



***Research report***

# **Understanding key problems for SMEs: Hidden Economy Levers, Ghosts and Moonlighters**

Identifying effective levers to reduce entrants into,  
and encourage SMEs out of the Hidden Economy

**Business Customer & Strategy**

**May 2012**

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**Understanding key problems for SMEs*****About Business Customer and Strategy (BC&S)***

Business Customer and Strategy is part of Business Tax Directorate.

The goal of BC&S is to maximise Business Customer compliance for HMRC at best cost for both HMRC and the customer. This is done by developing business tax strategies through customer understanding, working with teams in HMRC and across government departments.

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## Understanding key problems for SMEs

### *Research requirement (background to the project)*

Last year BC&S commissioned qualitative research into why SMEs enter and operate in the Hidden Economy, and what actions HMRC could take to prevent businesses entering the Hidden Economy and/or encourage them to re-join the Formal Economy.

This earlier work identified six customer ‘typologies’ within SME customers in the Hidden Economy: ‘No Other Way’, ‘Trying To Keep Up’, ‘Well Paid Hobby’, ‘Following The Crowd,’ ‘Entrepreneur At Heart’ through to ‘Catch Me If You Can’. Each have distinct profiles which allow us to contextualise the differing barriers to change, interventions and advice on how to reach the target population, and what messages / interventions to avoid for each group.

This report covers the next stage of the research. The objective was to build on earlier thinking, and qualitatively test a range of potential ideas to explore what actions and interventions could maximise HMRC’s impact on the Hidden Economy.

The specific research objectives were to understand:

- The reasons and/or circumstances that cause SMEs to enter the Hidden Economy;
- The policies and/or processes that HMRC could use to prevent and/or discourage a SME’s decision to enter the Hidden Economy;
- The levers that HMRC could use to encourage SMEs to re-join the Formal Economy;
- The strategic approach HMRC should develop to tackle the Hidden Economy tax gap.

### *Who did the work (research agency)*

The research was conducted by The Futures Company.

### *When the research took place*

The research was conducted between January and March 2012.

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### *Method, Data and Tools used, Sample*

#### **Phase 1: Concept Development**

- Desk research / literature review and expert interviews
- 2 x concept development workshops drawing on a breadth of HMRC expertise
- Concept refinement and research stimulus development

#### **Phase 2: Qualitative Research, Round 1 (Test and Build)**

- 1 x group discussion, 120 minutes duration, 8 respondents:
  - SMEs at risk of entering the Hidden Economy
- 15 x depth interviews, 90 minutes duration each
  - SMEs in the Hidden Economy

##### General criteria:

- All have own 'hidden' business
- All have at least one totally undeclared source of income (HMRC is unaware of the income and no tax is paid on it)
- Mixture of Ghosts and Moonlighters
- Spread of demographics and industry types
- Spread of Hidden Economy typologies
- Hidden income(s) to be more than £15k p/a

#### **Phase 3: Concept refinement**

- Refinement of concepts based on Round 1 of qualitative research

#### **Phase 4: Qualitative Research, Round 2 (Test and Prioritise)**

- 2 x group discussions, 90 minutes duration each, 8 respondents in each group:
  - Group 1: SMEs at risk of entering the Hidden Economy
  - Group 2: Customers of SMEs potentially operating in the Hidden Economy (All to have bought and/or used goods or services from businesses in the past 12 months that they knew, or suspected were not paying tax)

- 12 x depth interviews , 60 minutes duration each
  - SMEs in the Hidden Economy

##### General criteria:

- All have own 'hidden' business
- All have at least one totally undeclared source of income (HMRC is unaware of the income and no tax is paid on it)
- All either Ghosts or Moonlighters (mix of both)
- Spread of demographics and industry types
- Spread of Hidden Economy typologies
- Hidden income(s) to be more than £15k p/a

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## Understanding key problems for SMEs

### *Main Findings*

#### **Understanding the context to Ghost and Moonlighter responses**

People respond to Hidden Economy interventions in a broader context. The Ghosts and Moonlighters spoken to in this research, all of whom were earning more than £15k p/a from their hidden income, believe it is both unfair and ineffective for government to target ‘their little bit’ of non-compliance. There are clear levels of anger at ‘government’ (in all its forms) amongst this group, particularly with reference to specific recent events reported in the press (e.g. MPs’ expenses, large business avoidance, etc). Success in tackling the Hidden Economy in part depends on tackling public perceptions of avoidance, corruption and waste in tandem.

Hidden Economy attitudes and behaviours are also reinforced by the current economic context:

- People are finding new ways to make money to plug the gaps in their household income – sometimes because they have to - and are more reluctant to declare their income;
- Hidden Economy activity makes it harder for registered small businesses to compete;
- Ghosts and Moonlighters often feel they are helping customers in tough times by offering cheaper (tax-free) prices;
- Customers are increasingly seeking good deals to save money where possible, so appetite for competitive prices/ businesses that under-cut exists and is possibly increasing.

Another key finding is that many Ghosts and Moonlighters do not regard themselves, nor what they do, as a ‘business’ and so do not recognise nor engage with ‘business’ language as they do not see it as being relevant to them.

#### **Reactions to different types of intervention**

We ensured that a spread of different types of interventions were explored in this research by developing concepts against a range of (ideation) platforms:

- Joint liability;
- Changing social norms;
- Benefits and rewards;
- Deterrents and repercussions;
- Education;
- Simplification and support;
- Conditionality;
- Intermediaries and partnerships.

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Some common reactions to the tested platforms indicated that:

### **Deterrents and repercussions:**

Reactions against perceived heavy-handedness can be strong. Imposing extreme penalties in isolation and taking an aggressive approach to communications runs the risk of increasing anger against 'government' and driving people further into Hidden Economy behaviours.

### **Benefits and rewards:**

Ghosts and Moonlighters find it hard to see any benefit to operating in the Formal Economy. They can count multiple benefits of operating in the Hidden Economy including flexibility, freedom, less hassle and more profit, but precious few of formalising their tax affairs. The cost / benefit equation is therefore heavily weighted against change (staying in the Hidden economy) and difficult to tip (towards coming out of the Hidden Economy).

### **Changing social norms:**

Ghosts and Moonlighters are often self-reliant, proud of their achievements and have strong justifications for what they do. Social norms aspects are also hard to leverage, as Hidden Economy participants believe that not being registered for tax does not mean that they are not contributing: many justify their contribution through being active in their communities and/or undertaking volunteering activities. They do not regard themselves as bad people and consider what they do to be fundamentally different from those who take without contributing (e.g. benefit fraudsters). Morals are not seen as 'black and white' and changing people's strongly-held perceptions of 'right' and 'wrong' is clearly an uphill struggle.

### **Education / Simplification and support:**

Many Hidden Economy participants' starting points are often also inaccurate: myths, misconceptions and confusion about what registering a business would mean in practice are commonplace. In some cases, most impact would be derived from ensuring clear and simple education about what's already in place, and how tax actually works, rather than looking to develop new concepts.

### **Conditionality / Joint liability:**

Ghosts and Moonlighters are naturally independent and find ways round 'officialdom', and so do not feel that conditionality restrictions would be sufficient to stop their activities. Ghosts and Moonlighters feel that they and their customers will find loopholes in any potential restrictions.

### **Intermediaries and partnerships:**

Those in the Hidden economy are more likely to seek and receive their information and advice from informal and/or trade specific channels rather than more formal or government related channels which appear less likely to reach this audience. However, it is clear that there are lots of potential personal and business touch-points when a business is getting

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established that could be exploited if HMRC considered working across a broader range of intermediaries and partners.

### Targeting different Ghost & Moonlighter motivations

This research focussed on five of the six attitudinal typologies identified for Hidden Economy SMEs - 'Catch me if you can', Entrepreneur at heart', 'Following the crowd', 'Trying to keep up' and 'Well paid hobby' – and found that some will be easier to influence than others.

The underlying motivations behind two typologies are felt to be very difficult to shift:

- **'Catch me if you can'** – where participants exhibit a strong personal justification for being in the Hidden Economy, are often very angry with 'government', and are self-confessed risk takers. Focussing on changing the ingrained attitudes and behaviours of this group is a significant challenge.
- **'Trying to keep up'** – where participants believe they need to remain in the Hidden Economy to maintain their family's lifestyle. Their behaviour is often rooted in a desire to care for their families and make sure their children do not 'go without'. Changing behaviour amongst a group who feel they 'need' to pay less tax than they should is also difficult.

To have an impact on the motivations underlying these typologies there is a danger that you have to push very hard with heavy messaging around deterrents and repercussions, which can have an adverse effect on other audiences.

We feel there is a greater opportunity to affect change by targeting the motivations and behaviours of other typologies:

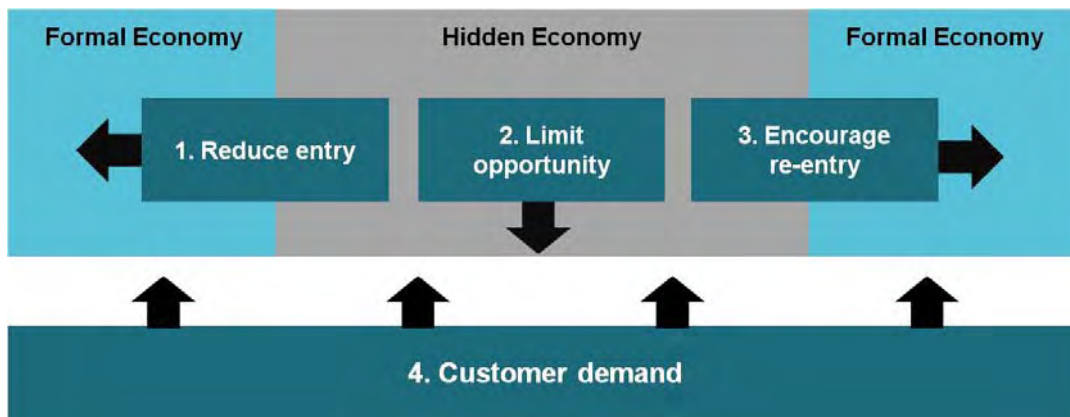
- **'Following the crowd'** – where participants are less likely to have deliberately entered the Hidden Economy, and more as a result of following the example set by others in their industry. They feel safe because 'everybody else is 'doing it', and/or believe they would not be able to survive in their industry if they registered their business officially.
- **'Entrepreneur at heart'** – where participants are highly success and profit oriented and see not registering for tax as a means of making more profit and avoiding time and administration costs. They perceive a number of barriers associated with being 'legit' - that it is difficult to register for tax, a misunderstanding of how tax actually works (e.g. expenses are tax deductible, businesses don't have to pay tax if they make no profit), not wanting to commit and so waiting to see if their new source of income becomes regular/reliable/'takes off' before they register, and a lack of awareness of what support is already available for registered businesses
- **'Well paid hobby'** – where participants are not necessarily focussed on earning a separate income, but their work may have developed from their interests/passions. They are less likely to consider what they do to be a 'business', or think that that

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they're not earning enough to make it worth declaring, or that declaring irregular amounts is too difficult, or to not know that you should register from the start.

There would appear to be more levers to exploit with these three typologies. Focussing on those who start earning an undeclared income less consciously is likely to be more profitable as they could be better influenced, particularly if they are targeted early.

### Looking across the Hidden Economy landscape



Looking holistically across the Hidden Economy landscape there are four main opportunities for intervention: reducing entry into the Hidden Economy, limiting opportunity, encouraging re-entry into the Formal Economy and targeting customer demand. Each of these was explored as part of this work.

#### 1. Reducing entry into the Hidden Economy

Once someone has neglected to declare their source of income, consciously or otherwise, it soon becomes a slippery slope, participants quickly become accustomed to their position and therefore increasingly less likely to consider registering their income as time goes by. Reaching people before they start having an informal income is therefore crucial, for example in:

- Targeting those on vocational courses, and/or influencing 'industry standards' in specific trades;
- Focussing on times when, and places where, people are starting out and making plans for a new business - e.g. online discussion forums;
- Messaging in places where people go to when they start trading (e.g. E-bay, markets etc.).

The research found three main barriers to registering a business and meeting tax requirements from the start:



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#### i. Fear of complexity

For some, fear of the complexity of registering, keeping records and/or completing tax returns was a fundamental barrier to compliance – whether it was either perceived or real and based on previous experience. Drivers found included inexperience with tax (e.g. have only ever been PAYE), a lack of literacy or learning skills, struggling with paperwork, not being able to afford an accountant, or not knowing where to find one. Providing more straightforward bite-sized help for those who struggle with paperwork could help establish good habits early. Changes to the tax system to make it easier to comply would also be welcomed and may encourage more people to register.

#### ii. Fear of commitment

The thought of being monitored on a long-term basis could also deter some from registering, particularly at a stage when the future of their new business can seem uncertain. People can be concerned that they will be tied into reporting to HMRC for years and years, even if their business does not take off as hoped. This fear is often exacerbated by misconceptions about the tax system itself – with some believing they have to pay tax on every penny of income they earn, a lack of understanding of what tax allowances they can claim, or not realising they do not have to pay tax if they make no profit. Raising awareness of what support is already in place for those starting out or on lower incomes could help motivate registration. Introducing a ‘trial period’ would also be a welcome measure. Flexibility and lower commitment options for paying tax are highly attractive.

#### iii. Not identifying as a ‘business’

Another key start-up barrier is that most Ghosts and Moonlighters do not identify with being a ‘business’ or ‘self-employed’. Many people simply do not connect with business language because:

- they started doing what they do for the love of it. The money is a by-product, not an end in itself;
- they weren’t proactively seeking business or customers (i.e. customers came to them because they are good at what they do);
- their undeclared income is something they do in their ‘spare time’ or a ‘bit on the side’ – it is not their main source of income and therefore feels quite separate;
- the nature of their work is removed from formal ‘business’ world so the language of formal employment or business seems irrelevant and geared against them.

Greater use of more informal language could help this group identify with tax.

## 2. Limiting opportunity in the Hidden Economy

Ghosts and Moonlighters do not currently feel constrained by operating in the Hidden Economy, indeed many have been able to grow their hidden source(s) of income quickly

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and significantly. The current economic situation is also seen to further fuel demand for Hidden Economy (i.e. tax free, and so cheaper) goods and services.

Ghosts and Moonlighters tend not to rely on formal channels and provisions. Strong word of mouth and personal networks means they have less need to require more official routes for business growth such as advertising. Most do not have a business bank account or need to seek finance or loans. Many are good at finding creative solutions to avoid more official routes.

Operating in the Hidden Economy is felt to be normal for some industries and in some cases Ghosts and Moonlighters believe that complying with the rules would actually limit the potential to grow their business, as some fear they would lose their source of income altogether if they registered for tax.

Many feel that their Hidden Economy activities are set up so as to be untraceable, and they are sceptical about whether HMRC would ever credibly be able to find them or join up data to prove their activity. They believe the onus is on HMRC to prove their activity.

Currently those Ghosts and Moonlighters we spoke to feel that few questions are asked of them during the time they are establishing or growing their business - even in instances where they are trading quite prominently and visibly as regards other requirements such as health and safety, business rates or licensing. (i.e. there's no apparent information exchange between different official agencies). Participants in the Hidden Economy feel free to go about business in their own way, and the risk of getting caught is perceived to be quite low.

Therefore, with attitudes and behaviours this ingrained, limiting opportunity is difficult.

### **3. Encouraging re-entry into the Formal Economy**

There is a distinct lack of perceived benefits of operating in the Formal Economy, leading to little desire to change habits. The longer a business has been operating in the Hidden Economy, the less likely it is that they will think about re-joining the Formal Economy. Changing behaviour once it has been entrenched is a difficult task. Reducing entry in the first place is likely to get a better return on investment than encouraging re-entry later down the line.

Ghosts/ Moonlighters seem split in terms of their perception of consequences of coming forwards:

- Some are clearly worried that the consequences of rejoining the Formal Economy would be too great in terms of being able to afford to pay the backlog of tax they owe. Many over-estimate what would happen if they came forward and feel they have no choice but to remain hidden, even if they did want to declare.

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- Others are more confident that they can operate without a trace and feel that if they ever wanted to re-enter there would be no proof of past trading meaning they would have nothing to pay back. These types feel they could re-enter at any point in the future with few negative repercussions if they decided they wanted to, which acts as a strong incentive to do nothing. Qualitatively this feels like the larger group.

In both cases Ghosts and Moonlighters are not compelled to come forward, either because the repercussions feel too high, or the risk feels too low.

Confidential information and advice about the results of coming forward can be difficult to find and participants in the Hidden Economy are unlikely to approach HMRC for information. Intermediaries play a crucial role in helping participants better understand their options – both in terms of their independence (trusted unbiased advice) and their ability to provide confidential, anonymous consultation (not obliged to ‘alert’ HMRC to individuals’ circumstances).

#### **4. Limiting customer demand**

Amongst customers, of potentially Hidden Economy businesses, the current economic climate motivates them to search for deals and keep costs down. Customers are not interested in whether a business is registered for tax or not as long as they feel are getting a good deal. Tax compliance is not seen to provide the customer any direct benefit, as their priorities are instead quality and value. Customers are therefore not interested in whether businesses they use are tax compliant. It is therefore difficult to impact the demand side as relationships between customers and businesses remain very strong and loyal.

There appears to be a spectrum of attitudes amongst customers of Hidden Economy businesses. Some customers are actively encouraging the Hidden Economy (e.g. by asking whether they can pay in cash to avoid VAT) whereas others are more passive (e.g. not actively asking for receipts or questioning businesses that only want payment in cash). Levels of awareness vary, but education on tell-tale signs of unregistered businesses may make some customers think twice about the types of businesses they use.

Customers strongly believe it is not their responsibility to ensure businesses are complying. Customers are unwilling to help HMRC find unregistered businesses and think that putting onus on them for a business they use being non-compliant (e.g. joint liability) is unfair. There is great reluctance to inform on a Hidden Economy business, not even for a financial reward, because of the perceived consequences of doing so (i.e. losing a cheaper supply of goods or services). Customers felt they would likely continue using unregistered businesses even if restrictions were introduced – seeing the risk/reward ratio as being weighted in their favour suggesting they remain prepared to take risks for the discount they received (which is often significant).

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However, customers *do* see the value of formal accreditation when it is their personal safety, belongings or loved ones that are potentially at risk through the service they are buying, or where quality and durability are important e.g.

- Home improvements
- Childcare
- Beauty therapies involving strong chemicals
- Cars and machinery

Whilst tax compliance is not a consumer priority, opportunities exist to link it (behind the scenes) to associated benefits they do care about – such as quality and safety.

## Summary of findings

### **Role of behavioural drivers and tailoring:**

There is, therefore, no ‘silver bullet’ or ‘one-size-fits-all’ solution to enable HMRC to reduce the Hidden Economy tax gap. A range of interventions will be needed to address the different drivers of participants’ behaviour. However, it is clear that many types of interventions stand more chance of being effective if they are more tailored to the participant’s trade and/or locale. Personalising and localising an intervention seems to increase its chances of resonating with Hidden Economy participants

### **Taking the right tone:**

The current economic climate also plays a major part in setting the context for participants’ operating in the Hidden Economy, and it is important for HMRC to show an understanding of how the downturn is affecting businesses, as well as clear messages around helping people who are working hard. An empathetic and enabling tone can break down some of the ‘us’ and ‘them’ barriers that fuel certain non-compliant attitudes and behaviours.

### **Adapting the language of business and making it personal:**

HMRC/Government messaging also needs to be more relevant and accessible to connect to those participants who do not regard what they do to be a ‘business’. Messages need to appeal to the person themselves, rather than being dressed in sometimes opaque ‘business’ language – and both benefits and deterrents need to be made personal if they are to leverage greater compliance.

### **Importance of sequencing:**

Sequencing of interventions is also critical – packaging initiatives in a different order will create a different response from participants. We feel it is important for HMRC to initially seek to build permission, relevance and credibility over time with Ghosts and Moonlighters. Establishing these foundations, and building an approach up ‘fairly’ over the near-term, will reduce the risk of unintentionally pushing more people into the Hidden Economy by being perceived to be disproportionately heavy-handed too soon.

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**Timing and focusing on earlier stages of the journey are key:**

Reducing entrance into the Hidden Economy has greater potential than encouraging existing participants out of the Hidden Economy. Habits form quickly - people soon get used to the benefits of being unregistered and not paying tax, and behaviours become entrenched even after only a few months of operating in the Hidden Economy. A longer-term preventative strategy is therefore likely to have more of an effect than merely focussing on curative measures. This though means that some of the most powerful initiatives are likely to have 'slow-release' results, and take a number of years before they deliver real results. Initiatives such as educating school leavers will come to fruition in the longer term, but may be more difficult to measure return on immediately.

**To reduce entry into the Hidden Economy**, education, simplification and support initiatives are likely to be the most powerful.

**To limit opportunity in the Hidden Economy**, linking up with other legislative requirements and asking more questions during the period businesses are establishing themselves is likely to have more impact than restricting the use of formal channels (or other forms of conditionality).

**To encourage re-entry into the Formal Economy**, anonymous and risk-free information and advice that provide participants with informed picture of the true consequences of coming forward, alongside simple means by which to disclose could benefit, although they are unlikely to change behaviours in isolation.

**To limit customer demand for Hidden Economy goods and services**, HMRC need to make interventions more relevant to consumers by linking tax compliance more closely to the criteria customers use in choosing products and services – e.g. safety, etc.

Many of these interventions are only effective over the longer-term, however, there may be some quicker win opportunities, namely:

- Better explaining current tax obligations (in a more personalised language Hidden Economy participants can relate to);
- Clarifying the details of and entitlements under current tax law (e.g. that you can claim back on some expenses, that you get a tax allowance etc.)
- Better signposting of the existing support initiatives that are already in place (e.g. My New Business);
- Targeting likely businesses with relevant, easy to understand education and guidance when they are starting out; and
- Working more closely with intermediaries and partners to use their trusted status to better connect to Hidden Economy participants, remove barriers and so reach new audiences.