector in order to find a range of solutions, whether they are 'carrot' or 'stick' (or both) approaches. Further research is needed to analyse the existing measures adopted around the world. Insurance, in all its forms: public liability, employer's liability, and project insurance, needs to be further considered as a way of protecting both employees and employers who are working informally. There is also a need to look at the positive side of informal employment, which brings benefits to communities, individuals and the sector, rather than the detrimental effects which receive the most publicity (and the most research).

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