

The Influence Of Procedural Fairness On The Small Business Entrepreneurs And Their Perception Of The Tax Authority: A Case Study Approach.

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This paper focuses on two major small business tax compliance issues. Firstly, it explores how small business taxpayers are treated (procedural fairness) when audited by the tax authority. Secondly, it discusses their perception of the tax authority. Using a qualitative approach, this research applies case studies and in-depth semi structured face to face interviews with small business participants. The findings clearly suggest that procedural fairness experienced by small business taxpayers and their perceptions of the tax authority determine the extent of their compliance cooperation. Additionally, small business taxpayers' perception of the tax authority can also influence the tax authority's legitimacy to regulate the small business sector. The conclusion sums up the key issues discussed, policy implications and the limitation of the analysis.

1. Introduction:

Small businesses, in particular, micro businesses do not have formal financial reporting requirements imposed upon them, as they normally do not source capital externally. Instead, many small business owners rely on their personal savings for venture creation. They are also managers of the same entity. Unlike their larger business counterparts, most small businesses are not accountable to external shareholders. They have different reporting requirements, mainly to discharge their tax obligations and to prove their creditworthiness for borrowing purposes.

In order to ensure funding for the nation, governments collect tax revenues. Thus efficiency in tax collection from small businesses is not a new phenomenon. However, approaches used in tax collection are important as they influence compliance. This paper predominantly examines how small business taxpayers had been treated by the tax authority (procedural fairness), in particular their perception relating to discharging their tax responsibilities and the rationale for their perceptions.

As defined by Blissenden (2002, p470), procedural fairness entails that administrators follow particular processes in ensuring their decision making process is fair. Inclusive of these are the procedures they undertake in auditing small

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businesses for tax compliance requirements. Importantly, authorities must treat small business taxpayers in a fair and respectful manner when undertaking such procedures, particularly when they show commitment to pay their share of taxes. Failing which, small business taxpayers may resist paying due taxes. Small businesses have complained that they are government's "unpaid" tax collectors (Rametse and Pope 2002, p436) for both consumption and employment taxes. They are custodians of the tax monies and are required to account and surrender these monies on due dates to the tax authorities. In addition, small businesses are also required to pay income taxes based on their annual financial performance. With this, the tax authorities become powerful stakeholders in shaping the compliance behaviours of small businesses. Tax authorities have adopted audit measures to ensure that small businesses adequately discharge their tax responsibilities. This form of control, however, as related to enforced compliance, can be costly, both for taxpayers and tax authorities. Notably, it can be less costly if tax authorities undertake measures that encourage voluntary compliance. This could be through tapping on the civic consciousness of the small businesses to do the right thing, regardless of external deterrence measures, such as audits and sanctions. Cautiously, when such deterrence measures are used as first choice strategies for tax compliance, this can undermine the legitimacy of regulators when perceived to be procedurally unfair (Hartner, Rechberger, Kirchler, and Schabmann, 2008).

As noted by Murphy (2004), the reasons for people to abide by or disobey institutional decisions have been prominent in psychological research. Voluntary compliance is inherent in people who do not need external stimulus to comply. Tyler (2006) asserts that people comply willingly if they are treated in a respectful and fair manner by the authorities. The way in which they are treated determines their perceptions of the authorities. In addition, Torgler (2003) argues that high tax morale by the taxpayers will increase compliance. Given this, as people's behaviour is strongly linked to views about justice and injustice (Tyler and Smith, 1998), the tax authorities may benefit from encouraging voluntary compliance through fair procedures. Thus if people believe that the authority is trying to be fair in dealing with them, they will trust the authority's motive; hence abide by their rules and regulations. The tax authorities possess the right to regulate taxpayers by collecting what is legally owed to them, i.e. they have the legal legitimacy to do so. However, the perceptions of the tax authority as a valid stakeholder (i.e. have psychological legitimacy) are also important determinants in ensuring high level of compliance among small businesses. Any decrease in the compliance level can have an adverse effect on the government's overall ability to undertake its social, fiscal and economic objectives via the tax policies. Thus to combat this situation, authorities must have regulatory strategies in place that will enhance the psychological legitimacy, hence accepted as regulators. These strategies should have the overall aim of encouraging mutual respect and cooperation from the small business community.

The reasons for focusing on small businesses in this research are as follows. First, small businesses are regarded as important contributors to the New Zealand (NZ) economy in terms of employment and generating revenue (Firebrace, 1999, McIntosh and Veal, 2001, Sandford and Hasseldine, 1992, Small business, 1998). Second, small businesses face regressive tax compliance costs (Hasseldine, 1995; Tran-Nam, Evans, Walpole and Ritchie, 2000). They bear a disproportionate burden

of compliance costs relative to their size. The smaller the business size, the higher is the compliance costs percentage. Third, the small business sector has one of the highest non-compliance statistics in New Zealand (Caragata, 1998) and overseas (Adams and Webley, 2001; Ahmed and Braithwaite, 2005; Wallschutzky, 1984). Combating the tax evasion statistics fairly, will improve the overall tax revenue and create a more equitable tax society. Additionally, as confirmed by recent research, whilst small business entrepreneurs are responsible, law abiding, conscientious, ambitious, and ethical (Ahmed and Braithwaite, 2005; Verheul, Uhlaner and Thurik, 2005), they are also often dissatisfied with authorities' procedural injustice. In particular, Ahmed and Braithwaite (2005) note that small business taxpayers are law abiding and have respect for authority like other taxpayers. However, they are often disgruntled because whilst they are required to pay taxes, they are unlikely to receive refunds at year end.

Small business also sees tax complexity as impacting on their tax compliance (Rametse and Yong, 2009). This situation has earlier been confirmed by an Australian study (Coleman and Freeman, 1999) that small business owners complained that the law was too complex and thus resented the time and money devoted to compliance. In fact, Sheffrin (1996) asserts that as the tax system is the most complex social contrivances; the public is expected to have limited knowledge about it. Thus attitudes about the tax system and perceptions of fairness naturally will be influenced by what the public actually knows about the tax system (Sheffrin, 1996). This paper explicitly takes a business research and psychological perspective, with a particular focus on two major small business tax compliance issues. Firstly, it explores how small business taxpayers are treated (procedural fairness) when audited by the tax authority. Secondly, it discusses their perception of the tax authority regarding their audit process. Thus in agreement with Tyler, Boeckmann, Smith and Huo (1997), a psychological stance is based on the premise that how people behave is strongly connected to their view about justice. Using a qualitative approach, this research applies case studies and in-depth semi structured face to face interviews with small business participants and tax agents/practitioners in New Zealand.

The structure of this paper is as follows. The second part discusses the importance of New Zealand Small and Medium Sized Enterprises and their characteristics. Section three reviews literature on tax compliance both internationally and in New Zealand, with a focus on conceptual issues. Section four discusses the methodology for this study. Section five and six presents the findings and conclusions respectively. Since the paper focuses on small businesses, it is therefore important to define the New Zealand SMEs and discuss their importance, as well as their characteristics.

2. The importance of the New Zealand SMEs and their characteristics

The New Zealand Ministry of Economic Development (MED) defines SMEs by the number of staff they employ and any enterprise that employs up to 19 staff falls under this category. In 2006, the number of enterprises that employ between 0 to 9 staff constituted 92.1% of total employment (Ministry of Economic Development, 2007). This was made up of:

- 63.6% for those that hired 0 staff (i.e. self employed)
- 23.3% for those that hired 1 to 5 staff
- 5.2% for those that hired 6 to 9 staff.

In addition, the SMEs provided a large amount of local equity and almost all of them were locally funded. The low percentage of foreign equity signified local ownership of assets, which contributed favourably to the balance of payments figures. The percentage of New Zealand's overseas equity by the size of the business is shown in **Table 1**. For example, in 2006, just over 98 per cent of SME had overseas equity of less than 1 per cent.

Table 1: Equity provided by the SMEs in 2006

Overseas equity	0 staff employed	1-5 staff employed	6-9 staff employed	10-19 staff employed
Less than 1%	98.41%	98.14%	97.24%	95.74%
1 to 24%	0.24%	0.26%	0.43%	0.6%
25 to 49%	0.11%	0.12%	0.23%	0.28%
50% of more	1.25%	1.49%	2.10%	3.39%

Source: (Ministry of Economic Development, 2007) p. 33.

Unlike other taxpayers, small business taxpayers do not have withholding taxes paid at source. Thus, they have an opportunity to under-report their tax liabilities by not declaring cash incomes and/or overstate the business expenses by including personal costs. Consequently, this sector has one of the highest tax evasion statistics in New Zealand in the 1990s (Caragata, 1998). In Australia, evidence suggests that the cash economy exists in this sector (Cash Economy Task Force, 2003). In their attempt to combat the cash economy, the Australian Taxation Office (ATO) introduced the Australian Business Number (ABN), with the introduction of the GST in 2000. All Australian businesses are required to register to enable the ATO to monitor tax returns and to cross match the GST and income tax information. The aim is to improve compliance by reducing the activities in the cash economy (Cash Economy Task Force, 2003). In New Zealand, the Inland Revenue Department (IRD) also attempts to combat the cash economy problem by building "industry partnerships" with selected business community.

As discussed above, New Zealand research has identified a unique feature of small businesses, which is regressivity of tax compliance costs, relative to the size of the business (Hasseldine, 1995; Massey and Quin, 2001; Sandford and Hasseldine,

1992). Other overseas tax compliance costs studies have confirmed this situation (Evans *et al.*, 1997; Pope, 1995; Sandford, Godwin and Hardwick, 1989; Slemrod and Venkatesh, 2002). Thus small businesses bear an overbearing and disproportionate cost in complying with tax regulations. This regressivity, coupled with high tax compliance costs may caused resentment among the SMEs in complying with the tax regulations (McIntosh and Veal, 2001). The next section discusses the literature on conceptual issues of compliance to regulations, highlighting the influence of the economic self interest view on compliance. Of particular focus in this paper are issues pertinent to tax morale, procedural justice, and psychological legitimacy. Some background rationale for including tax agents are also discussed as they are an important constituent of the compliance process undertaken in this research.

3. Literature Review and Conceptual Issues:

3-1 The economic self interest

Research has confirmed several motives for compliance. In particular, some people comply because of economic self interest and some comply due to their obligation as citizens of a country. Allingham and Sandmo (1972) have popularised the compliance research on economic self interest. This traditional deterrence approach considered taxpayers as purely self-interested rational agents; consequently, audits and sanctions were used to enforce compliance. The economic self interest view states that a utility maximising individual will assess the costs and benefits of cheating by weighing up the probability of being detected and caught. The research using the economic self interest stance had produced mixed results when variables such as changes in the audit, penalty and tax rates were tested (see research by Alm, Jackson and McKee, 1992; Alm, Jackson and McKee, 1993; Collins, Milliron and Toy, 1992). Various research methods were adopted including laboratory experiments and the use of surveys. However, despite the low audit probability, the compliance statistics had been relatively high (Andreoni, Erard and Feinstein, 1998). Cullis and Lewis (1997) and Andreoni *et al.*, (1998) suggest that there must be reasons beyond economic factors that may help explain the high compliance statistics. This paper, however, focuses on fiscal psychological factors that influence compliance, which encompass aspects of fairness or justice. This is analysed with reference to trust in the government and tax morale, and procedural fairness by the government. It also examines the perceptions of the tax authority by the taxpayers which impacts the overall compliance.

3-2 Trust in government and tax morale

Eberl (2003) as cited in (Kirchler, Hoelzl and Wahl, 2008) describes trust as “interacting partners ascribe each other positive aspects and intrinsic motivations to maintain that relationships”. If the citizens trust their government, compliance will therefore be more voluntary rather than enforced. The citizens trust the government when there is a general consensus that the tax authorities are working beneficially

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for the common good. This ascribes the government's legitimacy and their right to rule.

In order for compliance to be optimised, the taxpayers must trust their authorities and the authorities must reciprocate that trust. Thus if authorities have a fundamental distrust of the taxpayers and design tax policies assuming that all taxpayers are evaders, this may therefore crowd out the moral and civic culture of the taxpayers to willingly comply on their own accord (Kirchler, *et al.*, 2008).

Torgler (2002) notes that tax compliance will be relatively high when tax morale is favourable. High tax morale has to do with why people comply with their tax requirements rather than their motives for cheating. It is the inherent behaviour that motivates people to be civic conscious and do the right thing, even though opportunities to cheat are available to them. Taxpayers will pay their taxes because they believe that it is morally right to do so, even though the probability of being caught cheating is low. They adopt the responsible citizen approach with the belief that their tax contributions are important for the common good of the society. Frey (1997) asserts that intrinsic and extrinsic motivations are relevant for explaining compliance behaviour. Intrinsic motivation is the feeling of obligations which motivates a person without force or being paid externally. Frey further suggests that it is important to have tax policies that support intrinsic motivation. By doing so, it will not crowd out tax morale as any strict policy can be perceived by the honest taxpayers as targeting those who are dishonest. Rules and regulations which prevent free riding by others and help establish fairness and equity will help to preserve the tax morale.

It is important to note that different motives for compliance require different approach to tax regulation. Kirchler *et al.* (2008) view is that, a command and control regulation is required if the taxpayers comply out of economic self interest, whereas a responsive regulation is needed for those who want to contribute for the common good. Responsive regulation nurtures and encourages compliance by tapping on the taxpayer's civic consciousness and social responsibility towards others. As the regulatory strategies are very different in approach, it is therefore important for policy makers to discern carefully the types of taxpayers they are regulating. However, it can be argued that determining the taxpayers' attributes may be difficult from the outset. Tyler (2006) sees compliance to laws to be dependent on whether the citizens have an instrumental or normative perspective towards compliance. On the one hand, the instrumental perspective regards compliance to be a function of external deterrence, factors and circumstances. It implies understanding the extent and nature of the resources that authority uses to shape taxpayer's behaviour. On the other hand, a normative perspective focuses on people's internalised norms of justice and obligations. This implies the need to explore what the taxpayers think and to understand their values.

Kirchler *et al.* (2008) differentiates between antagonistic and synergistic tax climates created by the taxpayers and tax authorities. These authors express that taxpayers and tax authorities work against each other in an antagonistic climate, whilst in a synergistic climate they work together for a win-win situation. The features of an antagonistic tax climate are:

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- Taxpayers and tax authorities work against each other as their wishes do not align with each other. It is characterised by the idea that tax authorities are not part of the same community as the taxpayers.
- There exists a “cops” and “robbers” attitude, whereby the tax authorities view the taxpayers as robbers who try to evade whenever they can and must be held in check. With this, the taxpayers feel persecuted by the authorities (cops) and therefore feel it is their right to hide their true taxable income. Taxpayers will be likely to resort to “rational” weighing of the costs and benefits of evading.
- The social distance is likely to be large with little respect nor positive feelings towards the authorities by the taxpayers. Because of this, voluntary compliance is likely to be insignificant (Kirchler, Hoelzl and Wahl, 2008).

The features of a synergistic tax climate are:

- Taxpayers and tax authorities work together for a common goal. It is characterised by the idea that tax authorities perform a service for the community and they are part of the same community as the taxpayers.
- The approach taken by the authority to regulate the taxpayers is that of service and taxpayers are treated as customers. The tax authorities are friendly, supportive and respectful towards the taxpayers. Taxpayers will be less likely to consider the chances of evading and are more likely to contribute their share out of a sense of obligation.
- The social distance between the taxpayers and the tax authorities is likely to be low and therefore voluntary compliance is likely to prevail (Kirchler, Hoelzl and Wahl, 2008).

The tax climate determines, to some extent, the type of regulations needed. Since the trust of the government is low in antagonistic tax climate, enforced compliance using the threat of punishment is probably more appropriate to secure compliance in the short run. However, it may not always be effective in the long run as it can potentially deepen the social distance between the regulator and the taxpayer. A more appropriate long term approach is for the regulator to first of all gain the trust of the taxpayers by doing the right thing. For example, if the taxpayers perceive the taxing authority to have competence in managing tax evasion problems and spending the tax revenue wisely, this could gain their trust and motivate them to help the authorities. Once the authorities are able to gain the citizen's trust and have the legal right to rule, it may lead citizens to feel obliged to adhere to the regulations in the long run. An adversarial relationship between the taxpayers and the tax authorities only create further animosity and distrust. Since the trust of the government is high in a synergistic climate, it is important for the authorities to nurture and maintain the high level of voluntary compliance by demonstrating competency in tax administration. The authorities must be perceived to have the right to regulate in order for the citizens to willingly comply. Attempts to nurture and not crowd out tax morale will be beneficial in the long run since less detection resources is required to maintain taxpayers' compliance.

Tax morale is also closely related to other issues such as the fiscal exchange between the taxpayers and the government, perception of fairness by the taxpayers and their experiences with the tax authorities (Kirchler, 2007). By examining the interdependence of these issues, it may provide an avenue for the tax authorities to target their administrative policies at the grass roots level to sustain compliance in the long run.

3-4 Perception of fairness

How the taxpayers are managed and treated by the tax authority is an important influence on the fairness perception. If they are treated fairly, in a dignified and respectful manner, the tax authorities will gain taxpayers' consent to govern and to collect taxes. However, any unfair or differential treatment can only be detrimental to the fairness perceptions. Thus this situation "may lead to a loss of faith in the system with increased cheating and a general reduction in the level of compliance or increased administrative costs for the same level of compliance" (Sheffrin, S.M. 1996, p331).

Wenzel (2003) identified three different areas of fairness in relation to tax compliance. They are distributive justice, procedural justice and retributive justice. Distributive justice entails the exchange of resources, both benefits and cost, taxpayers want fair treatment for all; procedural justice refers to the process of resource distribution; and retributive justice is the perceived appropriateness of sanctions in the case of norm-breaking (Wenzel, 2003). These areas of justice are applicable to the individual, group and societal levels. For the purpose of this study, fairness is closely related to justice. Procedural justice in auditing small businesses for tax compliance is concerned with the neutrality of procedure, trustworthiness of the tax authority, polite, dignified and respectful treatment of the taxpayers by the tax authorities (Tyler and Lind, 1992; Wenzel, 2003).

Tax procedures that are neutral and are consistently applied to all will favourably impact on the perceptions of fairness by the taxpayers. Retributive justice centres on a situation where as a result of the tax authority imposing unreasonable and intrusive audits and unfair penalties, small business taxpayers exhibit negative attitude to them. Taxpayers who perceived unfair treatments from the tax authorities will decrease their level of compliance (Sheffrin and Triest, 1992; Spicer and Becker, 1980; Tan, 1998). Additionally, if the tax authorities provide the rationale for tax law changes as well as more information relating to the changes, it can increase fairness perceptions (Carnes and Cuccia, 1996). As noted by Hartner *et al* (2008), respectful, fair treatment and fair decision making procedure is important for taxpayers who identify with a group as it is indicative of their inclusion and standing in their social group, hence relevant to self-esteem. Again, taxpayers consider the neutrality of tax officers regarding the groups that they belonged to. If tax authorities and officers treat taxpayers equally, in a respectful and responsible way, trust in the authorities will increase and this will improve voluntary compliance at all levels (Wenzel, 2003). Perceived procedural justice is also strongly related to trust of authority (Job, Stout and Smith, 2007).

Given the importance of the normative perspective on compliance, issues pertinent to legitimacy of authorities, comprising of the legal and psychological, are discussed.

3-5 Legal and psychological legitimacy of authorities

Braithwaite (2003) identified the differences between authorities having legal legitimacy and psychological legitimacy. The former gives them the power to rule by law, whereas the latter gives them the right to rule because of the individual's consent. Psychological legitimacy is determined by the taxpayers in evaluating the authorities in terms of what they stand for and how they perform (Braithwaite, 2003). As they make those evaluations through sharing or having accumulated the information overtime, they develop positions in relation to the authority. They may impose some kind of social distance between themselves and the tax authority. Social distance is a form of behaviour involving liking the authority and ascribing status to the regulatory (Braithwaite, 2003). The extent of social distance decided by the taxpayers depends on how much they want to associate or be aligned with an authority and how much they want to be out of reach of and out of contact with the authority. Tax authorities cannot take for granted the goodwill of the citizen. They must create an environment that is favourable to psychological legitimacy. They can do so by rewarding voluntary compliance and punishing tax evaders. Also authorities need to be wise in their spending and not to be seen to be favouring one group. Aligning the government expenditure to the wishes of the citizens will help sustain psychological legitimacy.

The next section, discusses the methodology adopted for this research.

4. The Methodology:

4-1 Qualitative research and the constructivist-interpretivist paradigm

Following Cullis and Lewis (1997) research, this study takes a social constructivist perspective. The constructions of the participants form their realities and they act on those realities. As these constructions are unique to each participant, findings are not generalised to the wider population. In order to gain an in-depth understanding of the participants' audit experiences and their perceptions towards the tax authority, this research uses semi structured in-depth interviews. This method helps to unlock participants' experiences, thus implying an interpretivist methodology. The heterogeneity of the participants meant that one participant's opinions may not necessarily hold for others.

As articulated by (Kirchler, 2007), people discussing taxation issues evaluate fiscal policy, tax rates, use of taxes for the provision of public goods and their interaction between themselves as taxpayers and the tax authorities. With this, a qualitative approach is therefore considered more suitable to capture these interrelationships. Additionally, human compliance is not linear, predictable, controllable or well behaved (Denzin and Lincoln, 1994). Instead, it is a highly situated phenomenon as

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it is strongly determined by historical background, the participants' perception of the world and their attitudes. By adopting the qualitative approach with semi structured interviews, it enables tax compliance to be researched "in situ". Compliance behaviour needs to be understood and interpreted as a situated, context and dependent experience (Arksey and Knight, 1999; Yates, 2004).

Qualitative research acknowledges the naturalistic perspective of the participant's lived experiences by analysing their narrative and subjective information. These experiences are shaped and created by the participants thus forming their realities. To get the meaning behind these experiences, the researcher has to unlock the participants' mental constructions by interacting and conversing with them. With this, the constructivist- interpretivist paradigm has been adopted as the researchers seek to find answers to questions that emphasise the way in which social experiences are created and the meanings attached to those experiences (Guba, 1990; Putnam, 1983). Qualitative research is guided by a set of ontological and epistemological assumptions and methodology. Due to the uniqueness and individualised experiences of each participant, the relativist ontology is therefore assumed. The relativist accepts multiple realities since reality is socially constructed by the participants (Guba, 1990).

The researcher has to interact closely with the participants using interviews in order to unlock their mental constructions. This interaction will determine and help create understandings thus adopting a subjectivist epistemology (Guba, 1990). The researcher becomes part of the research which may affect the objectivity of the findings (Patton, 2002). Guba (1990) articulates that absolute objectivity cannot be achieved by researchers who conduct human inquiry since the researcher cannot step outside his/her own humanness. The subjectivist epistemology is therefore considered more appropriate in recognition of each participant's uniqueness.

The findings are grounded on actual accounts of taxpayers and tax agents. It is not the intention to make universal statistical generalisations from these findings because of the small number of participants involved (Punch, 2005). To deal with the subjectivity concerns of the inquiry, the participants were asked to verify and confirm the transcribed interview notes to add credibility to the research (Patton, 2002). This will help to minimise the researcher's value judgements on the data.

4-2 Profile of Participants

In-depth semi-structured interviews were carried out on 26 small business taxpayers and tax agents in Auckland, New Zealand from October 2006 to June 2007. A purposeful sampling process was used as participants were selected not randomly but rather "information rich" to illuminate the compliance experience (Patton, 2002). The time-consuming and labour-intensive interviewing process would necessitate a small sample. Opportunistic and "snowballing" samples are a common feature for qualitative research (Bauer and Aarts, 2000).

The small business taxpayers chosen are based on two criteria: have turnover of less than \$1 million per year and employees less than 10 full time staff during the year. These criteria were chosen to ensure the participants had some contact with

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the tax administration, hence able to account for their tax experiences. These criteria were also consistent with the definition of small businesses by the New Zealand Commerce Sub-Committee on the inquiry into Compliance Costs for Business (Pansy Wong (Chairperson), May 1998).

Data triangulation included interviews with tax agents who played an integral role in the compliance process. Their accounts are used to corroborate and verify the taxpayer's accounts (Patton, 2002). The taxpayer participants were selected from the following industries:

- Food sales
- Information technology
- Painting
- Building
- Furniture retailing
- Mortgage broking
- Automotive repair
- Carpet retailing
- Bakery,
- Saddling
- Electrical on-line sales
- Child-care education
- Jeweller, and
- Engineering & computing

The tax agents interviewed were either sole practitioners or from small to medium sized accounting firms whose core business is to service small businesses. This is followed by section 5 which discusses the findings and the way in which data are analysed.

5. Key Findings:

5-1 The Three Stage Process

The analysis of the transcripts follows a path as suggested by O' Dwyer (2004) using a three stage process:

- **Data reduction:** Provides a general overview of the data collected and loosely classifying any emerging themes. It also involves reflecting on the data after a time lag to identify any commonalities in the participants' accounts.
- **Data display:** Involves mind mapping of all the tax compliance factors identified from the data reduction stage with links between the factors. Formal coding and comparative core codes using matrices is found in this stage.
- **Data interpretation and conclusion drawing:** This involves examining the data holistically to create the "big picture". Any "outliers" that may challenge the big picture are noted. Thick description of the participants' accounts and selected quotes from participants are also included.

5-2 Participants experiences and their perceptions of the tax authority

The discussion of the findings is divided into two sections, viz;

1. Participants' experiences with tax audits and their relationship with the tax authority and
2. Small businesses' perceptions of the tax authority

5-2-1 Participants' experiences with tax audits and their relationship with the tax authority

Most of the participants assumed having filed accurate tax returns unless questioned by the Inland Revenue Department (IRD). Tax agents suggest accurate returns to be filed because of the long term benefits of honesty. However, audits do occur and some taxpayers delegate their audit tasks to the tax agents due to fear of the tax authority and a lack of technical expertise.

Majority of the small businesses do not look forward to audits as it can be costly and disrupts their business routine. All the participants do not welcome the audit activity except for one. Participants who were against the audit activity perceived audits as an intrusion into their daily business routine and a non productive activity. On the contrary, the participant who welcomed the audit believed that once the business had been audited and has a clean audit record it will reduce any future audits.

The participants' tax audit experiences have largely been unpleasant. Their unpleasant experiences included judgemental and harsh audit officers; fear of being implicated for tax cheating; miscommunication between the audit officer and taxpayer; misunderstanding of the audit officer's requirements; and penalties and substantial financial losses. The accounts given by both the small business taxpayers and tax agents were very similar. Their views on audits were based on their own experiences and/or have heard their peers' experiences.

Tax agents who had undertaken audit responsibilities on behalf of their clients had encountered varying skills among the audit officers. They found some of the audit officers to be technically competent, helpful while others were not. These findings are consistent with the research in the US (Andreoni, *et al.*, 1998) that there were varying degrees of the quality of auditors.

The next subsection examines the various audit experiences faced by both the taxpayers and the tax agents. These include:

1. Auditors acting more than a tax collection agency
2. Delegate the audit to the tax agents
3. Varying degrees of auditor's competency and their perceptions of the client's records
4. Challenging the auditor's ruling

5. Communication problems with the auditors
6. The frequency and the holistic approach to the audit process

5-2-2 Auditors acting more than a tax collection agency

The account of small business (SB) SB1 (an Asian female, new immigrant, owns a bakery for less than 2 years; aged between 20 and 25) found that the attitudes of the tax auditors vary between her and her peers. Some were acting beyond tax collection responsibility to be more like a police and a judge. Yet the one that she encountered was friendly and helpful. SB1 said:

“I find the IRD is acting like a police rather than a collection agency. The one that I met is pretty friendly but my Mum and friends contact with the IRD is not very friendly. She behaved more like a judge.” (SB1).

Thus this participant perceives the IRD treatment towards her family and peers to be unfair. This has the potential of creating a “culture of fear” amongst the taxpayers thereby widening the social distance between them and the IRD.

5-2-3 Delegate the audit to the tax agents

As for SB12 (a male European, owns a carpet retailing business for more than 10 years aged between 50 and 55), his business had been audited before. This participant asserts that in order to avoid business disruption, it was more efficient to employ the tax agent to deal with the audit process. In addition, he feared that the auditors could implicate more errors if he was unable to answer any query. SB12 said:

“During the audit, we had to pay the accountant to deal with the IRD as we would have to take time off from the business to attend to the IRD. If we have the audit, you can be nervous and there is certain anxiety that can make your presentation to the IRD incorrectly. It doesn’t take long for things to get out of hand.” (SB12).

The above is an example faced by small businesses regarding their lack of technical competency when dealing with the IRD. They addressed their perceived incompetency by employing tax agents to act as intermediaries and as a buffer between them and the IRD. Like SB1 above, the IRD has a tendency to create a “culture of fear” among the small business taxpayers.

5-2-4 Varying degrees of auditor’s competency and their perceptions of the client’s records

Some tax agents had encountered varying degrees of competency among the auditors. Some auditors were helpful and technically competent and others were not. Some auditors viewed the audit process as a means of helping taxpayers remedy

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their records to prevent future errors. Yet there were some who were vindictive and perceived taxpayers to deliberately make errors and evading taxes. This is the account given by tax agent (TA) TA8 (European female, partner of a medium sized chartered accounting firm aged between 40 and 50).

“It varies, they can be incredibly good auditors and also some malicious, vindictive auditors who are on the mission and we have laid complaints. There is no doubt that there are some very good audit staff and they go in with the perception that errors found are genuinely made by the clients but yet there are some who have the perception that the errors made by the clients are deliberate.” (TA8).

Another small business SB14 (Asian male, permanent resident, owns a mortgage broking firm for more than 5 years, a qualified accountant aged between 40 and 50) had this to say regarding his audit experience.

“The auditors came expecting to find something. But we know what we were doing and they were happy with our records and asked us to keep the records for 7 years!” (SB14)

Yet another tax agent has found the audit process to be better than expected and the auditors were professional in their approach. This is the account given by TA5 (European male, sole accounting practitioner aged between 40 and 50).

“The audit was better than what I thought. It wasn’t a harrowing experience and the IRD was quite nice and were very professional about it.”(TA5).

Three other participants had found the auditors to be not very qualified. TA4 (European male, sole practitioner aged between 50 and 65), TA2 (Asian male, sole practitioner aged between 40 and 50) and SB3 (Asian female, permanent resident, owns an IT business for more than 5 years aged between 30 and 45) had these to say from their audit experiences.

“My feeling is that the IRD officers are not highly trained”. (TA4).

“Many of the auditors are not very qualified.” (SB3).

“I had to go through the 7 year audit with this tax guy who was a farmer and he was very rigorous and they (2 of them) spent 1 week with us. After 1 week and another month of deliberation, they then narrow down to one area which was the transfer pricing – a new area at that time.” (TA2).

The above accounts are similar to the UK research (Adams and Webley, 2001) that VAT inspectors were also unhelpful to some small businesses during their inspection.

5-2-5 Challenging the auditor's ruling

There were times when tax agents had to challenge the auditor's enquiries when they think that it was unfair to their clients. TA8 and TA1 (European female, sole accounting practitioner aged between 50 and 60) were not afraid to challenge the auditor's understanding of tax laws to protect their client's interests. They recognised that auditors do not always get it right. These participants said:

"I have sometimes challenged their interpretation of the statutes and they have gone away and come back to agree with our interpretation. You do not expect them to know everything."(TA8)

"We had a Fringe Benefit Tax (FBT) audit and I had to tell the IRD auditors about some of the Goods and Services Tax (GST) treatment and ask them to check it out. They thought that I was wrong."(TA1)

Being an intermediary, tax agents are given the task in ensuring that their clients are treated fairly under the tax laws and are not unduly penalised. They believed that genuine mistakes should not be equated with fraudulent activities, which require different penalties.

5-2-6 Communication problems with the auditors

Communication problem with the auditors is one of the frustrations faced by tax agents during the audit process. Often what the auditors had requested was not the same as what was required. Because of this, the audit process becomes lengthy and more costly for the clients. TA8 expressed:

"I however have had problems with communications i.e. what they are asking for and what we are giving them is different. And then we were told that we did not give them the right stuff. Often what they ask for is not what they want." (TA8)

Thus this participant found the lack of clarity as to what was required by the auditors to be problematic and frustrating.

5-2-7 The frequency and the holistic approach to the audit process

Overseas research (Andreoni, *et al.*, 1998) had shown the audit probability to be small and this is confirmed by TA4 and TA1 in New Zealand. In addition, TA4 found the auditors to be fixated with doing one aspect of the audit instead of adopting a holistic approach to the audit process.

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“I have very few audits. It amazed me how few the audits were and the audits were always random.” (TA4).

“I have probably three audits out of the 30 years that I have been in business.” (TA1).

“They come to do small audits and they come and check the car expenses and they appeared to be relatively new employees of the IRD. The other major weakness of the IRD audit is that they never look at the whole picture of the GST, FBT and Income Tax. If there is a problem there, then there is a flow on effect from there”. (TA4)

From the above accounts, TA4 suggests that a more effective audit would require a holistic approach to minimise any flow-on effects. Instead of focussing on one aspect of the audit, experienced auditors should be able to detect the implications of the flow-on effects to other taxes. By doing so, it may prevent future recurring problems as well as portraying an effective audit by the IRD.

Unlike the views of TA4, small businesses perceived the auditors will implicate further if they found errors in one aspect of their record. They found record keeping being problematic with added stress. This is symptomatic of their fear towards the IRD. In addition, they thought that if the auditors found an error, they would be inclined to audit other areas. This is the account given by SB3 based on her peer’s audit experiences.

“Many of the auditors are not very qualified and my peers have found the keeping of records to be problematic. They were told to keep proper records and it is an experience that many do not want to go through again. I think it was the stress as they think if the auditors find something wrong, they will look at it on a wider basis.” (SB3).

Thus the audit process is stressful for many small businesses.

5-3 Small businesses’ perceptions of the tax authority

Many small businesses are reluctant to deal directly with the tax authority. Out of the 18 taxpayers in the sample, all except one will seek help from the tax authority directly if they have a tax problem. They prefer asking their tax agents or friends and to them, the tax authority is ranked last in their preference. This preference is indicative of the small business’ perceptions of the tax authority and they therefore unconsciously create a wide social distance between them and the tax authority, which reflects an antagonistic tax climate.

The tax agents were asked about their clients’ views of the IRD. These are some of the accounts given by the tax agents. The common theme was that the IRD is bureaucratic and it is difficult for taxpayers to obtain correct and prompt information from the IRD. TA1 has this to say:

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“The small businesses view of the IRD is not very good. They want little to no contact at all with the IRD if they can help it. This is because to get to the right person in the IRD if you have a query is really difficult. You can be asking the same question and two different IRD representatives can sometimes give you two different answers. Sometimes, you do not know who to talk to and with the multi-dial and waiting telephone system, this can be impersonal and some people cannot be bothered with this.” (TA1)

TA4 (Maori male, senior in a small accounting firm, aged between 30 and 40) believed that small businesses do not want to be in the IRD’s radar and prefers to use tax agents as buffers. He has this to say about his client’s perception of the IRD:

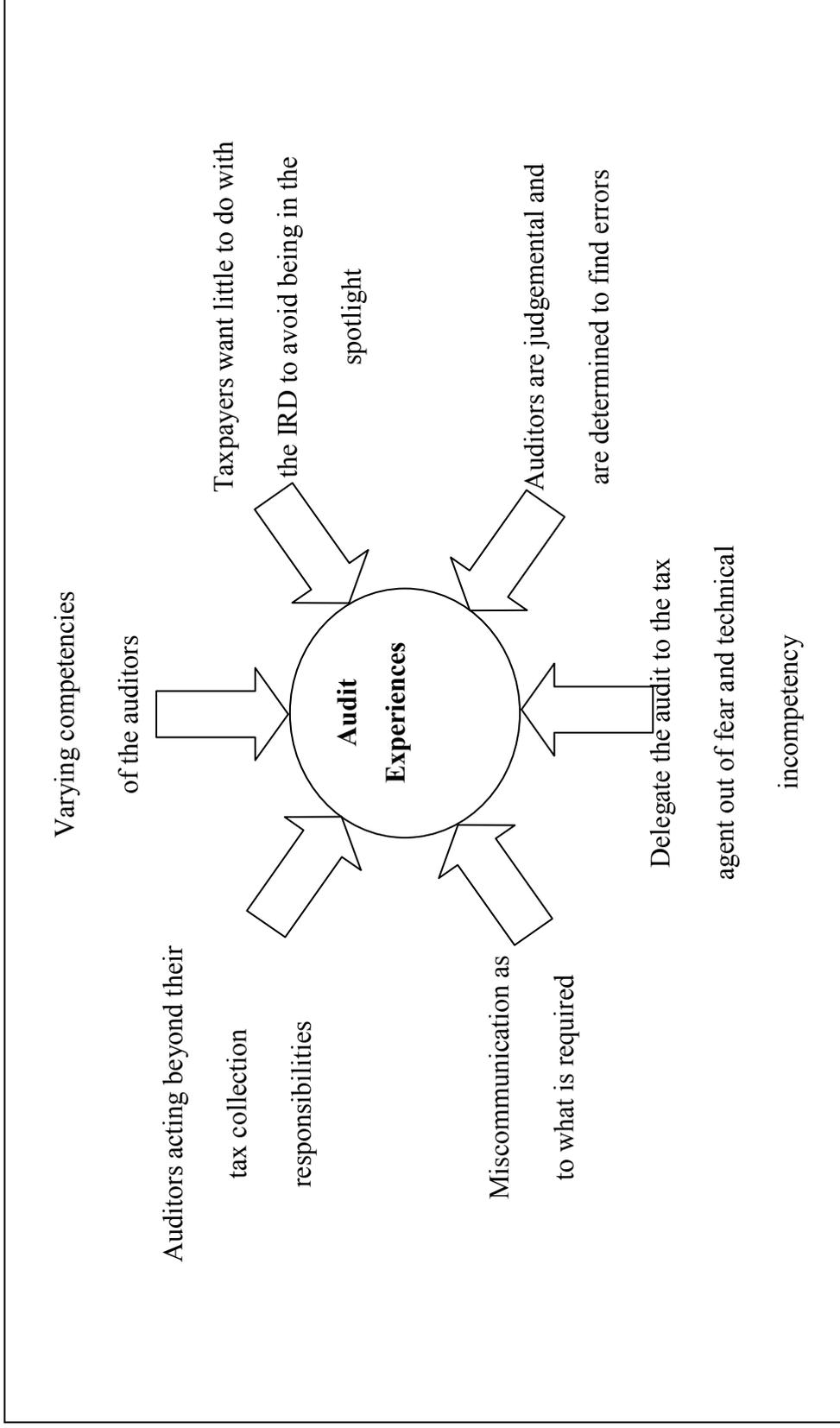
“No, I don’t think the small businesses have a good view about the IRD. I think there is a bit of feeling that once they are in the spotlight or on the IRD records, they feel that they have the burden as far as the IRD is concerned. I think they don’t feel comfortable dealing with the IRD and one of the reasons they hire the accountants is that they feel they have achieve a certain level of standard in the tax returns and the other is that they like the buffer of the accountant dealing with the IRD” (TA3).

Small businesses are not willing to deal with the IRD because of past experiences. This is the account given by SB3 that the IRD is always right and they are afraid to ask questions in case they are implicated for more taxes.

“Not many people will be comfortable to deal with the IRD. This is because if you ask anything else, you will probably be lumped with more tax especially if you say the wrong things. There is always the perception that the IRD is always right and you should be happy that you are paying this level of tax. I know none of my friends would be comfortable to ring up the IRD. The perception of the IRD is that they are like a blood hound, more like a policeman. They always seem to find that it is never enough” (SB3).

The above accounts demonstrate the participants’ experiences with the audit process and their perceptions towards the tax authority. The overall participants’ audit experiences are summarised in **Diagram 1**.

Diagram 1: Audit experiences by small business entrepreneurs and tax agents



5-4 Analysis

The above accounts show the tax experiences of the SMEs and the tax agents. These participants resist a close relationship with the IRD because of fear of adverse repercussions. The participants' accounts gave the impression that New Zealand has an antagonistic tax climate as suggested by Kirchler *et.al.*,(2008). Small businesses do not view the IRD as inclusive of their community. Instead, they prefer to have little to do with the IRD for the fear of being "in the radar" and therefore find it burdensome to have to cope with ongoing inquiries and audits. The stress of having to deal with the IRD is also very evident.

Even though the IRD is a legitimate stakeholder in demanding small businesses to discharge their tax obligations, this demand is often imposed rather than willingly undertaken by small businesses. Because of that, attempts should be made by the IRD to create a more cooperative climate for the taxpayers to willingly want to discharge their tax responsibility.

The rationale for the taxpayer's ill feelings towards the IRD is because they perceive the IRD to be working against them. Additionally small business taxpayers see the IRD wishes not in alignment with theirs. Small businesses perceived the IRD as always wanting to collect more taxes from them. This contradicts with their wishes in wanting to pay the least amount of taxes, since taxes involve loss of wealth and cash outflows.

According to the accounts of the participants, the IRD appears to have adopted more of a "cops and robbers" attitude. Many of the auditors are implicated that taxpayers try to evade taxes whenever they can and therefore must be held accountable. Some vindictive, unqualified auditors who are out to penalise taxpayers for errors made are perceived as violating the procedural fairness expected by the taxpayers. These attitudes are detrimental to creating a favourable perception of the tax authority. This further deepens the social distance between them and the business community. The deepening of the social distance between these two parties has the potential for taxpayers to either have little respect or positive feelings towards the authority. With this, voluntary compliance is expected to diminish and enforced compliance with the use of audits will prevail. These costly measures are not beneficial to both parties and the society as a whole.

Ill feelings towards the IRD can be created by some taxpayers who were persecuted by the auditors. These feelings may encourage some to retaliate. Consequently, they would feel that they have a right to hide their true taxable incomes. Thus enforced compliance from the tax authority will encourage small businesses less than optimal compliance and a rise in tax evasion.

In order to reduce the social distance between the taxpayers and the IRD, the IRD must strive to create a more synergistic tax climate. A synergistic climate will enhance both voluntary compliance and a more willing cooperation with the IRD. In doing so, the authority must begin to adopt a more customer focused approach in

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regulating the taxpayers. This would require the IRD staff to be more friendly, supportive and helpful towards the taxpayers.

Further changes in attitudes by the IRD staff to treat the taxpayers in a neutral, unbiased and respectful manner is also significant. The audit activity should be kept at a minimum, if the taxpayers have had a good history of compliance. The purpose of the audit should be to educate the taxpayers to keep proper records in order to minimise future compliance costs. By doing so, audits can be used as building relationships with the taxpayers.

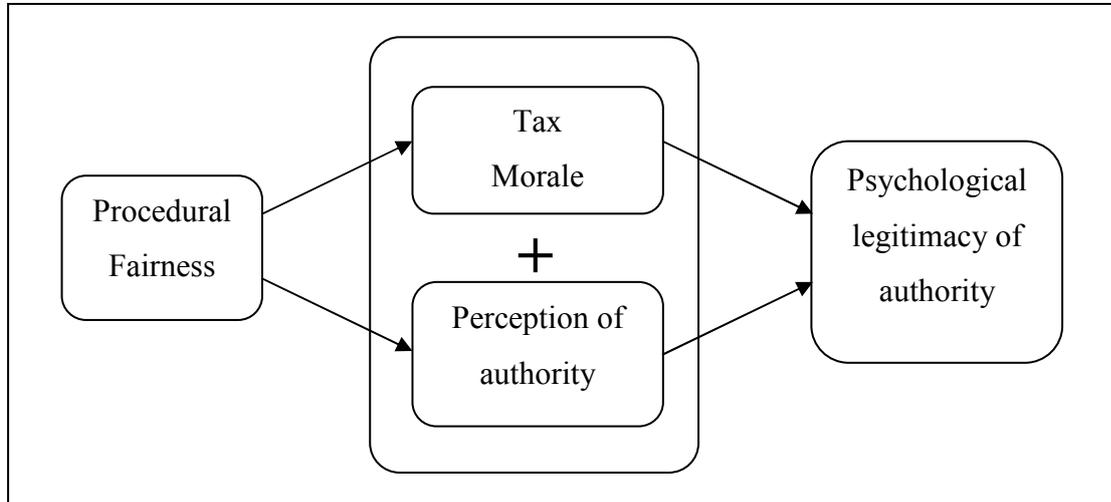
By having a more cooperative relationship, the social distance between with the taxpayers and the IRD would be small and therefore voluntary compliance would prevail. If this is the case, then taxpayers will be less likely to consider evading and are more likely to contribute their share out of a sense of obligation and doing the right thing. They may be more willing to work together with the IRD for a common goal in stamping out tax evasion.

In tapping the normative perspective of the taxpayers, taxpayers would be more willing to obey the law as suggested by Tyler (2006). By alleviating the taxpayers' intrinsic motivation to comply based on procedural fairness, the IRD may gain more psychological legitimacy in the views of the small businesses. By having both legal and psychological legitimacy, the administration tasks of the IRD will be lightened since taxpayers will self regulate with less monitoring measures required. A synergistic tax climate is beneficial to all parties with substantial cost savings.

The other benefit of a more cooperative relationship between the taxpayers and the IRD is that the tax morale will be enhanced. Consequently, the taxpayers will be motivated to do the right thing and comply fully even though there are opportunities to cheat. This is important in combating the high evasion statistics that is currently plaguing this sector.

In summary, the effects of the procedural fairness on the taxpayers and tax agents will influence the tax morale and their perceptions towards the tax authority. Consequently, the sum of the tax morale and their perceptions can affect the psychological legitimacy they ascribe to the tax authority as a stakeholder in regulating their behaviour. This is best depicted in **Diagram 2**.

Diagram 2: The effects of the procedural fairness on taxpayers and tax agents



6. Conclusion

The accounts given by the participants attest to the different audit experiences they face. However, there are some commonalities but each audit experience is unique to the participants. With this, generalising their experiences would be difficult. The rich descriptions of the diversity of participants' views enable further research on the SMEs for new conceptual developments.

Most taxpayers and tax agents do not welcome audits as they can be stressful, time consuming, and an intrusion into their business affairs. Many are apprehensive of the audit process due to fear of adverse outcomes and a lack of tax knowledge. To overcome the apprehension, many employ tax agents as buffers for any audit queries.

Audit officers vary in experience, attitudes and qualification. Some genuinely want to help small businesses address any error but there are also those that are intimidating and fault finding. Tax agents have also challenged the auditors' interpretation of the tax laws when it was perceived that the auditors have got it wrong.

The extent of the audit coverage varies depending on the circumstances. One tax agent felt that the audits were not comprehensive enough to fully detect all errors. This view, however, contradicts the beliefs of some small business taxpayers. They believe the auditors will extend their investigations to other tax areas should they find any error in the first instance.

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This research has offered some valuable insights on the taxpayers' perceptions of the IRD. Policy makers should pay attention to the perceptions of the small businesses towards the tax authority. Ill perceptions warrant an antagonistic tax climate and therefore the IRD would require more audit resources to enforce compliance.

A positive and favourable perception by the small businesses towards the IRD will help generate a synergistic tax climate. A synergistic tax climate will influence the voluntary compliance, hence less costly to regulate the small business taxpayers. By encouraging voluntary compliance, the IRD may be given the psychological legitimacy to regulate as a stakeholder in the small business community.

Despite the fact that these findings are limited to a small sample, the richness and depth of the data obtained has provided multiple views of the perceptions held by small businesses and tax agents on procedural fairness. These views will help inform tax authorities and government agencies to formulate relevant policies in addressing any existing perception concerns. Creating a positive attitude towards the taxing authority will enhance compliance as suggested by Torgler (2003). Assisting small businesses with the compliance process is not only beneficial to them but also to the society as a whole. It also helps the tax administration to address any problem area at the grass roots level in order to maintain a long and sustainable compliance attitude among the small business community.

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