

# Building trust through leadership: A longitudinal study on Inland Revenue's response to, and learnings from, the Canterbury earthquakes—Years 1 and 2

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## **Abstract**

The 2010 and 2011 Canterbury earthquakes in New Zealand caused major social and economic disruptions. Because a responsive tax regime is considered to be a key building block in re-development after an adverse event, the New Zealand Inland Revenue Department (Inland Revenue) is undertaking a longitudinal study of three to five years to better understand the impact these types of events can have on tax compliance and what impact its actions have had on mitigating these risks.

The research focuses on small and medium enterprises (SMEs). This sector makes a significant contribution to the New Zealand economy, but it is also more susceptible to incurring debt. A large proportion of the total tax debt is owed by this sector—about one third of tax debtors within New Zealand.

There is also a concern that tax debt could increase during the reconstruction phase, as some SMEs grow faster than their ability to meet their new tax filing and payment obligations. Disasters can also make people question and change their attitudes towards tax compliance. This could impact on SMEs in certain industries as they become exposed to hidden economy opportunities in the recovery and rebuild phases.

This research forms part of a suite of research that the government, universities and other organisations are undertaking on the impact of the Canterbury earthquakes on New Zealand's social and economic wellbeing. Findings from the longitudinal study will feed into this bigger pool of information which will help other agencies in their policy decision making. It will also help the government develop a collective view of the key issues facing Canterbury. The Year 1 (2012) findings showed that there has not been a major shift in attitudes towards tax compliance but tax compliance behaviour has worsened for some businesses. SMEs with business savings and better management practices were better able to meet tax obligations. However, concerns were raised by research participants in Year 2 (2013) about whether businesses have the time and expertise to maintain their tax compliance while they are growing. The Year 2 research provided a picture of business recovery and what the 'new normal' for Christchurch looks like in 2013. Key learnings for tax administrations highlight the importance of communication between the tax administration and businesses, and that proactivity on the part of a tax authority is vital. The New Zealand tax administration actions helped some businesses manage their tax obligations, with SMEs in Year 1 rating waiving of penalties, payment arrangements and extension of time as being helpful. The overall expectation for the tax administration was to be lenient and provide tailored assistance for businesses that are still struggling, but to return to 'business as usual' (BAU) monitoring and enforcement of tax compliance for businesses that have recovered.

The research to date has been used by Inland Revenue as a general barometer of where businesses are placed in terms of recovery and compliance. Specifically, it has used the research to inform government Ministers of the different stages of recovery of businesses when considering removing the Orders in Council that provided relief after the earthquakes. The research has also identified the risk areas in Christchurch. As it continues, the other benefit is in understanding what is actually happening to businesses and how SMEs are managing, and determining how a tax administration might address identified compliance issues and/or promote further voluntary compliance. The information has also influenced the Canterbury Earthquake Recovery Authority's (CERA's) work programme, which now has a stronger focus on existing businesses and investors than it otherwise might have.

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## 1. INTRODUCTION

In 2010 and 2011, a series of major earthquakes hit Canterbury, New Zealand, with one particular earthquake on 22 February 2011 resulting in 185 deaths. The earthquakes caused major economic and social disruptions to everyday activities and social life, and this prompted the New Zealand Inland Revenue Department (Inland Revenue) to look at how it responds to sudden large-scale adverse events (adverse events). This is because the department plays a central role in securing most of the financial resources required by the Government. These resources provide essential services and facilities that improve New Zealanders' quality of life.

Following an adverse event, a well-working tax system and its administration are key to helping the economic and social recovery of the affected region and country. This is why Inland Revenue wants to better understand how an adverse event can affect long-term tax debt, and whether social norms and attitudes change leading to increased hidden economy activity during recovery. As the tax administrator, Inland Revenue also wants to know what impact its actions may have in mitigating these risks so that learnings can be applied to respond appropriately to future adverse events.

In 2012 Inland Revenue commenced a longitudinal research project. The first two years of this study consisted of a desktop review of literature, analysis of Inland Revenue's administrative data, quantitative and qualitative research with small businesses and tax agents, Christchurch-based Inland Revenue staff, and other key stakeholders. This paper presents findings from the first two years of research and how the research is being used to influence Inland Revenue's decision making.

## 2. BACKGROUND

Natural disasters create a socially disorganised and disordered environment and this social disorganisation increases the opportunity for non-compliant behaviour (Davila, Marquart and Mullings, 2005; Kerstein, 2006).

Tax compliance behaviour is likely to be affected by a customer's relationship with their tax administration (Ayres and Braithwaite 1992; Braithwaite, 2002; Braithwaite, Murphy and Reinhart, 2007; Braithwaite and Wenzel, 2008; Murphy and Tyler, 2008; Murphy, Tyler and Curtis, 2009; Tyler, 1990, 2006, OECD, 2010). The 2010 and 2011 Canterbury earthquakes prompted New Zealand's tax administration to look at its response to major adverse events because of the flow-on effects on tax compliance behaviour and revenue collection.

Small to medium enterprises (SMEs) are more susceptible to incurring debt than other Inland Revenue customers, and a disaster makes SMEs from certain industry sectors more exposed to incurring tax debt. There is also a concern that tax debt could increase during the reconstruction phase as some SMEs grow faster than their ability to meet their new tax filing and payment demands.<sup>2</sup>

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<sup>2</sup> Research has found that while most SMEs are aware there are financial penalties for late payment of business tax, there is a lack of detailed knowledge and understanding of how they are applied (Poppelwell, Kelly and Wang, 'Intervening to reduce risk: Identifying sanction thresholds among SME

Disasters can also make people change their attitudes towards tax compliance. This could impact on SMEs in certain industries as they become exposed to hidden economy opportunities during the various recovery and rebuild phases.

Businesses do not always fail immediately after a disaster; sometimes it can take two to four years. Business owners can continue to struggle to recover until they have exhausted all their resources. The literature states that the smaller the business, the less likely the recovery. Those that rely on discretionary spend, or sustain more structural damage, and those that fail to comply with regulations (Stevenson, Kachali, Whitman, Seville, Vargo, & Wilson, 2011) are particularly affected. In addition, smaller businesses generally have fewer resources to prepare for disasters. Large businesses tend to fare better than small businesses after a disaster as they tend to have more resources for disaster recovery (Webb, Tierney and Dalhammer, 1999; Kroll, Landis, Shen and Stryker, 1991; Powell, 2010). For example, a New Zealand study found more than 80 per cent of small to medium businesses did not have adequate insurance (Powell and Harding, 2010).

## 2.1 Phases of a disaster

When events have large-scale adverse consequences for individuals, organisations and communities they become disasters. The more the event results in unravelling the community fabric, the greater the disaster and the harder it is for survival and recovery to occur (Alesch and James, 2007).

Disasters or adverse events generally have two or three phases: prevention, response and recovery (Webb, et al, 1999; Kerstein, 2006; Runyan, 2006; Powell, 2010). Research undertaken in the first year of this longitudinal study showed that SMEs in Canterbury who were still operating were in several stages of recovery—surviving, recovering and recovered. In the second year of the research, ‘stagnating’ and ‘booming’ were added to these stages.

Business disaster preparedness or lack thereof emerged as a main theme within the papers that were located in the literature search. The consensus of most studies on the disaster preparedness of small businesses is that the majority either do not engage or engage only to a low level, in formal planning to prepare for a disaster (Runyan, 2006; Powell, 2010; Popp, 2006).

### 2.1.1 Support from the New Zealand tax administration

In the aftermath of the Canterbury earthquakes, Inland Revenue offered a package of general support to SMEs to help businesses to recover by:

- providing a range of tools and services that help organisations self-manage
- educating businesses about how they can comply with tax requirements during the recovery
- offering free business seminars and tailored presentations, meetings, events and expos for businesses affected by the earthquake

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tax debtors.’ *eJournal of Tax Research*. Vol 10, No. 2. October 2012). This lack of detailed knowledge did not impact on the compliance behaviour of SMEs who have never been in debt, but did for those who were in debt or had been in debt.

- waiving penalties for late filing.

### 2.1.2 *What is good compliance?*

A critical component of an efficient and effective tax system is voluntary compliance, that is, taxpayers proactively comply with their tax obligations. For this research, good compliance<sup>3</sup> is when an Inland Revenue customer files their tax return on time and pays tax owing on time and in full. Examples<sup>4</sup> of good compliant attributes include a SME business owner who:

- is organised and uses a tax agent
- builds savings and uses personal cash reserves if necessary
- has a positive personal ethos or attitude about tax (for example, that tax provides services to society)
- has good business acumen
- creates a financial forecast for the business
- belongs to professional bodies
- builds networks
- uses technology (for example, MYOB) to help with their tax and other regulatory obligations
- uses good business practices (for example, calendar)
- has insurance
- is proactive in working with their tax agent and/or tax administration if facing a tax-related problem.

### 2.1.3 *What are the risk factors?*

Risk factors that can lead to non-compliance are when the SME business owner:

- lacks knowledge and interest in tax obligations, and has a poor knowledge of the business' financial situation
- considers tax agents an unnecessary expense, and sees tax as a burden and 'easy money' for the Government
- relies heavily on cash flow

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<sup>3</sup> There are five components of tax compliance. These are registration, reporting, filing, payment and claiming. The research will focus on the filing and payment components of compliance. These categories are defined as the percentage of returns filed on time and the percentage of payments made on time. That is, the ratio of number of late filings to a total number of filings per tax year. A return is considered to be on time if it is filed within seven days after the due date, and the ratio of number of late payments to a total number of payments per tax year. A payment is considered to be paid on time if it is paid in full within seven days after the due date.

<sup>4</sup> The examples of good and poor compliant behaviours were identified from the project's interviews and survey, and also from previous SME research (Poppelwell, Kelly and Wang 2012).

- has a small business (for example, no or few employees to help out)
- uses future earnings to pay staff, creditors, and debts
- has poor management practices for dealing with debt
- gives a low priority to administration work
- when having tax-related problems, does not work with a tax agent or the tax administration.

### 3. RESEARCH OBJECTIVES AND METHODOLOGY<sup>5</sup>

A responsive tax regime is seen in the research literature (on disasters<sup>6</sup>) as a key building block in re-development after an adverse event. By late 2011, there was anecdotal evidence<sup>7</sup> that the Canterbury earthquakes were having an impact on small business compliance behaviour. The longitudinal study will identify what the long-term tax implications are for Canterbury and the rest of New Zealand, and develop a framework<sup>8</sup> from the learnings for responding to future large-scale adverse events. Because there is very little international literature on the impact of adverse events or disasters on SME tax compliance behaviour, a large component of the study is exploratory.

The purpose of the research is to:

1. Understand the impact of an adverse event on SME tax compliance.
2. Understand the effect an adverse event has on long-term debt, and on norms and values.
3. Explore whether Inland Revenue's actions have mitigated the risk of increased long-term tax debt and hidden economy activity.
4. Identify learnings for tax administrations for future adverse events.

#### 3.1 Outcomes

The research will identify how the prolonged nature of recovery from the Canterbury earthquakes has impacted on SME compliance behaviour, how Inland Revenue tried to mitigate it, and how we can learn from this. In addition to identifying the long-term implications for Canterbury and the rest of New Zealand, findings from the study will form a body of information that will help Inland Revenue and other government agencies inform future strategies, and develop a framework for managing compliance behaviour following an adverse event.

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<sup>5</sup> A more detailed explanation of the methodology is in Appendix 2.

<sup>6</sup> The available research literature generally refers to sudden large-scale adverse events as 'disasters'.

<sup>7</sup> There were reports that some businesses were under-reporting the number of staff they have in their tax returns.

<sup>8</sup> For example, managing compliance behaviour: 1) in a cash economy immediately following an adverse event; 2) due to business failure; 3) during the reconstruction period.

Much of previous research looked at personal impact and general recovery. When we contacted other tax jurisdictions we found there has been very little, if any, research undertaken that focused specifically on the impact of an adverse event on SME tax revenue.

Our literature review helped us to better understand the different phases of a disaster (prevention, response, recovery) and that each phase may require different actions from a tax administration.

The first year of the project focused on gathering baseline data. This included analysis of Inland Revenue's administrative data to measure the impact of major disasters on tax compliance behaviours, and developing a framework to monitor the administrative data throughout the life of the project.<sup>9</sup>

Inland Revenue's National Research and Evaluation Unit commissioned Colmar Brunton, an external research provider, to undertake the field work and analyse the findings from the survey and interviews.

### 3.2 Year 1

The qualitative and quantitative research was carried out with SMEs and tax agents in Canterbury. The qualitative research stage consisted of individual in-depth interviews with 21 SMEs and nine tax agents in April 2012, and a focus group with Christchurch-based Inland Revenue staff.

The quantitative stage of the research consisted of a telephone survey of 1,161 SMEs and 100 tax agents in the Canterbury region. Fieldwork was conducted from 21 June to 31 July 2012. The overall response rates to the surveys were 35 per cent for SMEs and 42 per cent for tax agents. Data was weighted to ensure the sample reflected population characteristics in terms of business size and debt history status.

### 3.3 Year 2

In-depth individual interviews were conducted with 39 stakeholders from a range of business sectors, government agencies and professional bodies, as well as 11 with Inland Revenue staff<sup>10</sup> identified by the project advisory group and research team. The participants were all Christchurch-based, and were knowledgeable and experienced in their respective sector of activity. They also had a good understanding of SMEs within the sector.

The interviews were conducted face-to-face in Christchurch and over the telephone. Their duration was up to one hour in length, and a semi-structured discussion guide was used to elicit viewpoints.

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<sup>9</sup> The population base used is SMEs who were active on 4 September 2010. Using this data has the benefits of being able to take both historic and current measures (i.e. pre and post quakes). Inland Revenue will continue monitoring the data until SMEs return to pre-quake 'normality', or it is obvious that a 'new normal' has been established.

<sup>10</sup> Please note that the views, opinions, findings, and conclusions expressed by Inland Revenue staff do not necessarily reflect the views of the department.

An additional seven interviews were conducted in April 2013 by Inland Revenue's National Research & Evaluation Unit with contractors from New Zealand Contractors' Federation.

#### **4. KEY FINDINGS FROM YEAR 1 (2012) AND YEAR 2 (2013) RESEARCH**

This section looks at some of the main themes drawn from the last two years of research, including:

- the type and level of impact the earthquakes had on business activity and recovery
- what the 'new normal' might look like
- the extent to which the earthquakes changed business attitudes and behaviours with regard to tax compliance
- what impact the tax administration has had on mitigating long-term non-compliant behaviour.

##### **4.1 Impact of the 2010 and 2011 earthquakes on businesses**

Many businesses were adversely affected by the earthquakes. In 2012, business participants in the qualitative research commented that the quakes struck businesses 'blindly', and many suffered at different times and to different degrees over the long period of recurring earthquakes. Some businesses who were not affected by the magnitude 7.1 earthquake which occurred on 4 September 2010 suffered damage in the magnitude 6.3 earthquake on 22 February 2011.

Two thirds (67%) of business owners surveyed in 2012 reported having at least one business adversely affected by the earthquakes. Smaller SMEs, SMEs that were located in the central business district (CBD), SMEs that have experienced a decline in business income, and SMEs in the wholesale, retail and accommodation and food sectors, reported that they were more likely to have been negatively impacted by the earthquakes.

The qualitative research illustrates the difficulties that some business participants were experiencing one year on from the earthquakes. They spoke about the emotional effects of seeing their business failing.

Last year was emotionally hard. I lost half of my business. It was hard. I'm just coming to terms with it now. There's nothing positive ... (SME, hospitality)

They also spoke about the financial impacts arising from such things as keeping up with their tax payments and keeping their staff in employment.

What we bought [business] isn't here anymore, so we can't sell it. But we still have to pay tax. We'll foot the bill with personal money. (SME, hospitality)

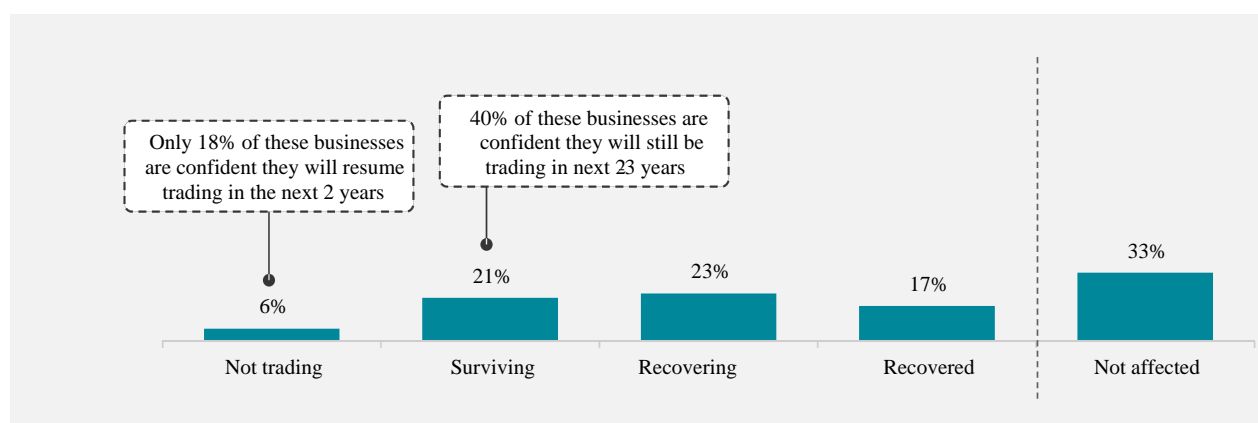
My priority is to survive today. My obligations are: pay my staff. I can't let them go. (SME retail)

## 4.2 Stages of recovery for businesses

Business impact and recovery following a disaster varies. As previously mentioned, a literature scan revealed that, generally, adverse events have two or three phases: prevention, response and recovery, but there is little specific research on the impact of adverse events on SME tax compliance behaviour. The research classified Canterbury in 2012 as being in the recovering phase and predicted that, with assistance, some small businesses would likely return to a growth phase. However, it was also expected that some SMEs would not recover, and Inland Revenue would need to take action (for example, closing down, bankruptcy, liquidation) to avoid the business getting into unrecoverable debt or increasing its debt level.

Figure 1 shows that business participants surveyed in 2012 are still in different stages of recovery one year after the February 2011 quake.

**Figure 1: Business impact and stage of recovery.<sup>11</sup>**



Base: All SMEs (1,161)

SMEs are spread across different stages of recovery from the earthquakes:

- six per cent are currently not trading—only 18 per cent of these SMEs are confident that they will resume trading in the next two years
- 21 per cent are ‘surviving’ (that is, the business is focused on doing what it takes just to survive)—only 40 per cent of ‘surviving’ SMEs are confident that they will still be trading in the next two to three years
- 23 per cent are ‘recovering’ (that is, the business has passed the survival stage, but is still focussed on minimising the impacts of the earthquakes)
- 17 per cent have ‘recovered’ (that is, the business is as strong, or stronger, than before the earthquakes)

<sup>11</sup> The diagram and analysis is from Colmar Brunton and published in the Inland Revenue and Colmar Brunton Year 1 report <http://www.ird.govt.nz/resources/4/0/4025ff804f2dec32a019b460ef02f5a5/r-and-e-report-adverse-events-year-1.pdf>.



- 33 per cent were not adversely affected by the earthquakes.

Other key impacts of the earthquakes on SMEs are:

- 40 per cent of SMEs still trading experienced a decrease in their business income since before the earthquakes, 40 per cent have experienced no change in their business income and 18 per cent have experienced income growth. SMEs in earlier stages of recovery are more likely to have experienced a decrease in business income (81% in 'surviving' and 58% in 'recovering')
- 18 per cent of SMEs adversely affected by the earthquakes, but still trading, reduced their staff levels. Only eight per cent have increased their staff levels. 38 per cent of SMEs no longer trading employed staff prior to the earthquakes
- Around one quarter (26%) of SMEs affected by the earthquakes have moved location since the earthquakes (12% have moved multiple times)
- Only one quarter (24%) of SMEs that are currently located outside of the CBD, but were previously located in the CBD, plan to move back to the CBD once the rebuild provides an opportunity to do so. An additional 28 per cent are unsure of their future movements. Nearly half (48%) say they are relocated permanently outside of the CBD.

From interviews undertaken in Year 2 (2013) with stakeholders and Inland Revenue staff, participants expected SMEs to have resumed trading or to have closed down their business. However, they also acknowledge that some SMEs would be still struggling (for example, with re-location and insurance issues).

Based on these interviews, the SME recovery model<sup>12</sup> (from the Year 1 research) was reviewed to reflect the variety of situations SMEs were still experiencing in 2013. Figure 2 illustrates the revised recovery model.

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<sup>12</sup> In Year 1, the 'failure vs growth' spectrum model showed that SMEs experienced different phases before reaching a growth phase. The linear model was: failure, loss, survival, recovery and growth.

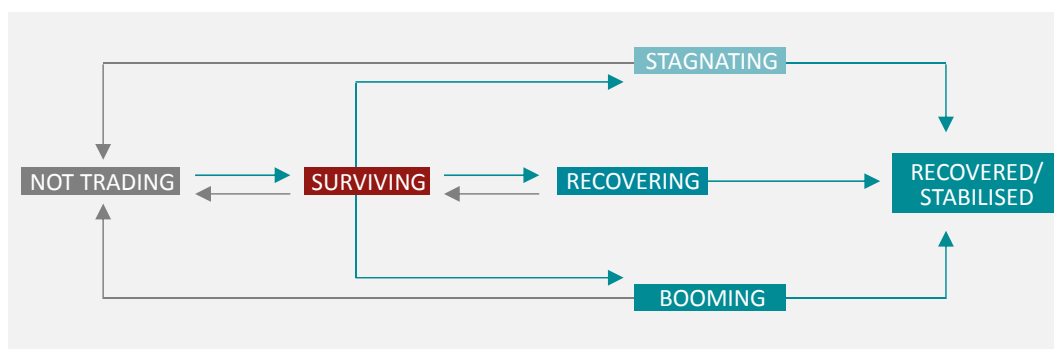
**Figure 2: Year 2 recovery model**<sup>13</sup>

Figure 2 shows the different stages of SME recovery after an adverse event:

- **Not trading:** This stage results *immediately* from the earthquakes. A variety of SMEs in different sectors found themselves unable to trade as a consequence of the earthquakes. Today, stakeholders and Inland Revenue staff believe that SMEs should not be in this stage anymore: they should have resumed trading or closed down. If SMEs are not trading today, stakeholders and Inland Revenue staff believe it is more likely due to other issues than the earthquakes themselves (for example, cashflow and insurance problems).
- **Surviving:** Some SMEs are still in this stage and struggle to resume regular business patterns (for example, business disruption through unexpected roadworks). They face financial difficulty (for example, irregular income, tax debt). This stage includes SMEs in a range of sectors.
- **Stagnating:** SMEs have resumed trading, but are unable to grow their business (e.g. due to limited foot traffic and online presence). Although their financial situation is better than in the Surviving stage, Stagnating SMEs still need to monitor their situation carefully. Their struggles result from dealing with the earthquakes' consequences (for example, insurance problems, roadworks and building assessment).
- **Recovering:** These SMEs have re-established regular business patterns and are in a better financial position to grow their business sustainably.
- **Booming:** A number of SMEs are experiencing exponential growth and feel financially secure. These SMEs need to ensure they have appropriate systems and processes in place to manage their rapid growth. In addition, this level of growth is unsustainable and these SMEs may face financial difficulty when the 'bubble bursts'. These SMEs are likely to be found in the building/construction sector, because of the rebuild, as well as in the hospitality sector (for example, café, bars and restaurants), because of the lack of competition.

<sup>13</sup> The diagram and analysis is from Colmar Brunton and published in the Inland Revenue and Colmar Brunton Year 2 report <http://www.ird.govt.nz/resources/8/8/88b4bc8040b39c1b8111cbe0a6c6ba36/r-and-e-report-adverse-events-year-2.pdf>

- **Recovered/Stabilised:** Very few SMEs are in this stage, which is characterised by a solid business foundation and practices leading to sustainable business growth.

Stakeholders and Inland Revenue staff believe that some SMEs have reached business-as-usual (BAU), while others have not. Those who have reached BAU have re-established their business and seem to be doing well (for example, earning an income). These SMEs are in the Recovering and Booming stages, and in the future will be in the Recovered/Stabilised stage. However, the SMEs that have not reached BAU are still struggling to reach a business activity level that would give them financial security. These SMEs are in the Surviving and Stagnating stages. Stakeholders and Inland Revenue staff think that it will take three to four years for these SMEs to reach BAU.

Stakeholders and Inland Revenue staff discussed BAU at the industry level or Christchurch city level. In these cases, it would take even longer for industries and the city to reach BAU (five years and at least ten years respectively). Stakeholders and Inland Revenue staff expect that BAU for Christchurch city will be reached when the CBD is functional.

### 4.3 Factors that have influenced SME recovery

The first year research findings showed that for SMEs in Canterbury there are several stages of a recovery, and that assistance during the survival stage is critical for businesses. Stakeholders and Inland Revenue staff who were interviewed in Year 2 of the research (2013) were divided about SME recovery times and when SMEs reach BAU. Since the earthquakes, SMEs have experienced some enabling and hindering factors that have influenced their recovery. They are summarised in Table 1.

**Table 1: Factors that have influenced SME recovery<sup>14</sup>**

Factors	Characteristics
Enabling	External assistance (e.g. wage subsidy) SMEs' proactivity Having a business branch outside of Canterbury Business resilience Personal resilience of business owners
Hindering	Lack of clarity around the roles and responsibilities of the parties involved in the rebuild SMEs' insurance and financial difficulties

<sup>14</sup> The table and analysis is from the Colmar Brunton (2013) Year 2 technical report and published in the Inland Revenue and Colmar Brunton Year 2 report <http://www.ird.govt.nz/resources/8/8/88b4bc8040b39c1b8111cbe0a6c6ba36/r-and-e-report-adverse-events-year-2.pdf>

#### 4.4 The extent the earthquakes changed business attitudes and behaviours with regard to tax compliance

A number of factors have impacted the tax compliance behaviour of SMEs across the stages of recovery from the earthquakes. These include:

- the priority the business places on tax compliance against other business priorities
- whether the business has appropriate and effective financial management and tax processes
- the use of cashflow to meet tax payments, as opposed to paying that from funds put aside.

These factors led to many businesses not meeting their tax requirements during the early recovery stage.

“Most people did nothing for some time after the earthquakes. It was a combination of trauma due to the quakes, and low anxiety about tax. People were not too worried about tax at the time.” (Interview 30 Tax agent)

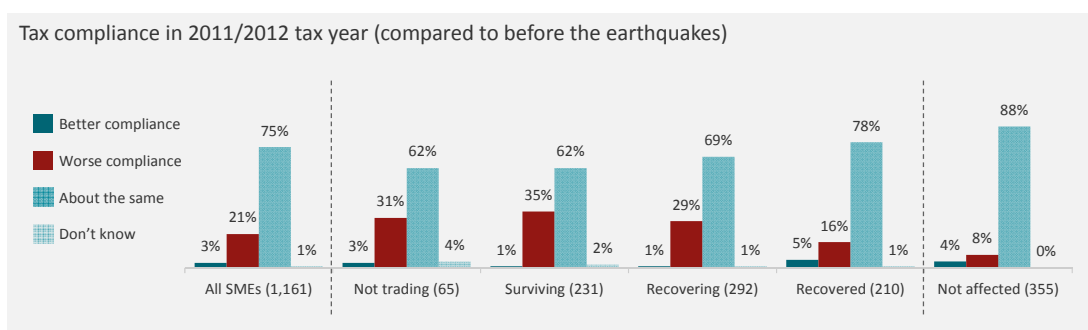
##### 4.4.1 SMEs' self-reported tax compliance in 2011/2012 (compared to before the earthquakes)

In the telephone survey, we also explored with SMEs how well they have been able to meet their tax obligations during the 2011/2012 tax year. 'Meeting tax obligations' was defined for respondents as whether the business filed its tax returns and paid its tax on time (or within any extensions of time given) and paid the correct amount (including any amounts agreed to as part of a payment arrangement). Respondents were then asked whether during the period of April 2011 to March 2012 their business was better, worse or about the same in meeting its tax obligations compared to before the earthquakes.<sup>15</sup>

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<sup>15</sup>The reader should note that this question is not measuring whether the business found it more difficult to meet their tax obligations. Rather the focus was on their end success or otherwise of filing and paying on time for the correct amount. Results for this question are presented by stage of recovery in the next chart.

**Figure 10: Tax compliance in 2011/2012 tax year (compared to before the earthquakes)<sup>16</sup>**



Source: Q5ci  
Base: Varies – see graph

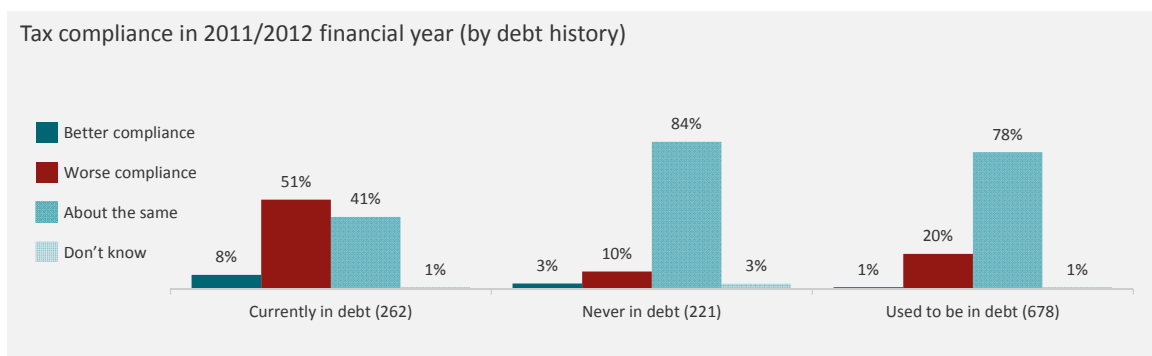
Around one in five SMEs (21%) indicated their business was worse at meeting its tax obligations during the 2011/2012 tax year than before the earthquakes. The majority (75%) said their compliance was about the same.

The degree of impact of the earthquakes on the business clearly has an impact on tax compliance. SMEs currently not trading or in the ‘surviving’ or ‘recovering’ stages are more likely to have worsened compliance (30% on average) compared to those who have recovered (16%) or were not affected (8%).

#### 4.4.2 Impact of debt history on meeting tax obligations

Debt status is also a defining factor in tax compliance, with around half (51%) of those in debt in late 2012 indicating they were worse at meeting their tax obligations in 2011/2012 than before the earthquakes.

**Figure 11: Tax compliance in 2011/2012 financial year (by debt history)**



Source: Q5ci  
Base: Varies – see graph

<sup>16</sup> Figures 10 and 11 are from Colmar Brunton’s analysis, and published in the Inland Revenue and Colmar Brunton Year 1 report

<http://www.ird.govt.nz/resources/4/0/4025ff804f2dec32a019b460ef02f5a5/r-and-e-report-adverse-events-year-1.pdf>.

These factors are consistent with previous research on SME tax debt.<sup>17</sup> However, in this research the earthquakes accentuate them, especially in the earlier stages of recovery (for example, 'surviving' stage). For instance, tax compliance becomes even less of a priority for SMEs. Likewise, the heavy reliance on cashflow is exposed as a poor strategy for tax compliance when income is unpredictably cut due to an adverse event.

The earthquakes compounded already poor tax compliance strategies, by introducing new factors such as damage to business premises and lost records.

There is limited evidence in the research that general attitudes towards tax have changed significantly one year after the earthquakes. Most business participants who were surveyed in 2012 agreed that they:

- accept responsibility for paying their fair share of tax (90%)
- believe paying tax is the right thing to do (86%)
- believe that by paying tax they are contributing to New Zealand society (80%).

These levels of agreement are similar to those evident among a national sample of SMEs in Inland Revenue's Customer Satisfaction and Perceptions (CS&P) survey (although the strength of agreement is somewhat weaker among Canterbury SMEs).

Few (8%) said that they resent paying tax. This level of resentment is lower than that among SMEs in the CS&P survey. It is possible that this lower level of resentment is tied to a belief that paying tax is important because it contributes to the Christchurch rebuild (65% of all SMEs in Canterbury agree with this notion).

Resentment that does exist among Canterbury SMEs largely stems from a belief that they pay too much tax, disapproval of how tax money is spent by government and a general sense of the tax system being unfair. However, none of these reasons appear to be unique to the Canterbury situation.

Stakeholders and Inland Revenue staff who were interviewed in 2013 (Year 2 of the longitudinal study) believe that attitudes have not fundamentally changed following the earthquakes. They explain that tax compliance is a mindset or a moral attitude, and as such is difficult to shift one way or the other.

Stakeholders and Inland Revenue staff consider that compliant taxpayers' fundamental attitude to tax compliance is unlikely to change, that is, these taxpayers believe that everyone needs to contribute their fair share of tax. With signs of the rebuild, people and SMEs are more optimistic about economic growth for the region and feel more positive about contributing to tax.

However, slight attitudinal shifts may occur in terms of relative priority for compliant taxpayers. For example, if they are forced to change from a long-term strategic business plan to a more short-term, functional approach to business. In addition, if people and businesses do not perceive much progress in the rebuild, they may lose confidence about the purpose of paying tax and contributing to the rebuild.

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<sup>17</sup> Poppelwell, Kelly, and Wang (2012). Intervening to reduce risk: identifying sanction thresholds among SME tax debtors. *E-Journal of Tax Research*, 10, 2, 403-435.

With regard to tax compliance behaviour, stakeholders and Inland Revenue staff note that it has changed following the earthquakes. Initially, SMEs were unable to file their returns and pay their tax because of the high levels of destruction (for example, buildings and records destroyed) and also personal injury and trauma.

In the months following the destructive earthquakes, some SMEs resumed filing their returns and paying their tax. For some, this involved setting up payment arrangements with the tax authority. However, some SMEs have continued deprioritising their tax obligations, either intentionally or accidentally.

SMEs at different stages of recovery may face more or less difficulty meeting their tax obligations. For example, Surviving SMEs are likely to have an irregular income, thus making it difficult to pay their tax. Recovering SMEs, however, earn a regular income and are more able and likely to meet their tax payments.

General attitudes towards tax tend to be more positive among SMEs in later stages of recovery from the earthquakes than SMEs in earlier stages of recovery (including those not trading).

However, the Year 1 survey findings indicate that many participants believe that businesses adversely affected by the earthquakes should be given tax leeway:

- around half (53%) of SMEs agree that businesses should not have to pay previous tax debts until they are fully operating again (with the remainder more likely to take a neutral stance)
- the notion of businesses adversely affected by the earthquakes paying a lower tax rate attracts a polarised response, with four in ten SMEs (41%) agreeing with this idea and around a quarter (28%) disagreeing.

The request for tax leeway can be explained by changes in ability to comply in that the tax compliance behaviour of SMEs has been impacted by the earthquakes both in the short term and the long term:

- seventy three per cent of tax agents say that more than three quarters (76% to 100%) of their business client base has stayed the same in terms of how well they meet their tax obligations. Likewise, the majority (75%) of SMEs said their compliance was about the same in 2011/12 compared to before the earthquakes. Cash reserves, savings (both personal and business), and adequate cashflow were important in enabling SMEs to meet their tax obligations
- just over half (54%) of tax agents say that up to a quarter (1% to 25%) of their business client base was worse in meeting their obligations in 2011/12 compared to before the earthquakes, with an additional 19 per cent of tax agents saying more than a quarter (26% to 100%) of their client base has got worse.

Around one in five of all SMEs (21%) indicate their business was worse at meeting its tax obligations during the 2011/12 tax year than before the earthquakes. Levels of worsened tax compliance are higher among:

- those in earlier ('surviving' or 'recovery') stages of recovery from the earthquakes (30% said their tax compliance was worse)



- those with declining business income (36% said their tax compliance was worse)
- those with debt in late December 2010 (50% said their tax compliance was worse).

Of the quarter (27%) of SMEs affected by the earthquakes that are currently trading and report experiencing a worsening in tax compliance since the earthquakes, 45 per cent expect to see an improvement in meeting their tax obligations by 2012/13 and 30 per cent by 2013/14, with the remaining 26 per cent not expecting to see an improvement by 2013/14 or being unsure. Irregular business patterns and the on-going earthquakes contribute to SMEs' uncertainty about their ability to meet future tax obligations.

## **5. MITIGATING THE EFFECT OF NON-COMPLIANT BEHAVIOUR FOLLOWING AN ADVERSE EVENT AND RESTORING PRE-DISASTER COMPLIANCE LEVELS**

The qualitative research findings suggest that there are slightly different views on what constitutes 'hidden economy activity', with a range of perceptions from deliberate cash payments and non-declaration of income through to accidental paperwork errors (claiming for expenses that they shouldn't, or making mistakes). SMEs' definitions in turn drive their behaviour and attitudes on the acceptability of the behaviours and what is the appropriate response from Inland Revenue.

Large majorities of both SMEs and tax agents think that there either has been no change in hidden economy activity<sup>18</sup> (69% and 64% respectively) or they are unsure (20% and 22% respectively). Business owners who perceive there has been a change are fairly evenly divided between those who think there has been an increase (6% of all SMEs) and those who think there has been a decrease (5% of all SMEs). Tax agents are more likely to think there has been a decrease (11%).

When prompted on what may have caused a change in the hidden economy, SMEs highlight the changes that are now unique to Christchurch—it is not 'business (and behaviour) as usual' which in turn drives attitudes and behaviour specific to the Christchurch environment. This can create more opportunities for hidden economy behaviour than previously.

Perceptions of an increase in hidden economy activity most commonly stem from recognition of financial pressures and competition, and a desire by smaller operators to cut corners and get the job done quicker. In the qualitative research findings, business owners distinguished between those who willingly deal with 'under the table' cash payments and those who, due to the general disruptions caused by the earthquakes, have or will inadvertently take part in the cash economy (for example, the need to use estimates if lost records cannot be recreated, or sloppy paperwork due to the business owner spending more time focusing on getting the business up and running again).

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<sup>18</sup> In the telephone survey, hidden economy activity was described to respondents as payments businesses receive for work completed that they do not declare for tax purposes. Respondents were further told that this included cash payments which are sometimes referred to as payments made 'under the table'.

Perceptions of a reduction in hidden economy activity most commonly stem from the involvement of professional organisations and the requirements of larger contracts, as well as a perceived increase in electronic transactions.

The tax administration taking a hard line in dealing with ‘under the table’ payments with fines and prosecution receives support from around half of SMEs (48%). While some disagree with this approach (16%), many hold a more neutral stance (30%). Tax agents are more strongly in favour of Inland Revenue taking a hard line approach (67%).

Relatively few believe that because of the earthquakes Inland Revenue should take a more lenient approach to ‘under the table’ payments (only 16% of SMEs and 5% of tax agents agree with this notion). However, only a small majority of SMEs (59%) disagree with this statement as some take a more neutral stance (21%).

In the qualitative research, SME owners suggested Inland Revenue use a softer/lenient approach during the survival phase as most SMEs are struggling. This includes educating and informing SMEs about appropriate business, financial and tax management versus cash, using an approachable and understanding manner that will enable business owners to ask for assistance if required, and communicating the option of payment arrangements to struggling SMEs. Inland Revenue is then expected to take a tougher/stricter approach during the recovery phase as SMEs should have resumed a regular, non-cash business pattern. Following education and advice about risks and consequences, SMEs expect audits and legal action, proceedings to be made public to discourage others, and Inland Revenue to proactively target SMEs/industries that are deemed at risk.

## 5.1 Assistance to SMEs

In the qualitative research, there was a perception that Inland Revenue responded to the earthquakes by offering the ‘usual’ assistance available to SMEs in compliance difficulty such as time extensions, waived penalties and payment arrangements. Inland Revenue further combined this with possibly increased proactivity, extending some of the provisions (for example, longer time periods than usual) and a sympathetic and helpful manner.

However, there is not a perception that there was an extraordinary ‘assistance package’ formulated in response to an adverse event.

Having said that, tax agents and SMEs are generally positive about Inland Revenue’s assistance and support during the earthquakes and feel that Inland Revenue was approachable, available, flexible and lenient, thus helping them to meet their tax obligations within the new context of their changing circumstances. Take-up rates of Inland Revenue’s assistance included:

- thirty seven per cent of all SMEs (or their accountants) received an extension of time for their business to file a tax return or make a payment (58% of those in debt late December 2010 received this)
- twenty one per cent of SMEs negotiated a payment arrangement for the late payment of tax

- fourteen per cent had penalties waived by Inland Revenue (43% of those in debt late December 2010 received this).

Large majorities (74% to 88%) of SMEs that received these types of assistance found them helpful. These forms of assistance enabled SMEs to address their immediate tax obligations and prevent them from incurring (sometimes additional) debt in the initial period following the earthquakes. However, there was a strong call in the qualitative research for support and assistance to be extended beyond the initial few weeks/months. Many SMEs are either still ‘surviving’ or feel they have only recently resumed a sense of ‘normal’ business.

SMEs appreciated the range of communication channels Inland Revenue used to let business owners know what to do if their business had been affected by the earthquakes. Only a minority of SMEs had direct contact with Inland Revenue: 19 per cent of SMEs phoned Inland Revenue, Inland Revenue phoned 12 per cent of SMEs, and just four per cent had face-to-face contact.

Recall levels of the more generic communication channels were higher: 45 per cent recalled the letter, 45 per cent recalled the advertisement and 33 per cent visited Inland Revenue’s website.

Face-to-face contact is viewed especially favourably (82% of those who had face-to-face contact found it helpful) as it enabled business owners to address their concerns, discuss the complexities of their situation, seek clarification and receive reassurance that they are doing the right thing.

Ratings of the other forms of contact and communications were not as high, with around half (or a little more) of recipients indicating they were helpful (many of the remainder gave a neutral rating). Key issues were a perceived drop off in Inland Revenue’s interest and understanding (evident in phone calls to Inland Revenue), as well as a decrease in the frequency of updates on the website, once a slowdown in earthquakes occurred.

The main suggestions for improving Inland Revenue’s overall approach to providing support and assistance during the survival stage of an adverse event are to provide a more ‘extraordinary response’ rather than an improved BAU response. This means, for example:

- greater profile and visibility in the community with the opportunity for face-to-face contact
- increased proactivity with Inland Revenue contacting SMEs (by phone), rather than the onus on SMEs to make the contact. Relying on SMEs to contact Inland Revenue means it may not happen as SMEs deprioritise tax or fear Inland Revenue’s response
- not sending automated, generic letters and statements. These often contradicted what business owners had agreed with their tax agents or Inland Revenue and caused some SMEs considerable anxiety
- additional assistance to sole traders. Smaller SMEs are more likely to have been adversely affected by the earthquakes than larger SMEs. The qualitative research suggests sole-traders wanted more personalised communication or

targeted information, especially if they did not have a tax agent. They felt that Inland Revenue's assistance was primarily aimed at employers.

## 5.2 Assistance to tax agents

As an authoritative intermediary between SMEs and Inland Revenue, tax agents play a critical role in supporting SME survival and recovery from the earthquakes and maintaining SME compliance behaviour. Over half (57%) of tax agents said they have been more involved in the financial management of their business clients since the earthquakes.

There has been a strengthening of relationships, negotiations and trust between Inland Revenue and tax agents, with face-to-face meetings being particularly helpful.

Tax agents report that the interventions provided by Inland Revenue directly to tax agents have been helpful to them professionally (managing their own workload) and to their SME clients. The most useful interventions have been:

- time extensions
- payment arrangements and penalties waived
- ability to negotiate what is provided and when
- use of estimates when lost records could not be recreated or duplicated.

Tax agents believe extensions of time, payment arrangements and the waiving of penalties continue to be important for SMEs in recovery. Tax agents also made suggestions about improving relationships through the provision of locally-based staff (see previous comments about visibility) and/or dedicated staff who were completely up-to-date with the situation in Christchurch.

Stakeholders and Inland Revenue staff are generally very positive about the diverse assistance Inland Revenue provided to SMEs. They believe it has been helpful to SMEs' recovery. Inland Revenue has been approachable, flexible and friendly, thus enabling SMEs to address their tax issues. This has also resulted in Inland Revenue's profile and reputation being lifted in the community.

However, stakeholders and Inland Revenue staff explain that struggling SMEs may have found it difficult to remain compliant because of the problems faced by their business (for example, irregular income and insurance issues). These SMEs need to reprioritise their tax obligations as soon as possible with Inland Revenue's personalised assistance. Stakeholders and Inland Revenue staff believe that non-compliance is unacceptable, but Inland Revenue needs to use its discretion to help SMEs address their tax obligations.

Surviving SMEs still require some specialised assistance from Inland Revenue to move to the Recovering stage. Stakeholders believe that Inland Revenue needs to assess each struggling SME's situation on an individual basis. Both stakeholders and Inland Revenue staff believe that a thorough evaluation of SMEs' viability is key to understanding if these SMEs can recover, and what type of assistance they require.

Some stakeholders and Inland Revenue staff recognised that Inland Revenue's leniency was helpful to SMEs during the earthquakes. However, they believe that,

today, Inland Revenue's leniency has become unhelpful to those SMEs that do not feel a sense of urgency to become compliant. These stakeholders and Inland Revenue staff believe a 'deadline on leniency', which can be revisited, is required.

## **6. LEARNINGS**

### **6.1 A new sense of normality in Christchurch**

The 'new normal' is vastly different from 'the normal' that people and businesses knew prior to the earthquakes. The following factors explain what has changed in Christchurch to create this new sense of normality:

- the rebuild is about recreating a place and a sense of place from scratch rather than renovating
- the rebuild is a journey rather than a point in time and the new sense of normality is achieved gradually through this journey. It is an incremental process of change and stakeholders and Inland Revenue staff are unable to pinpoint a specific point in time when it started
- underlying anxiety about more earthquakes.

Many stakeholders and Inland Revenue staff believe that Inland Revenue needs to return to BAU now and apply its practices of educating, investigating, following up, auditing and prosecuting. One person felt that Inland Revenue returning to BAU is a necessary part of helping SMEs return to better compliance levels, and decreasing hidden economy activity.

The place won't ever recover if we continue to treat it as broken. (Interview 33, Inland Revenue)

To mitigate the hidden economy, some stakeholders and Inland Revenue staff suggest that Inland Revenue develop social marketing campaigns to increase understanding of the tax obligations, and 'goodwill' about contributing to the rebuild.

They expect that these campaigns would increase compliance and reduce participation in the hidden economy. Stakeholders and Inland Revenue staff feel that, today, non-compliance has become even more unacceptable, as the destructive earthquakes were over two years ago, and SMEs should now be able to meet at least some of their obligations (for example filing returns).

Should SMEs remain non-compliant or take part in the hidden economy, stakeholders and Inland Revenue staff want Inland Revenue to make an example of these SMEs to show that Inland Revenue applies the rules and to deter SMEs from non-compliance and hidden economy activities.

However, stakeholders and Inland Revenue staff also emphasise that Inland Revenue needs to be flexible and use its discretion with SMEs that are still struggling and require assistance. This needs to be evaluated on a case-by-case basis. The key is that Inland Revenue needs to be consistent.

## 6.2 SMEs' creativity and innovation have flourished

Stakeholders and Inland Revenue staff believe that creativity and innovation have flourished since the earthquakes. In some cases, employees from large companies have left to start up their own businesses.

It has provided a springboard for smart, innovative people to create their own companies. So, we've got quite a lot of individuals who might have been working for, say, Fulton Hogan or some of the bigger companies, who've gone out and created, started up their own company and are doing well out of it: minimal overheads, [they] have some good skills, and so there's a great opportunity for companies like that. (Interview 45)

In other cases, businesses have had to rethink how to do things.

We've been able to do things that we weren't really good at ordinarily, like live music. We've had a lot of live music going on in the evenings, just because there was nowhere. So, we were really busy with that. (Interview 22)

Some businesses whose premises were destroyed have had to come up with new premises quickly, and some have set up an online presence instead of relying solely on foot traffic.

Some [business people] are smarter, more creative. They have reopened in a [shipping] container. And people [customers] are more accepting. (Interview 4, SME, hospitality)

## 6.3 Decreased competition for some SMEs

In different industries, SMEs have seen competition levels change due to the earthquakes. Some SMEs have benefited from the demise of their competitors and have thrived, regardless of how much the earthquakes have affected them.

I think the survivors did really well, most businesses, because there were fewer of them. There's less restaurants, there's less hotels, there's less accommodation, so everyone that is up and standing is doing really well and they still are. (Interview 3)

For some SMEs, business growth has been incremental while for others it has been exponential.

We can't get enough vans to meet up with demand. (SME, retail)

Over time, this new sense of normality has been strengthened because:

- the earthquakes have decreased in number and intensity
- many SMEs have resumed trading
- some level of disruption is tolerated (for example, roadworks)
- it feels like a long time since the earthquakes. People and SMEs have to 'get on with their life'

- today the rate of business creation and de-establishment is similar to what it was prior to the earthquakes.

Throughout [the earthquakes and after], they [births and deaths of SMEs] dropped away a little bit to begin with, but actually they came back quite quickly, and now births and deaths and failures are very similar to where they were [prior to the earthquakes]. Obviously, there's been some loss of retail, permanent loss of retail, tourism and accommodation in particular, and those will come back over time. But that's been offset by booms in construction, procurement, you know, supply chain kind of markets as the rebuild really kicks in. (Interview 44)

#### **6.4 The earthquakes have built a stronger community spirit and sense of resilience**

Throughout the ordeal, people and businesses have become a lot more supportive of each other. They have come together to restore the city and their business. Stakeholders and Inland Revenue staff believe that this sense of 'togetherness' will help rebuild a better and stronger Christchurch. They want the city to thrive again and grow economically.

Since the earthquakes, people and businesses that are outside of the 'old boys' network' have had to become less insular and more open to professional advice and business connections outside of Christchurch/ Canterbury. For example, SMEs recruit skilled and experienced staff from outside of Canterbury and overseas. This may help people and businesses get back into 'business mode' more rapidly with this new external support.

#### **6.5 More co-operation between SMEs and between government agencies**

Stakeholders and Inland Revenue staff observe that SMEs in Canterbury tend to co-operate more today. For example, hairdressers and architects whose salon and office were destroyed now share the same business premises. Business people, through professional organisations and business networks, help each other despite being competitors. SMEs have created a new 'business dynamic' unique to Christchurch and are more reliant on each other.

I know from my association with the local Institute of Architects that we formed a little committee to find out who needed help ... There's a real professional bond, I suppose. Different practices [worked] in other firms. I mean, we made an offer for other firms that they could come and use our space here, use our facilities, and a lot of firms went and worked from home on a temporary basis. Some firms did join ranks and work together. So no, there's no professional jealousy. It was basically a lot of collaboration and professional help and guidance. (Interview 9)

More co-operation also exists between government agencies and other organisations. For example, Inland Revenue and the Ministry of Social Development (MSD) shared work premises and have provided more coordinated assistance and information to SMEs. Inland Revenue's and MSD's collaboration has been more effective and productive for assisting SMEs.

I sense a really good collaboration. Across government and the business sector people are willing to share and open together. If you look at us, this is Corrections, so they're with us as well. There's willingness for people to give it a go and share things that traditionally they won't, and I think that's good for business. (Interview 29)

## 6.6 Learnings for a tax administration:

- Visibility and proactivity are important.
- A tax administration's actions need to match the different stages of a disaster and the stage of recovery a business is at.
- More awareness that the 'surviving' timeframe is variable from business to business.
- A more tailored approach is needed for businesses that are recovering.

## 7. CONCLUSION

### 7.1 In the short-term adverse events can impact on business tax compliance but not necessarily on attitudes towards meeting tax obligations

Due to the lack of a benchmark study, the research is limited in its ability to fully answer the question on whether attitudes towards tax have changed. However, research findings to date suggest there has not been a major shift in attitudes towards tax compliance. The vast majority of SMEs in Canterbury exhibited positive attitudes towards tax one year after the February 2011 quake. However, there is an expectation that businesses should be given tax leeway to help recover from the earthquakes.

Regarding their tax compliance behaviour, the research notes that SMEs were initially unable to file returns or pay tax due to their buildings and records being destroyed but also personal injury and trauma.

The administration data shows that tax compliance behaviour has worsened for some SMEs, and business and tax agent participants in Year 1 reported that their compliance behaviour had worsened following the earthquakes. Restoring good tax compliance behaviour may require the tax authority to encourage SMEs to get back into the habit of filing and paying tax so that these behaviours once again become routine.

Filing and payment compliance began to improve in the months following, and while some SMEs set up payment arrangements with Inland Revenue others continued to intentionally or unintentionally deprioritise their tax obligations. This may be due to the stage of recovery they were in—for example, SMEs earning a regular income are more capable and likely to pay tax than those with irregular income.

A corollary of this is the leniency Inland Revenue showed SMEs after the earthquakes. Some stakeholders interviewed believed this “has become unhelpful to those SMEs that do not feel a sense of urgency to become compliant” and that “Inland Revenue needs to return to BAU now and apply its practices of educating, investigating, following up, auditing and prosecuting. This will not only help SMEs return to better



compliance levels, but also help decrease hidden economy activities” (Inland Revenue & Colmar Brunton, 2013).

## 7.2 Learnings for tax administrations for future adverse events

The approach towards the hidden economy during the ‘survival’ stage is bound up with the type of response and interventions that a tax administration should take towards all tax non-compliance. A case-by-case approach is needed where the tax administration should be proactive, helpful, compassionate and lenient towards businesses whose lack of compliance is outside of their control or a ‘genuine’ error/oversight, while taking a hard-line approach to ‘deliberate’ tax avoidance.

Once SMEs have returned to a more regular business pattern (recovering and recovered), most SME participants believe that the tax authority should be tougher and more proactive in dealing with the hidden economy. SMEs’ suggestions are similar to previous debt research, in that deliberate tax avoidance requires enforcement.

The suggestions that stand out as slightly different in an adverse event situation are for the tax authority to be more visible in the community, meet with businesses face-to-face, build relationships, provide reassurance and apply more individual and tailored interventions and solutions.

Many of SMEs’ and tax agents’ suggestions for communication would also be appropriate in a BAU context. However, in extraordinary situations and while in the survival phase, SMEs and tax agents suggest more extraordinary communication. SMEs and tax agents need the tax authority to increase its visibility (for example, face-to-face) and to be proactive for an extended period of time and provide a more individualised/tailored approach, while reducing generic communications such as automated letters.

One of the key learnings of the research is that the ‘surviving’ timeframe is very variable from SME to SME and depends on a number of factors, for example, the nature and timeframe of the event itself, the extent of disruption to the business and industry demand. This means that a tax authority’s response and interventions will need to be tailored to the SME’s circumstances, rather than a more generic ‘survival’ response. The research suggests a survival timeframe anywhere on a spectrum of a few weeks, to 18 months or beyond.

Surviving is typified by using both personal and business resources to continue trading, generating revenue and/or cover costs. It seems that SMEs in the surviving phase oscillate between moving towards either ‘loss’ and failure of the business or eventual ‘recovery’. Many of the environmental factors and SMEs’ decision-making that sway the balance one way or the other will be outside of the tax administration’s control, but it would appear that proactive assistance of the tax administration (and tax agents) could be a tipping point factor to avert failure. The timing of this assistance will be critical and will need to include some objective measures of the likelihood of the intervention sustaining the business into recovery, or only staving off deepening debt and inevitable failure.

Surviving/recovering transition is likely to be based on personal and business resilience, environmental factors (for example, being in an industry that is in demand) and key interventions such as payment arrangements, waiving penalties, providing

time extensions etc. that enable the SME to financially re-establish itself. SMEs that are recovering may need close tax management to ensure that re-establishing tax compliance is as high a priority as re-establishing the business, for example, ensuring that reinvesting in the business, paying staff and suppliers etc. is not to the detriment of tax compliance.

SMEs may recover to a point where their financial position matches or even exceeds that prior to the adverse event. Some tax agents have suggested that SMEs that are recovered (and in growth) may also need close tax management to ensure that both their current and forward tax payments are accounted for. SMEs that are in growth industries may get themselves into a 'busy cycle', meeting new demands and accounting/financial management needs that may be more typical of a 'new' business, that is, they need to up-skill their financial and tax management to meet the new demands such as a growth in staff numbers, more invoicing etc.

A tax authority's response and interventions will need to be tailored to the SME's individual circumstances. This will ideally require close liaison between the authority and tax agents to determine which stage of recovery a business is at. Regardless of the stage of survival or recovery, it would appear to be critical for the tax authority to proactively contact these SMEs to ensure that they are maintained within the 'system' and ensure that there is an active plan in place to manage tax requirements. For SMEs that have become less visible (for example, the tax authority does not have up-to-date contact details), there may need to be some encouragement for SMEs to come forward (with no risk of penalty) so that a joint strategy/plan can be implemented.

## 8. NEXT STEPS

The research to date has been used by Inland Revenue as a general barometer of where businesses are at in terms of recovery and compliance. Specifically, it has used the research to inform government Ministers of the different stages of recovery of businesses when considering removing the Orders in Council that provided relief after the earthquakes.

The research has also identified the risk areas in Christchurch and, as it continues, the other benefit is in understanding what is actually happening to businesses and how SMEs were managing, and determining how a tax administration might address compliance issues identified or how to promote further voluntary compliance. The information has also influenced the Canterbury Earthquake Recovery Authority's (CERA's) work programme, which now has a stronger focus on existing businesses and investors than it otherwise might have.

In Year 3 of the study (2014) researchers will follow-up with the SMEs and tax agents who participated in the 2012 benchmark research. The research will revisit how the prolonged nature of recovery has impacted on SME compliance behaviour, how Inland Revenue tried to mitigate it, and how we can learn from this.

In addition to identifying the long-term implications for Canterbury and the rest of New Zealand, findings from the study will form a body of information that will help tax administrations and other government agencies inform future strategies, and develop a framework for managing compliance behaviour following an adverse event.

## 9. APPENDICES

### 9.1 Appendix 1: Key definitions

#### Adverse events

When events have large-scale adverse consequences for individuals, organisations and communities they become disasters. The more the event results in unravelling the community fabric, the greater the disaster and the harder it is for recovery to occur (Alesch & James, 2007; Alesch et al, 2001). The defining feature of such an event is a loss of productive capacity that is sufficiently large in relation to the income and wealth of the affected country that it reduces national consumption and welfare (Phaup & Kirschner, 2009). Disasters have a great impact on large concentrations of people, activity and wealth. Their effects spread beyond the region originally affected and they can generate widespread anxiety (OECD, 2004).

#### Small and Medium-sized Enterprises (SMEs)

For this project, SMEs are:

- All entities with an active relationship for GST or PAYE that do not belong to large enterprises or non-profit organisations, and
- All non-individual entities without active registration for GST or PAYE not belonging to non-profit organisations.<sup>19</sup>
- Enterprises with less than \$100 million GST turnover annually.

#### Locations

- The Canterbury Region is defined based on the Inland Revenue Christchurch District Office area which includes the Kaikoura, Hurunui, Waimakariri, Selwyn, and Christchurch City Councils.



<sup>19</sup> <http://www.ird.govt.nz/aboutir/external-stats/tax-statistics-terms-definitions.html>

## 9.2 Appendix 2: Methodology

### Research questions

Based on the project's four key objectives or overarching questions, the research questions are:

In what ways and to what extent have the earthquakes impacted on SME tax compliance?	What is the mechanism by which the earthquakes have an impact on SME tax compliance?	How have the actions of Inland Revenue affected that impact?	How should Inland Revenue act to get the best compliance result when adverse events occur?
<p>What are the recovery times before 'business as usual' is restored?</p> <p>How can Inland Revenue identify/ recognise signs of 'normality' (pre-quake activity)? (This will include a comparison between 'old normal' and 'new normal').</p> <p>How long does it take to return to SME compliance behaviour at pre-quake levels, if at all?</p> <p>To what extent have the Canterbury earthquakes changed SMEs' attitudes and behaviours with regard to tax compliance?</p>	How could Inland Revenue influence SME post-quake attitudes and behaviour to return to pre-quake tax compliance acceptable levels?	<p>What impacts did Inland Revenue's presence, its communication flow at various phases, and the assistance package have on maintaining SME compliance behaviour?</p> <p>Did Inland Revenue's presence or actions have a positive impact on business survival and recovery and did it prevent long-term tax debt?</p>	<p>What is the level of acceptable SME tax behaviour and can Inland Revenue mitigate the effect of non-compliant behaviour to reduce the 'acceptability' of committing hidden economy activity and restore pre-disaster compliance levels?</p> <p>What have we learnt from this event?</p> <p>Can these learnings be applied as part of the future response plan for sudden adverse events?</p>

### Method

A combination of qualitative and quantitative research methodologies were employed for both Year 1 and Year 2 of the research. In Year 1, qualitative research was conducted first to explore the subject matter in-depth and provide a diagnostic understanding of the issues. Quantitative research was then conducted to measure the extent to which perceptions and self-reported behaviours exist in the SME and tax agent populations. Detailed discussion of each methodology employed is provided below.

### *Out of scope and linkages*

This longitudinal study does not include the design of interventions and also excludes risk and assessment analysis (although it will provide robust information to underpin future strategies).<sup>20</sup> This research will complement social, economic wellbeing and natural hazard research that is currently being undertaken by other government and non-government agencies.

### *Qualitative research*

The qualitative research consisted of 30 in-depth individual interviews with SME owners (21) and tax agents (nine), as well as one focus group with Inland Revenue staff based in Christchurch. Interviews were around 1 ½ hours in length and were

<sup>20</sup> Although out of scope, economic measures identified in Brondolo's 2009 IMF paper '*Collecting taxes during an economic crisis: Challenges and policy options*' do provide us with some ideas, factors of influence and measures of change.

mainly conducted at the business's premises. All of the qualitative fieldwork was conducted during April, 2012. A semi-structured discussion guide was used to elicit business owners' responses while providing them with the freedom to explore the topic from their own distinct perspectives.

### ***Sample***

A range of SMEs were recruited according to four key criteria:

- Size: from sole trader to medium-sized SMEs (20 employees).
- Industry: building, retail, hospitality and agriculture (note, the agricultural industry was included to act as a control group as the impact of the earthquakes on this industry was felt to be more limited).
- Activity level: growing, dormant and declining.
- Location: Christchurch Red Zone, Greater Christchurch and Canterbury (e.g. Kaiapoi).

In the final sample:

- The majority of SME owners used a tax agent.
- All SMEs had different levels of business turnover compared to before the earthquakes.
- The focus was primarily on SMEs that have been affected (to varying degrees) by earthquakes and had experienced a change in tax compliance as a result.
- The tax agents were located in the Red Zone, Greater Christchurch or Canterbury, and varied in size from sole practitioner to large firms.

For the focus group, Inland Revenue contacted and internally recruited key local staff that had played an active role throughout the crisis (e.g. assisting SMEs and tax agents with information and support).

### ***Quantitative research***

The quantitative research consisted of a telephone survey of 1,161 SME owners and 100 tax agents in the Canterbury region. Fieldwork was conducted from 21 June to 31 July 2012.

### ***Questionnaire development***

The questionnaire was developed by Colmar Brunton in close consultation with the researchers from Inland Revenue's National Research & Evaluation Unit. Two rounds of questionnaire testing were undertaken:

- Six cognitive face-to-face interviews were conducted with respondents to qualitatively pre-test the survey questions (five of the interviews were with SME owners and one interview was with a tax agent).
- The revised questionnaire was then piloted with 16 respondents to test the survey processes, interview length, and provide further feedback on the questionnaire.

A small number of changes were made to the questionnaire following each round of testing. A copy of the final questionnaire used for the main fieldwork is appended to this document. The average interview lengths were 14 minutes (for SMEs) and 13 minutes (for tax agents).

### ***Sampling approach***

Contact lists were provided by Inland Revenue for sampling respondents.

The sample was stratified by a customer's tax debt history status and business size. A disproportionate sampling approach was undertaken that increased the number of interviews with employers and those who had current debt (in December 2010) so that sufficient numbers of interviews were conducted in these key subgroups of interest to allow for statistically robust comparisons between groups.

At the analysis stage, the data have been weighted to ensure that the sample reflects population characteristics in terms of business size and debt history status.

The table below provides a profile of the total sample (using both unweighted and weighted data).

**Table A.1. Total sample profile by weighted and unweighted data**

	Unweighted data		Weighted data	
	n=1,161	%	n=1,161	%
<b>Business size</b>				
sole traders	450	39%	879	76%
1-5 employees	337	29%	180	15%
6-19 employees	278	24%	78	7%
20+ employees	96	8%	24	2%
<b>Debt history status (December 2010)</b>				
Currently in debt	262	23%	152	13%
Never in debt	221	19%	316	27%
Used to be in debt	678	58%	693	60%
<b>Location (December 2010)</b>				
CBD	151	13%	145	13%
Rest of Great Christchurch	691	60%	687	59%
Rest of Canterbury	319	27%	329	28%
non CBD	1,010	87%	1,016	87%
<b>Use of a tax agent</b>				
Tax agent	842	73%	779	67%
no tax agent	319	27%	382	33%
<b>Industry</b>				
<b>Primary</b>	<b>156</b>	<b>13%</b>	<b>182</b>	<b>16%</b>
Agriculture, Forestry and Fishing	155	13%	182	16%
Mining	1	0%	0	0%
<b>Industrial</b>	<b>264</b>	<b>23%</b>	<b>229</b>	<b>20%</b>
Manufacturing	104	9%	69	6%
Electricity, Gas, Water and Waste Services	7	1%	12	1%
Construction	153	13%	148	13%

<b><i>Distribution</i></b>	<b>233</b>	<b>20%</b>	<b>190</b>	<b>16%</b>
Wholesale Trade	81	7%	73	6%
Retail Trade	113	10%	77	7%
Transport, Postal and Warehousing	39	3%	41	4%
<b><i>Business and finance</i></b>	<b>90</b>	<b>8%</b>	<b>132</b>	<b>11%</b>
Financial and Insurance Services	16	1%	18	2%
Rental, Hiring and Real Estate Services	74	6%	114	10%
<b><i>Service</i></b>	<b>418</b>	<b>36%</b>	<b>428</b>	<b>37%</b>
Accommodation and Food Services	85	7%	70	6%
Information Media and Telecommunications	12	1%	20	2%
Professional, Scientific and Technical Services	128	11%	148	13%
Administrative and Support Services	67	6%	64	5%
Public Administration and Training	4	0%	4	0%
Education and Training	20	2%	26	2%
Healthcare and Social Assistance	28	2%	26	2%
Arts and Recreation Services	16	1%	20	2%
Other Services	58	5%	50	4%

Base: All SME respondents

Source: Inland Revenue sample

#### **Response rates**

The overall response rates to the surveys were 35% for SMEs and 42% for tax agents.

#### **Margins of error**

The table below provides estimated margins of error for key groups used in the analysis. All margins of error have been calculated at the 95% confidence level.

**Table A.2 Maximum margins of error**

	<b>n=1,161</b>	<b>Maximum margin of error</b>
<b>All tax agents</b>	100	+/-9.8%
<b>All SMEs</b>	1,161	+/-3.8%*
<b>Business size</b>		
sole traders	450	+/-4.6%
1-5 employees	337	+/-5.3%
6-19 employees	278	+/-5.9%
20+ employees	96	+/-10.0%

<b>Debt history status</b>		
Currently in debt (December 2010)	262	+/-6.1%
Never in debt	221	+/-6.6%
Used to be in debt	678	+/-3.8%

\*The margin of error associated with the total sample of SMEs takes into account the 'effective sample size' (which takes into account weighting effects).

Extensive subgroup analysis has been carried out throughout this report. All differences noted in the written commentary are statistically significant at the 95% confidence level (unless otherwise stated) and assume simple random sampling.

#### *Notes to the reader*

Some of the analyses of the quantitative data use variables that Inland Revenue provided as part of the sample. These variables include the following:

- Debt history status (currently in debt, used to be in debt, never in debt) – as per Inland Revenue's records in December 2010.
- Business size (sole trader, 1-5 employees, 6-19 employees, 20+ employees) – as per Inland Revenue's records in December 2010.
- Location (CBD, rest of greater Christchurch, rest of Canterbury) – as per Inland Revenue's records in December 2010.
- Tax compliance (payments) – as per Inland Revenue's records during 2004 to 2009. Note, this variable has only been used in Section 2 of this report in the context of assessing whether attitudes towards tax differ by tax compliance history.



## 10. QUALITATIVE METHODOLOGY FOR YEAR 2 RESEARCH

This research project consisted of 50 in-depth individual interviews conducted face-to-face in Christchurch and over the telephone. One of these interviews was paired, i.e. it involved two respondents.

### 1 Sample

The project advisory group and research team identified 39 stakeholders and 11 Inland Revenue staff as instrumental to this project. These respondents are knowledgeable and experienced in their respective sector of activity. They have a good understanding of SMEs within the sector and give their views on SMEs' situations throughout the report. Please note that the views, opinions, findings, and conclusions expressed in this report do not necessarily reflect the views of Inland Revenue.

All respondents were based in Christchurch. Table A.3 provides a breakdown of the organisations participants are from.

**Table A.3 Breakdown of the organisations who took part in Year 2**

Sector of activity	Organisations
<b>Building/construction and manufacturing</b>	Interviews 1-8 (eight interviews involving six organisations)
<b>Design and architecture</b> (consultancy and project management)	Interviews 9-15 (seven interviews involving seven organisations)
<b>Finance</b> (investment and tax)	Interviews 16-19 (four interviews involving four organisations)
<b>Hospitality and tourism</b>	Interviews 20-23 (four interviews involving four organisations)
<b>Retail and services</b>	Interviews 24-28 (five interviews involving five organisations)
<b>Government organisations and infrastructure</b>	Interviews 29-43 (15 interviews involving five organisations, including Inland Revenue)
<b>Business and professional organisations</b>	Interviews 44-50 (seven interviews involving seven organisations)

*Note: some stakeholders and Inland Revenue staff do not want to be identified; therefore we have provided minimal identifier details.*

### 2 Fieldwork

Inland Revenue's National Research & Evaluation Unit commissioned Colmar Brunton to conduct the interviews during February and March 2013. The interviews were up to one hour in length. Most interviews (34) were conducted face-to-face at the respondent's business premises in Christchurch, the remaining 16 were conducted over the telephone.

A semi-structured discussion guide was used to elicit stakeholders' and Inland Revenue's staff's perceptions while providing them with the freedom to explore the topic from their own distinct perspectives.

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