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## Emerald Article: Tax compliance of small business owners: A review

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# Tax compliance of small business owners

## A review

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### Abstract

**Purpose** – Small business owners play an important role in the tax system. This paper seeks to establish a framework to highlight the particular tax situation of small business owners and the resulting implications, from a psychological perspective.

**Design/methodology/approach** – A framework identifying the key characteristics of small business owners' actual and perceived tax situation is established. Literature investigating these characteristics is reviewed in line with the proposed framework.

**Findings** – Three key aspects seem to distinguish small business owners' perceptions of their tax situation: small business owners are likely to perceive more opportunities not to comply than employed taxpayers; they are more likely to experience a lack of meaningful taxation knowledge; and they are more likely to face decision frames that render taxes as painful losses.

**Research limitations/implications** – The suggested link between the subjective experience of the tax situation and compliance calls for a focus on strategies that aim to influence taxpayers' perceptions of their own evasion opportunities, their level of legislative and procedural knowledge, and their sense of ownership of tax money. Such a strategy is suggested to be particularly likely to be effective in the phase of nascent entrepreneurship and in a climate of mutual trust between taxpayers and tax authorities.

**Originality/value** – This paper comprehensively identifies and reviews the perceptual correlates of factors unique to small business owners' tax behaviour.

**Keywords** Tax compliance, Framing, Perceived opportunity, Small business owners, Owner-managers, Taxes, Tax planning, Small enterprises

**Paper type** General review

### 1. Introduction

Small business owners are responsible for collecting as well as for remitting taxes (Christensen *et al.*, 2001). They are, hence, important players in a country's tax system. Though the evidence is not unequivocal (e.g. Hanlon *et al.*, 2007; Rice, 1992) most research suggests that small business owner-managers are more likely to cheat than other groups of taxpayers (e.g. Joulfaian and Rider, 1998; Kirchler *et al.*, 2006; Schuetze, 2002). Even the Organisation for Economic Co-operation and Development (2004) considers small business owners a high-risk group in terms of tax compliance. In many

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cases it is impossible to prove non-compliance. For example, the US Internal Revenue Service estimates that only half of corporate non-compliance is detected (Webley, 2004), and that tax audits are generally a costly matter. Increasing voluntary compliance among business owners is thus a worthwhile endeavour. In order to do so, an in-depth understanding of the factors fostering non-compliance is essential.

While paying taxes is likely to be an important topic for small business owners, the actual experience of paying taxes and small businesses' tax behaviours have received surprisingly little attention in the small business literature. For example, when searching the *International Journal of Entrepreneurial Behaviour and Research* for the term "tax," there are 53 hits but only two articles deal directly with tax behaviour (Rothengatter, 2005; Williams, 2005). Many other hits constitute predominantly qualitative research publications that focus on aspects of entrepreneurship other than taxpaying, for example human resource management (Leung, 2002), the entrepreneurial experience (Mitchell, 1997), or social processes of entrepreneurial innovation (Lowe, 1995).

This paper contributes to the quest of furthering our understanding of small business owners' tax compliance by pointing out that tax decisions tend to be made by and are personally relevant to small business owners, who can be characterised as individual decision makers. It follows from such a conceptualisation that tax decisions are susceptible to psychological influences. This reasoning forms the basis for what we consider the main contribution of this paper: in a conceptual framework we identify the main and unique characteristics (non-compliance opportunity, knowledge requirements, and decision frames) that may inform small business owners' perception of and reaction to taxation.

The paper is structured as follows: after defining the concepts used in the present paper, a brief overview of the literature on tax compliance is provided, followed by the presentation of a conceptual framework for understanding and investigating small business owners' particular taxpaying situation. The literature supporting the framework is reviewed. Building on this framework, a number of theoretical and practical implications are derived.

## 2. Definitions

Since the tax compliance literature typically does not distinguish between different forms of entrepreneurship and business sizes (for example micro businesses, small businesses, and medium-sized businesses), a broadly conceived definition of small businesses has been applied in the literature search. We refer to the Organisation for Economic Co-operation and Development (2004, p. 10), which characterises small businesses as:

> [. . .] any for-profit commercial entity other than those that exceed a given (high) asset threshold. Small businesses include sole proprietor, partnership and corporate forms of organisation. They also include individual return filers who have income from self-employment, even if self-employment income is not their primary source of income.

All these ventures are centred around a single individual (nearly always the owner manager, Hankinson *et al.*, 1997) or – in the case of team founders – around closely related people (for a similar conceptualisation of small businesses as individuals see for example Studdard and Munchus, 2009). These individuals usually make, or are accountable for, all managerial and operative decisions, including revenue generation and taxation. Their behaviour is crucial to the venture's success, which in turn tends to relate immediately and strongly to their personal income[1]. Hence, one way to view small business owners is to portray them as individuals whose behaviour is largely determined by their emotional as well as their rational perception of taxation, which is unlikely to be their core area of expertise. In larger businesses the operative side of taxation is entirely decoupled from such individual considerations. Issues of taxation are dealt with by experts who have limited personal interest in taxation outcomes and do not experience a direct link between company revenues and their own financial situation.

Tax compliance is defined as the full payment of all taxes due (Braithwaite, 2009). Tax non-compliance is referred to as any difference between the actual amount of taxes paid and the amount of taxes due. This difference occurs because of overstating and understating income, expenses, and deductions. Non-compliance comprises both intentional evasion and unintentional non-compliance, which is due to calculation errors and an inadequate understanding of tax laws (e.g. Robben *et al.*, 1990b; Webley, 2004). Taxpayer mistakes can be unintended and, thus, do not necessarily represent attempts to evade (Antonides and Robben, 1995) or may even lead to tax over-reporting.

## 3. General findings on tax compliance

The growing body of literature on tax compliance (for extensive reviews see Braithwaite, 2009; Kirchler, 2007) shows that both economic and psychological variables need to be considered to understand compliance (e.g. Erard and Feinstein, 1994; Organisation for Economic Co-operation and Development, 2004). Although the findings are not equivocal (e.g. Mason and Calvin, 1984, fail to find the usually documented link between compliance and fairness), researchers broadly agree that procedural and distributional fairness perceptions (e.g. Kim, 2002; Murphy, 2004), knowledge about taxation (Eriksen and Fallan, 1996), personal and social norms of tax compliance (e.g. Ashby *et al.*, 2009; Rothengatter, 2005; Wenzel, 2005), personal attitudes such as risk attitudes or egoism (e.g. Kirchler, 1997), tax rates (e.g. Alm *et al.*, 1992), and (perceived) audit and detection probabilities (e.g. Witte and Woodbury, 1985) combined with deterring fines (e.g. Grasmick and Bursik, 1990) relate positively to compliance.

In addition, particularities of national tax law and culture relate to tax compliance. The "shadow economy" as a proxy for tax evasion varies dramatically across countries; ranging from around 10 per cent of GNP in Switzerland, Austria, the US and Japan, to slightly below 30 per cent in Italy and Greece, to 46 per cent in the Russian Federation, and to 67 per cent in Bolivia in the year 2000 (Schneider and Klinglmair, 2004). The political history of a country, acceptance of government, social distance between citizens and political authorities (Bogardus, 1928) as well as religion are just a few of the national cultural characteristics that affect the citizens' willingness to cooperate with authorities in general and tax authorities in particular.

Despite non-compliance often being perceived as socially acceptable (e.g. Kirchler, 1998; Song and Yarbrough, 1978), people – including small business owners (e.g. Adams and Webley, 2001; Hite *et al.*, 1992) – are significantly more compliant than predicted by neoclassical economists who assumes that compliance depends predominantly on audit probability and fines (e.g. Andreoni *et al.*, 1998)[2].

## 4. Studies comparing small business owners with other taxpayers

Ahmed and Braithwaite (2005) compared a sample of Australian small business owners with employed taxpayers and found that they did not differ in terms of the following factors: subjectively perceived deterrence from non-compliance; subjective probability of being caught for tax evasion; preference for aggressive tax planning; cooperation with and resistance against tax authorities; attitudes towards equity issues; personal norms of tax honesty; tax morale; and the level of admitted tax evasion. In line with these findings, a scenario study showed no significant differences in terms of hypothetical tax compliance between fiscal officers, business lawyers, and small business owners (Kirchler *et al.*, 2003).

Although there are no notable differences in attitudinal variables, self-employed people perceive a significantly stronger imbalance between their own tax burden and state refunds; they feel a slightly higher subjective tax burden; and they feel they benefit much less from governmental benefits than other groups of taxpayers (Kirchler and Berger, 1998). Not surprisingly, small business owners were also shown to hold less favourable fairness perceptions in terms of distributional (e.g. Strümpel, 1966) and procedural (e.g. Adams *et al.*, 1996) fairness[3]. Other studies add to that picture by showing that small business owners hold different mental representations of taxes than employed people. For the self-employed, the stimulus word “tax” tends to elicit thoughts of tax complexity and the limitations that taxes impose on a business. For the employed, “taxes” are often associated with a necessary burden and considerations of justice (Kirchler, 1998). Although business owners were found to be less supportive of spending tax money on education, health, unemployment, and social welfare programmes, their commitment to values associated with security for the community and nation was even higher (Ahmed and Braithwaite, 2005).

Importantly, experiences with and competence in tax matters differed significantly between small business owners and all other groups of taxpayers (Ahmed and Braithwaite, 2005): small business owners reported more experiences of contested assessment, audits, and sanctions, signalling that this group is particularly likely to be audited due to its unique exposure to the tax system. As a consequence, small business owners may attest more power to tax authorities and report that they lack competence and autonomy in dealing with tax matters (Ahmed and Braithwaite, 2005).

## 5. A framework of factors influencing small business owners’ tax compliance

In contrast to the majority of employed people – who in many countries are paid net salaries with taxes being deducted at source – small business owners often need to self-assess and self-report their income and pay taxes “out of their pocket.” Small business owners not only pay their income tax but need to take account of various types of business taxes such as corporate tax, property taxes, and payroll taxes; they need to collect sales taxes such as VAT; and they need to withhold taxes such as personal income taxes in the case of having at least one employee (e.g. Christensen *et al.*, 2001). We assume that the various types of taxes and taxation requirements may significantly shape the perceived tax situation of small business owners.

Based on an initial review of the literature on small businesses' tax behaviour, three main characteristics of small business owners' tax situation emerged:

- due to self-reporting and limited control over underlying money flows, they have the opportunity for non-compliance;
- due to the need for self-reporting and facing different taxes, they require substantial knowledge in order to understand the rules and comply; and
- due to receiving gross sums that then have to be partly passed on to tax authorities, they face differential possibilities for framing taxes (cf. Weigel *et al.*, 1987).

In our framework of factors influencing small business owners' tax behaviour, we have adopted a psychological perspective and propose that the three identified main characteristics determine small business owners' tax behaviour (Figure 1). The framework assumes that the three main factors play a universal role for small business owners. It acknowledges, however, that the specific extent of for example perceived opportunity is co-determined by inter-individual factors such as risk-seeking, age, and gender (e.g. for an effect of gender see Kastlunger *et al.*, 2010; Robben *et al.*, 1990b), and situational factors such as line of industries (e.g. Andreoni *et al.*, 1998; Schuetze, 2002), relevant group (social) norms and social networks (e.g. Peterson, 2001; Rothengatter, 2005; Smith and Oakley, 1994), business forms (e.g. Hite *et al.*, 1992), and jurisdictions and cultures [e.g. differences between Dutch and Albanians (Gerxhani and Schram, 2006)] will have a direct and indirect impact on small business owners' tax behaviour and compliance. For example, different formal administrative requirements come along with different evasion opportunities, knowledge requirements, and framings. Similarly, non-compliance varies substantially across nations and there is a clear case to be made for the importance of cross-cultural and cross-national differences

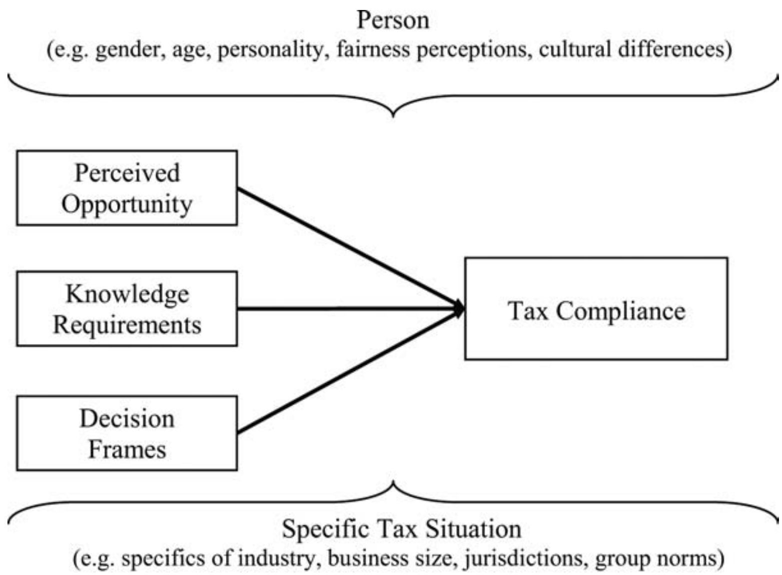


**Figure 1.**
A framework of factors influencing small business owners' tax compliance

(Tsakumis *et al.*, 2007). Most of the existing evidence does, however, not allow disentangling various legislative, administrative, cultural, and political causes for observed cross-national differences. In the interest of focus and brevity, this article focuses solely on those factors that tend to be of universal importance in the case of small businesses: (perceived) opportunity, knowledge requirements, and differential framings. The framework acknowledges that the concrete manifestation of these factors is itself influenced by the wider context which shapes an individual business' specific tax situation.

*5.1 Perceived opportunity*

Business owners are often mentioned as a high-risk group in terms of tax compliance because their opportunities to evade are high. Opportunity has often been documented as a major explanatory factor in non-compliance (e.g. Antonides and Robben, 1995; Robben *et al.*, 1990a; Webley, 2004). In particular, if incomes are not subject to automated third-party reporting, or if taxes are not withheld at source (e.g. in cases of receiving gross incomes or cash payments), opportunities to evade taxes exist (e.g. Shane, 2003; Shaver and Scott, 1991; Williams and Round, 2009).

The link between opportunity and non-compliance seems to have at least two different facets. First, in cases where people do not deliberately capitalise on opportunities, the specific circumstances leading to evasion opportunities might still lead to non-compliance. Opportunities usually come about when tax filings are not entirely automated. Through the lack of automation tax filing procedures are more likely to become error prone even without intent to capitalise on the entailed opportunities. Consequently, opportunities may lead to an increase in intended as well as unintended non-compliance. For instance, Robben *et al.* (1990b) show that an experimentally induced opportunity to cheat (more possibilities to deduct non-deductible expenses) increased non-compliance regardless of whether the participants actually intended to be non-compliant or not.

Second, assuming that people are willing to capitalise on opportunities, they are able to do so only if the opportunities are recognised in the first place. However, opportunities to evade often tend to remain unnoticed. While many taxpayers perceive opportunities for evading small amounts, only a minority perceives opportunities for evading larger amounts (Antonides and Robben, 1995). Such failure to perceive opportunities even persists in laboratory experiments explicitly manipulating opportunity. Whereas controlling for intended evasion annihilated the effect of opportunity on evasion, simultaneously controlling for intended evasion and perceived opportunity re-established the main effect of opportunity on non-compliance (Robben *et al.*, 1990b). Indeed, it has been shown that those actually evading perceive increased opportunities to do so (Ashby *et al.*, 2009; Wallschutzky, 1984).

Overall, actual opportunities can increase both intentional and unintentional evasion. Although such a distinction is theoretically and practically meaningful, it is difficult to determine whether filing errors were intentional or not. For example, in a study by Slemrod *et al.* (2001), taxpayers were informed that their tax files would be closely examined. Those with considerable opportunities to evade, including small business owners, reacted to this message by increasing their tax payments significantly[4]. Even though this might indicate severe tax evasion – as assumed by Slemrod *et al.* (2001) increased tax payments in response to the prospect of being audited may also originate from increased willingness to avoid errors. Those taxpayers facing high opportunities for evasion might feel less certain about how to pay their taxes correctly (Ahmed and Braithwaite, 2005), and consequently, threats may also elicit partly unintentional over-reporting: just to be on the safe side.

To conclude, opportunity is a key constituent of small business tax compliance and its role is moderated by its perceptual correlates. Given the opportunity to evade, those unwilling to evade may become involuntarily non-compliant and those willing to evade may fail to perceive the chance to do so. In order to determine the actual effect of opportunity, it is necessary to control for compliance intention as well as opportunity perception.

*5.2 Complexity and knowledge requirements*

In order to pay appropriate taxes small business owners must be knowledgeable about the different compliance measures and requirements. Taxation knowledge is a specific part of the general human potential of entrepreneurs, which increases the chances of business success (Haber and Reichel, 2007). The extent of non-compliance arising from knowledge deficits because of the complexity of reporting and returning requirements might be substantial: in the UK, for example, VAT non-compliance mostly results from errors that do not stem from evasion intent [only 3 per cent are attributed to tax-evasion (Webley, 2004)]. Similarly, differential taxation, that is, the need to apply differential taxation rules depending on the amount of income or the characteristics of the taxpayer, is an important explanation for non-compliance among small business owners (Joulfaian and Rider, 1998): excluding source misreporting (that is, looking at the overall reported income independent of the reported source) decreases non-compliance rates substantially.

Note that although an increase in opportunity will often be accompanied by increased knowledge requirements, this is not necessarily the case. For example, if the proportion of differentially taxable incomes changes, evading opportunities may be affected while knowledge requirements remain constant. Thus, as indicated in the framework, knowledge requirements are discussed separately from opportunities.

Navigating through the legal and procedural issues related to taxation is often taxing in itself. In many countries several (sometimes complicated) forms need to be completed, and detailed records need to be kept (e.g. for reporting requirements in Canada see Maingot and Zeghal, 2006). Substantial knowledge about the procedural aspects of tax laws is required. This is particularly challenging since tax laws tend to be changed frequently (Chittenden *et al.*, 2003) and to be more complex and ambiguous than laws in general (Carnes and Cuccia, 1996)[5]. Tax laws are often too complex to be understood by laymen (for a review see Kirchler, 2007), which many small business owners undoubtedly are. They were shown to have less tax knowledge than business students in an Austrian study (Kirchler *et al.*, 2003) and felt less competent in making their tax filings than employed persons with even less tax knowledge in an Australian study (Ahmed and Braithwaite, 2005). Though small business owner-managers often deal with (perceived) knowledge deficiencies by seeking the help of tax practitioners, they tend to handle part of the taxpaying process themselves (e.g. Coolidge *et al.*, 2009) and will, at least, have to keep the necessary records. Acquiring taxation knowledge is costly in terms of time (e.g. to become informed, to keep the records, to fill out the forms) and money (e.g. tax literature, tax practitioners). Across jurisdictions, compliance costs have been consistently shown to be highest for small businesses (e.g. Chittenden *et al.*, 2005; European Commission, 2004; Joumard, 2002; Pope and Abdul-Jabbar, 2008) – in particular if incomes are (still) low (e.g. Blumenthal and Slemrod, 1992). For example, in a mail survey, holding all else equal, self-employed business people spent an extra 35 hours and 69 dollars on tax handling compared with employees (Slemrod and Sorum, 1984).

Although there has been a trend towards simplification of tax laws and, more importantly, tax administration procedures (for example by the Australian Tax Office and European tax collectors; Braithwaite, 2009), compliance costs tend to remain high (Chittenden *et al.*, 2003) and a sufficient level of knowledge necessary to ensure procedural compliance is more difficult to reach for small than for large businesses (Gaetan, 2008). Also, tax practitioners acknowledge that the complexity of taxation is making compliance especially difficult to achieve for many small businesses (Berkery and Knell, 1992). It can be assumed that, sometimes, small business taxpayers are not even sure about whether they are fully compliant or not. For example, in several countries the distinction between the earnings/income from labour and capital is particularly hard to draw in the case of small businesses (e.g. Strand, 1999; Van Den Noord, 2000) and self-reported evasion within small businesses did not match actually documented non-compliance (Webley, 2004). This latter finding might be interpreted as resulting from a lack of taxation knowledge.

However, findings on the relation between knowledge and tax compliance are mixed. On the one hand, highly educated groups were shown to agree more with existing fiscal policies than less educated groups (Schmölders, 1960). Indeed, a low perceived complexity of tax laws (e.g. Kirchler *et al.*, 2006); education concerning taxation (e.g. Kasipillai *et al.*, 2003) as well as subjective (Kirchler *et al.*, 2006) and actual tax knowledge (e.g. Kirchler and Maciejovsky, 2001) were shown to relate positively to (hypothetical or intended) compliance. On the other hand, some researchers found that education was negatively related to compliance (Antonides and Robben, 1995) – also for small business owners (Hite *et al.*, 1992), whereas again others found no clear pattern of non-compliance across levels of education among the self-employed (Schuetze, 2002). Further adding to the contradictory pattern, Chan *et al.* (2000) found a small positive effect (via tax attitudes) of education on tax compliance in a US sample, whereas in a Hong Kong sample, education and compliance were unrelated.

Although these cumulative findings are contradictory at first sight, a closer inspection indicates that the type of knowledge matters; both general knowledge in terms of education as well as tax-specific knowledge influence the ability and willingness to comply or evade. General knowledge seems to be used to evade as often as it is used to comply. In contrast, tax-specific knowledge tends to lead to an increase in compliance; presumably because to learn about taxes also means to learn about their necessity in society or because this specific knowledge is a greater deterrent[6]. In fact, the pre- and post-tests of two groups of Norwegian students, who took part in either a tax law course or a marketing course, suggest that specific tax knowledge renders tax attitudes more favourable; increases fairness perceptions of the tax system; and leads people to perceive (their own) tax evasion as more serious (Eriksen and Fallan, 1996). To conclude, knowledge requirements for small business owners' tax compliance are relevant. Tax-specific knowledge is necessary in order to enable small business owners to comply, as well as to increase their willingness to do so.

*5.3 Decision frames*

Most taxes paid by employed people are withheld from the outset or included in gross prices. In contrast, small business owners typically pay their taxes "out of their pocket." In other words, while employed are passive recipients of information about the amount of taxes they pay, small business owners dispose of their gross income, which is mentally perceived as their own money, and actively determined taxes represent a loss. Paying the tax share out of one's own pocket represents a loss frame. While paying taxes typically constitutes a loss for small business owners, it constitutes a non-gain for taxpayers whose taxes are withheld at the source.

Research based on "prospect theory" (Kahneman and Tversky, 1979) has demonstrated that the perceived pain of a loss is greater than the perceived pain caused by an equally sized non-gain (e.g. Idson *et al.*, 2000). Furthermore, prospect theory suggests that people are more risk-seeking in the loss domain than in the gain domain. For small business owners, it might, thus, not only be painful to pay taxes, but the loss-framing might also make them risk-seeking. Tax non-compliance could be a consequence. However, as Chang *et al.* (1987) point out, there are other possible decision frames. Taxpayers can either view the compliance decision as a choice between a certain loss (tax payment) and a possible larger loss (tax payment plus penalty if audited); or they can view it as a choice between a certain reduced gain (net income after tax payment) and a possible larger gain (gross income without tax payment if not audited).

To test which frame was mostly applied, Chang *et al.* (1987) designed a tax lottery and asked executive MBA students how they perceived the lottery – whether they applied a "loss frame" or a "gain frame." Those applying a loss frame were significantly more risk-seeking; more likely to report to gain less from the government than they paid; more aware of tax evasion practices among others; more knowledgeable about taxation; younger than those applying a gain frame; and, most importantly, more likely to belong to the group of small business owners in the lottery experiment.

A related stream of literature might further explain why small business owners apply the painful loss frame. The theory of "mental accounting" (Thaler, 1985; Thaler, 1999) refers to the cognitive processes that individuals use to keep track of and group (monetary) costs and benefits. Mental accounts constitute frames for outcomes that influence the perception of these outcomes. Only if taxes are perceived as different from other streams of income, hence are booked to different mental accounts will they be treated differently. As long as taxes due are seen to form part of the mental income account, paying taxes hurts and is perceived as reducing income. Even for taxes that only need to be collected and transferred, such as VAT, mental accounting might come into play and have an impact on how willingly taxes are handed over. A study of business owners (Adams and Webley, 2001), a UK survey among business owners, and a business simulation study reported by Webley (2004) supported the assumption that many business owners regarded themselves as owners of VAT money (at least at some point in time) while only a minority viewed themselves as collectors. The perception of ownership indicates that tax money is not held in a separate mental account but mentally booked to accounts holding income. Perceiving VAT money as belonging to oneself was related to stronger inequity perceptions of the tax system (Adams and Webley, 2001) and to increased (self-reported) non-compliance (Webley, 2004). The perception of VAT money as something "briefly owned then taken" may explain the dislike many small business owners reported paying VAT (Adams and Webley, 2001).

Another line of argument for differential framing by small business owners can be derived from "reactance theory" (Brehm, 1966). Paying taxes can be perceived as a reduction of one's own financial resources and as a limitation of one's financial freedom. The perception of taxes as a limitation of financial freedom is particularly likely in response to experiencing tax payments as "out of pocket" losses. As a consequence, small business owners are more likely to experience and frame taxes as threats to their personal freedom than other groups of taxpayers (Kirchler, 1998). Brehm's (1966) reactance theory suggests that people respond to a perceived loss of freedom by reactance and by endeavours to re-establish the lost control. One way to achieve this in the context of taxes is non-compliance. Evidence on the role of perceived limitation of freedom is mixed. On the one hand, Kirchler (1998) found that for entrepreneurs the word tax evokes associations indicating a perceived threat of freedom (e.g. punishment, disincentives to work, and public constraints) more often than for blue- and white-collar workers, civil servants, and students; and a survey of business owners (Kirchler, 1999) found a direct and strong link between perceived limitation of freedom and hypothetical tax evasion (although no link of perceived limitation of freedom and tax attitudes and morale was found). On the other hand, a survey among business owners (Kirchler and Berger, 1998) found no relation between perceived limitation of freedom and hypothetical tax behaviour.

In addition to the general likelihood of loss framings in the first place, the specific tax situation of small business owners is likely to make paying taxes even more painful: compared with other taxpayers and at the time of tax filing, they seem to be more likely to face an outstanding tax balance rather than a refund (Ahmed and Braithwaite, 2005). The impact of additional tax payments and refunds on compliance is well documented. For example, a 1988 US Internal Revenue Service report referred to by Robben *et al.* (1990b) indicated that voluntary tax compliance varied depending on whether a refund or an additional payment was due and depending on the size of such a refund or payment. Small business owners who claimed substantial refunds (more than $1,000) were significantly more compliant (95 per cent) than those facing an equally substantial balance due (70 per cent). This finding was corroborated by survey studies (e.g. Ahmed and Braithwaite, 2005; Joulfaian and Rider, 1998), by an experimental business simulation carried out in six different countries (Robben *et al.*, 1990b), and by several experiments (e.g. Schepanski and Shearer, 1995)[7]. There are even some empirical indications that tax preparers exploit the positive effects of tax refund frames. Those who have their taxes professionally prepared are more likely to receive refunds. Tax professionals may do this on purpose (Jackson *et al.*, 2005). Receiving a refund increases taxpayers' willingness to pay for tax services (see also Lowe *et al.*, 1993).

Few studies conducted in this area distinguish between different types of businesses. Kirchler and Maciejovsky (2001) contrasted self-employed persons and small business owners in order to find out whether they framed tax payments and refunds differently. They reasoned that differences in accounting principles implied by tax codes might influence the reference point applied. For example, in Austria, small business owners are required to carry out accrual accounting. This necessitates long-term planning and, hence, anticipating and planning for additional tax payments. Kirchler and Maciejovsky (2001) found in their study using scenario techniques that even if the self-employed were given information that allowed them to anticipate additional tax payments or refunds, this information did not influence behaviour. Upon being informed about the outcome of their tax returns, they generally reacted with increased compliance towards tax refunds and with decreased compliance towards additional tax payments. Conversely, small business owners were sensitive towards information on expectations. Expected refunds had a positive effect and expected payments had a negative effect on compliance, whereas neither unexpected refunds nor unexpected payments had an impact on self-reported tax compliance.

To conclude, differential framings of tax payments matter in particular for small businesses' tax compliance. Small business owners are more likely to frame paying taxes as the loss of something that was previously theirs – even if they acted as collectors only – and they are more likely to view paying their taxes as a limitation to their freedom. In addition, small business owners are frequently made aware of these limiting losses by experiencing an additional "loss" (tax payment) after tax filing.

## 6. Discussion and conclusion

Tax non-compliance is often hard to prove[8]. Consequently, measures beyond tax audits are needed to tackle non-compliance (Kirchler, 2007). Such measures ought to be based on knowledge about the factors leading to non-compliance in the first place. In the case of small business owners, tax decisions are often personally relevant, individual decisions. Such decisions are likely to depend on the psychological perception of the situation. In our framework we argued that small business owners face circumstances that translate into particularly averse decision influences. Due to their individual nature and their specific tax situation they find it difficult to understand and comply with taxation procedures, they face decision frames that favour non-compliance, and they have and are likely to perceive enhanced opportunities not to comply. Building on this framework a number of theoretical and practical implications can be derived. In particular, we argue for the need to focus interventions on nascent entrepreneurs.

### *6.1 Theoretical implications of the framework*

One of the main features of our framework is to view small businesses' tax situation from a psychological, and in particular experiential, perspective. Paying taxes is presented as a decision that is informed by perceptions. We suggest that factors increasing the personal relevance of the taxpaying business owner relate to the importance that perceptions have in tax decisions. Specifically, all the factors that (psychologically) tie a business owners' fate to the fate of the company will increase the perceived pain of paying taxes. One such factor is the relation between personal and company income. The stronger the link, the more likely paying company taxes will be perceived as painful. Another relevant factor in this context is psychological ownership (e.g. Mayhew *et al.*, 2003; Pierce *et al.*, 2003; Van Dyne and Pierce, 2004). We posit that the degree of psychological business ownership experienced by the person(s) involved in making tax decisions predicts the experienced reluctance to give something (in this case: taxes) away from the company. There are several factors that influence the extent of psychological ownership. For example, the number of co-owners (the less co-owners, the more psychological ownership; Kamleitner and Rabinovich, n.d.), the asset structure (for the effect in franchise entreprises; Hou *et al.*, 2009), and work environment structures (the less structured, the more psychological ownership; O'Driscoll *et al.*, 2006) are able to influence psychological ownership. In turn, we expect that all these factors influence tax perceptions and behaviour.

Considering the psychological link between a person and her or his company also highlights an important boundary condition to our framework. If paying taxes is left to the owner-manager then outsourcing this task to tax planners and advisors should moderate the suggested relations. Most databases on tax compliance do not contain detailed information about the extent to which tax planners and advisors have been involved. It is therefore impossible to account for this systematically in a literature review. In future research, it would be interesting to investigate the possibly complex relationships between the use of tax professionals, personal relevancy of taxpaying (including individual-company income links and psychological ownership), and the perception of the tax situation and tax behaviour.

Another promising line for future research relates to an investigation of how specifics of the tax situation (e.g. industry and cultural norms) relate to the extent of perceived opportunities, knowledge requirements and decision framings. We expect that many findings that point towards, for example, cultural differences in compliance (Tsakumis *et al.*, 2007) are at least partly mediated by accompanying differences in the three identified key factors.

### *6.2 Practical implications of the framework*

The issue of small businesses' tax compliance has been acknowledged by authorities and researchers on several occasions. The most frequent suggestion in this respect has been simplifying the taxation process (e.g. Joumard, 2002). Steps such as unifying taxes or simplifying administrative requirements are indeed in line with our framework. However, the proposed framework and its focus on the psychological underpinnings of compliance impediments suggests that measures are needed on a structural as well as an individual level, that is, where perception takes place.

Changing non-compliance opportunities requires structural changes to the tax system. The increasing influence of electronic data storage and transfer has contributed to a reduction in opportunities and is likely to continue to do so in the future. Our framework suggests that taxpayers' opportunity perceptions are what matter most. Actual changes in opportunity are not necessarily perceived as such. One way of reducing the perceived opportunities is to increase the salience of detection likelihood or consequences. Based on our overall review we argue against this. Salience of punishment has the potential to create a threatening image of tax authorities, which may reduce voluntary compliance (Murphy, 2004). The reverse side of the coin is to increase the salience of norm-adhering behaviour. Learning that most taxpayers are compliant may not only strengthen tax morale, it may also (indirectly) raise the suspicion that non-compliance is likely to be detected. Future research that identifies new ways of decreasing perceived opportunities in a non-threatening manner, or consequences of different ways of communicating changes in evasion opportunities (e.g. being sent information material) on the perception of opportunities is a promising research avenue.

Knowledge requirements are difficult to change. Nevertheless, some successful attempts to increase legal and effective simplicity (for a comprehensive review of simplification possibilities see Tran-Nam, 1999) have been made in various jurisdictions across the Organisation for Economic Co-operation and Development (e.g. Australia has introduced a pay-as-you-go system to reduce the strains associated with cash flows[9]).

Based on our framework and review we argue that in addition to simplifying taxation factually, taxpayers have to be in a position to understand and cope with the administrative and legal requirements. One possible route of action is to increase small business owners' level of tax knowledge. There is evidence that even for experienced taxpayers involuntary non-compliance goes down as taxpayers learn, for example, how to complete forms (Antonides and Robben, 1995). However, with increasing tax knowledge taxpayers learn both how to comply and how to evade (taxation knowledge also decreases perceived audit probability Andreoni *et al.*, 1998) efficiently. Our review suggests that depending on the effect of knowledge on tax morale and compliance intention, increasing knowledge could lead to both a decrease in unintended non-compliance and an increase in intended tax evasion. Ideally taxation knowledge should, hence, be acquired in ways that simultaneously increase the salience of the benefits of a tax system. Though there are clear benefits to increasing taxation knowledge among small business owners, because of their ambivalent nature actual education programmes require substantial and careful pretesting. The potential for adverse effects on compliance is not the only reason for pretesting needs. Pretests are also essential in ensuring that learning actually takes place. The availability and accessibility of information may not be sufficient for small business owners to learn and meet the knowledge requirements. For example, the information provided (e.g. tax laws) may be difficult to comprehend or be comprehensive to the point of being discouraging, or taxpayers may simply refuse to make use of it. It is crucial to ensure that information transfer takes place and is followed by an increase in (perceived) tax competency and ideally also tax morale. A climate of mutual trust between taxpayers and authorities is a likely prerequisite to enable both outcomes (cf. Kirchler *et al.*, 2008).

Decision frames directly relate to the cognitive costs of compliance and hence to the willingness to comply. In contrast to tax knowledge internal framings are hardly recognised as part of the problem. In order to diminish the pain of paying taxes and enhance the willingness to comply, it is recommendable to discourage the application of a "loss" frame. The mental accounting literature (cf. Thaler, 1999) suggests that this may be achieved by encouraging taxpayers to book tax payments on separate mental accounts. Having separate tax accounts might help to avoid feelings of ownership of tax money and hence feelings of loss when taxes are due. Evidence of this comes from interviews with business owners. Some of those who held separate mental accounts for VAT reported that quite early in their business life it was made clear to them that VAT money is only collected and never possessed. Such an early encounter with this strong message might have contributed to the formation of a separate mental tax account (Adams and Webley, 2001). Another way to establish separate mental accounts for tax money is to focus on net prices. If business owners only communicate with their customers in terms of net prices or mainly think of net prices themselves, taxes are more likely to be booked on separate mental accounts (cf. Adams and Webley, 2001). An interesting research implication is to establish the degree to which differences in price communication (net vs gross) relate to differences in tax perception and compliance across countries.

Mental accounting also focuses on the costs and benefits of transactions (Prelec and Loewenstein, 1998). Most small business owners report that when handing over VAT they do not feel the connection between public goods or benefits and tax money strongly (Adams and Webley, 2001). As a result, they are often not aware of what they are paying for. In addition, they frequently perceive to benefit less from those public services that are most often in the media, such as pension systems and unemployment insurance. It seems necessary to outline the benefits received from the redistribution of tax money. Making this link clear and salient and maybe even helping small business owners to establish automatic cost-benefit associations has been argued to reduce the perceived tax burden and influence compliance positively (Kamleitner and Hölzl, 2009). Empirical support for this suggestion comes from research by Schwartz and Orleans (1967), who found that salience of moral reasons for compliance ("please contribute to public welfare by paying your share") and hence of cost-benefit associations helps to increase compliance, even more than stressing the severity of sanctions (1967 – is this really supporting evidence?).

The suggestion of fostering cost-benefit associations relates to internal framings, to taxation knowledge, but also to fairness considerations. Although this is no phenomenon specific to small businesses, fairness is an important consideration in tax decision making (e.g. Rawlings, 2003). Lack of trust in the fairness of a tax system and the legitimacy of tax authorities increases the likelihood of tax evasion among small business owners (Webley, 2004).

Trust in and perceived fairness of a tax system and authorities influence several perceptions directly and indirectly. It is a key to taxpayers' acceptance of messages (e.g. the likelihood of evasion detection) and support (e.g. information on taxation, framing) provided by tax authorities. To ensure fairness, several authors suggest a dialogic approach to address non-compliance (e.g. Braithwaite, 1995; Leviner, 2009; Rothengatter, 2005). An argument is made first to educate, inform, advise, and help taxpayers before threatening with the "big stick" and enforcing compliance via severe sanctions (e.g. Ahmed and Braithwaite, 2005; Kirchler *et al.*, 2008; Shover *et al.*, 2001).

### *6.3 Focus on nascent entrepreneurs*

The term "nascent entrepreneurship" is commonly used to describe the process of business development, from business conception to the early phase of business development (Davidsson, 2006). During these early phases of a business, tax authorities are argued to be particularly successful in influencing knowledge and internal framings and in establishing a climate of mutual trust. Nascent entrepreneurs face the liability of newness and tax handling is only one of several challenges to master (e.g. Berkery and Knell, 1992; Malach *et al.*, 2006). Having to adjust to the new role and the accompanying expectations (Wincent and Örtqvist, 2009), not (yet) understanding how to comply, and being incompetent can lead to several errors during tax filing and thus to involuntary non-compliance (Webley, 2004). In the start-up phase experienced threats to freedom are argued to be especially strong. Giving away some of the first money earned is a particularly painful experience that lends itself to being framed as a loss of something owned; in particular since one route into start-ups is via test runs with undeclared and therefore tax-free work (Williams, 2005).

A further argument for focusing on nascent entrepreneurs is that they have not yet established certain behavioural and perceptional patterns that will become more difficult to change the longer they persist (Guala and Mittone, 2005). Consequently, interventions are likely to be received positively. It is hence in particular in the case of nascent entrepreneurs that a strategy of responsive regulation that involves support and advice before punishment (e.g. Braithwaite, 1995) will be effective. First encountering the "big stick" might backfire and turn involuntary non-compliance into aggressive resistance (Murphy, 2004). In contrast, an initial experience of support will build up a climate of trust between taxpayers and tax authorities. In turn this might speed up and/or enhance beneficiary learning processes and increase the willingness and ability to mould perceptions and comply.

Empirical evidence suggests that focusing on nascent entrepreneurs and supporting them at an early stage is indeed promising (Waters *et al.*, 2002). First, personal age was shown to correlate positively with the degree of compliance. This was also found within self-employed people (Hite *et al.*, 1992; Schuetze, 2002) and may indicate the importance of focusing on early processes of business development. Second, time in business correlated negatively with perceived loss of freedom (Kirchler, 1999) – indicating that over time entrepreneurs become used to paying taxes and as a consequence less reactant. Third, experimental simulations indicate particularly positive effects of audits on compliance if they occur early in the tax life (Kastlunger *et al.*, 2009; Mittone, 2006). Proposed reasons are that they lead taxpayers to overestimate audit frequencies (i.e. decrease perceived opportunity) and disable the experience of early rewarding gains from undetected evasion. We argue that – depending on the nature of the audit – deterrence is not all that matters. Early audits can equally be used to teach small business owners how to pay their taxes correctly and how to keep psychological and monetary compliance costs low.

**Notes**

1. Joel Slemrod (2004) argues that the tax situation of owners and businesses should be looked at simultaneously.
2. These predictions are derived from the usually low detection probabilities and small expected penalties.
3. Note, however, that Ahmed and Braithwaite (2005) found no difference with regard to perceived procedural fairness in Australia, which is at the forefront of jurisdictions applying measures to increase and facilitate voluntary tax compliance.
4. In contrast to low- and middle-income groups, high-income groups reacted by reducing their tax payments.
5. Whereas the overall mean of complexity ratings (on a seven point scale, from not complex to very complex) amounted to 2.55, the mean for tax items related to self-employment income amounted to 4.15.
6. We thank an anonymous reviewer for this suggestion.
7. There is experimental evidence that the effect of refunds and extra payments on compliance only arises if the situation is perceived as such (Blumenthal and Slemrod, 1992).
8. This might partly explain why self-reports often do not correspond to actual reports (Robben *et al.*, 1990a).
9. We are grateful to an anonymous reviewer for pointing out this example.

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