

Microfoundations of small business tax behaviour: A capability perspective

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Abstract

Small business tax behaviour has received surprisingly little attention. We argue that an organisational capability perspective using microfoundations will allow us to better understand the relationships between different drivers and dynamics of small business tax behaviour. This study draws on in-depth interviews with 42 small business owners that are matched with the firms' factual tax compliance status. Using grounded theory, we build a framework that (a) identifies different microfoundations of small business capability to manage tax and (b) explains the dynamic nature of the relationship between organisational capability and compliance. Findings suggest that high capability does not necessarily translate into high tax compliance and this relationship is mediated by the owner-managers' perceptions of taxation as well changes in the economic and regulatory environment.

Key words

tax, compliance, organisational capability, microfoundations, small business, New Zealand

Introduction

Although small business tax compliance has attracted the interest of researchers for many years, the findings remain fragmented. Instead, the existing literature emphasises a variety of determinants of tax compliance that reflect a similar variety of disciplinary perspectives such as economic, political and socio-psychological perspectives (Kamleitner *et al.*, 2012; Kirchler, 2007; Batrancea, Nichita and Batrancea, 2013). Empirical findings on the determinants of tax compliance are mostly mixed which is indicative of a wider methodological problem – the prevailing use of self-reported compliance behaviour or compliance intentions by small businesses owners instead of factual compliance. Lastly, the dynamic and changing nature of small business compliance has not been sufficiently acknowledged to date. Kitching, Hart and Wilson (2015) call for regulation to be considered as a dynamic force that allows for variations in how firms respond. In this study, we argue that tax compliance behaviour is a result of the dynamic interaction between the firms' capability, the owner-mangers' experiences with and perception of the tax system as well as the external environment.

To address these shortcomings, we use an organisational capability perspective to identify the microfoundations of small business capability to manage tax while at the same time allowing us to explore the dynamic nature of the relationship between capability to manage tax and compliance. In this study, we conceptualise small business tax behaviour as an organisational capability that drives the compliance outcome. Building on in-depth interviews with 42 small business owners in New Zealand that are matched with the firms' factual tax compliance status, we argue that the nature of the relationship between the organisational capability and compliance outcomes is determined by managerial cognitions of taxation as well as the external environment. Using a grounded theory approach, we develop a framework of small business tax behaviour that shows that the capability to manage tax and actual compliance are two separate issues and that high organisational capability does not necessarily translate into high compliance.

Small business tax compliance

Previous studies of small business tax compliance have tended to avoid definitional matters as most studies focus on perceived and self-reported compliance as compared to factual compliance. Tax compliance broadly refers to the extent to which taxpayers meet their regulatory obligations in relation to registration in the system, filing of taxation information, reporting of complete and accurate information and paying of taxes on time (OECD, 2004; 2012). Braithwaite (2009) defines tax compliance as the full payment of all taxes due which implies that obligations in all areas have been met. This behavioural definition is relevant for our study for two reasons. First, it focuses on the tax compliance behaviour of small businesses rather than the underlying intentions which can be voluntarily or the result of enforcement activities by authorities (Kirchler, 2007). Second, it considers tax compliance in its entirety – from registration through to payment. It follows that tax non-compliance refers to any difference between the amount of taxes paid and the amount of taxes due (Braithwaite, 2009) and therefore only refers to not meeting the last of the four obligations – payment.

Review of research on small business tax behaviour

Tax compliance has been looked at from predominantly three perspectives: an economic, a political and a socio-psychological perspective (Kirchler, 2007; Batrancea *et al.*, 2013). From an economic perspective, tax compliance behaviour is driven by audit probability, fines, tax rates and income. Recent reviews by Batrancea *et al.* (2013) and Maciejovsky, Schwarzenberger and Kirchler (2012) suggest that empirical results on the impact of these economic determinants on tax compliance is – at best – mixed. Small businesses owners are, therefore, not fully rational utility maximisers whose behaviour is a reaction to financial cost and benefits consideration. Overall, it is clear that the phenomenon is simply too complex to be explained by economic variables only. From a political perspective, tax compliance behaviour is driven by fiscal policy and the complexity of the tax law and tax system (Kirchler, 2007; Batrancea *et al.*, 2013). Increased complexity means that taxpayers do not have sufficient control to ensure that all required tasks are successfully completed because of a lack of awareness and understanding of the regulatory processes and systems (Langham, Paulsen and Charmine, 2012). For small businesses complex filing procedures were found to be a key driver of tax non-compliance (Atawodi and Ojeka, 2012). The uncertainty caused by complex tax laws and systems also has another

effect – it increases the use of accountants, tax agents and other professionals to provide expert advice. The importance of this relationship between small businesses and accountants has been well documented (Blackburn and Jarvis, 2010; Gooderham *et al.*, 2004; Mole, 2002; Perry and Coetzer, 2009). From a socio-psychological perspective, tax compliance behaviour is driven by a range of cognitive and affective factors. First, small business owners' attitudes towards tax tend to be less favourable as they frequently frame taxes as a loss of something that once belonged to them, for example, VAT in the UK that was predominantly perceived as money owned rather than money collected (Adams and Webley, 2001; Webley, 2004). Approaches to measuring tax-related attitudes vary widely and Onu (2016) argues that caution is required when interpreting the findings on the relationship between attitudes and tax compliance behaviour (Onu, 2016). Overall, findings are mixed and attitudes alone are therefore considered to be an insufficient predictor for tax compliance behaviour (Kirchler, 2007). Second, while findings on the relationship between general knowledge and level of education and tax compliance are mixed, tax-specific knowledge results in an increase of compliance, because this knowledge helps small business owners understand its importance while at the same time acting as a deterrent (Kamleitner, Korunka and Kirchler, 2012). However, small businesses owners frequently lack tax-specific knowledge (McKerchar, 1995). Third, fairness perceptions of the tax system are a key driver of tax compliance (Wenzel, 2002) and research has suggested that small business owners have a heightened sense of being unfairly treated by tax authorities and the tax system (Adams and Webley, 2001; Tan and Veal, 2003) which increases the likelihood of tax evasion (Webley, 2004).

As this review shows, small business tax compliance behaviour has been the subject of empirical research for many decades, but the field nevertheless remains fragmented. Simplifying taxation and administrative requirements is an ongoing effort, but research suggests that compliance problems still exist (Batrancea *et al.*, 2013). In the following section, we argue that an organisational capability perspective using microfoundations will allow us to better understand the relationships between different drivers and dynamics of small business tax behaviour. We conceptualise tax compliance behaviour as an organisational capability that drives the compliance outcome. We show that the nature

of the relationship between the organisational capability and compliance outcomes is determined by managerial cognitions.

A capability perspective on small business tax compliance behaviour

Despite more than a decade of research on organisational capability – mainly within the strategic management and organisational theory literature – the concept still lacks clarity (Schreyoegg and Kliesch-Eberl, 2007; Helfat and Winter, 2011; Felin, Foss, Heimeriks and Madsen, 2012). In the broadest sense capabilities refer to a firm’s capacity to purposefully deploy a combination of resources and processes to achieve a desired goal (Amit and Schoemaker, 1993). This definition implies that organisational capability is a multi-level construct and that the combination of resources and processes is not only bound to a specific context (Schreyoegg and Kliesch-Eberl, 2007), but also dynamic to meet the demands of a constantly changing environment (Teece, Pisano and Shuen, 1997; Eisenhardt and Martin, 2000; Zollo and Winter, 2002; Winter 2003). It is the result of an organisational learning process in which informal and formal processes have been gradually linked to resources to develop distinct and reliable behavioural patterns (Schreyoegg and Kliesch-Eberl, 2007). Research has distinguished between dynamic capabilities and operational capabilities to reflect the firm’s capacity to adapt to changing environments compared to just maintain current operations (Teece, Pisano and Shuen, 1997; Eisenhardt and Martin, 2000; Winter, 2003; Helfat and Peteraf, 2003). But in the context of an ever-changing-world, the line between operational and dynamic capability becomes increasingly blurry (Helfat and Winter, 2011). For Eggers and Kaplan (2013) capabilities are developed from prior experiences that are transformed into routines as a result of managerial cognitions and interpretations. Routines form the “building blocks of capabilities, with a repetitive and context-dependent nature” (Dosi, Failllo and Marengo 2008; p1167). As “patterns of actions” (Eggers and Kaplan 2013, p.302), routines underpin organisational stability through inertia as well as change through organisational learning (Parmigiani and Howard-Grenville, 2011)

Microfoundations of organisational capabilities

While it has been acknowledged that organisational capability is a source of firm heterogeneity (Nelson and Winter, 1982), it is still very much a black box. To open the black box, a focus on the microfoundations of capabilities has emerged in the strategic management literature. Felin *et al.* (2012, p.1355) for example called for an increased exploration of the microfoundations of organisational capability by “specifying the underlying components, or parts, of routines and capabilities, and their interaction, the mechanisms connecting the parts to the collective constructs in time and space, and the boundary conditions for this line of inquiry”. In their review, the authors suggest that the microfoundations of organisational capability consist of three building blocks - (1) individuals, (2) processes and interactions, and (3) structures – as well as interaction effects between these. Individual-level foundations include, for example, behavioural elements, attitudes, beliefs and cognitions as well as skills and experience. The microfoundations of processes and interactions consist of elements related to the methods of coordination and integration as well as technology and human ecology. Structure-level foundations, for example resources, provide the organisational conditions that enable or constrain capability development. An individual’s organising logic, however, affects how the firm’s resources are deployed, stressing the importance of managerial cognitions and the interactions effects between individual and structure-level foundations. While it is acknowledged that it is the interaction effects that contribute to the assembly of capabilities, the nature of these interaction effects and the assembly process itself are not further specified. Eggers and Kaplan (2013) suggest that more attention needs to be paid to the role of managerial cognitions in assembling these building blocks into capabilities.

Importance of managerial cognitions

It has long been argued that organisational capabilities lie within the firm’s management (Helfat and Peteraf, 2003; Teece, 2007) and managerial cognitions and interpretive processes are therefore crucial to understand the assembly of organisational capabilities (Ambrosini and Bowman, 2009). According to Helfat and Peteraf (2015), however, the literature has been almost silent about the nature of these cognitions and the relationship between managerial cognitions and organisational capabilities has remained largely unexplored – theoretically as well as empirically. They refer to perceptions as an important managerial cognition of mental processes that help recognise emerging patterns or threats in

the external environment and enable more effective responses. Eggers and Kaplan (2013) suggest that capabilities can be developed as a result of managerial awareness of a problem or an unmet need in the market that needs to be addressed. Assembly also depends on the manager's perceptions of what the organisation is capable of and how the current capabilities compare to organisations that they regard as similar and relevant to their own. Similarly, managerial cognitions impact on the deployment of capabilities. Similar firms can deploy different capabilities as a result of differences in their managers' perception of the environment (Aragon-Correa and Sharma, 2003). Organisational capabilities might even be ineffective if managers perceive that they don't fit the environment (Eggers and Kaplan, 2013).

Helfat and Peteraf (2015) argue that heterogeneity of managerial cognitions is likely to result in different firm performance outcomes – in our case full tax compliance. We therefore argue that organisational capabilities don't necessarily translate into compliance, but that the relationship between capability and compliance is mediated by managerial cognitions and consequently their decisions on how to deploy the organisation's capabilities.

Methodology

For the purpose of this research, critical realism has been considered an appropriate methodological lens because it allows the investigation of context and process issues by integrating different theoretical approaches across multiple levels of analysis (Blundel, 2007). Critical realism allows a deep understanding of social situations by going beyond the observable and investigating the mechanisms behind any event. Critical realism is based on retrodution, a form of enquiry that is a combination of inductive and deductive inference to explain events by identifying the causal mechanisms that generated the event in question (Archer, Bhaskar, Collier, Lawson and Norrie, 2013; Danermark, Ekstrom and Jakobsen, 2001). To reflect the complexity of social phenomena retrodution suggests drawing on multiple data sources. Grounded theory meets this requirement of critical realism (Menzies, 2012) with the use of triangulation as an important means to reduce misinterpretations by bringing together information from different perspectives (Corbin and Strauss, 2008). Further, critical realism requires a focus on structure as well as agency. Grounded theory has traditionally been interested in

contextualising action within broader social structures. The theoretical sampling approach as well as the open coding and constant comparison approach meets the requirement of critical realism for conceptualisation and reconceptualization (Corbin and Strauss, 2008).

Theoretical sampling

The research comprises face-to-face, semi-structured interviews with 42 small business owners, employing less than 50 staff. The research design followed the University's Code of Ethical Conduct for Research, Teaching and Evaluation, was peer reviewed and consequently judged to be low risk. The first step of our theoretical sampling approach (Corbin and Strauss, 2008) was to select businesses with a high and low compliance status. New Zealand Inland Revenue's (IR)¹ administrative data of small business - provided the sampling frame for this study. This provided factual tax compliance data rather than self-reported compliance data that has been predominantly used in previous research. Tax compliance was defined as having Goods and Services Tax (GST) and Pay-As-You-Earn (PAYE) returns filed and payments made on time i.e. within seven days after the due date and compliance was then measured over a period of four tax years (2006 – 2009) including multiple returns². For more detailed information in relation to Inland Revenue and their administrative processes, please see Appendix B. From the sample the top 25 percent and the bottom 25 per cent were selected to represent businesses with a high and low compliance status respectively. At the time of data collection and analysis, researchers were 'blind' as to the compliance status of businesses; that is the categorisation was not revealed until after all the interviews had been completed and data analysed. This ensured that the researchers did not introduce any bias that might have been acquired from prior knowledge of respondents' tax compliance. Over the course of enquiry, firm size and industry sector were used as additional sample criteria. We did not aim for a representative sample to generalise the findings for the broader small business population. Instead, the chosen sampling approach permitted the investigation of the dynamic nature of the relationship between organisational capability and compliance.

¹ For more information in relation to Inland Revenue and their administrative processes, please see Appendix B.

² It is important to note that the sample includes only firms registered for GST. Firms that are non-compliant at an early stage, i.e. because they have failed to register for GST, were not part of the sample. Therefore, our results only refer to compliance behaviour of GST registered firms.

Sample description

Of the 42 respondents 74 per cent were male with an average age of 50 years. Slightly more than one quarter of respondents had previous business experience. In relation to the firms they operated, 12 per cent were self-employed, 43 percent employed five or less staff and 45 per cent employed between six and 49 staff. This size categorisation is in line with the OECD's definition of small firms (OECD, 2005). Slightly less than half of the firms generated an annual turnover of less than NZD 1 million (USD 700,000), 21 per cent between NZD 1 and 5 million (USD 700,000 and 3,5 million) and 19 per cent generated more than NZD 5 million (USD 3,5 million). The remaining respondents did not disclose their annual turnover. The majority of firms operated as limited liability companies with only 24 per cent operating as sole traders or in partnerships. With regards to industry, the sample was almost equally split with about one quarter of firms from construction, manufacturing, primary production and services industry. Lastly, 60 per cent of the sample had a high compliance status.

Development of interview schedule

In keeping with our philosophical approach of seeking to understand the phenomenon of tax compliance behaviour, we carefully designed the interview structure to avoid introducing confirmatory evidence bias, but allowed the nature of the compliance behaviour to emerge during the course of the interview so that we could situate it within the everyday management of the respondent's business. The questions broadly covered the individual level, structural level as well as processes and interactions within the firms (Appendix A).

Collecting data using semi-structured interviews

Small business owners were initially contacted by phone to seek their participation in the research. This was done by a third-party provider - ConsumerLink - to ensure adequate sampling of businesses with high and low compliance status without compromising the blinded research approach. Between March and October 2010, interviews were conducted by the authors on the organisation's premises and averaged around one hour. In all cases notes were made during and immediately after the interview to capture issues raised at the time and to record immediate thoughts and ideas of the researcher. Informed

consent was obtained and with the permission of the respondents the interviews were recorded and transcribed. The transcript was shared with the interviewee to give opportunity to amend and augment the initial responses or to withdraw the transcript completely.

Data analysis

Data collection and analysis was an iterative process to allow continuous triangulation between theory and data (Yin, 2009). The first step was to write up a descriptive case summary for each interview to ‘allow for the unique pattern of each case to emerge’ (Eisenhardt, 2002, p.18) and to capture the diversity of small business tax compliance behaviour. We then followed Corbin and Strauss’s (2008) approach of systematically comparing data to build a framework. This process included three main steps:

Step 1: Developing a coding structure

Using inductive data coding, the first author coded all interviews using in vivo codes or short descriptions. NVivo 10 was used to systemise the data coding. Each interview was reread several times to discern differences and similarities among small business owners. Similar codes were then collapsed into 11 first-order categories. These were then cross-checked by the second author and disagreements were resolved through discussion. Along with developing first-order concepts, we started identifying relationships between these concepts using constant comparison of interviews. These emerging relationships allowed us to collapse the 11 first-order concepts into theoretically distinct groupings, or so called second-order themes. We labelled the themes by referring to existing literature. Cross-case analysis (Eisenhardt, 2002) allowed us to identify relationships between second-order themes and similar themes were gathered into two aggregate dimensions. Table 1 depicts the data structure for small business tax compliance behaviour.

Step 2: Assigning each firm a capability rating

The first author then assigned each firm a capability rating - high capability versus limited capability - using the six previously identified first-order concepts of the aggregate dimension small business

capability to manage tax regulation. Using the initial in vivo codes, each firm was assigned a value (e.g. low or substantial) for each concept (e.g. for management experience). A high capability rating was assigned when at least four of the six concepts had values that represented high capability. For example, a firm with a high capability rating would have a small business owner with substantial management experience, substantial financial and tax knowledge, well established routines for record keeping and would not be overly reliant on their accountant or tax advisor. However, a firm with a high capability rating could also have a small business owners with limited managerial experience, but instead be well embedded in the support network and/or have substantial resource capacity. The capability ratings were again cross-checked by the second author and disagreements were resolved through discussions. Overall, 31 of the 42 firms in the sample were assigned a high capability rating. Table 2 provides a summary distribution of small business capability to manage tax regulation.

Table 1: Data structure and research questions

First-order concepts	Second-order theme	Aggregate dimension	Research question
Management experience: Limited vs substantial	Individual level microfoundations	Small business capability to manage tax regulation	Capability assembly: What are the micro foundations of small business capability to manage tax?
Financial and tax knowledge: Limited vs substantial			
Record keeping and tax filing processes: Routine, mostly software supported vs ad-hoc, mostly manual	Processes and interaction microfoundations		
Interaction with accountants and tax advisors: Limited reliance vs strong reliance			
Structure of support network: Self-reliant and mostly isolated vs well embedded	Structural level microfoundations		
Resource capacity: Limited vs substantial			
Necessary part of doing business		Managerial cognitions	Capability deployment: What are the
Burden and cost			

Driver of good management practices	Owner-managers' perceptions of taxation		factors that determine the relationship between small business capability and tax compliance?
Economic conditions	Owner-managers' perceptions of changes in the external environmental		
Regulatory conditions			

While Tables 1 and 2 are relevant for analytical reasons, as they show the emergent data structure and distributions of responses, the framework depicted in Figure 1 captures the relationship between organisational capability and compliance. The framework was developed by refining our emerging understanding of the relationships between concepts, themes and dimensions by comparing them with previous studies of small business tax behaviour which then resulted in the framework presented in Figure 1. Figure 1 is therefore the result of repeatedly iterating between data and theory. The capability rating together with the tax compliance data allowed us to further refine our framework by identifying the dynamic interactions and mechanisms between capability and compliance. This resulted in four distinct behavioural patterns of firms based on their capability to manage taxation and the actual compliance outcome.

Table 2: Summary distribution of small business capability to manage tax regulation

Small business capability to manage tax regulation		N	Percent
Management experience	Limited	14	33
	Substantial	28	67
Financial and tax knowledge	Limited	11	26
	Substantial	31	74
Record keeping and tax filing processes	Routine, mostly software supported	32	76
	Ad-hoc, mostly manual	10	24
Interaction with accountants and tax advisors	Limited reliance on professional support	31	74
	Strong reliance on professional support	11	26
Structure of support network	Self-reliant and mostly isolated	11	26
	Well embedded	31	74
Resource capacity	Limited	24	57
	Substantial	18	43

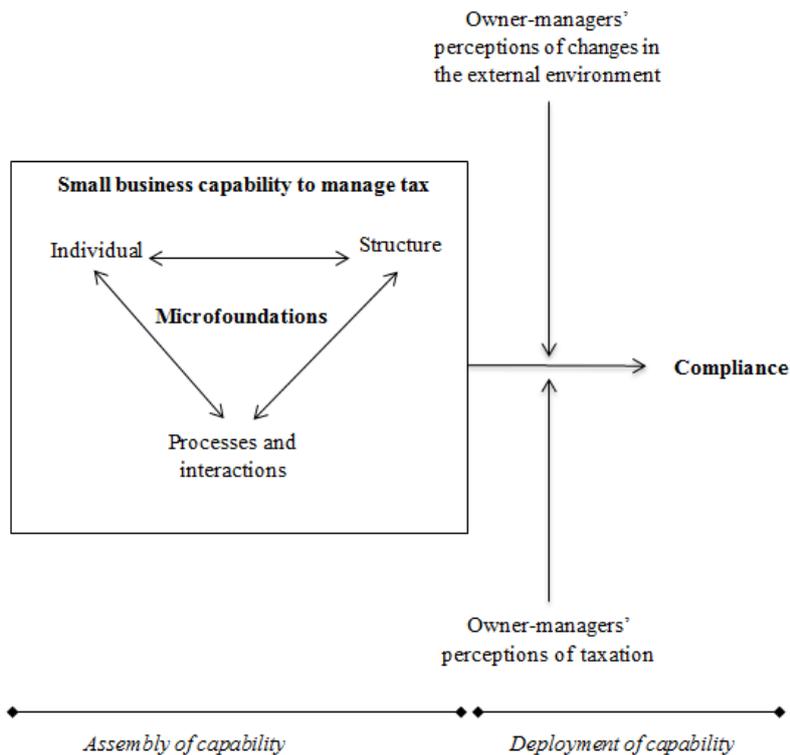
New Zealand regulatory context

New Zealand is a small open economy with a population of around 4.5 million, but over 487,000 registered businesses (Ministry of Business Innovation and Employment, 2015). While it has a comparably high business population per capita, the number of small firms in New Zealand is broadly comparable internationally. Ninety per cent are classified as micro-enterprises and 69 per cent have no employees. On the Global Competitiveness Index, New Zealand ranks third in relation to the quality of its institutional environment, behind Finland and Singapore (Schwab *et al.*, 2016). Similarly, the World Bank ranks New Zealand second for the overall ease of doing business - behind Singapore - indicating a favourable regulatory environment for conducting business (The World Bank, 2016). Despite New Zealand's high ranking internationally, compliance costs associated with tax related regulations are still considered a disproportionate burden by small businesses (Small Business Development Group, 2016) and it has been suggested that the efforts to simplify tax have not yet translate into increased compliance (Batrancea *et al.*, 2013).

A framework of small business tax behaviour: Results and discussion

In this section we present and discuss an empirically grounded framework of small business tax behaviour. The overall conceptual structure and relationships that emerged from our analysis are depicted in Figure 1 and we start this section by discussing the microfoundations of small business capability to manage tax before investigating the dynamic relationship between capability and tax compliance.

Figure 1: A framework of small business tax behaviour



What are the microfoundations of small business capability to manage tax?

First, we present the microfoundations following the building blocks identified in the organisational capability literature (Felin *et al.*, 2012) and discuss the interlinkages between them.

Individual level microfoundations

Managerial experience has previously been found to be an important predictor of small firm growth (Storey, 1994) as well as self-employment success (Robinson and Sexton, 1994). Results of this study extends those findings to small business tax behaviour as results showed that managerial experience was an important microfoundation of the small business capability to manage tax regulation. Experience was predominantly developed through senior management roles in large firms or previous founding experience. An example of a respondent with high levels of managerial experience is a 55 year old owner of an IT consultancy company who had a track record as a business founder. *“I’ve been involved in five IT start-up businesses, as a director and in some cases chair of the board.”* (#27) This contrasts to a 53 year old manufacturer of water pumps who had no previous management experience and struggled to manage the tax obligations in his business. *“I used to work for a company and they made*

me redundant and at the same time they wanted to outsource this manufacturing, so I put my hand up and said, "I'll do it." (#108).

Closely related was the level of financial and tax knowledge of owners. Financial and tax knowledge allowed respondents to better manage and plan their financial situation and if necessary take early action. Poor financial and tax knowledge however, often resulted in respondents struggling to understand their tax obligations. An example is a 45 year old director of an engineering business who had a background in accounting and finance. *I pride myself on forecasting three months in advance and usually I've only got a 10% variation so I can tell virtually what will be in the bank in three months' time. That's the sort of accuracy you need. (#107)* In contrast, the manufacturer of water pumps. *I don't know any of the accounting terms. It makes no sense to me that a book must balance. (#108)* Similarly, the respondent of a floor sanding business employing four staff expresses his anxiety of getting fined because of his lack of understanding of the tax system. *The tax system is beyond me. It takes someone five years to study at University, but as a business owner you are expected to know exactly how the tax system works and if you don't know, you can't plead ignorance. You are still going to get your knuckles rapped. (#21).* Financial and tax knowledge has previously been acknowledged as an important driver of compliance (Kamleitner *et al.*, 2012) and Webley (2004) found that the amount of VAT non-compliance in the UK that results from knowledge deficits is significant and McKerchar (1995) concluded that the knowledge of taxation amongst small business taxpayers was limited.

Processes and interactions microfoundations

Managing tax regulations tended to become a routine task for respondents who had formal and automated record keeping and tax filing processes in place. Formalisation and automatization was frequently supported by technology i.e. specialised software solutions which gave rise to managerial benefits (Pope and Rametse, 2001). The routines resulting from those processes reduced ad-hoc approaches and variations which in turn helped meeting tax obligations. *It's a good discipline for businesses. No journals with things written in and rubbed out and all that (#55). If you have your [software] system in place to meet the requirements, you meet the requirements – it's not an issue (#65).*

In contrast, manual record keeping and filing processes were considered to be more error prone. *You can see which ones you've got to deal with first instead of me thinking well that's a little one I can pay that. Meanwhile there's probably a big one that I should pay that's older (#38).* The use of technology-solutions did not only formalise the record keeping and tax filing process, but changed the nature of the respondents' interaction with their accountants and tax advisors by becoming less reliant on them. With regard to taxation external accountants and tax advisors were a key source of information and advice. A typical strategy for respondents, who lacked financial and tax knowledge, was to contract accountants "to do the books" and externalise the responsibility for and control of compliance. An example is a husband and wife operated professional building maintenance business that was struggling to comply with their tax obligations. The owner was a cabinet maker by trade and started the business after he was made redundant by his previous employer. He relied heavily on his accountant with no understanding of his tax requirements. *The accountant tells us what we pay each month. We take everything for that month over to them and then they just calculate what we've done, what we haven't done and then they say right you've got to pay x amount of dollars this month. I drop a cheque with them and they send it in for us. (#31).* This contrasts with a 42 year old owner of a commercial contract plumbing firm that employs seven staff. He established formal record keeping and tax filing processes to better manage his financial and tax obligations. *We do all our own bookwork here up to trial balance. It gives us an idea all the way through, so that I know more accurately where we're at. (#42).* The social interactions with accountants and tax agents increased the learning rate of respondents which led to improved financial and tax knowledge. According to Evans *et al.* (2005) poor record keeping does not necessarily translate into compliance problems and the relationship between the two is more complex than previous research has acknowledged. In our framework, record keeping is only one of the identified microfoundations and the overall capability to manage tax depends on the linkages between microfoundations (Felin *et al.*, 2012).

Structural level microfoundations

The structure of the support network that small firms were embedded in clearly contributed to their overall capability to manage taxation. Some respondents seemed to be self-reliant and mostly isolated

from sources of learning and development. These respondents relied on peer group sources and they engaged with them in an ad-hoc manner. In the face of regulatory changes, these respondents were particularly vulnerable. An example was a 53 old respondent who operated a footpath repair and maintenance business with her husband and 15 staff. The business was virtually self-reliant with no established support network structure. The only person, her husband would consult was the previous owner of the business. *He still talks to him, but not to outside people. (#52)* Other respondents, however, were well embedded in a wide network of trusted advisors that allowed them to access the information and advice they needed to manage regulation. An example is a high-value manufacturer of industrial juice processing equipment. *We are a member of the industry association and my business partner is a member of the Society of Chemical Engineers. I'm a member of the Institute of Chemistry and the company is a member of the Employers and Manufacturers Association. So, if for example, there's a question about the Holidays Act - you know, how much is this and that -, instead of trolling through the government website, we can just phone them up (#64).* To effectively translate and implement information and advice gained through the firm's support network, previously discussed managerial experience as well as internal processes were important.

The firm's resource capacity was another microfoundation of the capability to manage tax regulation and it was often the result of the firm's financing and organizing logic. Small business owners prefer to fund their operations internally using own savings and earnings rather than using debt or third party equity (Hussain and Scott, 2015). The majority of businesses in our sample ran on their operating cash flow and a bank overdraft with only limited additional resources. While respondents often claimed to understand their tax obligations, tight cash flow and liquidity problems were a main constraint on the small firms' capability to meet their tax obligations. An example is a 50 year old, self-employed male who specializes in fixing laminate bench tops for insurance companies. Tight cash flow and no bank overdraft facilities have meant that the respondent has struggled to meet tax obligations and at some stage he even borrowed money from his mother to pay on time. *Sometimes it's quite tight with money but I've never had an overdraft per se, although once or twice I've had a big tax bill and I've just sent the cheque away hoping that some money will come in the next couple of days. (#12).* The logic behind

these financing preferences is frequently driven by the business owner's desire to have full control over the business and being independent in the decision-making (Chell, 1985) which subsequently affects the broader organizing logics and the firm's development. The smaller the firm, the more likely it is that the owner-manager is responsible to deal with all aspects of the business which was often described as "debilitating" and "tiring" (#63). With businesses that were able to grow, however, this issue reduced in importance. As the firm's resource capacity grew, the owner-managers were able to employ staff that helped with meeting tax obligations. Without these resources, often 'silent' personnel, such as the owner's spouse or other family members, assist with those tasks, but are often not suitably qualified. An example is a 34 year old niche manufacturer of sheet metal for the yachting industry. Since start-up in 2007 the business has been steadily growing and currently employs eight staff with recruitment for more staff ongoing. *I have a really good office manager who works on MYOB and does all of that for me, she does the GST returns etc. and I check things at the end of each month. She has made a huge difference to the business because before that my wife - she's a school teacher - and I would do it and we are both novices at accounting, we would be here at 11pm at night doing accounts and we said "this is stupid", so we hired Linda and it's one of the best things that I have done.* (#17)

Overall, results showed strong interlinkage between the individual-level, process-level and structural-level microfoundations which have not been considered in previous research. While the microfoundations have all been identified previously as drivers of tax compliance, it is the complex interlinkages between them that explain why findings on single drivers of small business compliance have often been mixed. To achieve high levels of organisational tax capability, it is not enough to have an experienced and knowledgeable owner-manager, but it also needs the relevant structural resources, organisational processes and social interactions.

What are the factors that determine the relationship between small business capability and tax compliance?

The results indicate that the capability to manage regulation and compliance are two separate issues. While a positive relationship between those two concepts might be assumed, our findings suggest that

a high level of capability to manage regulation does not necessarily translate into compliance and similarly, a low level of capability does not mean that firms are automatically non-compliant. We identified four distinct behavioural patterns of firms based on their level of capability to manage taxation and the actual compliance outcome that we discuss in detail below. First, however, we discuss the factors that impact on the relationship between capability and compliance.

Owner-managers' perceptions of taxation

Respondents held different perceptions and felt differently about taxes based on their past experiences as well as individual and social norms. One group of respondents (n=19) considered taxation to be “*just part of doing business*” (#89) i.e. a necessity that comes with being in business and is accepted as such without any particularly positive or negative connotations. Other issues such as market conditions, competition or customer demand were of much more strategic relevance, whereas tax compliance was often considered an operational foundation for being in business. The second group (n=18) perceived taxation to be a burden and cost to the business or as a 54 year old owner of an architectural practice with 16 staff said - “*a pain in the arse*” (#83). Respondents voiced negative associations with taxation and compliance, which was often generalized across the wider spectrum of regulations. Lastly, the third group (n=5) perceived taxation to be beneficial because managing tax obligations helps them developing a routine and becomes part of good business practice. An example is a 58 year old manufacturer of fencing posts employing 15 staff. “*If you keep it up to date and review it regularly it becomes an attitude to what you do.*” (#56). Previous research has portrayed small business owners predominantly as considering tax obligations as burdensome, costly and a painful loss (e.g. Schoonjans, van Cauwenberge, Reekmans and Simoens, 2011; Lignier, Evans and Tran-Nam, 2014; Kamleitner *et al.*, 2012), but our results confirm that the positive and neutral perceptions of taxation are just as relevant.

Owner-managers' perceptions of changes in external environmental

Besides the owner-managers' perceptions of taxation, changes in the external environment were another factor that impacted on the relationship between capability and compliance. The two key changes that

were identified were perceptions of changes in economic and regulatory conditions. The global financial crisis and its resulting recession was the most significant recent change in economic conditions that respondents (n=27) identified. Businesses in our sample frequently operated on a tightly controlled cash flow. Reduction in demand, late or no customer payments together with reduced credit availability left a number of businesses struggling to meet their financial obligations. As a result, some ended up prioritising payments – typically paying staff before paying taxes. An example is the owner of a tiling business who states: *The economic downturn - I had to keep my compliance up, but I still had wages to pay. I got into a very precarious state. (#33)*. This illustrates that depending on the owner-managers' perception of the economic environment, they assemble and deployed the firms' capabilities differently (Aragon-Correa and Sharma, 2003).

Regulatory changes, such as the introduction of new regulation or changes to existing regulation, were another key influencing factor mentioned by respondents (n=8). In the New Zealand context, the introduction of KiwiSaver³ provided an interesting regulatory change that is directly related to taxation. It is administered by the employer through the Pay-As-You-Earn (PAYE) returns. Some respondents commented that its introduction not only increased the administrative cost of compliance, but also potential filing and payment errors which resulted in non-compliance. *I had trouble with KiwiSaver, you know, how it's calculated and what not sort of thing (#25)*. Lignier (2009) found that changes to tax regulations are often triggers for behaviour change and record keeping practices. While those adaptation processes might significantly increase compliance costs (Lignier *et al.*, 2014), it does not mean that they negatively affect compliance. This shows that compliance costs might not be a good proxy for actual tax compliance. The changes in external conditions caused some businesses to face a novel problem and challenged their owner-managers to adapt their resources and routines i.e. their capabilities (Miller *et al.*, 2012). Results showed that some respondents were better at adapting than others, pointing towards the dynamic nature of tax compliance behaviour. Previous research has argued that capabilities suitable for stable environment might not be suitable for disruptive environments

³ KiwiSaver is a voluntary work-based saving scheme that was launched in 2007, but since went through a number of subsequent changes.

(Ambrosini *et al.*, 2009) and the results from this study suggest that future research into small business tax compliance might benefit from a dynamic capabilities perspective.

Patterns of small business tax behaviour

Next, we discuss how the above two factors impact on the relationship between capability and tax compliance by presenting four conceptually distinct patterns of small businesses tax behaviour. While a positive relationship between capability and tax compliance might be assumed, our findings suggest that the situation is more complex.

High capability – high compliance

For this first group of business owners (n=23) high capability to manage tax regulation translated into a high compliance status. This link was reinforced by the owner-managers' perceptions, but interestingly it was not only positive or ambivalent representations that had an impact. We encountered cases like the previously mentioned architectural practice (#83) that expressed very negative views about the complexity of tax regulation and the burden it represents for businesses. *I mean there's no point in running small business in this country because the tax system is too complex.* The owner-manager employed a chartered accountant, so that he did not 'notice' the compliance costs. *The compliance cost, I mean I don't notice it. It's just sort of built in.*

This highlights that small business owners' negative perceptions do not necessarily translate into non-compliance if capability to manage is high. The owner-managers might dislike the tax system and authorities in general, but as Ahmend and Braithwaite (2005) argue, might still be law-abiding citizens at the same time and therefore seek help from accountants and tax advisors (Blackburn and Jarvis, 2010). More importantly, this shows that perceptions do not necessarily translate into actual behaviour, confirming that agent perceptions do not exhaust all regulatory effects (Kitching *et al.*, 2015). Our results, however, show that this is only one possible pattern of small business tax behaviour.

Low capability – low compliance

For the second group of business owners (n=9) low capability to manage tax regulation resulted in a low compliance status. The perception of taxation as mostly a burden and cost and only in some cases as a necessity of being in business reinforced the relationship between capability and compliance. Further, the previously discussed changes in the external environment caused some of those already struggling businesses to get into rather precarious situations. This illustrates that organisational capabilities were ineffective and did not fit the environment (Eggers and Kaplan, 2013). An example (#47) is the 37 year old owner of an engineering and welding firm who started the business because he was 'sick of' his previous managers. He had no previous business or management experience and limited financial and tax knowledge. His accounting practices were very basic and reliant on his accountant. He considered tax compliance a cost and burden to the business and expressed sentiments of being let down by the government in general. Work has almost completely dried up as a result of the recession and he had to make staff redundant. He is unable to meet his tax obligations and struggles to stay afloat.

This behavioural pattern corresponds with the 'conventional wisdom' (Kitching *et al.*, 2015) of small businesses as being resource constrained and therefore facing higher compliance costs (Schoonjans *et al.*, 2011; Chittenden, Kauser and Poutziouris, 2003; 2005; Kauser, Chittenden and Poutziouris, 2005) and are more at risk of being non-compliant (Kamleitner *et al.*, 2012).

High capability – low compliance

The third group (n=8) presents an interesting case of businesses that had a low compliance status despite being capable of managing tax regulations. We encountered cases which were affected by the underlying change in their economic environment, which, at the time of the study, was the worsening recessionary economic climate. This affected some small business owners' otherwise positive perceptions on compliance by undermining the link between capability and compliance. In other cases, it was the owner-managers negative perceptions of taxation that prevented the business from being compliant despite their high level of capability. Finally, in some cases it was a combination of both – owner-managers' perceptions of taxation and changes in external environment – that affected the

relationship between capability and compliance. One example (#56) is a traditional manufacturer employing 15 staff that operated internationally. Due to the firm's strong international focus, the business had to navigate a more complex regulatory environment and the owner-manager employed a general manager who was responsible for running the day-to-day operation including all compliance related matters. Taxation was considered a necessity and being compliant was important for the respondent to minimise the risk of '*disruption*' to the business. The economic downturn severely affected the firm's key markets overseas resulting in constrained cash flow. The respondent had to cut staff hours and struggled to meet the ongoing tax obligations. Under those specific circumstances, deferring paying taxes was considered less detrimental to the business' survival than deferring payments to other stakeholders such as e.g. staff or suppliers. This is illustrated by the owner of a plumbing business who argues that *at the end of the day we've got to pay the people that keep our business running first* (#39).

This pattern illustrates that organisational capabilities don't automatically translate into compliance, but that the relationship is mediated by managerial cognitions and consequently the owner-manager's ability to assemble organisational capabilities and/or their decisions how to deploy them (Aragon-Correa and Sharma, 2003; Eggers and Kaplan, 2013).

Low capability – high compliance

Lastly, the fourth group (n=2) represented some outliers of 'accidentally' compliant businesses despite having only limited capability to manage tax regulation. These respondents were self-employed - being for example subcontractors in the construction industry - and traded only on a small scale that resulted in relatively simple tax obligations. An example (#7) is a home-based engineer who became self-employed over 20 years ago when his employer went into liquidation and he took over the equipment as part of his redundancy and some of the customers. He is now semi-retired, but tries to keep enough work to '*stay alive*', but in recent years his turnover fell even below the threshold for needing to register for GST.

Conclusions and implications

This study provides an in-depth, micro-level insights into small business tax behaviour. It is the first study that we are aware of that has examined the nature of small business tax compliance behaviour that builds on actual rather than self-reported compliance data.

Small business tax behaviour has received surprisingly little attention (Kamleitner et al., 2012). This study has helped to open the black box of small business tax behaviour by identifying the microfoundations and understanding the interlinkages between the individual, processes and structural factors. We responded to Felin *et al.*'s (2012) call for research that identifies the complexities in how managers – or in our case owner-managers, enact these processes in practice. Further, our findings point to the importance of distinguishing between capability and compliance. While compliance is only a measure of demonstrated action, capability expresses the broader potential to act and allows for a more nuanced understanding of small business tax behaviour.

Our study provided a framework for understanding the dynamic relationship between the small firm's capability to manage regulation and its tax compliance. We operationalised capability using a microfoundations perspective and identified six factors at the individual level, the structural level and the process level. Undoubtedly, we have not identified all relevant microfoundations in our study. However, by identifying specific microfoundations, we view this study as a first step to better understand the heterogeneity associated with small business tax behaviour. The four different behaviour patterns that we identified are a strong endorsement of the dynamic nature of compliance behaviour.

The study is, however, not without limitations. The findings of this study are based on small businesses from a single regulatory context which limits the generalisability of the results. Research in countries with different regulatory systems and processes might result in other behavioural patterns. Further, the cross-sectional nature of the data limits the extent to which behavioural changes and dynamics can be interpreted. Longitudinal data would allow for a more fine-grained analysis of how small business capability to manage tax develops and changes over time and how the relationship between capability and compliance changes as a result.

There are several avenues for future research. First, our framework provides the basis for a quantitative study with specific measures for each of the identified microfoundations to expand generalisability. Second, it could be used to investigate the compliance behaviour in relation to other types of regulation, e.g. health and safety or employment, to see to what extent our framework is more widely applicable to small business regulation. Third, the proposed framework could be extended by considering additional factors such as the role of organisational and managerial learning. Fourth, research on managerial cognitions and their relationship with organisational capability is still in its infancy and more work is needed to improve our understanding of the complex nature of managerial cognitions – including perceptions of taxation - and to disentangle their relationship with organisational capability.

Due to the size and significance of the SME sector for national economies, small business owners are a crucial part of national tax systems. The findings of this study provide a number of implications – specifically for policy makers and regulators who are concerned with the enforcement of tax regulation. Regulators and tax advisors can use the identified microfoundations to develop capability profiles of their clients that go beyond classifications based upon firm size, sector and turnover. Depending on high or low capability profiles, regulators and tax advisors can develop different support mechanisms. Most importantly, however, findings point to the importance of better understanding the impact of managerial cognitions and how small business owners adapt their firms' capabilities as a result of those cognitions. Induction and training programs might help raise awareness and understanding of the dynamic nature between capability and compliance, so that regulators and tax advisors can develop more tailored solutions that fit the different behavioural patterns of small businesses.

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Appendix A: Interview structure

1. Business background and general environment

Please tell me about your business.

Prompts: Products and service offered, nature of competition, staffing, revenue

2. Owner-manager background

Please tell me how you came to be in this business.

Prompts: Previous experiences, qualifications, motivation

3. Recent challenges and opportunities

Please tell me about the recent biggest challenge the business has been facing.

Prompts: Response, support mechanisms, learnings

Please tell me about the recent biggest opportunity the business has been facing.

Prompts: Response, support mechanisms, learnings

4. Experience and impact of regulation

Please tell me to what extent your business is affected by regulation.

Prompts: knowledge of regulation, perception of regulation, impact, resources, management practices

Optional: Please tell me why you think you are not affected.

Please tell me more about your sources of information and support.

Prompts: role of and relationship with advisors, learnings

Appendix B: Institutional context

Brief overview of New Zealand's tax system

In the mid-1980s when New Zealand faced a major economic crisis, tax reform was a key part in the overall reform process. One component of the tax reform was the introduction of the Goods and Services Tax (GST) in 1986 (Sawyer, 2016).

Overall, New Zealand's tax revenue makes up 32.9 percent of GDP which places it just below the OECD average of 34.5 percent. GST makes up 32 percent of New Zealand's tax revenue, a figure that has increased since 2010 when the GST rate was changed from 12.5 to 15 percent. Despite this increase, New Zealand's GST rates are still at the lower end compared with other OECD countries. Overall, GST makes up 9.9 percent of New Zealand's GDP, the highest in the OECD. The comparably high amount of tax raised through GST despite its relatively low rate, is reflective of New Zealand's broad base – low rate approach to GST (Inland Revenue, 2014). As a result, New Zealand's VAT revenue rate is 0.96 the highest of all OECD countries and well above its average of 0.55 (OECD, 2015). The tax development process is underpinned by the Generic Tax Policy Process (GTPP) that was introduced in 1994 and sustained the commitment to reform the tax system over more than 20 years. The GTPP ensures government works in consultation with businesses, tax professionals and academics in the development of tax policy, its communication as well as in the reduction of complexity within the administrative process and compliance costs (Sawyer, 2016).

Administrative processes associated with GST

The threshold for registering for GST is when turnover was NZ\$60,000 (USD 42,000) or more in the last 12 months or will be NZ\$60,000 or more in the next 12 months or if prices charged are inclusive of GST. For claiming and returning GST, there are three methods to choose from: Payment basis, invoice basis and hybrid basis, but payment basis is the most commonly used one by small businesses. Options for filing frequency include monthly, two-monthly or six-monthly GST filing, but restrictions apply

depending on the value of total sales. GST returns can be filed electronically through an online service, through accounting software or in paper form.⁴

⁴ More information is available on <http://www.ird.govt.nz/gst/>