

Self-employed People in the Informal Economy - Cheats or Contributors?

*Evidence,
Implications and
Policy Recommendations*

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About the Authors' Organisations

Street(UK), a micro-finance organisation

Street(UK) was launched in late 2000 to offer loans and business support to self-employed people and owners of tiny businesses (micro-entrepreneurs) not considered creditworthy by banks. The reasons for its clients' 'financial exclusion' may be that they are too small, do not possess a long enough (or, indeed, any) documented track record, have insufficient or no assets to offer as security, or do not wish to borrow a large enough sum to be profitable for a bank.

Street(UK) 's approach is to give its clients a hand-up rather than a hand-out and provide them with effective tools to transition into the mainstream. Street(UK) believes this not only shows them the proper respect, but also enables it to maintain a high quality range of tailored products that can be offered at scale and to develop its operations into a permanent organisation, ultimately free of dependency on grants or donations.

In addition to supporting micro-entrepreneurs with loans and advice, Street(UK) has developed three further activities. These are:

1. Creating additional tailored financial services and business development support tools, for micro-entrepreneurs and other low income individuals without access to mainstream services.

2. Offering a back-office loan administration and systems support service for other community loan funds. This will be followed by additional 'wholesale' services.

3. Undertaking research, policy recommendation and advocacy work with government and regulatory bodies, focused on a) the elimination of the barriers that prevent low income people and micro-businesses from becoming customers of mainstream banks, and b) the creation of a suitable regulatory framework for community finance organisations, such as itself, to be able to provide the services needed by their clients.

In summary, Street(UK) is about helping people to help themselves and help each other, on a long term, sustainable basis, through enterprise development and financial services provision.

Community Links and the Social Enterprise Zone (SEZ)

Community Links is an innovative and ground-breaking inner city charity running community-based projects in east London. Founded in 1977, it now helps over 30,000 vulnerable children, young people and adults every year, with most of its work delivered in Newham, one of the poorest boroughs in Europe. Its successes influence both community-based organisations nationwide and government policy.

The **Social Enterprise Zone (SEZ)** is a project of Community Links, where ideas for using mainstream resources and budgets more effectively are generated, tested and shared. Some ideas are simple and practical and can be implemented locally, for example, setting up an independent disability benefits helpline or a new claim support service in local jobcentres. Others require government support and changes to rules – these form the basis of its contributions to policy development, for example, developing new solutions to existing government programmes which support the unemployed into self-employment.

The purpose of SEZ is:

1. To ensure that the needs of people in Forest Gate & Plaistow and Newham are met through efficient and effective use of public resources.

2. To research and campaign for national policy changes, which affect local people in Forest Gate & Plaistow and Newham.

3. To provide a paid consultancy service.

Foreword

AS I KNOW from my work with Community Links, the informal economy is a prevalent force in many communities throughout the UK. Indeed, it often provides an essential mechanism for people to support themselves and their families, become more financially independent and less reliant on State support. It gives them the capacity to work, and with that comes self-esteem and personal dignity, a sense of contributing to society, and perhaps the only opportunity available to them to acquire the necessary skills and experience to move into mainstream business or employment.

In poorer countries of the world, 'micro-entrepreneurs' trading informally are praised for their initiative, enterprise and sheer hard work. Their stories are held up as examples of courage in the face of adversity. Our government even provides substantial aid to programmes which support them. And yet, in our own country, we seem to focus almost exclusively on the legal and regulatory compliance aspects of their lives, viewing their efforts to improve their situation only in a criminal light.

I believe it is time to take a much closer look at the way the informal economy actually works in the UK, based on a deeper understanding of the real situations of both self-employed and employed people. We need a better grasp of their motivations and goals, as well as the obstacles they face in achieving them. Only then can we properly consider the suitability of the current framework of regulation and support structures and make appropriate adjustments.

This is why I truly welcome this report by two organisations that are well qualified to give a first-hand account of the reality 'on the ground' and offer practical solutions covering the whole gamut of regulations and policies that affect the people they work with. The public and private sector should also be working together to look at developing appropriate responses to help meet people's needs and develop appropriate strategies and policies. This report offers some simple and straightforward recommendations of how these may look and work in practice.

I warmly recommend this report to policy-makers, regulators, businesses and all those concerned with the well-being of our society, as an excellent starting point for an increased understanding of the informal economy and a much needed debate.

David Walker

Chairman, Morgan Stanley International

September 2004

Sir David Walker is Chair of Community Links' Leadership Group and has been involved with Community Links since 1998.

Background To This Report

This report is the first of a two-part series, focused on people working in the informal, cash or grey economy¹. Specifically, it concerns the many of hundreds of thousands, possibly millions, of self-employed, unemployed or employed people in Britain who survive on the upper margins of welfare and the lower margin of formal employment or small business ownership. Whereas this report looks at the employer's perspective, i.e. that of self-employed people and owners of very small businesses, the second report (to be published in Winter 2004) will take the employee's perspective, i.e. that of casually hired labour.

Unlike other reports on the informal economy published by government policy-makers, regulatory bodies or academic institutions, this one is co-authored by two community-based, non-profit organisations. Their respective missions are to help their clients to move out of situations of disadvantage, deprivation and social or financial exclusion, and fulfil their potential as active, financially independent citizens, with access to mainstream services and the ability to contribute to the welfare of others in their community. The perspective of this report is therefore one of understanding the reasons why such a large population group work in the informal economy, as well as the ways that this both helps and hinders their progression into mainstream society. It is not intended to be a quantitative study, but rather a qualitative, grassroots-based insight into the practical issues that policy-makers need to consider, based on a combination of structured client interviews and individual profiles, and the wider conclusions and recommendations of two organisations with 30 years' combined experience of working with people in this situation.

The authors of this report are from Street(UK), a Birmingham-based micro-finance organisation assisting self-employed people and owners of very small businesses with loans, advice and support; and the Social Enterprise Zone (SEZ), a project of the east London based charity Community Links, where ideas for using mainstream resources and budgets more effectively are generated, tested and shared. This first report, which is focused on self-employed people, has been authored by Street(UK), with editorial assistance from Community Links. The last chapter, however, which contains our policy recommendations for removing many of the obstacles preventing self-employed people from becoming fully regulated small business owners, has been jointly authored.

In September 2003, Street(UK) joined forces with Community Links to host an Inland Revenue Inspector from the Cross-Cutting Policy Team for six months (funded by the Inland Revenue). This enabled her to interview Street(UK)'s and Community Links' clients for herself and form her own views. Concurrently, in late 2003/early 2004, Street(UK) and Community Links were invited to provide input to the Social Exclusion Unit's research into 'Stimulating Jobs and Enterprise in Deprived Neighbourhoods'. The Social Exclusion Unit covered the costs of the Street(UK) client interviews featured in this report. Both the Inland Revenue and the Social Exclusion Unit plan to publish their own reports in Summer / Autumn 2004². Street(UK) and Community Links gratefully acknowledge the in-kind and financial contributions of both organisations towards the production of this report, as well as the opportunity over several months to work together, at the same time emphasising that the views and recommendations expressed in this report are entirely their own.

1 The informal or grey economy is here defined as trade, services or production, that is non-compliant in any aspect(s) of company registration, tax declaration/payment, business regulation (eg. employer's national insurance, public/employer's liability insurance), and/or licensing requirements for the specific trade (eg. health and safety certificate, driving instructor's licence, publican's licence). It does not include either 'self-provisioning' (eg. doing one's own cleaning, plumbing, car repairs), or illegal 'black economy' activities (eg. drugs, child labour, money laundering).

2 In addition, the Small Business Council (within the SBS/Dti) has started to undertake its own investigation into the informal economy.

Executive Summary

The specific aims of this report are threefold

1. To raise awareness of the informal economy as an issue that needs far more attention by mainstream organisations, particularly government policy-makers and regulators.
2. To shift the general attitude towards people working in the informal economy from one of 'benefits cheats and tax dodgers', to people who mostly use cash transactions either to try to make ends meet, or advance into financial independence from the State, or even help others (by subsidising their support to members of their community in even greater need than themselves), i.e. to understand the informal economy within the context of 'obstacles and solutions'.
3. To provide pointers to broad categories of policy recommendations and hypotheses that need testing with larger sample sizes, as well as suggestions for action research through pilot projects.



The report is divided into the following Sections

Introduces the purpose of the report and seeks to describe Street(UK)'s client group in relation to the informal economy.

Section 2: Explains the work of Street(UK) and the context within which we have gained our understanding of this population group.

Section 3: Provides a case study as background to Street(UK)'s view that the obstacles facing its clients' graduation into formal, regulated small businesses are widespread and therefore need serious attention and consideration by public policy makers.

Section 4: Summarises the results of additional interviews with 17 Street(UK) clients, illustrated by a matrix and supplemented by client profiles (found in Section 7).

Section 5: Draws out the main conclusions Street(UK) has come to after three years of operations, which are given below.

Section 6: Identifies a number of policy areas and makes recommendations for removing many of the obstacles facing self-employed people who have to work informally.

Section 7: Street(UK) client profiles, followed by a Bibliography.

Our main conclusions are as follows

■ Widespread problem

Though the number of clients Street(UK) has served since its inception in 2000 is relatively small, we believe it is sufficient to conclude that there is a widespread problem and to identify a number of specific circumstances and difficulties people are experiencing pushing and pulling them into informal activity. Further work is needed to quantify the population size affected by each specific difficulty.

■ Complex issue – no single cause of simple solution

The very large number of different kinds of problems people face demonstrates how complex this issue is. A multi-pronged and tailored approach is therefore required, rather than a 'one size fits all' solution.

■ Positive functions of the informal economy

We believe the informal economy provides our clients with significant positive value, giving them individually crucial and otherwise unavailable transitional support, as well as building social capital within their community by enabling them to help others up the ladder on an affordable basis.

■ Re-define objective: to support opportunity for all

Given the above, we do not believe the objective should be to eliminate the informal economy. Rather, the focus should be on providing sufficient practical opportunities to support people out of dependency. Where no better alternatives exist, a segment of informal economic activity should be deliberately left alone and recognised for the value it provides.

■ Re-define desired outputs: allow for many small, gradual steps

The current mechanisms to help people out of welfare are often too demanding or difficult. What are needed are mechanisms which allow much smaller and more frequent, gradual steps to be taken in people's own time, thus making each step more manageable.

■ Extend eligibility for support

One reason that people are not able to transition into the mainstream is that, despite a number of initiatives such as Working Tax Credit, government policy is still too focused on supporting people 'in need' as opposed to supporting people to graduate 'out of need'. The eligibility criteria for public support therefore need to be extended to the zone which lies between the upper margin of poverty and the lower margin of eligibility for mainstream business and financial services, in order to incentivise and fully bridge the transition for people to cross into the mainstream.



■ More carrots needed, in proportion to sticks

Despite a number of government schemes such as New Deal, the current emphasis in the design of these programmes is still heavily weighted towards 'sticks' rather than a more even balance of 'sticks' and 'carrots'. If these programmes are to achieve better results, greater sensitivity has to be built in to the motivational impact of the rules on the target population, in order to expand the take-up or use of the programmes by those who will truly benefit from them and for whom they were intended.

■ Three building blocks: cover the cost of living; build savings/reserves; and increase business net income

Any scheme that provides effective transition support for people to graduate from welfare to self-employment needs to take into consideration the fact that a person will not attempt the transition unless, firstly, they are sure that they can cover their cost of living, whatever the consequences of their business start-up efforts; and secondly, they have a savings/reserve 'rainy day' fund to fall back on in the event of cashflow difficulties. Once these two pre-requisites have been covered, they will then be able to focus on increasing their business net income. These three objectives should therefore be the key elements or building blocks of an effective welfare-to-self-employment transition scheme.

Our main recommendations are as follows

■ Education and lifelong learning

- The National Curriculum needs to be developed to include business and the world of work for the general education of all children in the UK.
- At secondary school, the ethical issues for and against doing business in the informal economy should be discussed.
- Entrepreneurial skills need to be further supported, particularly in schools in deprived areas, where the students have fewer potential future employment alternatives.
- Generic financial management skills are crucially needed, for both young people and adults.
- Additional education support is also needed for adults, through training in various elements of business development and understanding the tax system.
- An upgrade is recommended in the use of business mentors, together with the development of 'wholesale' business decision-making tools for mentors, to raise the quality and consistency of the mentoring profession.

■ Business advice and support

- A specialised offshoot of Business Links or independent business support network/franchise needs to be created, to focus specifically on the micro-entrepreneur market.
- Informal economy transition or 'formalisation' business advice and support needs to become a recognised activity for which public funding is made available and appropriate targets are developed.
- Greater use of existing government agencies is needed at a local level, e.g. Inland Revenue Small Business Support teams.
- Exemptions should be made for micro-businesses (up to 5 employees) in respect of the many areas of business regulatory compliance and red tape, based on a common sense

approach e.g. to the health, safety and consumer protection issues involved.

- A new type of 'business incubator' is proposed, again specifically focused on the needs of the micro-market.

■ Tax and benefits rules

The objectives of the recommended adjustments to the current tax and benefits policies are to:

- Re-balance the carrots vs. sticks, and offer a 'nothing to lose' approach to starting and developing a business, i.e. a defined period of guaranteed living cost reimbursement.
- Enable and encourage people to build their own 'rainy day' fund, partly by increasing the asset caps to qualify for benefits and partly by incentivising savings.
- Co-ordinate the tax and benefits thresholds more closely, so that transition is as seamless as possible for people receiving benefits to progress through a 'no benefits, no tax' point before becoming a tax-payer. This will involve an elimination of such 'distortions' as absolute caps on permitted earnings disregards, work hours or savings levels for benefits retention.
- Give as much control as possible to those transitioning from welfare to self-employment, to determine their own timing of when they switch from state support to business income. A special dual bank account system is proposed for this purpose.
- Re-balance the emphasis on optimising the benefit from usage, as opposed to the current focus on minimising non-abuse (and thus failing to achieve the desired take-up rates and intended impact).
- Review the VAT rules and introduce a flat tax system as an alternative option for low-income groups.
- Make additional changes to the existing government programmes which do not sufficiently support unemployed people into self-employment, as well as the rules of non work-related benefits, in order to reduce the necessity for people to work informally.

■ Role of the voluntary and community sector

- We recommend much greater involvement of local voluntary and community organisations in the design and delivery of 'formalisation' programmes.
- Discretion should be given to local community organisations to determine the precise level of support within pre-set bands, for people in transition, in order to achieve two objectives:
 - To minimise the over- or under- payments that inevitably occur when setting standardised policy rules for a large and diverse group of people.
 - To enable the rules of support to be more geared to optimising the benefit, as opposed to the current situation where they tend to be over-focused on the prevention of abuse.

■ Debt management and incentives to save

- A staggered and/or deferred debt repayment schedule should be introduced for people leaving the benefits system.
- Further steps should be taken to tighten the Consumer Credit Act beyond those included in the government's recent white paper, including the introduction of a ceiling on lending interest rates by loan companies and banks, as well as the elimination of a number of continuing predatory lending practices.

- Community Development Finance Institutions and Credit Unions should be given increased promotion and financial support.
- Strong incentives are needed to restore a culture of savings, including a roll-out of the Savings Gateway scheme and other financial literacy initiatives, and the introduction of new, affordable financial planning services.

■ Government agency database linkages

- The 'client' databases of the various relevant government departments and agencies need to be better linked to each other. This should help people not to miss out on or be delayed in receiving state benefits such as tax credits or housing benefit run-on, as well as reduce abuse and increase overall efficiency.

■ Cross-governmental working groups

- We recommend that the existing work that has been started by the Inland Revenue and the Office of the Deputy Prime Minister (Social Exclusion Unit and Neighbourhood Renewal Unit) as well as the Small Business Council, act as the foundations for building cross-cutting working groups to develop joint strategies and policies, and test specific changes to different elements of the current system.
- We recommend that these working groups be led by a member of the Cabinet, include representatives of the voluntary and community and business sectors, and involve the following government departments, agencies and regulatory bodies:

Cabinet Office

Department of Trade & Industry

Department of Work & Pensions

Department of Education and Skills

HM Treasury

Home Office

Financial Services Authority

Office of the Deputy Prime Minister



■ Action research through pilot-testing

- We recommend action research/pilot-testing be considered for each of the specific changes proposed in the fields of education, tax, benefits and the regulatory system, through partnerships of voluntary and community organisations and local government offices, with appropriate funding streams to support the process.

■ Areas for further academic research

We suggest further academic research be undertaken on a selective basis. The greatest need, in our view, is to:

- Determine the size of the informal economy.
- Investigate the positive benefits of the informal economy.
- Understand other countries' approach to their own informal economies.



1 Introduction

1 Purpose

The purpose of this paper is to give a grass-roots perspective on the situation of the many hundreds of thousands, possibly millions, of self-employed people in Britain who survive on the upper margin of welfare and on the lower margin of small business ownership. The paper will:

- Explain the work of Street(UK) and the context within which we have gained our understanding of this population group.
- Provide a case study as background to our view that the obstacles facing our clients' graduation into formal, regulated small businesses are widespread and therefore need to be given serious attention and consideration by public policy makers.
- Summarise the results of additional interviews with 17 of Street(UK)'s clients.
- Draw-out the main conclusions we have come to after three years of operations.
- Identify a number of policy areas for more in-depth review, as a first step in determining the changes needed to remove the obstacles facing this segment of self-employed people.

2 Market definition

While all of the people referred to in this paper work in legal trades or professions as opposed to illegal 'black market' activities³, some will be part-time and others full-time self-employed; some will work from home while others will have business premises; a portion will be operating entirely in cash while the majority will be declaring some, but not all, of their income. Few will be on work-related benefits other than Working Tax Credit because, however fragile or tiny their income-generating activities, the specific population group referred to here consider themselves to be 'in business'. They therefore mainly divide into those who have other benefits (such as housing or disability support) and those who have no benefits at all. In other words, within the spectrum of people who are self-employed and working in the informal economy (from poorest upwards), our work focuses mostly on groups 3 and 4 below, with a small proportion in groups 2 and 5. The recommendations at the end of this report, however, cover groups 2–5.



3 'Black market' activities are here defined as illegal trades, e.g. drugs, child labour, money-laundering, as opposed to 'grey market' activities which are defined in footnote 1.

4 The specific issues facing women in these population groups are well summarised in a recent NEF/Prowess publication entitled 'Who Benefits?' by S. Marlow, A. Westall and E. Watson, 2003.

Spectrum of self-employed people working in the informal economy:

- *Group 1:* People in receipt of Jobseekers Allowance, other state benefits and supplementary earned income within the legal maximum⁴.
- *Group 2:* People in receipt of Jobseekers Allowance, other state benefits and supplementary earned income, exceeding the legal maximum.
- *Group 3:* People not on Jobseekers Allowance but in receipt of other state benefits and earned income which may be wholly or partly undeclared.
- *Group 4:* People not in receipt of any state benefits but not declaring any or part of their earned income and/or not meeting any/all other regulatory requirements.
- *Group 5:* People declaring all of their income and meeting all other regulatory requirements, but still not able to access mainstream financial services for their business.
- *Group 6:* Fully bankable small businesses.



2 Background on Street(UK)

and its Support Services for self-employed people working in the Informal Economy

1 Mission and purpose

Street(UK) was launched in late 2000 to offer loans and business support to self-employed people and owners of tiny businesses (micro-entrepreneurs) not considered creditworthy by banks. The reasons for our clients' 'financial exclusion' may be that they are too small, do not possess a long enough (or, indeed, any) documented track record, have insufficient or no assets to offer as security, or do not wish to borrow a large enough sum to be profitable for a bank.

Whereas many existing providers of finance to disadvantaged population groups in the UK operate very clearly as a *charity*, often focusing exclusively on start-ups and treating their clients more as 'beneficiaries', Street(UK)'s approach is that of a *friendly financial institution*, albeit not-for-profit, with registered charity status.

We specifically believe that it is only by treating clients as our business partners (i.e. giving them a hand-up rather than a hand-out) and providing them with effective transition tools into the mainstream, that we can show them the proper respect, maintain a high quality range of tailored products that can be offered at scale and develop our own operations into a permanent organisation, ultimately free of dependency on grants or donations.

In addition to supporting micro-entrepreneurs with loans and advice, Street(UK) has developed three further activities. These are:

- Creating additional tailored financial services and business development support tools, for micro-entrepreneurs and other low income individuals without access to mainstream services.
- Offering a back-office loan administration and systems support service for other community loan funds. This will be followed by additional 'wholesale' services.
- Undertaking research, policy recommendation and advocacy work with government and regulatory bodies, focused on a) the elimination of the barriers that prevent low income people and micro-businesses from becoming customers of mainstream banks, and b) the creation of a suitable regulatory framework for community finance organisations, such as ourselves, to be able to provide the services needed by our clients.

In summary, Street(UK) is about helping people to help themselves and help each other, on a long term, sustainable basis, through enterprise development and financial services provision.



“*Street(UK) is about helping people to help themselves and help each other, on a long-term, sustainable basis*”

2 Operations

■ Status and Governance

Street(UK) is run as a social business. Its parent company, Street(UK) Foundation, is an independent registered charity (Charity no. 1081902) while its 100% subsidiary, Street(UK) Ltd, acts as its trading arm. A service agreement between the Foundation and the Limited company provides for Street's operations to be undertaken by the latter and Street(UK)'s fundraising to be split between the two. Any profits earned by the Limited company will be covenanted back to the Foundation. The founding trustees of Street(UK) comprise several leading practitioners in the field of international micro-credit. More recently Street(UK) has started to build its domestic profile with its first UK trustees. Street(UK) Ltd is a Charter Member of the Community Development Finance Association (CDFA).

■ Management

The founding directors and management team comprise Rosalind Copisarow, Executive Director and Martin Hockly, Operations Director. Between them, Rosalind and Martin bring together over 30 years of micro- and community enterprise lending experience (including over 30,000 loans), both internationally and in the UK. Rosalind also serves on the board of the CDFA. Street(UK)'s operations incorporate the lessons of Fundusz Mikro (Poland), the Micro-Finance Centre (Eastern Europe), CGAP (World Bank) and ICOF (Industrial Common Ownership Fund) where Rosalind and Martin have worked, as well as its own three years of lending experience.

■ Funding

The funding committed to Street(UK) comprises commercial bank loans from Barclays, Bank of Scotland (HBOS), Northern Rock Plc., Co-op Bank and Alliance and Leicester, for on-lending to Street(UK)'s clients. These are unsecured facilities, granted on the basis of Street(UK)'s business plan and management track record. In addition, the Esmée Fairbairn Foundation, Northern Rock Foundation, Tudor Trust, World in Need, Gulbenkian Foundation, John Ellerman Foundation and City Parochial Foundation have all contributed grant funds towards our operating expenses, as have the Newcastle Employment Bond, Scottish Enterprise, Leaside Regeneration and the Small Business Service's Phoenix Fund. In total, Street(UK) has raised over £5 million from all of these sources.

■ Description of our clients, their needs and our services

Street(UK) now has three years of micro-lending experience, having made its first loan in April 2001. It has to date disbursed over £600,000 to micro-entrepreneurs in Birmingham, Birmingham and East London, borrowing an average of £2,000 each. Incorporated into its lending activity, Street(UK) also provides business advice and ongoing support to its clients. Since its inception Street(UK) has advised well over 1,000 micro-entrepreneurs.

Although a micro-enterprise is defined as a business with up to five employees, many of our clients are 'one-man-band' businesses run by sole traders. A fair proportion are part-time or not fully-fledged businesses where the owner may be supplementing his/her income from benefits and is not equipped to transition the income-generating activity into a fully viable, legitimate business, without assistance in the following areas:

- A review of all aspects of their business, particularly from the perspective of
 - Identifying and reducing the risks which may cause liquidation
 - Identifying any marketing opportunities to generate additional revenue.
- A review of their loan capital request to ensure that the money is borrowed for the most appropriate (i.e. safest and/or highest income-generating) purpose.
- Preparation of cashflow statements and education in cash management issues.
- Provision of loan capital wherever the business needs it and is able to repay it.
- Signposting with facilitated introductions to:
 - Sources of additional business support, particularly in respect of formal training.
 - Providers of insurance, book-keeping, legal, premises and other professional services.
 - Other clients in a similar business field as themselves, to help develop peer group support. We further support this with larger networking events for all clients.

Once a business has more than 2–3 employees, it is generally starting to employ non-family members and therefore needs transition support into the formal economy. This includes:

- Help with understanding and fulfilling regulatory and licence requirements, public liability and employer’s liability insurance, VAT registration, payment of taxes and book-keeping.
- Help with a pricing and marketing strategy for invoiced (as opposed to cash-based) services.
- Support to build a good enough loan repayment track record that they can graduate with a solid credit history from Street(UK) to a mainstream bank.

Our clients therefore range from single mothers in deprived communities, trying to generate an income perhaps from home, to refugees, ethnic minority residents or ex-offenders who are discriminated against by mainstream credit providers despite being good business people, to micro-business owners that simply have insufficient documented track record or insufficient assets that can be used as security by banks. They include hairdressers, carpenters, cafe owners, builders, taxi drivers, bakers, stall keepers, window cleaners, dressmakers and music promoters. Every kind of business is eligible for help from us as long as it is engaged in a legal activity.

The common factor that links them all is that they are all already undertaking, albeit in a fragile way, some kind of trading activity. Any support given to them (vs. to people who need financial incentives to be encouraged to start their own business) should therefore bear the greatest fruit, since the initial risk capital for the business was their own and they at least have some proven demand for their products and services.

Our main objectives are therefore to:

- Help turn fragile, informal income-generating activities into registered new businesses.
- Secure their chances of survival with advice, finance and introductions to other services.
- Increase their prospects of growing and creating new (unsubsidised) jobs, by supporting them through the entire transition process until they qualify for mainstream bank credit.

3 Impact

Despite our short history, the impact that we have made on those micro-entrepreneurs whom we have lent to is already strong. One of our earliest clients – a builder whom we first met 18 months ago, has expanded from a ‘one-man-band’ to 10 sub-contracted full-

“... hairdressers, carpenters, cafe owners, builders, taxi drivers, bakers, stall keepers, window cleaners, dressmakers and music promoters. Every kind of business is eligible for help from us, as long as it is engaged in a legal activity”

time workers (on a totally unsubsidised basis) and is now on his third Street(UK) loan which is to buy a JCB costing £24,000. In an even shorter time frame, we have supported a hairdresser who arrived penniless from Ghana four years ago. She has expanded in less than two years from part-time, home-based self-employment to a thriving salon with five full-time employees and four sub-contracted positions for nail technicians and beauty therapists. Her latest loan of £6,000 from Street(UK) will enable her to refurbish the unused basement

premises of her salon to house the new beauty therapy service.

Though these examples are at the upper end of the transformation we witness with our borrowers, a typical loan can still benefit about 8 people: the owner of the enterprise, his/her immediate family, the new employees brought in as the business starts to grow and the people in the local neighbourhood who draw inspiration and confidence from our client as a role model and advisor in their own aspirations to start a business themselves. In terms of measuring the impact on the business, our approach is to monitor our clients’ progression in each of the areas listed below:

- Moving from part-time to full-time work.
- Moving from home to business premises.
- Keeping basic level records.
- Keeping higher level accounts.
- Purchasing public liability and employer’s liability insurance.
- Hiring employees on a PAYE basis.
- Using a bank account for their business transactions and/or opening a separate business bank account.
- Obtaining the required licences and permits to operate the business, e.g. Health and Safety inspection certificates, driving instructor licence, etc.
- Graduating off all non-work state benefits.
- Graduating from majority cash revenues to majority invoiced revenues.
- Incurring a formal business tax liability.
- Becoming VAT registered.

So far, our experience has been that for every 10 businesses to which we make loans, 4 businesses (40%), which would very likely have been liquidated within the next 12 months, have been safeguarded, and 4 businesses (40%) which would very likely have not been liquidated within the next 12 months, have been able to grow and create new jobs. The average number of new (unsubsidised) jobs created by the 4 ‘growth’ businesses since they first became Street(UK) clients is 2.5.

3 Understanding the Obstacles – the case of Michael, a shop-fitter⁵

Michael was first interviewed at the office of a private recruitment agency which operates a government New Deal contract to help people into employment and/or self-employment. He was there, officially as an unemployed person wishing to become self-employed, despite in reality having a joinery business that had been going for at least 10 years. Michael specialised in making and/or fitting new counters/shelves and lighting, as well as doing the decorating for small high street shops. 100% of his work came through word of mouth and 100% of his income was in cash. Through this work he claimed that he had accumulated £15,000 of savings. Since arriving from Jamaica 15 years ago, Michael had never registered for self-employment. And yet the quality of his work was excellent and, because he charged cash prices, he had no shortage of clients.

The second time we met him, at a butcher's shop where he was working, the florist from three doors down came in and asked him if he could next give her shop a 'new look'. The subsequent negotiation was not about price but timing, as he had a fixed idea in his mind of what was the maximum level of business he could undertake in a month and stay 'invisible'. After further discussion (with us), it emerged that the amount of new business Michael was delaying or turning down for this reason was at least twice the business he accepted as soon as 'capacity' permitted.

Michael did not actually do any of the work himself. He was on disability benefit (for asthma). He had five school-leavers working for him, all on a cash basis, and managed their work. At least some of the 'employees' were on benefits, which meant this income was (illegal and) supplementary. This meant the wage levels could be relatively low.

What was interesting about Michael was the reason he finally went to an agency to 'give himself up' and try to see if he could get help to 'go legit'. His main motivation was a combination of frustration when he realised how much more he could achieve if he didn't have to deliberately cap his income, pressure from his wife who couldn't sleep properly for fear of tax inspectors knocking at the door and, strongest of all, the very real desire to give his children a legacy and a better start in life than he had had himself. On the other side, what had kept him underground all those years was a major fear of losing the financial security he gained from his benefits and more importantly, from his cash pricing which could normally undercut formal small business competitors.

Looking at the costs of formalising Michael's business and making it bankable, the included the following points were notable:

- Purchasing public liability and employer liability insurance.
- Obtaining extra 'in-transit' cover for his household contents insurance so that his joinery tools and other business assets would be covered, when they were in his van or on a client's premises, from the high risk of theft.
- Putting his employees on a formal employment contract, resulting in payment of employer's national insurance contributions.



“...frustration when he realised how much more he could achieve if he didn't have to deliberately cap his income...”

⁵ All micro-entrepreneurs referred to in this paper have had their names changed and location omitted, in order to protect their anonymity. However, false names have been chosen to keep their ethnic origin and gender the same.

- Paying higher wage levels, as he would no longer be able to use employees on benefits who only needed supplementary income.
- Coming off benefits, as both his income and savings exceeded the permitted thresholds.
- Paying VAT. (His gross revenue was well above the threshold).
- Paying income tax.
- Opening a bank account, putting all transactions through it and paying bank charges.
- Hiring a book-keeper.
- Incurring significant marketing costs to try to attract a new, upper level client base, due to having to charge much higher prices to cover these costs.

After realising just how expensive and difficult this would all be, I then talked with another five clients to see how their legitimisation costs compared. With every client, their cost categories were slightly different. For example, two clients in childcare and catering had to obtain operators' licences and premises which complied with Health and Safety regulations. This entailed:

- Major investment in their homes, or
- Rental of suitably equipped business premises.

In general, the regulatory requirements seemed to disproportionately disadvantage women, as so many women-owned businesses were in highly regulated trades.

The average gross margin increase that I calculated was necessary to give the person the same net cashflow situation, albeit for this tiny sample of clients, was about 350% (e.g. for a service business, increasing the charges from £10/hour to £35/hour), excluding the benefit of any tax deductions to which they were entitled. In particular, deductions would be able to be made for:

- Their utility bills.
- An allocation of their home premises costs.
- Any (consumer) borrowing costs for their businesses.
- Any pension fund contribution they were able to make.

Nevertheless, the total net legitimisation costs were still substantial.

Perhaps the biggest challenge of all was how they could develop an entirely new client base (of their own), willing to pay fully-loaded prices, as there was very little likelihood of keeping their current clients with their new prices whilst other cash entrepreneurs could so easily undercut them.

A client charged substantially more would certainly expect a higher quality product or service. This also therefore needed to be developed. In fact, the whole client and product niche market focus would have to be upgraded to a much higher level, inevitably beyond the capabilities of a substantial proportion of our clients, resulting in their having to close down their business and, for the majority, regress to being a benefits recipient. Given their work ethic, business orientation and pride in not being unemployment benefit 'spongers', this would have been a real humiliation for them. Psychologically, it would have meant shifting from being an active, working citizen, trying to be as independent of state support as possible, to a passive benefits recipient.

It is perhaps worth mentioning that self-employment is not the preferred occupation of a substantial proportion of our clients. For these people, it is often either their only option or the least objectionable or financially insecure option. Therefore, if they did have to close their business because it could not survive on a fully regulated, tax-paying basis, suitable employment would be very unlikely for the vast majority.

4 Street(UK) Client Interviews

As a result of the realisation that there were some major policy issues, that needed to be addressed before Britain would have an environment in which people could legally transition from welfare to fully-legitimate self-employment, Street(UK) joined forces with another voluntary sector organisation, Community Links, to host an Inland Revenue Inspector (Izzie O'Hara) from the Cross-Cutting Policy Team, for 6 months (from September 2003–February 2004), as a secondee (funded by the Inland Revenue), and enable her to interview Street(UK)'s and Community Links' clients herself and form her own view.⁶

Through a series of over 100 interviews, carried out in London, Birmingham and Newcastle, she was able to gain an understanding into the motivations, attitudes, perceptions and circumstances that lead people to work in the Informal Economy.

The Inland Revenue have taken not only the findings but also the solutions seriously, whilst fully understanding and appreciating the politically sensitive nature of the subject. It demonstrates their commitment to this work that they have created a senior position for the secondee, with responsibility for the whole organisation's strategy and policy on the Informal Economy in the UK. It is anticipated that their report and strategy will be published in Summer/Autumn 2004.

Alongside these interviews, 17 of our clients provided further data on a narrower range of issues around their life and business goals, their motivations and attitude to working in the informal economy and their (perceived and actual) obstacles to achieving their goals. The individual interviews are each summarised in Section 7, while below are the main conclusions from the interviews and a matrix of psychological scores, social measures, business and financial data that we thought could be relevant variables against which to look at their current degree of informality and progress in formalising their business.

It should be noted that the interviews were conducted with a random selection of clients who fulfilled two criteria: They were not delinquent on their loans and they had not been visited by Street(UK) too recently. Unfortunately, there was a problem in visiting delinquent clients as the interview would have undermined our separate efforts to ensure their loan repayment was brought back onto a timely basis. This has therefore biased the sample slightly. There is unlikely, however, to be any bias in the results based on the second criteria – that of interviewing clients who have not been recently visited by us. Our objective here was simply not to overburden any one client.

A final point concerns the inclusion in the sample of a few clients who are running their businesses almost or entirely on a legitimate, fully-regulated basis. The reason that they have been included is to help show the degree to which the client's informality of business operation is determined by his/her financial situation vs. attitude, personal experience and other non-financial factors. In other words, although in general, the poorer a person is, the less they will be operating in the formal economy, there will be some people who are extremely poor whilst nevertheless trying to be fully legitimate, whilst others could certainly afford to be more legitimate than they are currently. Having both informal and formal businesses in the sample should give an idea of the overlap between these groups.



⁶ Consultation with local residents in Newham by the Social Enterprise Zone (SEZ), a project of Community Links, revealed the barriers faced by people who are forced by circumstance to work informally, i.e. work for cash and not declare this to benefits authorities. By building on previous work carried out by SEZ in 2000/01 with Dr Andrew Travers, Exeter University, SEZ Evidence Paper No.2 'Prospects for Enterprise – An investigation into the motivations of workers in the informal economy'; two Public Attitude Surveys about the Informal Economy conducted in Newham and Oxford Street, Central London in 2000 and 2001 respectively; and following the success of a Tax Credit take-up project; SEZ used the links with the Inland Revenue's Personal Tax department to submit this research to Inland Revenue officials.

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Street(UK) Client Interview Matrix

Description		Personal Information								Business Information				
Client	Business	Ethnicity	Gender	Self-Esteem	Ambitions	Business skills	Home status	Non-work benefits	Work benefits	Trading start date	Initial investment	Subsequent investment	Employees	Business premises?
1 Sharon	Hair & Beauty	W	F	M	M	M	R	H C	W	12/99	£0	£500	0	N
2 Sanjay	Decorating	A	M	H	H	H	D	N	N ^a	01/02	£900	£1600	2 C	N
3 Robert	Tiling	A-C	M	L	M	M	D	N	N ^a	12/02	£250	£0	0	N
4 Titus	Catering	A-C	M	L	H	M	R	N	N ^b	02/02	£750	£400	2 C	N
5 Sonia	Café	A-C	F	H	M	M	R	N	N ^c	04/01	£2,800	£0	0	Y
6 Craig	Window Cleaning	W	M	M	M	M	R	N	N ^d	06/98	£2,300	£7,000	2 C	N
7 Otis	Music School	A-C	M	H	M	H	R	C	N ^c	07/99	£500	£1,500	0	Y
8 Tina	Barber's Shop	W	F	M	M	M	R	C H	W	03/03	£0	£0	0	Y
9 Neil	Greengrocer	W	M	L	M	M	D	N	N ^d	01/03	£1,800	£2,000	2 C	Y
10 Pat & Jane	Fishing/ Security Equipment Shop	W	M+F	H	H	H	R	N	N	05/96	£9,000	£15,000	0	Y
11 Devon	Catering	A-C	M	M	M	M	R	N	N	06/02	£1,500	£1,200	2 C	Y
12 Kevin	Guitar Tuition	W	M	L	L	H	R	N	N	05/02	£0	£1,250	0	N
13 Malcolm	Washing Machine Rental/Repairs	W	M	H	M	M	R	N	N	04/02	£1,200	£4,000	1 C	Y
14 Ravi	Indian Takeaway/ Frozen Meals	A	M	H	H	H	H	N	N	06/00	£20,000	£8,000	5 C	Y
15 Shamir	TV/Radio Advert. Production	A	M	L	M	H	R	N	N	03/02	£16,000	£4,000	3-4 C	Y
16 Sunil	Car Repair Garage	A	M	H	H	H	H	D	N	05/03	£25,000	£10,000	5 F	Y
17 Marcus	Car Repair Garage	A-C	M	M	H	M	H	N	N	06/99	£1,000	£5,000	1 C	Y

Superscript letters, for client-specific comments on figures in 'Work benefits' and 'Net cashflow' columns

a Not a direct recipient but living in a household where another family member is receiving benefits.

b Formerly in receipt of (Over 50s 1 year) benefits. No longer eligible. Now worse off.

c Eligible for Working Tax Credit/child-related benefits but not claiming, due to cash income situation.

d Business since liquidated. Neil is now claiming benefits.

e Fishing tackle income is 100% declared, while security equipment is a separate cash side activity.

f Average income at the time of interview. Sunil's income is now £0, due to losing the business entirely.

Financial Information				Transition Information					Example of Interview Conclusion	Additional Street(UK) Data Used
Turnover/ Month	Gross Profit/ Month	Last Street(UK) Loan	Net Cashflow/ Month	Tax Registration	VAT Registration	Declared Income	Insurance	Documents/ Records		
£1,500	£1,110	£750	£152	Y	N	Min	C	S	8,9	Dec '02
£3,629	£3,629	£6,000	£1,000	N	N	N	C	S	2,3,6	June '03
£480	£480	£500	£170	N	N	N	N	S	3,6,9	July '03
£1,075	£835	£350	£198	N	N	N	N	S	2,3,4,6	May '03
£3,017	£2,086	£2,000	£392	Y	N	Maj	C P	A	4,5,8	Nov '02
£1,780	£1,272	£3,000	£456	Y	N	Maj	C P	S	2,3,5,6,8	April '03
£1,637	£1,637	£3,000	£1,150	Y	N	100%	C P	A	4,5,9,10	Nov '03
£2,104	£2,086	£3,000	£435	Y	N	Maj	C P	S	3,6,9	Feb '03
£5,561	£1,750	£1,500	£313	Y	Y	Maj	C E P	S	8	May '03
£10,343	£5,439	£6,000	£2,558	Y	Y	Maj	C	A	5	Feb '03
£6,510	£4,677	£5,000	£1,837	N	N	N	N	S	2,3,6	May '03
£1,396	£1,396	£2,500	£224	Y	N	Maj	C P	S	4,5,6	Oct '03
£4,261	£2,613	£1,500	£909	Y	Y	100%	P	A	10	May '03
£12,800	£9,500	£10,000	£1,900	Y	N	Maj	C P	S	2,6,8	Nov '03
£4,465	£2,632	£7,000	£1,392	Y	Y	Maj	C	A	8	Nov '03
£11,895	£9,197	£9,800	£2,689 ^f	Y	N	100%	C P E	A	-	Aug '03
£3,060	£2,245	£1,800	£400	Y	Y	Maj	C	A	2,3,4,7	May '03

A key to the client interview matrix can be found on the following pages, 24 and 25.

Key to Street(UK) Client Interview Matrix

Column Headings	Comments
Self-Esteem Aspirations Business Skills	These are subjective relative judgments made just after the completion of all the interviews, simply for the purpose of looking at the correlation, if any, between the self-esteem, aspirations and/or business skills of the person and the level of informality of their business. H = High; M = Medium, L = Low.
Home Status	H = Home Owner; R = Rented; D = Dependent (in a family member's home).
Non-Work Benefits	H = Housing; C = Child; D = Disability.
Work Benefits	W = Working Tax Credit; J = Job Seekers Allowance; N = No Work Benefits.
Initial Investment Subsequent Investment	These are the amounts that the person invested to start the business and the total cumulative amount invested since then, until the time of their last Street(UK) loan draw-down, when the data was collected (see right-hand column).
Employees	The number of full-time equivalent employees is given. F = Formal employment; C = Casual employment.
Business Premises	Refers to whether or not a person has business premises. Y = Yes; N = No (i.e. home-based).
Turnover/Month★	This is an estimate of the person's total monthly declared and undeclared business revenues. The calculations were made by Street(UK) staff at the time of assessing the client's last loan request, so are as accurate as possible but there will inevitably be a margin of error as we rarely had any formal documentation to work from. The data was collected on the date given in the right-hand column. The purpose of <i>this</i> column is to give an indicative guide only to the financial situation of the business, particularly in relation to its VAT status.
Gross Profit/ Month★	This is an estimate of the person's total monthly gross profit after taking into account the business's declared and undeclared revenues and costs. The calculations were made by Street(UK) staff at the same time as the turnover figures were collected. The purpose of this column is to give an indicative guide only to the overall scale of the business, in particular by putting trade, services and production businesses on a comparable basis.
Last Street(UK) Loan	The last amount borrowed from Street(UK) has been included in this table to give an additional perspective on the financial situation of the client. Most of the loans are repayable over a 12-month period, in equal monthly instalments.
Net Cashflow/ Month★	This is an estimate of the client's net monthly household income after taking into account the business's declared and undeclared revenues and costs, the income derived from any other source, including other household family members, less all household fixed costs including an assumed amount for groceries, etc. Deductions do not include additional discretionary expenses. The calculations were made by Street(UK) staff at the same time as the turnover and gross profit figures were estimated. The purpose of this column is to give an indicative guide only to the (relative and absolute) overall financial situation of the client, combining his/her personal and business finances and the rest of the household's.

continued on next page

Tax Registration Refers to whether or not the business is registered for tax purposes. Y = Yes; N = No.

VAT Registration Refers to whether or not the business is VAT-registered. Y = Yes; N = No.

Declared Income Refers to whether or not any portions of the business's revenues are declared.
N = None; Min = Minority; Maj = Majority; 100% = All

Insurance Refers to whether a person has insurance cover for Public Liability (P); Employer Liability (E); Household Contents Insurance covering their business tools whilst in the home (C); and/or In-transit Insurance for their business tools whilst not in their home (T).

Documents/Records Refers to the level of documentation maintained on the business.
N = None; S = Some – this ranges from a receipt book or manually maintained notes of jobs done (e.g. in a diary) to fully reconciled accounts prepared by the person him/herself; B = Book-keeper or accountant used and management accounts kept.

Example of Conclusion Means that the numbered interview conclusion marked in the column was derived, inter alia, from this client's situation or comments.

Additional Street(UK) Data Used This refers to the date of collection of Street(UK) file data (particularly financial) which was added to information gained during the interview.

★ The figures provided in the matrix do not exactly match those quoted by the client during their interviews and shown in the client profiles in Section 7, because the matrix figures were calculated by Street(UK) after more data was supplied by the client.



As far as the reliability of the data we gathered is concerned, we believe that it is fairly accurate, as there was already a strong trust-based relationship with the client and our assurance that participating in the interview would not penalise them in any way and their experience could even help other micro-entrepreneurs to struggle less in trying to formalise their businesses in the future. It was this latter motivation which made many of them much more forthcoming than they might otherwise have been.

3 Street(UK) interview conclusions

1 Strong work ethic, but high level of financial insecurity

Most of the clients interviewed were very hard-working (60+ hours/week in some cases) and had clear goals. Most of them had struggled to establish their business in difficult circumstances, and expressed a strong desire to earn an 'honest' living for themselves and their families. This was reinforced by the fact that none of the 17 clients were illegally claiming unemployment benefits. We found no evidence of a desire to 'cheat' the system, but rather a situation in which people operating in the informal economy needed to be informal for their businesses to survive and keep them off unemployment benefit. Many clients seemed to be experiencing a conflict between their desire to make their businesses fully legitimate and a fear that doing so would 'pull them under'.

2 Benefits fraud vs. non-tax declaration: two separate moral codes

Most of the clients perceived the immorality of operating in cash quite differently from that of fraudulently claiming unemployment benefits. In their minds, the former was more an

issue of information withholding, resulting in contributing less of their own efforts to the state, which they justified to themselves by still 'needing the money', whereas the latter was more about taking other tax-payers' cash to which they were not entitled, and therefore a much bigger 'sin'. Most had a strong moral code of their own in which they viewed their own behaviour as quite distinct

from that of 'benefits scroungers' who didn't really want to work. In particular, many clients expressed a desire to fully formalise their business and it was just a matter of time until they could afford to do so.

“ *Most clients ... expressed a strong desire to earn an 'honest' living for themselves and their families.* ”

See clients 2, 3, 4, 11, 12, 14

3 Tax declaration levels as an efficient, flexible subsidy

Of the clients whose businesses were registered for tax purposes, many deliberately adjusted the level of income they declared each month to the business's results, declaring more when business was good and less in leaner times. Their approach was to minimise their non-declaration subsidy to the level which maintained their ability to pay their regular bills. Of the five clients that claimed to be declaring 100% of their income, three were severely struggling as a result.

See clients 1, 5, 6, 9, 14, 15

4 Mixed advantages and disadvantages of casual labour

Of the nine clients that employed other people, only two offered formal contracts. In the large majority of cases, casual employment was seen as a mutually beneficial for both employer and employee. Clients tended to view formal contracts as adding an extra burden of inflexibility and cost onto the business. Of those clients that already had or said they were considering offering formal employment contracts, the main reason given was that they had experienced difficulties in recruiting high quality staff and saw formal employment as a way of 'locking in' good employees, particularly those with rarer, specialist skills.

See clients 2, 4, 6, 11, 14, 17

5 Unaffordable insurance protection

The large majority of clients were insufficiently insured to protect their businesses. While most clients had taken out household contents insurance, other forms of insurance were often seen as a very expensive 'luxury'. Most of those who had not taken out public liability insurance or employer insurance were aware that this left them in an extremely vulnerable position. Some had even experienced serious losses. But nevertheless, they could not see how the business could afford the on-going premiums. This was born out by the correlation between the size of the enterprise and the level of protection arranged, with larger businesses much more likely than smaller ones to be better insured.

See clients 2, 3, 4, 6, 8, 11, 17

6 Inappropriate/inadequate statutory support schemes

There was a general feeling among the clients that the mainstream statutory services were unsympathetic and unhelpful to people on low-incomes that wished to become self-employed. There was a perception that Jobcentre staff were mainly interested in filling quotas and were not trained to deal with a client who wished to start their own company rather than take paid employment. In many cases, this contributed to the client's decision to cease contact with the statutory agencies. Forfeiting benefits was seen as a price worth paying for avoiding dealing with agency staff who didn't understand the client's needs. Of the few schemes in place to help low-income people start their own businesses, most were perceived to offer an inadequate level of support to participants, both in terms of the amount/purpose of subsidy and the length of time given for transitioning into a formal small business.

“... mainstream statutory services were unsympathetic and unhelpful to people on low-incomes that wished to become self-employed.”

See clients 4, 5, 6, 7, 8, 12, 17

7 No support from Business Links or its delivery agents

Only one client mentioned Business Links or any of its delivery agents as having been referred to them by a Jobcentre. The client who was advised to go to them (client 17, Marcus) did not find anyone there with the understanding and/or expertise to help him develop his business from the real situation and constraints he faced. Their approach was to undertake a business plan development exercise, as if he were a start-up, needing to undertake market research. Further comments are made in the General Conclusions and Recommendations sections of this paper on appropriate business support for this type of clientele.

8 No access to business loans from mainstream financial institutions

The overwhelming opinion among the clients was that mainstream financial providers were not interested in supporting their businesses and, in most cases, neither would they provide personal finance (for use in the business). In some cases this view was based on personal experience, while in others it was a perception which nevertheless deterred them from

“... clients expressed their satisfaction in being able to help others contemplating a transition from welfare to self-employment ...”

See clients 5, 6, 7, 10, 12

applying from mainstream finance. Start-up capital for businesses was usually drawn from the client's own savings or loans from friends or family. This method of financing businesses helped to create a 'them and us' mentality which placed banks along with job centres and the Inland Revenue as part of a hostile establishment that was unsympathetic to low-income entrepreneurs. Applying for finance from public funding bodies was often found to be as difficult an experience as applying to mainstream finance providers. Comments raised included the impossibility of being taken seriously by public agencies, and overly-bureaucratic application procedures.

9 Employment alternatives were generally worse

These clients who had either formerly been employed or were currently considering employment alternatives generally expressed the view that the sort of jobs they could obtain would provide them with the same level of remuneration for a much lower level of financial security which, in self-employment terms, was like relying on only one client. In addition, employment was unlikely to be available in any field that utilised their key skills and/or involved their interests.

See clients 1, 3, 7, 8.

10 The desire to 'give back' to the community

A number of clients expressed their satisfaction in being able to help others contemplating a transition from welfare to self-employment or to help others in the community more disadvantaged than themselves. It was clear that their position as a grey/informal market business person, moving towards legitimisation of their activities, enabled them to connect to the kind of people that formal (statutory and voluntary) organisations might not be able to reach.

See clients 7, 13.

As such, they were important contributors to both the social cohesion and the economic well-being of their communities

5 General Conclusions

1 Widespread problem

The vast majority of people in the UK have, at some point in their lives, dealt with or played a part in the informal economy, whether paying for a service cash-in-hand or receiving wages in cash without declaring this to the tax or relevant authority. The informal economy is diverse and straddles all sections and sectors of the UK's economy. The EU has estimated that the informal economy accounts for between 7–16% of GDP in Europe in the 1990s⁸. National Account figures suggest that in 1999, undeclared income in the UK amounted to about £14 billion, or approximately 1½% of GDP⁹. Our experience would suggest that informal activities are higher in deprived areas.

In order to seriously examine the correlation between the degree of informality of the business and a variety of psychological, socio-economic and/or financial variables, we would have needed to interview at least 100¹⁰ micro-entrepreneurs to gain any meaningful results¹¹. For this reason, no attempt has been made to provide correlation or regression analyses on the data collected from the clients interviewed.

We do, however, believe that the interviews we have undertaken, which include both those in this report and those separately conducted by the seconded Inland Revenue Inspector, as well as our overall experience with our clients and desk research, give sufficient data for us to:

- Conclude that the problem of transition into the formal economy is widespread and warrants the investment of serious resources to try to address it.
- Point to some of the critical stumbling blocks where further research and/or pilot testing is likely to yield the greatest results.
- In some particular cases, to directly recommend specific policy changes, new strategies and initiatives.

2 Complex issue – no single cause or simple solution

After three years of working with micro-entrepreneurs in Britain, our overall conclusion is that our clients break down into four categories in respect of their attitude to working in the informal economy:

- Those who could not manage to cover their basic needs without the subsidy provided by operating in cash.
- Those who perceive operating in the informal economy as a mechanism which gives them the opportunity to advance into mainstream society and fulfil their potential.
- Those who use informal economy practices to support their capacity to give back to the community and help more disadvantaged people to advance in life.
- Those who are deliberately out to cheat the system for as much as they can get away with.

Amongst our clients, category 4 is a small percentage of the total. The vast majority have a mixture of motivations 1, 2 and 3 in varying proportions.



8 Williams C. and Windebank J., (2003) 'Reconceptualising women's paid informal work; some lessons from lower income urban neighbourhoods', *Gender, Work & Organisations*, 10, 3, pp.281-300.

9 Ed. Clegg R., (2003) 'The Blue Book', HMSO. See <http://www.statistics.gov.uk/statbase/Product.asp?vlnk=1143&More=N>

10 Although 100 interviews would not give us any statistically significant results, we believe that 100 in-depth interviews would capture 95% of the various types of issues grey-market entrepreneurs face and give a fairly accurate picture of the proportions of people facing each kind of issue.

11 The government and academic institutes have undertaken various studies into the informal economy. See the Bibliography for more information.

Within these overall categories, it is also clear that there are a huge number of different reasons that people are unable or unwilling to formalise their businesses and that a one-size-fits-all policy approach to dealing with the informal economy/employment is not appropriate because people that operate in this economy have vastly varied abilities and

circumstances. Rather, a tailored approach is needed, recognising that an appropriate response to an individual's needs and circumstances will make more significant, far reaching and long-term changes possible¹². Part of the difficulty for policy makers is that such a tailored policy approach is difficult to develop and deliver. The recommendations in Section 6 offer some solutions, in order to address this issue.

“... a one-size-fits-all policy approach to dealing with the informal economy is not appropriate ...”

3 Positive functions of the informal economy

The main benefits that we see the informal economy providing amongst our clients are:

- A means of encouraging affordable mutual service provision in a *community*, which builds its social capital and reduces community residents' individual difficulties; and
- A transition mechanism for *individuals* who wish to build an income-generating activity into a fully-fledged business on a secure, gradual basis. In practice, this means spending more time and resources on the business as the demand for the person's services justifies it, and only letting go of alternative income when it is clear, after a significant period of trading, that the business will yield more. (The more volatile the trading income, the longer the period will need to be before the person is comfortable to do without the alternative income – see 8, below).

4 Re-defining the objective: to support opportunity for all

Current strategies for tackling informal employment are not working effectively, because they try to stamp it out, encouraging people to report others and threatening sanctions. These measures drive people further underground, away from the mainstream economy. At best, the informal economy is ignored. Rather than this approach, we would suggest that it is better for government to act now to acknowledge it, understand it and develop appropriate strategies and policies to bring the people trapped within it into the mainstream, and so provide a benefit to the economy overall.

With this objective in mind, our goal must then be to eliminate the obstacles which prevent people from being able to advance in life. If the informal economy is deemed to serve a useful purpose, and have positive effects in providing crucial stepping stones to their advancement, it is our view that it should be allowed to remain a part of the economic system, though within strictly controlled limits¹³.

As a corollary, we believe that the overriding emphasis of the welfare system on supporting people 'in need', as opposed to equally helping them 'out of need', also needs to be addressed. Otherwise, people will always be more compensated for their poverty than incentivised out of it. As a result, the benefits/poverty trap is perpetuated.

12 Academics and voluntary and community organisations are changing their rhetoric to talk about multiple informal economies and not the informal economy (singular). This reflects its diverse nature and the spectrum of different informal activities.

13 See The McKinsey Quarterly, 2004 Number 3 'The Hidden Dangers of the Informal Economy' by Diana Farrell. This article, though principally concerning developing countries, makes strong arguments for the elimination of the grey economy, based on the view that it neither creates jobs nor relieves social tensions. Interestingly, however, its 'Mandate for Policy-makers' comprises the same broad recommendations (excluding the welfare component which is specific to developed countries) as are contained in this report, namely: 1) Cut taxes; 2) Eliminate red-tape; 3) Strengthen enforcement.

5 Re-defining the desired outputs: allow for many small, gradual steps

Once one recognises how important it is for people seeking to graduate from welfare to self-employment to do so in as many small, low-risk steps as possible (as opposed to in fewer, larger, more risky steps), it is then necessary to change the government's desired outputs. In other words, the simple creation of new jobs and new businesses is inadequate, because what is actually needing to be undertaken is the enhancing, strengthening and safeguarding of jobs and businesses, e.g. helping a person to increase the percentage of their total income coming from their trading activities (as opposed to some form of state support), and/or helping to underpin an existing micro-business to minimise the chances of it folding.

“ ... it is important for people graduating from welfare to self-employment to do so in as many small, low-risk steps as possible ”

6 Extend eligibility for support

Part of the difficulty people face in transitioning from welfare into mainstream self-employment concerns the significant gap between the top-end of the population on welfare and the bottom-end of the population who are able to access mainstream financial and business support services¹⁴. If the annual household income of a typical family in receipt of benefits is, say, £10,000 p.a., but the annual household income of the poorest family with a strong likelihood of gaining access to mainstream services is, say, £16,000–£24,000, depending on their location and the local cost of living, then people between these two brackets need to be eligible for assistance in addition to the poorest groups. Otherwise, the support will be inadequate to transition people into the mainstream.



7 More carrots needed in proportion to sticks

Despite the various government initiatives that have been introduced over the last few years, it is our view that there is still a major imbalance between the carrots vs. sticks needed to incentivise people to advance further towards financial independence from state support. Ideally, as a micro-entrepreneur increases his/her trading income, his/her overall financial situation should improve. The reason that this is not always the case is that many of the current benefits and tax rules create systemic distortions to the net household income. It is these that need to be 'smoothed'. Examples include the minimum period of unemployment before certain benefits apply, the maximum working hours permitted whilst still on benefits, the fixed period of the benefit before it stops, etc.

8 Three building blocks: Cover the cost of living; build savings/reserves; increase business net income

In our experience, the three steps to incentivising people to switch from welfare to full self-employment are, firstly, to ensure that they are no worse off than their current situation throughout the process of seeking to develop their business. This means ensuring that they

¹⁴ This has been described as the Transition Zone in this report.

can continue to cover their current living expenses. Secondly, in order to protect them in the event that their business efforts fail and/or increase the chances that their business can survive through periods of volatility, they need to build a 'rainy day' fund of savings. Thirdly, after taking care of these first two objectives, they are then able to concentrate on increasing their business net income.

Some of the current obstacles to their ability to pursue these three objectives are provided below:

■ Covering the cost of living

- Interrupted benefits (e.g. delays in paying housing benefit to landlords, which can lead to tenants being threatened with eviction).
- Suddenly discontinued benefits (e.g. after one year for the 'Over-50's' scheme).
- Lack of beneficiary control (e.g. childcare benefit is only available for registered minders).
- Exclusion of specific population groups (e.g. people undertaking specific categories of training or education).
- Systemic distortions (e.g. the minimum 6 month unemployment pre-qualification for Job Seekers' Allowance).
- Lack of an assumed need for a basic income to underpin the risk in starting a business.

■ Building up savings/reserves

- The savings cap on eligibility for benefits disincentivises savings accumulation.
- FSA anti-money laundering measures disqualify many people from opening a bank account.

“*Insufficient tightening of the consumer credit regulatory framework has resulted in a continuing debt culture*”

- There are no positive incentives to save. Savings Gateway scheme pilots are underway but insufficiently address the needs of the total affected population.
- Insufficient tightening of the consumer credit regulatory framework has resulted in a continuing debt culture.

■ Increasing the business's net income

- There are few incentives to declare true revenues and costs due to the high cost of income tax, VAT and Employer's National Insurance.
- The disconnection between the Inland Revenue, Department for Work and Pensions and Jobcentre Plus frequently leads to inappropriate tax liability for welfare recipients.

6 Policy Recommendations

The following recommendations are based on evidence gathered from a number of sources. These include local people, whom we have supported in East London, Birmingham and Newcastle, a literature review and desk research. We have also held discussions with think-tanks, academics, government officials and voluntary and community sector practitioners throughout the UK. They are, nevertheless, only preliminary recommendations intended to guide the policy-making process and help determine the selection of potential policy changes that will need testing and refining through pilot demonstration projects.

It should also be noted that while the people discussed in this report are not 'unemployed', the recommendations below are relevant for everyone seeking to become legitimately self-employed, and therefore include transition mechanisms for those currently on Job Seeker's Allowance as well as those who are not¹⁵.

Thirdly, the recommendations below are deliberately wide-ranging because we believe the issue needs an inter-disciplinary and cross-departmental/organisational understanding and approach, if it is to be addressed from its root causes rather than just from its symptoms. Accordingly, the recommendations cover the following areas:

1. Education and lifelong learning
2. Business advice and support
3. Tax and benefits rules
4. Role of the voluntary and community sector
5. Debt management and incentives to save
6. Government agency database linkages
7. Cross-government working groups
8. Action research through pilot-testing
9. Areas for further academic research

1 Education and lifelong learning

■ Children

- The National Curriculum (e.g. from age 11) needs to be developed to include **business and the world of work** for the general education of all children in the UK. This supports and, in the case of entrepreneurship topics, goes beyond the recommendations from the 2002 Davies Review of 'Enterprise and the Economy in Education'.
- At secondary school (e.g. from age 14), the **ethical issues** for and against doing business in the informal economy should be discussed. In particular, we believe that the message needs to start at a young age to overcome generations accustomed to informal economic activities as a normal part of life. There is also a need to discuss the issue of paying tax as a normal part of citizenship. For example, they could celebrate the means by which society pools its wealth to pay for universal access to support services. The educational game 'The Red Box', developed by the Inland Revenue and used in citizenship classes, (www.redbox.gov.uk/entry.html) is an excellent tool for this purpose.



¹⁵ See the Market Definition section of the Introduction to this report. Our recommendations cover groups 2–5.

- **Entrepreneurial skills** need to be further supported, particularly in schools in deprived areas, where the students have fewer potential future employment alternatives, in order to re-direct young people's illegal (as opposed to grey/informal) trading activities into more positive channels. The NFTE (National Foundation for Teaching Entrepreneurship) charity model is particularly recommended for further review in respect of any national roll-out). See www.nfte.org.uk for more information.
- Generic financial management skills are also crucially needed, for both young people and adults. These include both personal financial skills, such as basic household budgeting and some financial planning capacity; and business finance skills such as cashflow management for the enterprise.

■ Adults

There is a need to increase the options and choices of business training and be more client-sensitive in their design, particularly in respect of poorer, less educated communities who need them most.

- Developing more **experienced-based business training**. For a lot of small business people, their preferred learning method is through experience rather than theory. Courses should give people enough theory to have the capacity to hire experts to complete specific tasks for them, for example, for a baker to have the knowledge to be able to hire a competent book-keeper, but keep the emphasis practical.
- Understanding the **basic principles of the tax system**. More information

dissemination is needed, for example, on the business expenses which can be legitimately deducted for tax purposes, so that those people who would not in fact be tax-payers after deducting their legitimate expenses, or would end up paying very little, can become legal without it costing them as much as they feared.

“*financial management skills are also crucially needed, for both young people and adults*”

- **An upgrade in the use of business mentors**. The Prince's Trust has demonstrated that there is a market of readily available mentors; and that having a mentor assist a start-up business has a direct correlation on its longevity and success¹⁶. However, the quality of the advice given by mentors across the UK is highly variable. Therefore:
 - Mentors should principally be used for **generic support and sharing their experience**, rather than for key business decisions, unless they use formal business decision-making tools.
 - **A system of accreditation of mentors** should be considered, co-ordinated by a national body. This development could tie in with the 'National Mentoring Scheme' operated by the new Business Volunteer Mentor Association, which is led by National Federation of Enterprise Agencies, alongside work with the National Mentoring Network.
 - **Standardised business decision-making tools** should be developed for mentors and their 'mentees', to be able to give specific high quality and consistent advice. These could include the use of breakeven and sensitivity analyses for business decision purposes.

16 Westall A., Ramsden P., Foley J., (2000) 'Micro-Entrepreneurs – Creating Enterprising Communities', New Economics Foundation and IPPR. See also Meager N., Bates P., Cowling M., (2001) 'Long-term evaluation of self-employment assistance provided by the Prince's Trust', p.49, table 5.26, 5.29 and 5.30, DfES Research Report RR292.

2 Business advice and support

The type of business advice and support available to people seeking to transfer their businesses into the formal economy needs to be designed in an entirely different way from the current approach, which caters solely for people willing and able to go through a formal business planning process, and is used by Business Links and other government delivery agencies, for start-up or growth businesses.

- We recommend the consideration of a separate offshoot of Business Links or the creation of an independent **business support network/franchise to focus specifically on the micro-entrepreneur market**¹⁷.
- We believe there is a widespread need for **specialised informal economy transition business advice and support** to become a recognised activity for which public funding is made available and appropriate output targets are set, (see General Conclusions, point 6). The type of organisations most appropriate to deliver this advice and support need to fulfil two criteria:
 - Specialised business and finance expertise in dealing with this niche market.
 - High levels of cultural sensitivity and community embeddedness.
- We further recommend the **greater use of existing government agencies at a local level**, and the granting of greater discretion and flexibility to each of them to meet local needs e.g. by setting their own performance measurement indicators¹⁸. These include Inland Revenue Small Business Support teams and Jobcentre Plus advisers and other business support agencies.
- **Exemptions should be made for micro-businesses** (up to 5 employees) **in respect of the many areas of business regulatory compliance and red tape**, based on a common sense approach e.g. to the health, safety and consumer protection issues involved. For example, public liability insurance is clearly necessary for a builder but not for a book-keeper.
- We also recommend the piloting of a **new type of 'business incubator'**, again specifically focused on the needs of the micro-market. This would have three objectives.
 - To provide a one-stop shop for the provision of business support, finance and (legal, tax, debt, and benefits) advisory services that micro-entrepreneurs need. It is anticipated that the services would be provided on an open-market basis by a wide range of private, public and voluntary sector organisations.
 - To fill the considerable gap in trade services between a home-based, hobby-level activity and the lowest level for formal small businesses.
 - To provide peer group networking and support opportunities without having to join any clubs or associations e.g. with competitors for the same kind of service able to occupy space in the centre.

The table overleaf gives a further idea of the range of products and services we believe are needed to be provided in one place, in order to fill the gap between the support currently available for grey-market entrepreneurs and the support available for formal small businesses.

“ *there is a widespread need for specialised informal economy transition business advice and support* ”

17 See www.enterprising-communities.org.uk for more information.

18 Smerdon M. and Robinson D., (2004) 'Enduring change: the experience of the Community Links Social Enterprise Zone. Lessons learnt and next steps', The Policy Press and Community Links, July.

Finance	Advice	Business support	Trade services	Information/Publications	Other facilities ¹⁹
Grants Barter Loans Savings Insurance Equity	Legal Tax Regulatory Benefits Debt Business (signposting)	Consultancy Training courses Self-help tools	Book-keeping Tools/Equipment rental Equipped premises rental Marketing materials Printing services Secretarial services Meeting rooms	Library CD/bookshop Internet access Notice board for seminars, events, offers	Commercial space for cash & carry, and wholesalers Café Creche facility Toilets Cash machines Interpreter/translation

3 Tax and benefits rules

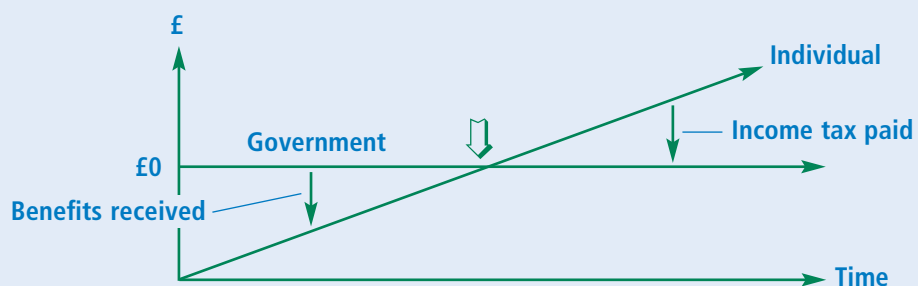
The effects of the tax and benefits rules for people on benefits or low incomes can leave people in the already well-documented dilemma of the ‘benefits trap’ or ‘poverty trap’, which can ‘push’ and ‘pull’ people to work informally. The single biggest reason for people turning to the informal economy is ‘need, not greed’.

The objectives of the proposed adjustments to the current policies and tax and benefits rules are:

- **To re-balance the carrots vs. sticks**, including offering a ‘nothing to lose’ approach to starting and developing a business, i.e. a defined period of guaranteed living cost reimbursement.
- **To enable and even encourage people to build a ‘rainy day’ savings fund, partly by increasing the asset caps to qualify for benefits** and partly by **incentivising savings**, e.g. through a national roll-out of the Savings Gateway scheme.
- **To co-ordinate the tax and benefits thresholds more closely**, so that the transition is as seamless as possible for people to graduate from receiving benefits, to progressing through a ‘no benefits, no tax’ point, to becoming a tax payer (see diagram below). This will eliminate some current anomalies in which people’s benefits are inappropriately taxed away.

¹⁹ Many of the services in this category have been especially requested by clients of the Financial Exclusion Newcastle pilot support centre.

An Individual’s Seamless Progression from Benefits Recipient to Tax Payer



Key ↓ = The point at which people neither need State support, nor are in a position to pay tax

This streamlining process will also involve an elimination of such 'distortions' as absolute caps on permitted earnings disregards, work hours or savings levels for benefits retention. What is needed instead is a sliding-scale system which encourages people to work, earn and save as much as they can, rather than manage down their capacity to become independent of State support in order to fit into the current benefits rules.

- **To give people as much control as possible to determine their own timing of when they switch from state support to business income.** This could be achieved by means of a dual bank account system as follows:
- **To re-balance the emphasis on optimising the benefit from usage,** as opposed to the current focus on minimising non-abuse (and thus failing to achieve the desired take-up rates and intended impact).



Dual Bank Account System

For streamlining the welfare-to-self-employment transition process

Each person has two bank or credit union accounts, but can only access the funds in the Personal Account until they switch to the Business Account: The Personal Account is then closed.

	Personal Account	Business Account
Income	Welfare benefits e.g. £10,000	Business revenue e.g. £24,000
Expenses	Living costs e.g. £10,000	Business expenses e.g. £12,000
	Net balance £0	Net Balance £12,000

Each individual receives welfare benefits for a maximum period, which pays for the living costs. During this time (s)he can make a one-time switch to access the business account, (with a £12,000 net balance in this example), out of which the living costs (of £10,000 in this example) must be paid. This leaves a net balance of £2,000 which, depending on their risk profile, may or may not be enough to give a person the level of security needed to be able to make the switch.

Given that everyone is different, this scheme would allow each individual to make the switch in their own time but, once made, not be able to revert back to benefits for a minimum period. If the business did not make enough during the allowable period to make the individual wish to switch account, the balance in the Business Account would then be forfeited (i.e. be credited back to the government) and the person would be no worse off than before they started, as they would have kept the security of their benefits at all times. They could potentially then have a second chance with another new business.

- **To overhaul the tax system for micro-enterprises.** This includes a review of:
 - The rules of VAT: Specifically, the threshold amounts; the annual index-linking of these thresholds; and the equalising of retail and service industries, by setting the threshold against gross profit levels rather than turnover.
 - Tax allowance thresholds for business.
 - Possible introduction of alternative methods such as flat tax amounts for lower income brackets. We recommend the exploration of international models for best practice in alternative tax formulae for lower income tax brackets²⁰.
- **To consider other inhibiting factors which at present hold people in the benefits trap.** We recommend that these include increases, extensions or graduation tapers in the support provided by:
 - Existing government work programmes (New Deal and Work Based Learning for Adults)²¹
 - Lower and/or subsidised housing rent costs
 - Assistance with childcare costs and increased number of childcare places
 - Assistance with or subsidised transport costs
 - Debt repayment levels once a person comes off benefits
 - Tapering off from secondary benefits e.g. transport allowances
 - Earnings disregards. (These should also be index linked)
 - Flexible working hours

4 Role of the voluntary and community sector

Voluntary and community organisations are often working directly with people ‘on the ground’, or at a grass roots level. They not only experience and understand the problems but are already providing services to support people in their situations. In our opinion, they are very well placed to develop policies and deliver work programmes to address the needs of local people, on their own or when appropriate, in conjunction with local public sector services.

“Local organisations need greater involvement in the design of services and the flexibility to use discretion in delivering them”

20 There are some very interesting alternatives in Poland that we are aware of.

21 See Barbour A., (2003) ‘Analysis of government support programmes for the unemployed into self-employment’, Community Links, May, for suggests and practical solutions; and Marlow S., Westall A., Watson E., (2003) ‘Who Benefits?’, NEF/Prowess, November. The Social Exclusion Unit (ODPM) and Small Business Service (Dti) are both reviewing these programmes and are expected to publish their reports in summer 2004.

We recommend:

- **Greater involvement and influence on the design of services by local organisations** and those with practical experience, to meet the local community’s needs. We believe this will lead to increased efficiency and effectiveness in the way public resources are spent and used, ensuring much better value for money.
- **To better enable voluntary and community sector organisations to tender for the delivery of local services.** There are many instances in which they are more suited than public agencies to provide the service needed. One such example is in the delivery of ‘formalisation’ programmes to help grey market entrepreneurs graduate into mainstream business. For this to be possible, community organisations need to be able to obtain longer term contracts (e.g. 1–3 yrs) than are currently generally available, and also charge for their services on a full cost, rather than marginal cost recovery basis.
- National policies should contain **the ability for local organisations to use discretion and flexibility**, to take into account local distinctiveness and be able to respond to changing local conditions and demands. Additionally, appropriately accredited

local organisations should be able to determine the precise level of support that individuals in transition between welfare and self-employment in their community can receive. This should minimise the two types of errors that inevitably occur when setting standardised policy rules: overpaying people who do not need so much support, and underpaying people who need more support. Local organisations would have the ability to visit the person's home, talk to neighbours and obtain other relevant information in order to set the appropriate level of support for each individual.

5 Debt management and incentives to save

With £49 billion owed by UK credit card customers alone, debt has now become an extremely serious problem for many people in the UK, particularly those on low incomes. Borrowing money can be a useful way of meeting one's needs, but for others it is a very expensive necessity with sometimes extremely damaging consequences. A life event such as a death in the family, sickness or accident, forcing people to take out loans, can cause serious repayment problems²². The Financial Services Authority (FSA) reported that in 2004, 6.1 million families have difficulties meeting their debt repayments²³. More than half of all households with serious debt problems have incomes of less than £7,500 a year. Debt is a problem hitting the poor, one consequence being that people will work informally.

There is a second issue facing people who have debts and are receiving specific state benefits. If an individual is receiving certain benefits, then debt repayments are dramatically reduced to an average of £2/week. However, the original contractual repayment schedule is re-instated immediately upon an individual leaving the benefits system. Many people when considering their options will not return to work because of their high debt repayments and choose to remain on benefits, which again can lead people to work informally because the benefit payments do not meet their needs.

We believe the key is a substantial tightening of the consumer credit regulations, as well as the provision of support to people to build their savings and assets, and use these in balance with debt, to finance their purchases and grow their business. The latter is not an easy task, as it involves running counter to the widespread availability of credit, both from financial providers and from retailers. In respect of the tightening of the Credit Consumer Act, we are particularly disappointed with the recent measures announced by the Dti (on 9th June 2004) which has been looking into this problem for some time. Specifically, in particular, they do not address a number of the most important issues. These include capping on legal interest rates, making prepayment penalties affordable and designing a foolproof system to prominently disclose all hidden charges.

In addressing debt and savings, we recommend that:

- **A staggered and/or deferred debt repayment system is introduced for people leaving benefits.**
- **Further steps should be taken to tighten the Consumer Credit Act** including the introduction of a variable cap on lending interest rates by loan companies and banks. A useful precedent for the success of such a cap can be found in Germany, where predatory lending practices have now been very effectively controlled.

“ Many people ... will not return to work because of their high debt repayments and choose to remain on benefits ... ”

22 See the 'Debt on our Doorstep' campaign, www.debt-on-our-doorstep.com; and Kempson E. and Whyley C., (1999) 'Kept out or opted out?: Understanding and combating Financial Exclusion', Personal Finance Department, Bristol University.

23 Financial Services Authority, (2004) 'Financial Risk Outlook 2004'. www.fsa.gov.uk

- **Community Development Finance Institutions (CDFIs) and Credit Unions should be given increased promotion and financial support, as well as more joined-up support** vs. the current separate funding criteria and targets issued by different government departments supporting enterprise vs. personal lending. Equal support should be given to CDFIs helping people with enterprise finance and personal finance, especially given that a self-employed borrower rarely makes any distinction between his/her various financial needs.
- Strong incentives will be needed to **encourage back a culture of savings**. We recommend that these include: assistance with personal and business financial planning; a roll-out of incentivised matched savings schemes (e.g. Savings Gateway²⁴ or US Individual Development Accounts); and savings discipline support schemes to help keep savers on track.

6 Government agency database linkages

The current separation between the Inland Revenue and the Benefits Agencies means that it is relatively easy for people to miss out on or be delayed in receiving state benefits, such as tax credits or housing benefit run-on, as well as to cheat the system. Both practices would be significantly reduced if the **data systems used by the various agencies and/or government departments were further linked**, e.g. showing a person's situation and therefore eligibility for housing benefit, child benefit, working tax credit and taxable income and/or taxes paid.

An additional advantage of greater database unification is that it would facilitate the transition path as set out in the earlier graph (see Recommendation 3). A system which can monitor and track the transition people make from benefits into work could respond immediately to changes and keep the right balance between benefits and tax, and so guarantee the basic income of the individual.

Clearly there are data protection and privacy issues that need to be taken into consideration. However this is still an important issue, which we believe, should be reviewed. The forthcoming merger of the Inland Revenue and Customs & Excise should help this process.

7 Cross-government working groups

As we have attempted to demonstrate, the informal economy is a highly complex issue that does not lend itself to either simple analysis or solutions. As the table below shows, **a number of different government departments and agencies** are responsible for its various aspects and each of these **needs to participate in the joint consideration of relevant policy proposals**. See the table opposite.

We commend the existing work that has been started by the Inland Revenue, the Office of the Deputy Prime Minister's Social Exclusion Unit and Neighbourhood Renewal Unit and the Small Business Council within the Small Business Service/Dti. This work should act as the foundations for building future work plans and for developing strategies, policies and practical work programmes.

We are also pleased that **a cross-government working group has been established** to develop joint strategies and policies, and test specific changes to different elements of the current system. However, we **recommend that this group be expanded to take account of all the relevant bodies**, and also draw upon the valuable experience gained by the voluntary, community and business sectors, to develop the strategy and partake in pilot projects.

²⁴ See www.hm-treasury.gov.uk for more information and contact details.

Rationale for cross-government working groups

<i>Government Department</i>	<i>Relevant Issue</i>
Cabinet Office	Overall leadership/co-ordination of all government departments
Department for Work & Pensions	Benefits rules. Interface with Inland Revenue.
Department for Education and Skills	Job creation targets/skill needs. Financial literacy.
Department for Trade & Industry/Small Business Service/Business Links	Business support. Financial support for organisations providing business support.
Office for the Deputy Prime Minister: Social Exclusion Unit/ Neighbourhood Renewal unit Home Office: Active Communities Unit	Informal economy benefits to the community. Impact on neighbourhood renewal/building of social capital/active citizenship.
HM Treasury	Building savings and reducing indebtedness. Supporting CDFIs e.g. throughout Community Investment Tax Relief.
Inland Revenue	Developing appropriate tax structure. Interface with benefits system.
Financial Services Authority	Financial literacy. Money laundering regulations for re: support organisations helping informal economy entrepreneurs to transition. Para-banking regulatory framework for CDFIs.

Finally, we believe that if any of the above recommendations are to truly work, then the backing of the whole government will be crucial. We recommend that a **member of the Cabinet take the responsibility and leadership in moving the informal economy up the political and parliamentary agenda**²⁵. Until there is commitment at a senior level then significant political and practical change will be unlikely.

8 Action research through pilot-testing

In general, we believe that wherever possible, the best way of researching such a complex issue as the informal economy is through action research, i.e. pilot-testing of specific changes to the education, tax and benefits system, and so be able to monitor the impact and acceptability of them²⁶. **We recommend that voluntary and community organisations, in partnership with local government offices, undertake this pilot-testing and appropriate funding streams be provided** for the purpose.

9 Areas for further academic research

There is a recognised body of academic research that has been conducted into the UK's informal economy (see Bibliography). Many aspects of the informal economy do not warrant further research, as we feel the benefits would be far outweighed by the costs and delay in developing practical and testable solutions. However, we do believe that research would be valuable in the following areas:

25 Building upon the UK Employment Action Plan 2003. See http://www.dwp.gov.uk/publications/dwp/2003/uk_action_plan/index.asp

26 See the Prime Minister's Strategy Unit, (2003) 'Trying It Out' – 'The role of 'pilots' in policy-making', December 2003 www.strategy.gov.uk

- **Determining the size of the informal economy.** More work is needed to quantify the size and scale of the market of informal economy entrepreneurs and the growth trend in these numbers, so that the various recommendations made in this paper can be costed. The Grabiner Report²⁷ and others have stated the difficulties of quantifying the scale and size of the informal economy, but we nevertheless believe this could be estimated to a reasonable degree of accuracy either by the Inland Revenue's Analysis & Research team or by academic specialists.
- **Investigating the positive benefits and functions of the informal economy.** Many of the negative or detrimental effects of the informal economy have been researched and published. However, more evidence needs to be collected to show the very real positive benefits that informal employment brings to communities and individuals, if the Inland Revenue and other government departments are to consider any policy that deliberately enables it to continue in some form²⁸. The Social Exclusion Unit's report on Jobs and Enterprise in Deprived Areas, due to be published later this year, has been looking at what government can do to take advantage of the skills and entrepreneurship that exist in the informal economy, within the context of recognising the positive contribution they can make to raising formal employment and enterprise. Hopefully, some specific recommendations, along the lines of those outlined in this report, will also be made.
- **Understanding overseas countries' approach to the informal economy.** Comparative research should be undertaken, in order to draw upon and learn from the experiences of other countries, in terms of their legal, regulatory, tax and funding frameworks that affect people working in the informal economy. An EU-wide informal economy conference held in Sicily, in November 2003 highlighted the UK as one of the leading countries in the EU addressing the informal economy. Nevertheless, many lessons can still be learned from both industrialised and developing countries.

27 Lord Grabiner, (2000) 'The Informal Economy', HMSO, March. www.hm-treasury.gov.uk

28 See Dr Travers A., (2000) 'Prospects for Enterprise. An investigation into the motivations of workers in the informal economy', Community Links Evidence Paper No.2; and the forthcoming Inland Revenue Report completed whilst on secondment at Community Links and Street(UK), expected publication in summer 2004.



7 Street(UK) Client profiles

Client 1 Sharon

SHARON has been running her own mobile beauty therapy business for three years, but has been involved in the industry for 20 years. She offers a range of services including manicure, waxing and massages, in her clients' homes, travelling by bus with her entire 'business assets' in one small bag. She lives very modestly with her 13-year-old son from a previous relationship (we visited her in her home).

When she first started her business, she rented a space at a ladies' club about thirty miles from her home, but found the daily travel made it difficult for her to spend time with her son. She then began working with a group called L Leisure, who paid her a commission to work in one of their tanning studios for a few months before suddenly refusing to renew her contract. *'They basically got me in to establish a customer base and then got me out as soon as they could,'* she says.

Sharon now operates for two days a week at a local hairdresser and three-to-four days-a-week offering a mobile beauty therapy service. Due to fluctuations in demand, Sharon's sales figures vary considerably from month to month, but average at around £1,500, approximately 75 per cent of which comes from the mobile operation. She legally claims Working Tax Credit and housing benefit. After her business costs and fixed household expenses, Sharon is left with an average of around £150 a month.

Sharon's business is tax-registered and she does all her book-keeping manually. On average, she declares around 50 per cent of her business for tax purposes. However, this varies in accordance with her earnings. Sharon's approach is to declare the maximum she can afford to, after first ensuring that she can pay her rent and feed her family. That way, she feels she is not taking a penny more of state support than she needs for her basic living costs. She takes quite a strict approach to minimising her state dependency and abiding by her own moral code, distinguishing this radically from 'real benefit scroungers'. Without the undeclared income, Sharon believes she would find it impossible to make ends meet, but she is uncomfortable and fearful about what she is doing. A neighbour was recently prosecuted for tax fraud even though, she says, he was hardly earning 'more than a few bob' through landscape gardening.

“*She takes quite a strict approach to minimising her state dependency*”

Sharon would like to develop her business and declare all her earnings in order to build up a good credit history, but calculates that she would need to earn around £350 a week (i.e. 10 times her current earnings) in order to do this. *'I wouldn't even need the housing benefit then,'* she says.

Prior to setting up her business, Sharon practiced beauty therapy in established outlets and also worked for a while in the catering industry, but found employment in both fields to be insecure and patchy. She was once sacked from a restaurant for refusing to wear a short skirt while pregnant. Overall, she feels no worse off and certainly less financially insecure being her own boss and in control of her own capacity to generate an income, however little it provides.

Client 2 Sanjay

SANJAY has run an unregistered decorating and refurbishing business since January 2002. He lives with his mother in rented accommodation and is the household's only breadwinner following the recent death of his father. His mother is eligible for housing benefit and a widow's pension, but Sanjay pays all of the bills and makes a significant contribution to other household costs. With three younger siblings, who are all at college, despite being only 25, Sanjay as the oldest male in the family regards himself as having head of household responsibilities.

Sanjay decided to set up his company following several years of employment. After completing a City and Guilds electrical course he worked in a McDonald's restaurant for two years before getting a job as a night supervisor at a local Texaco garage. *'The money was good but after a while I got sick of working nights,'* he says. He left to become a technical assistant at a local girl's high school. The job paid considerably less than the garage but Sanjay was frequently sent on courses to learn more about equipment maintenance and health and safety issues – a professional investment that he would not have been able to afford himself, but regarded as a pre-requisite to advancing his long term job prospects.

As he developed his skills, Sanjay started taking on small decorating jobs, mainly as favours to friends and family members. *'People would just ask me to do stuff for them at weekends and in the holidays.'* It soon became apparent that he was earning more through this 'extra' work than from his regular job, so he left the school and became a full-time decorator.

In the 18 months since he started the business, Sanjay's sales figures have increased steadily. His average monthly gross profit is £3,700, which leaves him with £1,000 a month after his business costs and fixed contribution to household expenses have been deducted.

“ He would like to take on skilled sub-contractors to expand his capacity, but is concerned about the expense incurred by offering formal contracts ”

Although his business is developing, Sanjay is still some distance from establishing his business legitimately. He is not tax-registered and requests all client payments in cash. He keeps only partial

records of his transactions, does not have public liability insurance and does not insure his tools, which he keeps at home or in his car. He occasionally employs other workers to help with bigger jobs, who he pays on a cash-in-hand basis.

Sanjay would like to build up his business by taking on larger contracts, but this is impossible at the moment because his capacity is restricted through having no permanent employees. He would like to take on skilled sub-contractors to expand his capacity, but is concerned about the expense incurred by offering formal contracts, paying National Insurance and taking out employer liability insurance. *'I would like to become fully legitimate,'* he says, *'but I can't see it happening just yet.'*

Client 3 Robert

ROBERT, who is in his thirties, has tried a range of different trades since leaving school at the age of sixteen. He began his career as a chef and worked for several years in restaurants before deciding to return to college to train as a gym instructor. He then spent time working as a security guard before returning to college to re-train once more, this time completing a City and Guilds qualification in wall and floor tiling. Upon completion of this course, he worked for an agency but was then made redundant again in 2002, since when he has been working as a self-employed tiler. Despite working mostly at the bottom level of the business, i.e. as a sub-contractor rather than at higher rates directly for clients, Robert still feels 'more secure working for myself than in previous jobs'.

Robert's business is very fragile and his monthly gross income averages at around only £480. He lives with his sister in her flat and has a son from a previous relationship, for whom he pays maintenance. After being made redundant several times, Robert is very cautious with his money and tries hard to save a portion of his income to guard himself against future financial difficulties. After his business costs, contribution to his sister for household expenses and loan repayments are taken into account, he has on average £170 left each month.

“ He does not have public liability insurance and does not insure his equipment because he cannot afford either ”

Robert is proud of his financial independence and has never claimed benefits. He maintains a reasonable level of book-keeping but is not tax-registered, although he says he would prefer to be fully legitimate. He does not have public liability insurance and does not insure his equipment because he cannot afford either. This resulted in a huge cost recently when he was forced to replace £200 worth of tools that were stolen from a job he was working on.

Sub-contracting on a casual basis is a vulnerable profession. *'Last month I had £200 worth of tools nicked,'* Robert says. *'And right now I've got two or three clients that still owe me money from months ago.'* So far, he has managed to keep afloat, by using his savings to support himself in really bad times. This leaves him unable to advance.

Robert would like to expand his business and become more financially secure, but at the moment is unable to do so because of his low sales figures. He takes a great deal of pride in his work and is determined to mark himself out as a fast-working, skilled professional who provides a good service. *'There are lots of people that cut corners and don't do a good job, but if you do it properly, they'll remember you and come back when they need something else doing,'* he says.

Client 4 Titus

TITUS, who is 53-years-old, runs a catering business specialising in Caribbean foods. He was taught to cook by his mother and has been involved in catering for much of his adult life, though it wasn't until February 2002 that he finally started up on his own. He is very active in the local community, and was recently featured in the local newspaper after he received an award for his work in helping local unemployed people.

Before setting up his company, Titus spent a year at a local Sixth Form College studying business management. The tutors on the course were extremely supportive and continue to give him mentoring advice when he needs it. When he first started his business, Titus received £60 a week from the Over-50s allowance, which provided him with an essential means of extra support during this time. He stopped receiving these benefits six months ago. 'I'm now worse off than when I started the business,' he says.

“... the lack of extra financial support since his Over-50s allowance ended has left him vulnerable. 'I'm now worse off than when I started the business,' he says.”

The core of Titus' business is providing a catering service for weddings, birthday parties and business functions. On average, he takes on three of these jobs a month at £300-£400 a time, using casual labour (often his own family members) to help prepare the food and serve the guests. He has a health and safety certificate for his home but does not have public liability insurance because, he says, he cannot afford it.

Titus has also recently begun to serve food through the bar of a local theatre. This will not be as lucrative as the external catering business, but will provide some extra revenue. He will employ two people part-time to help at the theatre bar, initially on a cash-in-hand basis but later, he hopes, on formal contracts. He does his own book-keeping, using manual records. Over 90 per cent of his clients pay him in cash and the business is not registered for tax or VAT.

Titus would like to expand his business and take on more contracts for private functions, but as he does his catering from home, there is currently not enough capacity for him to take on more work. His dream is to produce and market his own brand of Jerk seasoning and sell it through local supermarkets. 'I want to have my own brand, like Madhur Jaffrey,' he says.

But while Titus' business is growing, the lack of extra financial support since his Over-50s allowance ended has left him vulnerable. After his business costs and fixed living expenses have been deducted, he is left with around £200 a month. He has calculated that he would need to take on at least one more major catering contract every four weeks to restore his income to the level it was when he received the Over-50s allowance. 'But I already work over 60 hours-a-week, so I can't really do much more,' he says.

Client 5 **Sonia**

AFTER graduating with a degree in philosophy, Sonia, 46, spent most of the next twenty years selling office equipment. For a long time she has been attracted to the idea of owning her own business and when the opportunity arose to take over the running of a café, she decided to give it a go. Finance was initially a problem – *‘The banks just wouldn’t touch me,’* she says – but she eventually managed to obtain a £2,000 loan from a friend and a further £800 from her brother. The café opened under her ownership in April 2001.

Sonia does not employ anybody else, working in the café for six days a week, from 7.30am, serving a combination of English and West Indian food. She retains a very high percentage of her customers – many of the elderly patrons rely on her for their daily hot meal – and says she likes to look after everyone who comes into her shop *‘as if they were my family’*.

The Café has seen a slow but steady increase in sales since Sonia took over, from an average of £500 per week in the beginning to an average of around £750 per week today. Her average gross profit per month is just over £2,000, which leaves her about £400 a month after her business and household expenses have been taken into account.

Sonia became tax-registered for self-employment in April 2002 and started paying tax in January 2004. She does her own book-keeping and has two bank accounts, one for business and the other for personal use. She is eligible for the Working Tax Credit, but is wary of registering for it because she fears attracting attention to the years she did not pay tax. She is anxious about a visit from the Inland Revenue and hopes the records she has kept (showing lower than actual sales levels) will protect her. *‘I’m between a rock and a hard place’* she says, referring to the unaffordability of declaring all her income as against breaking the law.

***“I’m between a rock and a hard place’
she says, referring to the unaffordability of
declaring all her income as against
breaking the law”***

The café has a health and safety certificate and Sonia has also taken out contents insurance for the equipment. She pays £50 per month for public liability insurance.

Sonia would now like to expand her business but feels restricted by the small size of the cafe, which only seats ten people at a time. She would like one day to open a *‘proper restaurant’* serving good quality Caribbean and English food at low prices. She strongly believes that there should be more help for people in her position, but is sceptical about the prospects of this happening. *‘Most Government schemes come in, hang around for a bit, and then go away again. They don’t stick with them long enough. The only way to improve an area is through long-term investment over generations,’* she says.

Client 6 Craig

CRAIG, a self-employed window cleaner, is in his mid-20s. He started his business in 1998 with an £1,800 loan and a £400 grant from the Prince's Trust, plus a £1,000 grant from the City Council. Since then he has built up his business steadily, investing £7,000 over the last five years.

The value of a window cleaner's business is determined by the number and quality of rounds that he has. Rounds are bought and sold between window cleaners, sometimes fetching over £3,000. A valuable round will consist of a solid base of regular customers, providing a fixed income every month. Craig likes to invest in rounds and build them up by increasing the customer base, before selling them on. He loves being a window cleaner, and says he *'wouldn't want to be doing anything else in the world'*.

Craig's sales average at around £1,800 per month, with gross profits at £1,300 per month. After his living and business expenses have been taken into account, he is left with about £500 a month. He keeps a manual record of his sales, only a portion of which he puts through the books and declares to his accountant for tax purposes. He says that every

window cleaner he knows keeps at least some of their income back, and many do not declare any of their earnings.

“ *He is holding back from declaring all his income, because he fears that the increased tax burden will prevent his business from getting to the scale that will enable him to sustain the payments on a mortgage* ”

Craig would like to own his own home. He knows that in order to obtain a mortgage for the amount he wants – about £70,000 – he needs more documented income, and so would like to declare all of his income for this purpose. But he is currently holding back from doing this because he fears that the increased tax burden will prevent his

business from getting to the scale that will enable him to sustain the payments on a mortgage, once obtained. However, he hopes to be ready to 'go legit' within one more year.

Craig has a public liability insurance policy, but this only covers himself. If one of his employees caused injury or damage, he would have to take responsibility himself to make a claim. He has insurance policies taken out on his van and his equipment.

The growth of his business has meant that Craig has had to take on two employees to cope with all the rounds. He pays his employees in cash, which both parties regard as a mutually beneficial arrangement. *'I'm happy because I don't have to do paperwork and pay National Insurance, and the lads are happy because they can avoid tax'*, he says. The only thing that would motivate Craig to offer formal contracts would be if he couldn't find casual labour of a high enough quality. But, he says, *'you can always find kids for this kind of work'*.

OTIS, 36, teaches the theory and practice of music to children. He works mainly from rented premises in a community centre, where he has established a music school equipped with a wide range of instruments, computers and technical equipment. The local authority pays him to teach music to talented youngsters from nearby schools, in addition to which he has freelance contracts with two other local organisations. He is also the spiritual leader of the local church and a well-known community figure. He lives with his wife, a part-time primary school teacher, and their two young children.

Before he set up his school, Otis scraped a living as a professional musician and a part-time teacher, while also spending a lot of his time doing voluntary work at the local church. When the idea first came to him about the music school, he approached the local Job Centre for advice and was told he had to stop working before they could help him. He says: *'They basically told me I had to become*

unemployed in order for them to give me advice. But when I did that, they started trying to force me to do something completely different, like van driving and factory work. I tried to tell them that I wanted to set up a music school, but they wouldn't listen.'

“They told me I had to become unemployed in order for them to give me advice. But when I did that, they started trying to force me to do something completely different”

When Otis refused to take work offered by the Job Centre, he began to receive letters threatening to remove his benefits. *'They turned me into a criminal,'* he says. Eventually he decided voluntarily to relinquish his benefit payments and sever ties with the Job Centre.

'I know a lot of people who have done the same.' When Otis's wife gave birth to their first child, he says they were 'inundated' with offers of further benefits but decided against applying for them when they read of all the conditions that had to be met.

Otis is adamant that he wants the music school to support the local community by being both a private business and a social enterprise. He would like to attract public funding to teach children from deprived backgrounds free of charge while simultaneously teaching paying customers to boost the centre's income. So far, however, he has met with little success in applying for public funding. *'We've applied for lots of money from the local authority and regeneration bodies but have had very few positive responses. When we've asked for feedback on our applications, we haven't been able to get any.'*

The income of Otis and his wife combined is £2,000 a month. After their personal and business costs have been taken into account, they are left with just over £1,000 per month. Otis is registered as a sole trader and declares his own income. He does not yet have enough capital for a full VAT-registered business. He keeps manual records of transactions but does not use an accountant. His dream is to grow the music centre into a not-for-profit enterprise that would take on lots of local young people from disadvantaged backgrounds and teach them at subsidised rates, until they could become net contributors to help the next generation of youngsters. For the time being, however, the centre's lack of finances means that this prospect is still a long way off.

Client 8 Tina

TINA, a 31-year-old single mother, bought a gentlemen's barber shop earlier this year as a going concern. The shop has a long tradition in the area and a solid client base, comprising about 50 per cent OAPs, 25 per cent working adults and 25 per cent children. The shop is situated in a poor area of the town suffering from a declining population, but faces little competition.

Tina trained as a stylist after leaving school and has a City and Guilds qualification in unisex hairdressing and a HAB qualification in hair and beauty. After leaving college she worked locally for six months before moving to work in a friend's salon, where she ended up running the whole operation herself. Upon returning she set up her own salon in a local neighbourhood, which she ran for three-and-a-half years until the lease ran out, following which she taught hairdressing and then worked for social services with youth offenders.

“ *My income has gone up, I pay more taxes, I get a bit extra from the tax credit and I'm no better off than I was* ”

Her decision to return to her original trade was due partly to a desire to 'get back to what she knows best' and partly due to a strong attraction to running her own

business. She knows her decision to leave a secure job with the local authority to return to self-employment was a risky one, but she is adamant that she wants to be her own boss, which she describes as '*less security, same money, more hours, more freedom*'.

Tina is a scrupulous book-keeper and accounts for every penny she spends and receives. At the time we visited her she said she was about to register for self-employment. She has public liability insurance but struggled to obtain contents insurance for her shop due to the poor reputation of the area. She was refused contents' insurance by two companies before eventually obtaining a policy for £212 a year – much more than she would expect to pay were she operating in a less deprived neighbourhood.

Since taking over the shop Tina has made efforts to attract new customers and has seen takings rise by £70 per week. Gross profit per month averages at £2,000, and once her household costs, business expenses and loan repayments have been taken into account, she has around £400 per month left. However, despite building the business, she claims she is surviving on approximately the same amount as before. '*My income has gone up, I pay more taxes, I get a bit extra from the tax credit and I'm no better off than I was,*' she says.

Client 9 Neil

NEIL owns a fruit and veg shop in a deprived area that is largely populated by immigrant communities. He first started working at the shop in May 2002 after previously being employed as a chef for 19 years. The opportunity to take over the business came up when the owner, John, who is a good friend of Neil, decided to concentrate all his efforts on his other shop, which is situated in a better neighbourhood.

Neil has struggled financially since taking over the business. In the spring he took out a loan for £1,500 to buy a van for collections and deliveries, but the vehicle broke down almost straight away. It couldn't be fixed so he sold the shell for £450, losing over £1,000 in the space of a week. Business was slow in the summer months, largely due to the Jewish holiday season, which had taken away a lot of customers. Until June, Neil was still working three nights a week as a chef in addition to running the business, but he found this made him exhausted and could no longer continue both jobs.

The business potential of the fruit and veg shop would appear to be good, with large Jewish and European immigrant communities nearby, and the nearest competitor over half-a-mile away. But despite this, the shop continues to struggle. Neil believes that this is largely due to its shabby appearance and would like to redecorate both the interior and exterior, but is unable to afford this at the present time. He was told that he might qualify for a shop front grant from the local authority, but when he made further enquiries, was told that unlike the neighbouring area, the Council do not provide such grants.

Neil is trying to run the shop as a legitimate business. He is registered for tax and VAT, and intends to make a full declaration to the Inland Revenue. He has taken out contents insurance and employer liability insurance, and intends to take out public liability insurance as soon as possible.

He employs his sister and his brother's girlfriend on a casual basis, but would like to take on a full-time assistant as soon as he can find a suitable candidate, to whom he would offer a formal contract.

In an average month the shop's total sales would be expected to exceed £5,500, with gross profit at around £1,750. After his household and business costs have been taken into account, this would leave Neil with just over £300 a month. But following recent difficulties, the profits of the business have dropped considerably. When we saw him in September, Neil was ploughing all his takings into the shop and had not taken a wage for seven weeks.

“When we saw him in September, Neil was ploughing all his takings into the shop and had not taken a wage for seven weeks”

Client 10 Pat and June

PAT and his wife June run a fishing tackle and air gun shop, which they double-up as a private detective agency and security advice centre. They live locally in a council-owned property with their two children and Pat's mother.

Pat is a butcher by trade, but opted for a change of career in 1996 when he opened a security and surveillance equipment shop. At the same time he started a private detective agency, which he operated through a back room at the shop, and later began to sell replica guns. The increasing demand for this side of the business led Pat to concentrate on selling air guns and related equipment until earlier this year, when he decided to diversify into selling bait for local fishermen. He borrowed £6,000 from Street(UK) to buy starting stock and has since invested a significant amount more. He currently has around £15,000 worth of

fishing bait in stock, which is rapidly becoming the most profitable aspect of his business.

“ *Pat and his wife have repeatedly been refused finance from banks, despite monthly sales of over £10,000, and gross profits of around £5,500* ”

A poor credit history and the location of the shop in a deprived area have meant that Pat and his wife have repeatedly been refused finance from banks. Despite this, they have worked hard on developing their business, which is growing at a fast rate. In an average month they can expect sales of

over £10,000, and gross profits of around £5,500. After their business and household costs have been taken into account, Pat and his wife will usually be left with around £2,500 per month.

The couple run the shop as a legitimate business. They are registered for tax and VAT and have all appropriate insurance policies. They run the security advice service and detective agency on a cash-in-hand basis. Pat has a range of equipment that he will hire out to local businesses that suspect their employees of stealing. He will install this equipment, aid in the surveillance and sometimes interview the suspected employees himself. Pat regards this side of his business, through which he makes about £300 a month, as an 'extra' that he uses as security for his children's future.

Pat and June are at a critical stage in the development of their business. Having recently expanded into selling fishing bait, they have attracted a number of customers from other shops but frequently find that they do not have the range of stock to satisfy everyone's needs. They are concerned that if they don't invest heavily in stock soon, their customers will go elsewhere. They applied to Lloyds TSB for a loan to build up their stock, but their application was refused.

Client 11 Devon

DEVON, 33, came to study in the UK in 1995 from Jamaica where he had worked as a chef. Upon arriving, he lived with relations while he studied IT, Maths and English at college before marrying his girlfriend – whom he had met since coming to the UK. He now lives with his wife, their daughter, and three children from his wife’s previous marriage, in rented accommodation in Essex.

During his first few years in the UK, Devon scraped a living by working as a chef on a cash-in-hand basis in restaurants owned by his relatives and other members of the Jamaican community in his area. But as his wife cannot walk and is unable to work following an accident two years ago, it was difficult for them to make ends meet, so Devon decided to set up on his own. *‘I made some enquiries and realised that there was a potential market for Jamaican patties,’* he says.

Devon now operates partly from home and partly from a rented space and is beginning to struggle to keep up with rising demand – in June 2002 his takings were £2,000, in November 2002 they were £4,400 and in April 2003 they were £7,500. *‘The patties have been more popular than I could have hoped for.’* His average monthly sales over the last 12 months are just over £6,500, with average gross profits at £4,500. After accounting for business costs, household expenses and loan repayments, he is left with around £1,800 per month.

Devon’s business is not registered for tax or VAT. He has insurance and an MOT on his car, a catering licence and a health and safety certificate, but does not have public liability insurance or contents insurance. He does his book-keeping manually and is paid 100% in cash by his clients. He currently employs staff on a cash-in-hand basis when his business needs require it.

Having established a firm client base and secured a business premises, Devon is ready to expand his enterprise. He has recently had gas fitted at the business premises at a cost of £1,500 and invested in a large mixer to cope with extra demand. He intends to employ people on a more regular basis but so far has had little success in finding suitable candidates.

Devon is aware of the potential benefits of legitimising his enterprise, but fears the cost of registering for tax and VAT and obtaining insurance. The business is still relatively insecure, even in its current ‘informal’ state and, for the time being, he sees no way of burdening it further with formalisation costs.

“ The business is still relatively insecure, even in its current ‘informal’ state and, for the time being, he sees no way of burdening it further with formalisation costs. ”

Client 12 Kevin

AFTER leaving school in 1977, Kevin worked in the catering industry for thirteen years before he was made redundant and decided to set up his own frozen food retail business. His company did well before suffering in the 1992 recession, prompting Kevin to return to education to take a degree in Business Administration. After he left college, he resumed self-employment but struggled and was hit hard when a former client refused to pay £6,000 that he owed him. He eventually got his money but then spent a year off work with illness, during which time he received £50 a week in income support.

“ They eventually give you your trading income back when the six months are up, but it makes life very difficult while you are on the scheme. I had to do a lot of cash-in-hand work just to survive. ”

Kevin has played the guitar for over ten years and in 2000 he began to teach it on a casual, part-time basis to boost his income. His reputation grew and he began to attract more clients before he decided to approach local schools with offers of paid tuition for students. He currently works for the local education authority, an adult education authority and seven schools that employ him independently.

To develop his business Kevin joined Inbiz, through which he received support from the New Deal between November 2001 and May 2002. He believes he benefited from the experience, but was frustrated about aspects of the scheme’s administration. He says: *‘You get income support for six months while you grow your business, but they keep all the trading income you make during that time, which is ridiculous. They eventually give you your trading income back when the six months are up, but it makes life very difficult while you are on the scheme. I had to do a lot of cash-in-hand work just to survive.’*

Kevin works around forty hours-a-week for his main clients, in addition to which he performs an average of two gigs a month himself to boost his income. Because he works mainly during the academic year, his income drops considerably during the school holidays. He is tax-registered and does his own book-keeping, though it is unclear how much of his income he declares for tax purposes. He has taken out insurance on all of his instruments, which are worth around £7,000. His average monthly takings are £1,400, which after business and household costs have been taken into account leaves him with about £200 a month.

Kevin says he would like to increase his holiday work by opening a summer ‘rock school’ for talented local youngsters. He has applied to several local bodies for finance but so far has met with little success. A particular source of frustration has been the funding body Northern Arts – to qualify for a grant from them the applicant must already have at least 25% of the amount they need and even if the grant is approved it is not paid up front, but can only be claimed back once the recipient has spent the money.

Client 13 **Malcolm**

MALCOLM, who is 40, has been in business of one sort or another for most of his working life. Over the past twenty years he has been a window cleaner, a grocery shop owner and a florist. A few years ago he used compensation from a road accident to buy an ice cream van before opening a second-hand furniture shop. *'Meanwhile I had met a chap who repaired washing machines,'* he says. *'I bought them from him and sold them on with a six-month guarantee.'*

Despite being experienced in business, Malcolm has never been bankable. He explains: *'I have never even thought of approaching a bank for a loan. People in my position are not in the running. We're too small and most of the lenders want you to match the funds they put up. That was out of my league. Like most people round here, if I needed something I paid in cash, or did without.'*

In September 2001 Malcolm borrowed £700 from Street(UK) to buy security shutters for his shop. He has since taken out three further loans to fund his expanding business and has taken out a further lease on a larger shop nearby. *'With the extra space, I was able to handle more machines,'* he says. *'Then I saw there was a rental market and followed it up. Some people simply don't have the money to buy new and others haven't enough for any breakdowns.'* For a small deposit, customers can rent washing machines and tumble dryers, with Malcolm doing the repairs, delivery and installation, as well as collecting the money. He plans to turn his original shop into an ice cream parlour.

When the combined sales of the shop, the ice cream van and the washing machine rentals are taken into account, Malcolm's average monthly takings are £4,000, with a gross profit of £2,500. After household and business costs have been taken into account, he is left with around £900 per month.

Whereas when we first met Malcolm two years ago he was operating entirely on a cash basis, Malcolm is now registered for tax and VAT and declares all of his income for tax purposes. He keeps computerised records of all transactions and has taken out all the appropriate insurance policies. His business continues to grow and he has further plans for expansion and diversification. Meantime, his local community is also benefiting as Malcolm has become an important role model and advisor for several aspiring entrepreneurs to come off benefits and follow his example.

“ Malcolm has become an important role model and advisor for several aspiring entrepreneurs to come off benefits and follow his example ”

Client 14 Ravi

RAVI, 26, opened an Indian takeaway three years ago on an industrial park. His business grew initially but reached a plateau last year, so he borrowed money from Street(UK) for a blast freezer and a vacuum packing machine and diversified into supplying pre-packed frozen meals to local supermarkets and shops. Ravi is highly respected in the local community and lives in his own house with his wife and three children.

The combined income of the two sides of the business averages at £12,500 per month, with gross profits at £9,500. After his business and household costs have been taken into account, he is left with around £1,900 per month.

“ *If business is good I can declare more, if it is bad I can't* ”

However, despite his success, Ravi's business is still only partially legitimate. He is tax-registered but only declares a portion of his income. *'If business is good I can declare more, if it is bad I can't,'* he says. He is not registered for VAT or employer's insurance. He has a bank account but operates mainly in cash and does not process all of his

money through the bank, despite keeping detailed records of all transactions. He employs three people full-time and two part-time, all on a casual, cash-in-hand basis, which he sees as a mutually beneficial arrangement. His kitchen has a health and safety certificate and he has taken out public liability insurance.

The growth of the business means that Ravi is looking for new premises. His current kitchen is difficult to maintain for health and safety purposes, and he would like somewhere larger and more convenient. Eventually, he says, he may give up the takeaway to concentrate purely on the frozen meal side of the business. *'The frozen side is more profitable and the hours are less unsociable, which is good if you have a young family,'* he explains. One day he dreams of eventually selling £10,000 worth of frozen meals a week.

Ravi now faces a dilemma. He is aware of his standing within the local community and wishes to justify his profile as a 'legitimate' businessman but is hesitant about registering for VAT and offering formal employment contracts because of the cost. He is aware of the benefits that formalisation of his business would bring, but at present is still one step away from cutting off the last remaining subsidies and fully engaging in the formal economy .

Client 15 Shamir

SHAMIR came to the UK from Bangladesh in 1987. Having previously set up a media business at home, he wanted to learn more about the industry and enrolled on a college course to study direction, editing and marketing. While studying, he lived with relations and supplemented his income by being a waiter in Indian restaurants and a casino.

As soon as he finished his course, Shamir started his first UK business, an international telephone call shop. He says: *'Lots of people from the Asian communities wanted to call home but couldn't afford to from their homes. I offered them cheap rates.'* But two years ago, the local authority closed the shop for a month 'by mistake' because of a dispute with the previous tenant. The closure resulted in many of the shop's customers going elsewhere, and Shamir was forced to close the business.

In March 2002, after borrowing money from friends and family, Shamir established a new business producing TV, radio and newspaper advertisements. His clients are mainly clothing retailers, car showrooms, restaurants and jewellery shops who wish to promote their business to the Bengali community using Bengali media. *'At first I had no equipment of my own and had to borrow everything, but slowly things have built up. The business is now registered as a limited company and I have £10,000 worth of equipment.'*

Shamir's business is the only dedicated media company producing commercials for Bengali TV and radio in the UK. Until recently, most Bengali businesses made their own commercials using simple scripts and cheap equipment. Shamir saw this as a gap in the market. *'We use good storylines, original jingles and paid actors – nobody else is doing that,'* he says.

Initially, Shamir's customers paid with their order, but competition from non-Bengali companies trying to undercut his service has meant that, since December 2002, he has taken a 50% payment at the time of the shoot and 50% when he delivers the final product. His company also takes a commission from TV companies, radio stations and newspapers when they bring them business.

The average sales of Shamir's business are £4,500 per month, with gross profits at £2,500 per month. After his business and household costs and loan repayments have been taken into account, Shamir is left with around £1,400 a month, most of which he re-invests in his business. He is registered for tax and VAT and is scrupulous about doing everything legally. For every project, Shamir takes on freelance staff according to the project requirements, whom he pays by cheque. He keeps manual records of transactions and issues invoices to all his clients.

Shamir is very hard-working and would like to expand his business in two ways. Firstly, he would like to make a drama series for Bangla TV – the UK's TV station for the Bengali community. He is already working on such a project and is confident that he will be commissioned to make more.

He would also like to move into producing commercials for the mainstream media, but is unsure how to go about doing this. All of his business contacts are within the Asian community and he is nervous about dealing with people outside of this familiar environment. *'I don't know how to start,'* he says. *'I need a lot of help with marketing the business and making new contacts.'*

“ *I need a lot of help with marketing the business and making new contacts* ”

Client 16 Sunil

SUNIL, who is 50, trained as a mechanic after leaving school and worked for several garages before quitting and spending two years travelling the world. Upon his return to the UK, he managed a car dealership before deciding to set up on his own. He explains: *'I was doing all the work but only getting paid a wage. I thought, "I might as well do this for myself and take all the money."'*

In May this year Sunil used his savings to purchase a lease on a car repair garage. The lease, which he bought on the retirement of the previous owner (a friend of a friend), cost £30,000. *'The business is forty years old and has a very strong customer base,'* Sunil says. *'I got a really good bargain.'* He borrowed £9,800 from Street(UK) – after being turned down for finance from several banks – to upgrade the equipment at the garage.

“Both Sunil and his friend had been advised by us to get a solicitor involved in the purchase contract but they were reluctant, as it was counter-cultural to their belief in doing business on trust”

The average monthly sales at the garage are just under £12,000, with gross monthly profits averaging at around £9,000. When his household expenditure, business costs and loan repayments have been taken into account, Sunil is left with about £2,500 a month.

Sunil is keen to run his business legitimately. He is already tax-registered and is just completing his VAT registration. He has an umbrella insurance policy covering his business for every eventuality, for which he pays £384 a month. He employs five people on formal contracts and pays an accountant to organise their wages, although he admits he is tempted to employ more people informally.

Sunil would like to expand the garage by buying the freehold to the site and using the outside of the premises to store and sell spare parts, which he obtains by purchasing old cars and stripping them down. Eventually, he would like to purchase a second premises and start up another garage. *'I've already got my eye on a place,'* he says. *'But I'd need a bank loan to get it.'*

Sunil works an average 60-hour week to support his wife and two children. He hopes to retire in 10 years time at the age of 60 and return to Pakistan, where he believes the quality of life is better than that of the UK.

■ *As a postscript to our visit, Sunil has sadly lost his business, due to the lack of proper legal ownership when he bought the lease and the 'disappearance' back to Pakistan of the previous owner who was 'a friend of a friend'. Both Sunil and the friend who guaranteed his loan from Street(UK) had been advised by us to get a solicitor involved in the purchase contract but they were reluctant, as it was counter-cultural to their belief in doing business on trust.*

Client 17 **Marcus**

SINCE leaving school Marcus, who is in his early thirties, has worked in a variety of jobs including landscape gardening and chocolate-making. In between jobs he claimed unemployment and housing benefit, and supplemented his income by repairing cars in front of his house. Eventually, in 1999, he decided to turn this additional source of income into his main occupation and set up a car repair garage. *'I'd been doing it all of my life so it seemed an obvious step,'* he says.

When Marcus told the Job Centre that he wanted to become self-employed, they put him in touch with Pertemps – a private recruitment company with a Government contract to get local people into work. Through Pertemps, he qualified for a £5,000 grant to cover living expenses while he built up his business, but he found that this wasn't enough. *'The £5,000 comes in a lump sum and is intended to cover you for both your business and living expenses, but it's nowhere near enough to do both. The government really needs to offer some money for living expenses and some for investing in the business.'*

Marcus runs his business from small rented premises on an industrial park in a deprived area. Since he began, he has managed to invest about £4,000 a year of savings. In addition to repairing cars, he buys individual parts and reconditions them before selling them on. He estimates that this side of his business is potentially more profitable. *'The repairs side just covers its costs,'* he says.

In an average month, Marcus's sales will be around £3,000, with gross profits at £2,000. After his business and household expenditure has been subtracted, he is left with an average of £400 per month, though this will vary considerably throughout the year.

Marcus does not claim any benefits and is registered for both tax and VAT. His sister, who is an accountant, does his book-keeping, and he declares all of his revenue for tax purposes. He has insured his tools to the value of £10,000, but no longer has any public liability insurance after struggling to keep up with the payments on the policy he originally took out. He has a part-time apprentice, whom he pays cash-in-hand.

Having struggled to build his business over the last few years, Marcus is pessimistic about the future for other people in his situation. *'The Government will help you get into self-employment, but then they just forget about you,'* he says. *'All they do is get you off the statistics, but most people will just re-appear on them after a year or two. There's no long-term investment.'*

“All they do is get you off the statistics, but most people will just re-appear on them after a year or two. There's no long-term investment”

Appendix

Benefits Trap 'Boosts Black Economy'

By David Turner,
Employment
Correspondent;
Financial Times;
August 29, 2003

A black market entrepreneur charging £10 an hour would have to increase the price to £35 an hour to earn the same profit legally, a labour expert has warned. The figure, calculated by Rosalind Copisarow, head of the micro-finance institution Street(UK), shows the obstacles facing the government in its fight against the black economy.

Ministers must hack away at the mass of state-imposed barriers that deter workers going legitimate, anti-poverty campaigners warn. But they admit that the solutions may be too radical for government to contemplate, in spite of plans for the Social Exclusion Unit to find innovative solutions.

The conundrum of how to move thousands of Britons from the shadowy world of the black economy – where workers have missed out on a raft of new rights – remains one of New Labour's most difficult challenges.

Those who refuse to pay tax – or the right amount of tax – seem to be most prevalent among caterers, cleaners, hairdressers, beauticians, builders and farm workers. The government is hit in two ways. Not only does it receive less tax than it should, but it pays out more in benefits to those fiddling the system. Research has suggested that more than 120,000 Britons are claiming benefits as well as earning a wage.

Campaigners say black-economy workers need a greater incentive to switch. That means giving people on benefits the right to keep much of what they earn, as well as taking an axe to the jungle of bureaucracy that hangs over small and legal businesses.

Jim Battle, an expert on poverty and head of the Housing Federation's northern region, laments the fact that there are '*so many obstacles and pieces of paper*' involved in setting up a legitimate business. '*It does make sense for the economy to have regulation. But when a business has below four or five people the regulation becomes burdensome,*' he says.

Working inside the law costs money: operating licences have to be funded, national insurance, VAT and other taxes have to be paid, and people must walk away from the cosy cushion of benefits. Ms Copisarow's verdict as a lender to businesses in the informal economy is stark: '*Anyone getting off benefits and starting up their own business has to go through a steep financial sacrifice.*'

Black-economy workers who do not have their own business may face less steep a curve, but they still stand to lose benefit payments by becoming legitimate.

Yvette Cooper, the minister charged with finding a solution, is supervising an investigation by the Social Exclusion Unit into how to increase formal employment in deprived areas. Ms Cooper argues that because of the minimum wage and workers' tax credits – New Labour inventions – it makes even more sense to join the formal labour market.

The formal economy also means pensions, sick pay, and easier access to credit for the self-employed, she adds. '*There are a lot of reasons why it's in people's interest, particularly in their long-term interest.*'

But anti-poverty campaigners want to increase the incentives still further by resorting to measures that are likely to be unpalatable to the government.

Ms Copisarow wants many more exemptions for micro-businesses when it comes to non-essential regulations. She thinks, for example, that health and safety regulations make it too difficult to run businesses such as catering from home.

Matthew Smerdon of Community Links, a charity that delivers services in London's East End, wants an end to the draconian rules which prevent people from earning and claiming means-tested benefits at the same time.

Single people claiming contributions-based unemployment benefit can earn only £5 a week before every extra pound they earn is lopped off their payment from the state. He thinks that if benefit recipients were able to keep more of what they earned, the legitimate labour market might hold more attraction.

But Mr Smerdon concedes that ministers are facing a knotty problem. *'In all our work we've done with government on this we've never tried to suggest this is easy.'*

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Postscript

Should you wish to discuss any aspects of this report, or would like support in developing the recommendations further, then do please contact the authors (see page 2).

Further Information

If you would like further information on the work and findings of **Street(UK)**, a short paper and a full report entitled *Street(UK), A Micro-Finance Organisation – lessons learned from its first three years' operations* by Rosalind Copisarow and Sarah Foster, will be published later this year (2004).

They will also be available from Street(UK)'s website www.street-uk.com

Community Links' programme of publications continues to share voluntary sector learning from across the country and present the evidence to government. As part of our ongoing work we are constantly in touch with communities who are experiencing difficulties and many who have come up with ways to tackle them.

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