

VAT COMPLIANCE IN THE UNITED KINGDOM

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This series of working papers is designed to bring the research of the Centre for Tax System Integrity to as wide an audience as possible and to promote discussion among researchers, academics and practitioners both nationally and internationally on taxation compliance.

The working papers are selected with three criteria in mind: (1) to share knowledge, experience and preliminary findings from research projects; (2) to provide an outlet for policy focused research and discussion papers; and (3) to give ready access to previews of papers destined for publication in academic journals, edited collections, or research monographs.

Abstract

This study aimed to uncover the factors that influence Value Added Tax (VAT) compliance. Small businesses from the catering and flooring/furnishing trades in the United Kingdom were sent a questionnaire designed to elicit their views on VAT and related issues. Responses were obtained from 359 businesses. Results showed that VAT compliance in small businesses shares a number of similarities with private income tax compliance: Social norms, equity, economic factors and personality are all important in predicting compliance.

VAT compliance in the United Kingdom

Paul Webley¹, Caroline Adams² and Henk Elffers³

Introduction

Over the last fifteen years there has been a considerable amount of research into tax compliance (Andreoni, Erard & Feinstein, 1998). Many new models of the compliance process have been devised and there has been a wide range of empirical studies. But the focus of nearly all of this research has been personal income tax compliance: business tax evasion in general and Value Added Tax (VAT) compliance in particular have received very little attention (Murray, 1995: interesting exceptions are Adams, 1996; Gordon & Nielsen, 1997; Hite, 1991; Murray, 1995, Roberts & McGill, 1991). This is surprising given the economic and social importance of business taxation and the fact that VAT has been introduced in a large number of countries (most recently China - Yeh, 1997 - and those countries in Central and Eastern Europe applying for membership of the European Union - Cnossen, 1998). It is difficult to get an accurate picture, but it is clear from the few studies that have been published that VAT evasion is widespread and involves significant revenue losses, though the extent varies considerably across countries. Agha and Haughton (1996) summarise the findings of studies from five countries in Europe and two in Asia: their figures suggest that revenue losses vary from a low of 3% (France, United Kingdom) to a high of 40% (Italy). Even the low figure represents a huge sum of money (three billion dollars for France) and a very high proportion of firms involved in some non-compliance. Duverne (1990), for instance, reports that 66% of French VAT taxpayers audited had understated the value of taxable sales (a quarter of them fraudulently) and 40% had overstated the value of taxable inputs. Similarly a study of Dutch businesses found that 34% of firms had evaded VAT (Cnossen, 1981). All of these studies involve official figures: there have, to our knowledge, been no studies which have studied VAT compliance by asking businesses directly about their actions and no studies which have looked at the role played by psychological and social variables.

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In the absence of studies on the causes of VAT non-compliance, we can draw on the economic psychological literature into income tax evasion (for example, Cowell, 1992; Elffers, 1991; Lewis, 1982; Webley, Robben, Elffers & Hessing, 1991) to identify what are likely to be the most important explanatory factors. Five factors seem likely to be particularly crucial: sanctions and punishments (deterrence), equity, personality, satisfaction with the tax authorities and mental accounting. Each will be considered in turn.

Economic models clearly predict that higher penalties and audit probabilities should discourage non-compliance. The evidence suggests that though both have some deterrence effect (Andreoni, Erard & Feinstein, 1998), higher audit probabilities probably have more impact than higher penalties (Hessing, Elffers, Robben & Webley, 1992). The results of several surveys have indicated that self-reported non-compliers are less likely than compliers to believe that such acts would result in apprehension and punishment (Hessing, Elffers & Weigel, 1988). Nothing is known about what people running small businesses believe about the sanctions for VAT non-compliance. It must be remembered that deterrence is not solely a matter of legal sanctions: a belief that one's reputation may suffer as a result of being caught evading is also a deterrent and this may be particularly relevant in a business context.

The perceived fairness of a tax system is important both to its acceptability and smooth functioning. A recent example of how an unacceptable tax system impacts on the public consciousness is the saga of the poll tax in Britain (Cullis, Jones & Morrissey, 1993). A tax can be seen as unfair in a number of ways: if those of similar incomes are taxed differently, for example or if the government is seen as giving little back in return. Cowell (1992) has shown that how a person perceives his own role in influencing the perceived inequity is of central importance and it has been argued that a taxpayer may withdraw from the exchange relationship by evading taxes in order to offset or reduce the disparity. Although such research has looked almost exclusively at the private individual, recent work by Adams (1996) showed that perceived inequity in the taxation system was found to be the most important variable predicting non-compliance in those running small businesses in Holland. Furthermore in a recent qualitative study on VAT and small businessmen and

women (see Adams & Webley, 2001) the idea that small businesses in particular carry an unfair burden was a recurrent theme.

Weigel, Hessing and Elffers (1998) suggest that some individuals may be characterised by egoistic tendencies, whilst others may exhibit a strong identification with community responsibilities, and thus be less motivated to avoid taxes owed. In other words, the more egoistic an individual, the less likely he or she will be to comply with rules and laws when compliance conflicts with their interests. There is a good deal of evidence that egoism (Weigel, Hessing & Elffers, 1998) predicts rule-breaking in a number of areas, including income tax evasion (Elffers, 1991), social security fraud (Hessing et al., 1993) and parking violations (Adams & Webley, 1996).

Dissatisfaction with the tax authorities in other ways has also been suggested by a number of investigators as motivators to avoid taxation (for example, Elffers, 1991; Wallschutzky, 1984; Wärneryd & Walerud, 1982). What evidence there is suggests that believing the system to be inefficient correlates positively with a propensity to evade (Vogel, 1974; Wearing & Heady, 1995).

How business people think about the VAT money they collect may also influence their behaviour towards it: the notion of mental accounting (see Shefrin & Thaler, 1988) may be helpful here. Mental accounting is often described as a psychological mechanism whereby income is framed (Winnett & Lewis, 1995). Shefrin and Thaler (1988) propose, in respect of personal finance, that people have a number of mental accounts that operate independently of one another. What is interesting in the current context is whether business men and women psychologically separate monies owed to the VAT into a separate mental account from that of business turnover. If they do not, they may be more likely to try to evade VAT as a result of seeing it as 'their' money.

The purpose of the present study was to build on previous research into income tax evasion, first, to provide a descriptive account of small business people's views on VAT and related issues and second, to see if those social psychological factors which play an

important causal role in income tax evasion are also relevant to VAT. Two business sectors (catering; flooring and furnishing retailers) were investigated as there is some confidential evidence that the first group is generally less compliant with regards to VAT than the second.

Method

Sample

The sample consisted of the names and addresses of business owners with a turnover of less than one million in the South West of England and the Midlands active as of the end of April 1997. The businesses were classified as either catering (licensed restaurants, unlicensed restaurants and cafes, take-away food shops) or flooring/furnishing retailers. A random sample of 1600 of each type of business was selected; thus 3200 questionnaires were distributed in total. Three hundred and fifty-nine responses were received.

Questionnaire

The questionnaire was primarily quantitative but with some questions that were in an open format. The questionnaire was divided into seven sections described below.

General Information

Both personal and business related information was requested. This included, among other things, 'age', 'gender', 'main business activity', 'number of staff employed', the year the business was first registered for VAT and questions about the use of an outside advisor, penalties for late payment of VAT and the number of times the business had been inspected by the tax authorities. Respondents were also asked an open-ended question, 'As a result of an inspection someone in your line of business has been found to have *unintentionally* declared less VAT than he or she legally owed. What do you think would happen?'

You, the tax authorities and VAT

This consisted of nine questions, all answered on a five-point scale from strongly disagree to strongly agree. The questions focused on the service provided by the authorities and general questions about VAT (for example, about its fairness, whether VAT money is seen as coming from business funds, about the prevalence of VAT fraud).

You and other people

This section comprised twelve questions from the egoism scale. This has an alpha of over 0.80 (Weigel, Hessing & Elffers, 1998).

You and VAT compliance

This consisted of 16 questions, all answered on a five-point scale from strongly disagree to strongly agree. The questions dealt with a range of compliance issues, from the ease of making unintentional mistakes, through the acceptability of VAT rules and the detectability of VAT fraud both by other businesses and by the tax authorities.

Features of VAT

This section included an open question in respect of the purpose of VAT, and two questions about errors in returns; 1) 'If you found an error in your returns after you had submitted them, would you bring this to the attention of the tax authorities' (yes/no) and 2) 'If you have ever made an error on a VAT return, why do you think it occurred?'

Declaring VAT

To measure attitude to VAT evasion the question read 'VAT evasion is ...' (five point scale 'wrong' to 'acceptable'). Another question asked 'How often over the past five years have you been involved in cash transactions so as to reduce VAT payments? (very often/often/sometimes/rarely/never). A social norm measure asked 'If my friends knew that I sometimes underdeclared VAT they would say this was ...' (very wrong/wrong/irresponsible/unwise/normal/a good thing). The final question in this section

asked ‘If you had the opportunity to pay less VAT than you should do and you believed that there was absolutely *no* chance of getting caught, would you do so?’ (certainly/probably/probably not/certainly not).

Some imaginary situations

Two hypothetical situations were presented, one concerning the introduction of a reward system for paying VAT promptly, the other concerning reactions to a normal supplier offering to deliver some goods/services without charging VAT.

Procedure

A questionnaire was sent to each sample business with a covering letter stating that we were interested in business people’s views about VAT issues and related matters. The letter informed them that their business had been selected as part of a representative sample and that any information given would be anonymous and confidential. Participants were also offered the opportunity of receiving a brief report on the findings and a reply card was enclosed which had to be returned separately from the completed questionnaire if they wished to receive a report. A freepost envelope was also included for the return of the questionnaire.

Prior experience with research on compliance suggested that the response rate would be low, which raises the question of how representative the response group would be. Oppenheim (1992) reports that late responders to surveys tend to be similar to non-responders, so a comparison between late and early responders gives an indication of any likely bias. Replies were date stamped as they arrived in order for this analysis to be carried out.

In order to provide a further check on the representativeness of the sample, we attempted to maximise the return rate for a sub-set of the sample using the prompting procedure of the Dillman Total Design Method. The extra respondents obtained using this method were then compared to the original respondents to see if there was a difference between those

responding initially and those who required heavy prompting to reply. To this end 52 businesses were randomly selected and targeted using Dillman's (1978) method. This involved annotating their freepost reply envelope by individually allocating a mix of traceable initial letters of the addressee and the presence or absence of full stops after the initials. After a period of 16 days this sub-group was sent another questionnaire and covering letter which reminded them of the previous correspondence and asked them to give up ten minutes of their time to complete and return the questionnaire. When another 10 days had passed the 'late response' group was sent another questionnaire and covering letter by recorded delivery.

Results

The main body of results is divided into two main sections. The first section will deal with the descriptive aspect of the data and the second section will deal with the prediction of compliance.

Representativeness checks

Of the 52 businesses in the 'Dillman' group, 10 returned within 18 days, and were therefore excluded from this special group. Of the remaining forty two, 24 returned questionnaires as a result of further prompting. No significant differences emerged between the 'Dillman' sample and the main sample or between the late responders and early responders.

Response rate

The final number of questionnaires received was 359. This equates to a crude response rate of 11%. However, annual deregistration rates for newly registered businesses are 20% and for established business 15% and so, given that the questionnaire was distributed in Jan/Feb 1998, it is likely that approximately 520 of the businesses on the address file are unlikely to be active. The final response rate is more accurately assessed at 13.5%. Most of the questionnaires were completed to a high standard. However, where the total numbers do not equate to 359 or 100%, this is due to missing data.

Differences between business types

There were no significant differences in self-reported compliance between the two types of businesses. However those in the catering business were more likely to believe fraud was widespread in their line of business ($t = 2.08$, $df = 304$, $p < 0.05$), were less likely to believe that people were honest ($t = 3.36$, $df = 304$, $p < 0.001$) and were more likely to believe that underdeclaring VAT could contribute to increased profits ($t = 3.25$, $df = 307$, $p < 0.001$). They were also more egoistic ($t = 2.02$, $df = 311$, $p < 0.05$).

Section 1: Descriptive data

General information

Two hundred and sixty-three (73%) of the respondents were male and 87 (24%) were female. Ages ranged from under thirty to over sixty, with 83% ($N = 297$) of people being between the ages of 31 and 60. As expected, most businesses described themselves as being either in the catering trade ($N = 199$) or the flooring/furnishing trade ($N = 117$) but a minority of replies ($N = 30$) did not fit either of these categories and were coded as 'other'. Some of the 'other' group may well have been in the catering or flooring/furnishing businesses but responses such as 'company director' or 'all aspects of my business' could not be so classified. Some respondents, however, clearly fell outside the expected categories, for example, 'hairdresser'. The majority of businesses ($N = 186$, 52%) employed between one and five members of staff, 86% of businesses employed between one and twenty members of staff.

The number of years registered for VAT ranged from one to twenty-five with an average of 11.5 years. Forty-one percent of the sample ($N = 149$) employed an outside advisor to do VAT work. Thirty-three percent ($N = 118$) of the respondents had been penalised for late payment of VAT monies owed and 31 (9%) of the respondents stated that they regularly received repayments rather than paying VAT monies to the tax authorities. Respondents were asked how many inspections they had had and this information used to construct a code based on the frequency of inspection, for example, 'Infrequent' (less than every eight years); 'Normal' (every three to seven years); and 'Frequent' (every second year or more).

If the business had been registered for four years or less and had not had any inspections it was not allocated a code. Twenty-two percent (N = 80) were coded as infrequent, 53% (N = 191) as normal and 10% (N = 35) as frequent.

One open question asked respondents to list up to three powers they thought the relevant tax authority (HM Customs & Excise) had. Responses were coded into eighteen categories. The top six categories were inspection (mentioned by 150 respondents), entry and or search (N = 144), fine (N = 125), seizure of goods (N = 69), legal action (N = 60), close business down (N = 55).

Responses to the open question on the consequences of unintentional underdeclaration of VAT were coded as either a 'punitive' response, for example, fine, or 'reasonable' response, for example, asked to pay the money back. Respondents were fairly evenly split: 43% (N = 153) believed that there would be some form of punishment, with the majority of these stating that a financial penalty would be incurred.

You, the tax authorities and VAT

Respondents felt that the tax authorities were courteous (N = 203 - 57% agreeing with this), efficient (only 52 - 14% respondents felt that they dealt with their business inefficiently) but inflexible (only 78 - 22% of respondents believed them to be flexible).

The majority of respondents (N = 190, 53%) did not appear to think that VAT is levied fairly over the whole range of businesses. Only 73 (20%) of the respondents agreed that it was fair, the remainder took the neutral (middle) option. There was also a strong consensus that small businesses carry an unfair VAT burden. Two hundred and sixty-two (73%) of the respondents thought that the small business burden was unfair. Only 37 (10%) disagreed that the burden was unfair. Most people seemed to be unsure of the incidence of fraud in their own line of business with 150 (42%) taking the neutral (middle) option. Two hundred and three (56%) people agreed (4 and 5 on scale) that VAT is reasonably straightforward in their line of business. However a significant number 94 (26%) disagreed (1 and 2 on scale).

When asked ‘when I send off my cheque to the tax authorities I think of the money as coming from my business funds’ a large proportion agreed (N = 236, 66%; 4 and 5 on scale). Only 72 (20%) disagreed that they thought of the VAT as coming from their business funds. Many people (N = 174, 49%) did agree that there are advantages to being registered for VAT however 115 (32%) did not agree.

You and other people

The egoism scale had a mean score of 30.3 with an alpha coefficient of 0.83.

You and VAT compliance

Most people (N = 190, 53%) agreed that people in their line of business understand how VAT works and that it is time-consuming to ensure that VAT returns are done properly (N = 232, 65%). There was a strong feeling that mistakes are easily made on VAT returns (N = 249, 70% expressed this view). Many agreed that VAT rules were acceptable (N = 162, 45%) and that people in their line of business are generally honest when it comes to VAT (34% being neutral, 46% agreeing). There was a consensus that inspectors are good at detecting errors in the VAT returns (N = 272, 76% agreed) and that if a business is caught evading VAT it would get a heavy fine (N = 295, 82% agreed). There was some agreement that a businessman’s reputation would suffer if he was discovered to have underdeclared VAT (N = 181, 50% agreed and only N = 77, 21% disagreed).

There was much less certainty on other questions, with the largest proportion opting for the middle (neutral) option. Most were uncertain about whether it was costly to operate a VAT fiddling scheme (N = 219, 61%) and this may suggest that these people have either never given it any thought or that they have never engaged in such behaviour and thus felt unable to give an opinion. Likewise they were unsure as to whether underdeclaring can substantially contribute to business profit, whether it was easy to spot competitors not paying VAT properly and whether a business not paying VAT properly would soon find itself reported to the tax authorities by other businesses. Some respondents seemed unsure as to whether the authorities inspect frequently and keep a close eye on all businesses with

119 (33%) taking the middle option. There were roughly equal amounts of people agreeing and disagreeing. Although a large proportion of the respondents took the middle option indicating that they are unsure if those businesses that are suspected of underdeclaring VAT are inspected far more often than those following the rules, there is a strong bias towards agreement with 187 (52%) agreeing and only 35 (10%) disagreeing.

Respondents differed in their views as to whether the authorities would impose a penalty if they found an error, however small: 93 (26%) took the middle option; 141 (39%) respondents agreed and 122 (34%) disagreed.

Features of VAT

The responses to the open question on the purpose of VAT were coded into six categories as follows with results: 1) general taxation fund (the correct answer), N = 211 (59%); 2) European funding, N = 18 (5%) ; 3) tax administration costs, N = 17 (5%); 4) derogatory comments aimed at government mismanagement, N = 18 (5%); 5) don't know, N = 40 (11%); 6) other, N = 19 (5%). Three hundred and four (85%) of the respondents said that if they found an error in their returns after they had submitted them, they would bring it to the attention of the authorities.

Respondents were asked to state why they had made errors on past returns. The commonest responses were 'insufficient care due to time pressures' (N = 112) and 'insufficient knowledge of a particular area' (N = 89). Seventy-four respondents claimed that they had never made an error to their knowledge. Only seven admitted making an error out of a desire to reduce liability.

Views on underdeclaration of VAT

The vast majority of respondents (N = 262, 73%) thought that evasion is wrong. A few people (N = 57, 16%) chose options 2 and 3 suggesting that they did not hold strong convictions as to the wrongful nature of VAT evasion. Very few people (N = 15), however, viewed evasion as acceptable. Although 188 (52%) of the respondents claimed they have

never been involved in cash transactions so as to reduce VAT, 159 (44%) admitted to having done so at some time in the past though most (N = 102) said that this had happened rarely.

Two hundred and five (57%) of the respondents said that if their friends believed they sometimes underdeclared VAT they would believe it was either 'unwise' or 'normal'. Only 87 (24%) said that their friends would say it was 'very wrong' or 'wrong'. The remainder said either 'irresponsible' (N = 33, 9%) or 'a good thing' (N = 18, 5%). One hundred and forty (39%) of the respondents said that if they had the opportunity to pay less VAT and they believed there was absolutely no chance of getting caught they would either 'certainly' or 'probably' do so. Two hundred and six (57%) said that they would either 'probably not' or 'certainly not' do so.

Some imaginary situations

One hypothetical question (see 'some imaginary situations', Method section) sought to measure the influence of inspections on compliance. The majority of respondents said they would not engage in the fraudulent scheme anyway (N = 258, 72%). The remainder agreed that: 'whether I would do it or not would depend on things other than inspections' (N = 42, 12%); 'I would be less likely to do this knowing that inspections were being carried out' (N = 14, 4%); 'I would certainly be less likely to do this knowing that inspections were being carried out' (N = 27, 8%).

Section 2: The prediction of non-compliance

Dependent measure

A number of questions address the issue of non-compliance, and we have combined them in order to construct an optimal dependent non-compliance self-report measure. This was done by means of homogeneity analysis using HOMALS (Van de Geer, 1993a; 1993b). Homogeneity analysis is a form of non-metric multidimensional scaling and can be seen as a generalisation of principal component analysis, allowing for non-interval variates that are

non-linearly transformed during the process. The homogeneity analysis was carried out in a number of steps:

First we entered a set of 12 variates that could be seen as indicators of non-compliance and used the original answer categories. The analysis revealed an interpretable first dimension of compliance-non-compliance. However, this analysis also showed that a number of variates did not covary with the others, and so these were removed from further analyses; moreover, as homogeneity analysis is sensitive to variables with answer categories with few responses, some answer categories were subsequently grouped together. Non-compliance is also very skewed, but could not be grouped further as it has only two categories anyway.

The second analysis shows the non-compliance-dimension again as first dimension, while a second dimension was uninterpretable. Variates that had no clear relevance on the first dimension were therefore omitted and the one-dimensional solution used.

The final one dimensional solution used the variates:

[HQ1] 'if you have ever made an error on a VAT-return, why do you think it occurred', with answer categories: 'wilful attempt for evasion', 'other';

[HQ2] 'how often in the past five years have you been involved in cash transactions so as to reduce VAT', with answer categories: '(very) often', 'sometimes', 'rarely', 'never';

[HQ3] 'if you had the opportunities to pay less VAT than you should do and you believed that there was absolutely no chance of getting caught, would you do so', with answer categories: 'certainly', 'probably', 'probably not', 'certainly not';

[HQ4] the second 'imaginary situation' to engage in a questionable trade deal concerning VAT irregularities, with answer categories: 'won't do it anyway', 'dependent on circumstances other than C&E-inspection density', '(strongly) dependent on C&E-inspection density';

[HQ5] ‘VAT-fraud is widespread in my line of business’, with answer categories: 1 – 5 (strongly disagree – strongly agree).

Order restrictions are satisfied for all variates. The category quantifications differed considerably for some variates. Heavy weights in the ‘non-compliance’ direction are applicable for those who admit evasion, and those who often enter into cash transactions for VAT reasons. Less heavy weights are associated with agreeing that VAT fraud is widespread, or imagining seizing the opportunity when no risk was present, or admitting that inspection density determines whether to engage in questionable VAT-deals. The heaviest weight in the ‘compliance’ direction is associated with the answer that one would not undertake VAT fraud even if there was no risk of being caught.

HOMALS computes a score for the first dimension for each individual, but this is not particularly transparent. However, it is straightforward to compute an approximation that makes it easier for the reader to follow what is happening. An index was constructed by allotting the following points: four points for answering ‘wilful attempt’ on HQ1, three points for answering ‘(very) often’ on HQ2, one point for answering ‘sometimes’ on HQ2, one point for answering ‘certainly’ on HQ3, one point when not answering ‘won't do it anyway’ on HQ4, one point when answering 4 or 5 (agree/strongly agree) on HQ5, and then summing up.

The resulting compliance score is very highly correlated with the HOMALS score ($r = 0.91$). After the points had been totalled this produced 171 (48%) of respondents with a score of zero; one hundred (28%) with a score of one and fifty-four (15%) with a score of between two and ten. The respondents scoring two or more were placed into a single category making a total of three groups. To further contrast the groups into self-reported non-compliers and self-reported compliers only those with a score of zero (compliers) or two (non-compliers) were used for analysis. By removing the non consistent group it is thought that the resulting measure would be better able to contrast compliers and non-compliers. The dependent measure had a final count of 171 compliers and 54 non-compliers.

Variables that predict self-reported compliance

Where possible the variables were tested to see if a scale of items could be constructed as such scales are generally more reliable than single item measures. The self-serving scale is an existing scale and was thus used as such. One other scale and one two item measure emerged from the data. The scale has been entitled 'Quality of service'⁴ and the two item measure has been entitled 'Equity'⁵. All the remaining variables are single item measures. The 'purpose' variable has been recoded into responders who believed that VAT is a general taxation and those who believed it has another (specific) purpose, however, those making a derogatory comment have been removed as these comments usually implied that the purpose was general and that all taxation was mismanaged.

Each variable (single item, correlation or scale) was independently analysed using a t-test or chi-squared and the variables that proved to be significant in explaining differences in self-reported compliance behaviour are listed below. We added the qualified effect size of the difference according to Cohen (1977). The effect size is defined as the absolute value of the difference between the two means compared over the average standard deviations. Cohen deems a difference large if effect size is larger than 0.8, moderate if it is between 0.5 and 0.8, small if it is between 0.2 and 0.5, negligible if it is smaller than 0.2. Table 1 presents all the variables on which the two groups differ significantly. This shows that compliers were older than non-compliers. They also wrote their books up more frequently, were more likely to have sought advice, rated quality of service higher than non-compliers and had stronger beliefs that VAT was equitable. They were more community oriented (less egoistic) than non-compliers, were more likely to believe that everybody in their line of business understands how VAT works, were less likely to believe that underdeclaration can substantially contribute to profit and more likely to say that business people generally find VAT rules acceptable. They were more likely to believe that

⁴ This variable consists of five independent variables as follows: The service I receive from Customs & Excise is courteous; Customs & Excise are flexible in the way they deal with businesses; Customs & Excise deals with my business efficiently; As it stands, VAT is reasonably straightforward in my line of business; There are advantages in being a VAT registered business. The mean score was 16.1 and Cronbach's alpha coefficient for the scale was 0.71 which indicates a good scale homogeneity.

⁵The equity variable consisted of two variables: 'VAT is levied fairly over the whole range of businesses' and 'Small business carry an unfair burden when it comes to VAT' ($r = 0.26$, $p < 0.001$).

Table 1: Summary of first order differences between compliers and non-compliers. Only differences significant at at least the 0.05 level are shown

Variable	t	χ^2	d.f.	p <	Non-compliers		Compliers		effect size
					mean	SD	mean	SD	
Underdeclaring contributes to profit	-7.08		221	0.001	3.87	1.1	2.47	1.4	1.12
Egoism	-5.94		222	0.001	35.91	8.8	28.11	8.3	0.91
Attitude to evasion	-5.65		213	0.001	2.02	1.2	1.24	0.71	0.81
What friends say	-5.08		217	0.001	4.36	1.2	3.26	1.4	0.85
Quality of service	3.87		223	0.001	14.31	3.9	16.61	3.8	0.60
VAT rules acceptable	3.05		223	0.005	2.83	1.2	3.36	1.1	0.46
Equity	2.98		222	0.005	3.69	1.6	4.56	1.9	0.50
Reputation	2.81		221	0.01	3.17	1.3	3.71	1.2	0.43
Age	2.48		222	0.05	2.42	0.81	2.72	0.73	0.39
Understand how VAT works	2.46		222	0.05	2.94	1.3	3.42	1.2	0.38
Reported by other businesses	2.26		222	0.05	2.33	1.1	2.72	1.1	0.35
Penalty for errors	-2.25		223	0.05	3.28	1.4	2.83	1.3	0.33
Books written up	-2.05		222	0.05	2.53	1.1	2.20	0.98	0.31
Purpose		4.67	1	0.05					
Advice sought		9.30	1	0.005					

a business not paying VAT properly would soon find itself reported to the authorities by other businesses and less likely to believe that if the tax authorities found an error, however small, they would be certain to impose a penalty. They were also more likely to believe that a businessman's reputation would suffer if he was discovered to have underdeclared VAT. Compliers were more likely to believe that VAT is a source of general taxation revenue, that VAT evasion is wrong and that their friends would have a more negative attitude if they underdeclared VAT.

Multivariate analysis for self-reported compliance

To test the extent to which all of the significant variables taken together can explain compliance behaviour the data were analysed by forward-step logistic regression. Results show that the final model of five variables can correctly classify 84% of respondents. Each of these variables is also independently significant (see Table 2). Thus, if we knew that a

Table 2: Results of logistic regression analysis on the two compliance groups

Variable	% cases classified correctly	Chi Squared		N
		Model	Improvement	
Underdeclaration leads to profit	76.6	34.45***	34.45***	198
What friends say	82.8	50.71***	16.26**	198
Egoism	84.3	60.43***	9.71*	198
Attitude to evasion	83.3	65.50***	5.07*	198
Purpose of VAT	84.3	70.46***	4.61*	198

person believed that underdeclaring profits could substantially contribute to profits, that they believed their friends to be relatively undisapproving if they sometimes underdeclared VAT, that they had an egoistic personality, a positive attitude to evasion and believed that VAT had a specific purpose, we could say, with a good degree of certainty, that these people are non-compliers.

Discussion

Though these results are valuable, there are two obvious threats to the validity and generalisability of the findings. First the response rate is poor and this raises concerns about the representativeness of the sample. Second, as all of our measures rely upon self-report and we are dealing with sensitive issues, one needs to consider how valid the responses are. We believe that the similarity in responses of the late- and early- responders suggests that the sample is reasonably representative of VAT registered catering and

flooring/furniture businesses in the United Kingdom as a whole. We also believe that the anonymity afforded people in this study means that the responses given are generally valid. Studies in related areas (for example, black labour market participation - Kazemier & Van Eck, 1992) show that questionnaire surveys lead to only a slight to moderate underestimate of the incidence of illegal behaviours. Whilst some of the respondents may well have minimised their participation in VAT evasion and that the self-report measures are not perfect, we are confident that the non-compliant group is more non-compliant than the compliant group. From a methodological point of view it is encouraging that adding a number of compliance-related (but less sensitive) questions to the single straightforward self-report question produces an index which turns out to be predictable from our independent measures.

The comments from the open question asking respondents to list up to three powers that the relevant tax authority (HM Customs & Excise) have, show that people correctly believe them to be a very powerful body. Although the most reported power was 'inspection' the next most reported powers (that is, entry/search; fines; seizure of goods; legal action; power to bankrupt) all show the extent of the respondents' beliefs about their power. Those running small businesses generally do believe that non-compliers will come to the attention of the authorities and that the authorities are good at detecting errors and are likely to impose penalties for transgressions. However, none of the variables measuring perceived detection and punishment, except for 'businesses not paying properly would soon find themselves reported', differed significantly between compliers and non-compliers. Interestingly, compliers were less likely to believe that errors (however small) would be penalised even though they believed sanctions to be tougher against evasion. Thus, it would seem that compliers view the authorities as less authoritarian than non-compliers.

Reducing non-compliance is not, however, solely a matter of legal deterrence. A large proportion of people agreed that a businessman's reputation would suffer if he were discovered to have underdeclared VAT. This was also a significant variable between the compliant and non-compliant groups. This may mean that non-compliers believe that being caught evading would not have any affect on, not only his reputation, but also his business

success. In reality this is unlikely, as few people would agree that being caught in an illegal act would not be viewed by many of the public, and thus customers, in a negative light. If underdeclaring VAT were to be made more public by reporting incidents of fraud (with names) in the press it is likely that the reality of damaging a businessman's reputation was indeed perceived as detrimental.

The discussion so far has been concerned with ways of discouraging non-compliers. However, there is a fine balance here. This sample of small business people is generally honest and where non-compliance has been admitted, for the most part, it is a rare occurrence. Many of the respondents, however, do not seem to be sure about the incidence of fraud and this could be worrying as it raises the question of perceived equity and what steps people may take to redress the balance. This concept of equity is known as 'social comparison equity' and is well documented in the literature as a factor influencing compliance (see Cowell, 1992). As it is known that people do seem to look to their reference group and take action against a system to balance the equation, whereby it seems fair to the individual, there is clearly an educational role for the authorities to inform people that in fact the population seem to be generally honest and that fraud is not widespread. Thus, while informing the public that they are tough on non-compliers they should also inform them that most people are honest and that VAT fraud is uncommon.

Most people view evasion as wrong and the fact that some people believe non-compliance to be wrong and still admit to occasionally engaging in it is not an uncommon finding in taxation and other rule-breaking research. There may be a number of reasons for this, but a motivator to act against one's beliefs in this instance is likely, once again, to be a desire to create equity in the system. The fairness of the system is a significant factor in the predictive analysis between the two groups. What would appear to be important is the perceived unfair burden carried by small businesses. A large proportion of business people think that the VAT system is unfair towards small businesses. Previous research (Adams & Webley, 2001) suggests it is likely to be two prominent factors: first, the cost and effort of collecting the tax, and second, that small businesses do not have the resources to minimise the impact of VAT by employing experts to make use of loop-holes. Thus, if the tax

authorities could be seen to be closing down loopholes, this may create a more evenly balanced perception of the VAT system in the minds of small businessmen and women. To overcome the objections as to the costs of collecting VAT one possible way would be to reward business people for the collection.

As with much other rule-breaking behaviour, VAT compliance is influenced by social norms. The fact that non-compliers are more likely to say their friends would tolerate evasion is unsurprising. Smith and Kinsey (1987) found in investigating income tax evasion, that people's social networks help shape perceptions, norms and attitudes and can and do influence behaviour. Furthermore, Paternoster et al., (1983) have also found that social disapproval by significant others has an inverse effect on illegal behaviour. What we can not ascertain here is whether the respondents have indeed discussed the matter with their friends (though what little evidence there is suggests that discussing such matters is unlikely - Sigala, Burgoyne & Webley, 1999) or if there is just a commonly held belief that other people (including friends) tolerate fraud, perhaps because they may be engaging in it. If this is the case, once again an educational role, whereby the tax authorities inform their clients that most people do think that evasion is wrong and are generally honest may help reduce non-compliance.

Literature on how a person rates the service of an official body is thin on the ground, however, Adams (1996) and Van Giels and Elffers (1998) showed that how tax authorities behaved towards their clients does matter and this research confirms this. The general standard of service was highly rated by many, especially in respect of efficiency and courtesy. This was also a significant predictor of non-compliance and it would certainly seem there would be a pay-off in ensuring that high standards of service are maintained and even improved. Compliers were also more likely to find the rules acceptable, thus if it could be established what exactly non-compliers object to and a way were found to make the rules more acceptable to this group this may also have a positive affect. Interestingly, non-compliers were also less likely to believe that the rules were understood, and whilst this question was projective in nature, it may well be an indicator of their level of

understanding, providing another opportunity for the tax authorities to reinforce their advisory role and become more accessible to small businesses.

The findings for personality differences between compliers and non-compliers is now well documented in social psychological literature. Much recent rule-breaking work has shown that these personality differences do exist and do influence compliance (see Adams & Webley, 1996). However, there would seem to be little to be done as these traits are likely to be deep-rooted and not responsive to change. Indeed, the egoistic individuals identified in this study are also likely to be rule-breakers in other contexts. These findings for the personality differences highlight the 'social dilemma' nature of any taxation compliance. In social dilemmas people are faced with a conflict between the pursuit of their own individual outcomes. Non-compliance implies individual gain at some cost to others, whilst compliance implies gain to others at some cost to oneself. If, however, egoistic individuals could be assisted to reduce the conflict by helping them to perceive that they may benefit from VAT, this may reduce non-compliance. The people in this study who erroneously believed that VAT had a purpose such as European funding or funding administrative costs were significantly more likely to be non-compliant. Thus, they may become more favourable to VAT if they understood its general nature.

In an earlier qualitative study (Adams & Webley, 2001) differences were found between the catering trade and the flooring/furnishing trade. Similarly in this study some differences have been found. For example, catering businesses believed fraud to be more widespread and also believed that people are less honest in their line of business. There were also some differences in areas that separate compliers from non-compliers. For instance, the flooring/furnishing businesses believed the VAT system to be more equitable and the rules more acceptable. However, these differences do not appear to be robust enough to influence compliance and thus we have been unable to find clear evidence that the two groups differ significantly in levels of compliance. Also, mental accounting was not a significant predictor of compliance. It could of course be that it does not matter if people think of the VAT monies they collect as coming from their business, however, this is the first time this concept has been addressed in taxation research it would seem premature to

reach such a conclusion. The most striking finding in respect of mental accounting is the high level of people who ‘strongly agreed’ that the money is viewed as their part of their business funds. It may well be that the measure was not sensitive enough for the sample used and future research would need to refine it.

Younger respondents were more likely to be non-compliant and, as Adams and Webley (1996) have argued in other contexts, this is more likely to be a cohort effect, whereby people are generally becoming less respectful of the law and official bodies, than an age effect. This strongly argues for measures to be taken which break down some of the ‘them and us’ barriers between the authorities and people running small businesses with steps taken to create a more mutual working climate. The fact that compliers were more likely to have sought advice suggests that perceiving the authorities as supportive may improve compliance. The fact that non-compliers write their books up less frequently than compliers raises the question of whether this is done to facilitate fraudulent entries. Alternately, it may just be that these people are inherently less organised and that the last minute urgency required to undertake weeks or months of the necessary accounting required results in negative feeling towards the authorities and the paying of VAT, thus leading to non-compliance. If this is the case, Customs & Excise could try and encourage these people to see the benefits of keeping their books in order on a daily basis.

All five important predictor variables have, bar one, all been discussed. The belief that underdeclaring VAT can substantially contribute to profit needs little explanation, for without the belief there would be little point in engaging in, what is in fact, risky behaviour. What is likely to differ is not only the level of belief that underdeclared funds will increase profit, but also how much risk is perceived by the individual, as any profits to be gained will be offset by penalties imposed.

Overall, the message would seem to be that VAT payers, and non-compliers in particular, need to change the way that they perceive the tax authorities. They could be helped by the adoption of a more positive attitude by the latter through an emphasis placed on the advisory role and by a general education or reeducation of the true nature and purpose of

VAT and by making people aware that most VAT payers are honest. A more mutual working climate is likely to prove of benefit to both parties. However, it would also be prudent to reinforce the costs of non-compliance whilst emphasising how the system ensures fairness. This would serve as reassurance for existing compliers and as a warning to non-compliers.

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