

eJournal of Tax Research

Volume 10, Number 2

October 2012

(Special Edition: Atax 10th International Tax Administration Conference)

CONTENTS

- 182** Editorial
Margaret McKerchar, Michael Walpole and Binh Tran-Nam
- 184** Tax compliance costs for the small business sector in South Africa –
establishing a baseline
**Sharon Smulders, Madeleing Stiglingh, Riel Franzsen and Lizelle
Fletcher**
- 227** Australian business taxpayer rights to compensation for loss caused by
tax official wrongs – a call for legislative clarification
John Bevacqua
- 250** Findings of tax compliance cost surveys in developing countries
Jacqueline Coolidge
- 288** Tax compliance costs for small and medium sized enterprises (SMEs):
the case of the UK
Ann Hansford and John Hasseldine
- 304** FACTA and Schedule UTP: Are these unilateral US actions doomed
unless accepted by other countries?
J. Richard (Dick) Harvey, Jr

CONTENTS CONTINUED

- 329 Navigating a transition in US tax administration
Kristin Hickman
- 345 Behavioural economics and the risks of tax administration
Simon James
- 364 Improving tax compliance strategies: can the theory of planned behavior predict business compliance?
Jo'Anne Langham, Neil Paulsen and Charmine E. J. Härtel
- 403 Intervening to reduce risk: identifying sanction thresholds among SME tax debtors
Elisabeth Poppelwell, Gail Kelly and Xin Wang
- 436 Developing risk management strategies in tax administration: the evolution of the Australian Tax Office's compliance model
Robert Whait
- 465 Tax return simplification: risk key engagement, a return to risk?
Jason Kerr
- 483 New dimensions in regulatory compliance – building the bridge to better compliance
Stuart Hamilton

Intervening to reduce risk: identifying sanction thresholds among SME tax debtors

Elisabeth Poppelwell, Gail Kelly and Xin Wang¹

Abstract

Debt growth is outpacing the New Zealand Inland Revenue's capacity to manage it. This has triggered investment by the Government for Inland Revenue to look at new systems, approaches and tools to reduce debt, while maintaining integrity of the tax system. In New Zealand the small business sector makes a significant contribution to the economy, but it tends to be more susceptible to incurring debt. A large proportion of the total tax debt is owed by this sector with it making up about a third of tax debtors within New Zealand.

This research was designed to better understand intervention to reduce the risk of higher levels of debt for this business group. The research used a multi-method approach and included both debtor and non-debtor small and medium business participants to better understand what determines compliance behaviour. It explored the effectiveness of current sanctions and sought views on non-financial sanctions. It also attempted to identify tipping points and thresholds when penalties and interest become so large the SME debtor is unable to continue to make repayments.

The findings indicate that penalties and interest are influential. Improving awareness and knowledge of penalties would be effective in preventing or limiting tax debt in the early stages, but there are thresholds and tipping points based on business size and debt status. The results indicate that a better targeted 'wrap around approach' to early intervention would be more effective and suggest that, rather than changing the penalty rules, Inland Revenue can use the existing sanctions more effectively. The research identified the use of Inland Revenue's discretionary power to waive penalty charges is an effective lever and this, along with the threat of non-financial sanctions, will provide a more effective approach to managing SME tax debt.

1. INTRODUCTION

This research was undertaken to reduce Inland Revenue's risk of investing in tax debt mitigation actions that are unlikely to work. The Inland Revenue department plays a central role in securing and delivering most of the financial resources required by Government to provide services and facilities that improve New Zealanders' quality of life. Delays in collection can affect the level and timeliness of resources available to the government, and in the worst case scenario at the macro-economic level those delays could add to the level of government borrowing and public debt interest (Inland Revenue, February 2011). A further impact of delays in collection is that those who withhold tax payments to improve their cash flow can secure an unfair competitive advantage and 'push' other businesses to follow suit.

¹ Respectively, National Advisor, National Manager Research and National Advisor of Inland Revenue, New Zealand.

In broader terms, considerable research has been undertaken to understand compliance behaviour of taxpayers. A 2010 OECD report collating research on taxpayers' compliance behaviour confirms that although the success of deterrence strategies can be linked to fear of detection or severity of punishment, deterrence is more effective when strong positive social norms exist.

However, despite this high level understanding of drivers of compliance behaviour, tax debt in New Zealand continues to grow rapidly.² It appears that current sanctions are only partially effective as a compliance mechanism. The OECD report argues that revenue bodies should consider the use of non-monetary penalties to influence compliance behaviour.

Introducing different sanctions is a risky business. What will work best to reduce tax debt? And what other changes could be made to current policies and processes (or social messages) to support a new sanctions regime? These questions were the key reasons for conducting research on the usefulness of sanctions and identifying debt tipping points in influencing compliance behaviour.

2. THE PROBLEM OF DEBT

Debt³ growth is outpacing Inland Revenue's capacity to manage it. In 2005-2006 total debt was \$3.5 billion and total tax revenue for the same period was \$46.8 billion. In 2010-11 the total debt increased by 57.1% to \$5.5 billion, whereas there was no change (\$46.8 billion) to the total tax revenue for the same period.⁴

This has triggered investment by the Government for Inland Revenue to look at new systems, approaches and tools to reduce debt, while maintaining integrity of the tax system. The (2009) Inland Revenue Annual Report notes that debt growth is influenced by historical factors such as the effects of rising revenue along with consistent increases in the customer base. In New Zealand and internationally, the recession has created challenges for tax administrations managing the growth of tax debt with increases in uncollectable debt and decreases in collectable debt.

Inland Revenue recognises that to reduce tax debt it needs to have better information on tax administrative sanctions such as late payment penalties and interest charges. It is important that these sanctions are administered appropriately and evaluated for their effectiveness. A review of recent debt research and consultation highlighted areas for further investigation to inform debt management policy and operations.

² There are five components of tax compliance. These are registration, reporting, filing, payment and claiming. The research focuses on the payment component of compliance. This category is defined as the percentage of payments made on time. That is 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 of the due date.

³ Overdue tax debt is the amount of tax that remains unpaid after the due date for payment. This includes any penalty and interest applied to the debt.

⁴ Note: During this period, total tax revenue peaked at 51.9 billion in 2007-08 (11% up on 2005-06). *Briefing for the Incoming Minister of Revenue – 2011*. November 2011.

The taxpayer group of interest for this research was the small and medium enterprise (SME) sector.⁵ The economic downturn has, in particular, put small businesses under pressure to prioritise payment obligations. In New Zealand this sector makes a significant contribution to the economy, but small businesses tend to be more susceptible to incurring tax debt when compared to other Inland Revenue customer groups. A large proportion of the total tax debt is owed by SMEs, with this sector making up about a third of tax debtors within New Zealand. This debt is primarily made up of financial penalties that result from late payment of income tax, GST⁶ and PAYE.⁷

2.1 The role sanctions play in compliance behaviour

Earlier research on compliance behaviour (Allingham and Sandmo, 1972; Srinivansan, 1973) argues that for some tax customers, sanctions (as a deterrence tool) are effective motivators to compliance. These tax customers tend to be the 'rational economic actors', who are motivated to comply by a financial advantage and see sanctions as an 'incentive' to comply.

However, the OECD (2010) report comments that deterrence on its own (in the absence of personal and social norms) "*will have to be very strong in order to work (and thus running the risk of further preventing norms to be fostered). It is therefore essential to use deterrence and interventions as a way of creating or supporting social norms*" (p.35).

Norms can drive tax compliance, with deterrence playing a role when obligation and social pressure fails (Wenzel, 2004; OECD, 2010). A tax policy based on the use of sanctions to enforce compliance behaviour can be more effective where trust in authorities is low. High tax morale, perceived fairness of the tax system, good tax knowledge, trust in the tax authority and strong social norms, are all important drivers for compliance (Braithwaite, 2002; Wenzel, 2004; Kirchler et al., 2007).

Tax customers who have high tax morale (Feld and Frey, n.d.; Frey and Feld, 2002; Feld and Tyran, 2002; Torgler, 2002, 2007) are motivated to comply because it is the 'right thing to do'. The behavioural approach acknowledges that taxpayers do not always behave like rational beings, motivated purely by self-interest and the desire to maximise economic outcomes. Instead, individuals act on their motivations to participate in the tax system (Torgler, 2007). People are influenced by the attitudes and behaviours of others within their social reference group. In other words, individuals look towards their family and friends to establish what is socially acceptable and what is not. The resultant collective behaviour is referred to as a social norm (Inland Revenue, September 2011).

⁵ 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 and with an annual GST turnover less than \$100 million.

⁶ GST stands for Goods and Services tax.

⁷ PAYE stands for 'pay as you earn' and is the tax element on employee salaries and wages.

A review of research conducted by other tax jurisdictions has investigated the role of sanctions in relation to compliance behaviour. These are briefly reviewed below.

The Irish Revenue postal Survey of Small and Medium Sized Business Customers 2008: Results and Analysis (2009) identified a range of factors that influence compliance. These include revenue sanctions (concern at having to pay interest charges for late payment of tax), concern of being audited, and concern that the revenue department will obtain a court judgement and publish details of the judgement.

Most participants in the Canada Revenue Agency (CRA) Attitudes towards payment of debt and compliance (2009) research thought that the financial consequences of late payment can be serious. They also thought that experiencing interest or penalty charges has a deterrent impact on late payment in the future for some respondents, but not for others.

The Australian Taxation Office (ATO) Understanding the characteristics of micro business tax debtors (2008) study reported low levels of comfort regarding having a tax debt; significantly lower than comfort levels of debt with other creditors. Businesses with recent debt were significantly more likely to believe ATO is lenient on businesses regarding missed payments.

Participants in the UK HM Revenue and Customs (HMRC) late payment of tax: motivations and sanctions (2008) study acknowledged that sanctions are essential in the tax system. They felt that systems need to be in place to encourage taxpayers to pay on time and penalise those who deliberately do not pay when cash availability is not an issue. They said that the sanctions helped the system be fair to all taxpayers and were necessary to both deter avoidance and encourage payment by all.

2.2 The role fairness plays in compliance behaviour

The OECD (2010) report notes that fairness and trust are important drivers for compliance. For example, *“it is not only important what a revenue body does; it is also important how the revenue body does it”* (p.30).

Researchers (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) have found that if authorities treat people with trust, fairness, respect and neutrality, people will be more willing to cooperate with authorities, and also more likely to comply with authority decisions and rules such as sanctions (penalties) for late payment of taxes. Customers will see the tax authority's status as more legitimate and be more inclined to accept decisions even if the outcomes, such as tax owing, are unfavourable.

Sanctions are used to help the system be fair to all taxpayers - to encourage both payment and discourage avoidance. Sanctions become ineffective motivators when the balance between deterrence measures and perceived justice tips towards excessive use of sanctions to 'punish' customers. If it tips the other way, the public perceive a lack of fairness and trust, and lose confidence in the integrity of the tax system thereby

increasing the risk of non-compliance from tax payers who have previously complied. The balance is restored when tax debtors are perceived to receive their deserved 'penalty' by the tax authority, tax compliers and the tax debtor.

Lack of confidence in the system or perception that there is a lack of fairness or trust can occur when there is a disjoint between tax administration policy and operations. For example, participant perceptions, in the (2009) CRA study, was that written communication did not give an indication that the revenue body was willing to work with people unable to pay the full amount right away or offer payment options. Some instalment payers said it took too long to hear about their late payment and most said they preferred written communication to a phone call about their late payment.

2.3 Lack of understanding of tax sanctions

Inadequate knowledge of tax law has been argued by small business taxpayers as a reason for their inability to meet their obligations (McKerchar, 1995; Coleman and Freeman, 1994, 1997; CRA, 2009). A meta-analysis conducted by the National Research Unit within Inland Revenue (2010) noted that the number of customers filing GST but not filing income tax was approximately 20,000 per annum and warranted further investigation.

Although the majority of participants in the (2009) CRA study assumed there would be some sort of adverse financial consequence, such as interest, awareness was low about late filing penalty and how charges are calculated, and participants felt that information on interest and penalty charges was hard to understand. In addition, while none of the participants from the study had filed late due to lack of awareness of the filing deadline, some suggested that young people and newcomers to Canada might be at risk of filing late. Some participants suggested that more advertising of the consequences of not filing on time, and promotion of payment options, could help taxpayers file on time.

Although some respondents did understand the role of charges as a penalty (and for some it was a deterrent) they thought that more knowledge about how charges were calculated could have a stronger deterrent impact. Participants also thought tax debt, caused by late filing of returns, was due to a lack of awareness of how penalties and interest were charged, and a lack of awareness of options for partial payments.

Some participants suggested more advertising about the specific consequences of not filing or paying by the due date. There was also confusion for those who are self-employed over the filing deadline date and the payment date being the same. Others reported that they pay when instructed by their accountant, which helped mitigate the impact of misunderstanding over deadlines.

While accruing debt is often part of small business, the authors of the (2008) ATO study identified steps and investigations that ATO could undertake to reduce the level of debt generally and of collectable debt in particular. These include further investigation between the link with a business life cycle (issues of capability and business growth) and tax debt; whether encouraging or compelling businesses to

update records more regularly will minimise business activity statement (BAS) related debt;⁸ and the extent payment methods contribute to the likelihood of incurring debt.⁹

The literature and data reveals that tax debt is caused by a combination of economic and social factors, and that SMEs are more susceptible to incurring debt than other tax authority customers. Based on this understanding, Inland Revenue recognised that it needed to identify why sanctions are effective to a certain extent, and if there are sanction thresholds and debt tipping points. Better information will help tax authorities to intervene to reduce the growing number of SMEs with tax debt, minimise the time SMEs spend with tax debt, and reduce the level of long-term debt.

By identifying SMEs at risk of incurring tax debt and the drivers behind SMEs' debt it would enable tax authorities to more effectively use its interventions to assist its customers to comply with their tax obligations.

3. OBJECTIVES OF THE RESEARCH PROJECT

The objectives of the project were to explore whether current financial sanctions can be used more effectively to change debt behaviour, and whether different sanctions work better for different SME taxpayer groups. Hence the research explored opinions and effectiveness of current late payment sanctions, and participant response to other types of sanctions. The research also wanted to determine if there is a tipping point where the penalties regime changes compliance behaviour, and identify penalty thresholds to help Inland Revenue better target its intervention processes.

The research focused specifically on tax debt incurred through late payment of income tax, GST and PAYE, and was principally concerned with late penalty payments and associated interest charges.

4. METHODOLOGY

The research used a mixed-method approach to reach its target groups: SMEs with debt, SMEs with cleared debt, SMEs that have never been in debt, and tax agents (who have SME clients). This included in-depth face-to-face interviews, a phone survey, and a behavioural economics 'tax experiment'. The approach was taken as involvement by participants, in the decision-making process can increase the likelihood of support for changes to procedures and policy (Hall, 1992; O'Brien, 2001; Tashakkori and Teddlie, 2003; Ahmed and Braithwaite, 2005). Furthermore, using qualitative and quantitative methods also increases the reliability and validity of the results by reducing bias (Denzin and Lincoln, 2000; 2003).

⁸ The majority of respondents reported changing businesses practices as a result of incurring debt, with half of these changing their cash flow planning and management.

⁹ The ATO findings showed a marked difference in tax payment methods; those with recent BAS debt were more likely to use BPAY (an electronic payment banking service) and less likely to use a cheque or money order.

Inland Revenue's National Research Unit commissioned an external provider (Colmar Brunton) to undertake the fieldwork. Tax debt is a sensitive issue and the unit decided that using an external researcher would encourage more respondents to participate due to any perceived lack of 'objectivity' and independence from Inland Revenue.

4.1 Inland Revenue administrative data

The analysis of Inland Revenue's administrative data (at April 2010) investigated tax debt owed by SME customers. It includes analysis by industry type, SME size and debt by tax type. It also includes the components of penalty and interest and the portion that can be collected under Inland Revenue administrative definition.¹⁰

4.2 Interviews

Analysis of Inland Revenue's administration data only tells part of the story – it tells us 'what is'. Interviews provide in-depth information about why people have certain attitudes and behaviour and it increases the likelihood that participants will discuss sensitive issues (like debt). It was anticipated that the qualitative component would provide deep insight into participant awareness and understanding of Inland Revenue penalties.

A total of 60 in-depth interviews were conducted as part of the qualitative phase. These were undertaken in two phases; 15 interviews were undertaken in Auckland and Wellington in April 2011 prior to the implementation of a quantitative survey. The remaining 45 were undertaken in the main metropolitan centres of Auckland, Hamilton, Wellington and Dunedin during the month of August 2011.¹¹

4.3 Survey

Surveys are useful in describing the characteristics of a large population. No other method of observation can provide this general capability.

A quantitative survey of 500 Computer Assisted Telephone Interviews (CATI) (450 active SMEs and 50 tax agents) was conducted in June and July 2011. The final draft of the questionnaire was pre-tested among six SMEs and a tax agent. As a result of the cognitive pre-testing phase further changes were made to improve the flow of the questionnaire, the relevance of the questions to SMEs and tax agents, and the accuracy of the data collected.

¹⁰ Collectable debt is debt Inland Revenue expects to collect and where active collection is occurring or possible. This includes debt that is being progressively repaid under an instalment arrangement.

¹¹ Thirty interviews were with SMEs with a current tax debt (nine with cash flow difficulties and no payment arrangement, 14 caused by cash flow difficulties and with a payment arrangement, seven with tax debt caused by administrative error), 12 with cleared tax debt, 8 SMEs that have never had tax debt, and 10 tax agents.

4.4 Tax Experiment

An online behavioural experiment was designed by Victoria University of Wellington (VUW)¹² The tax experiment was an environmental economics exercise and was the first time Inland Revenue has used this type of method to research taxpayer behaviour. It provided an environment where (unlike a survey) actual debt prioritisation behaviour can be observed. The experiment tested how individuals behaved in response to different levels of payment; that is, whether larger tax debts generated higher or lower levels of subsequent compliance than smaller tax debts.

Colmar Brunton distributed an electronic invitation to individuals on its own database to participate in this experiment. The database consisted of members of New Zealand's largest retail rewards programme. The target was 500 New Zealand taxpayers who were senior decision-makers in a business; in total 527 participated in the 'tax game'. Individuals were rewarded with 'points' from the retail reward scheme for participation. The advantage with using an independent research company to target their members is the ability to target the types of individuals that we wanted to take part in the experiment. Moreover, this approach guaranteed a specified number of responses. The data was compiled by VUW and anonymous results were analysed by the National Research Unit within Inland Revenue.

4.5 Sample sources

The samples for the interviews and survey are from Inland Revenue's administrative data. They included SMEs with current tax debt, SMEs who have a history of debt but are not currently in debt, and SMEs who have never been in debt. A smaller sample of tax agents (who have SME clients) was also included. Variables also included entity types, business size (number of employees), and location.

Tables 1 and 2 show the breakdown by debt status of participants for the in-depth interviews and phone survey.

¹²Dr Lisa Marriott is a senior lecturer at the School of Accounting and Commercial Law and Dr John Randal is a senior lecturer at the School of Economics and Finance at Victoria University of Wellington.

Table 1: Profile of participants by debt status for the qualitative phase (in-depth face-to-face interviews) N=60

Interview participants by debt status		Number of participants
Current tax debt	Tax debt caused by cash flow difficulties with no payment arrangement	9
	Tax debt caused by cash flow difficulties with payment arrangements	14
	Tax debt caused by administrative error (with or without payment arrangements)	7
Cleared tax debt	No current tax debt although have had tax debt in the past	12
Never had tax debt	No current tax debt and no previous tax debt	8
Tax agents with SME clients	Currently working as a tax agent for SMEs	10
TOTAL		60

Table 2: Phone survey SME participants by debt status, age of debt and business size group (N=450)

Debt status	Age of current debt	Sole trader	1 to 5 employees	6 or more employees
Never had debt	Not applicable	50	30	20
Has a debt history	Not applicable	73	47	31
Currently has debt	Less than 1 year	36	29	15
	1 to 3 years	34	16	20
	More than three years	19	10	20

Note: For this survey SMEs were not considered to have had a debt unless that debt was over \$100. Fifty tax agents who had SME clients also took part in the phone survey.

The research began shortly after the Canterbury earthquakes and this region was excluded from the sample because many SMEs were busy dealing with more urgent issues.

Pre-notification letters were sent to all contacts by Inland Revenue's National Research Unit approximately two weeks prior to the beginning of fieldwork. This letter informed businesses of the nature of the research, and gave them the opportunity to opt out of the research before their contact information was passed to the external research provider. Businesses were assured through the pre-notification letter and during the interview and survey introduction that only the research provider and researchers from the National Research Unit within Inland Revenue would have access to their individual responses.

Disproportionate sampling schemes were employed so the final active SME and tax agent samples contained large enough sub-groups for analysis purposes.

4.6 Analysis of data

The analysis of survey and interview data included a comparison of the three SME groups; SMEs in debt, SMEs with cleared debt and SMEs that have never incurred tax debt.

The analysis of the interviews consisted of: highlighting the key relevant findings from the quantitative survey report; analysing interview summary notes (in Excel) against each of the objectives; and analysing the verbatim quotes from a cross-section of 25 transcribed interviews.

The survey was analysed by Colmar Brunton using the Toolbox programme, by Info Tools as a visualisation tool for reporting of findings, and SPSS for in-depth statistical analysis. All sub-group differences described in the technical survey report are statistically significant at the 95% confidence level (unless otherwise specified). The sample of SMEs has a maximum margin of error of +/- 6.4% at the 95% confidence level. The sample of tax agents has a maximum margin of error of +/- 16% at the 95% confidence level.

Two SME populations were analysed in the administrative data; SMEs under Inland Revenue definition¹³ and Active SMEs.¹⁴ The descriptive analysis also included a breakdown of the debt by the following areas: tax type; location; entity type; business age; industrial areas; agent linkage; GST turnover; business size (number of employees) and customer initiated contact. The data was analysed by Inland Revenue researchers using the statistical software SAS.

The tax experiment was hosted by the external research provider. VUW collated the data and the data was analysed by the National Research Unit within Inland Revenue

¹³The SME population, in this research, includes all non-individual customers that are not non-profit organisations and not registered in a Corporate Service Centre area, individual customers if they registered for tax types of 'GST' and/or 'PAYE', with annual GST turnover less than \$100 million. The SME customers in the analysis include all active entities that meet the above definition at 1st April 2010. For those owing debt to IR, the debt value and debt elements are measured at the same date

¹⁴Active SMEs, for this research, are the SMEs that filed GST returns and/or employer returns for the period of April 2009 to March 2010.

using the statistical software SAS. The data was analysed by participant region, industry areas, business size and GST turnover.

4.7 Limitations

Telephone surveys achieve a higher response rate among SMEs because interviewers can ask for a named contact, and can make appointments and carry out call backs. The vast majority of SMEs will use a telephone for business purposes, and there are a lower proportion of incomplete surveys because respondents are less likely to withdraw when speaking to a 'real person'. However, they can be cognitively demanding, especially when asking respondents how they would act in certain scenarios (e.g. tipping point questions or to visualise what information they would like to have in a statement).

In-depth interviews are very time-consuming and can be off-putting to busy SMEs. To help with recruitment, the external research provider offered SMEs an incentive for participating. In qualitative research, reciprocity is ethically important. Incentives can be useful for increasing participation rates, and may help reduce sampling bias among individuals who are typically less likely to take part in research projects.

Nobel Laureate Vernon Smith (1982) has established the importance of financial incentives in experimental economics research. While not all disciplines adopt this approach, tax experiments typically use reward payments to assist in aligning behaviours in the artificial experimental environment.¹⁵ In this research we provided a reward to encourage participation in the experiment, rather than as a tool to align behaviours. This approach was adopted as the experiment did not follow the typical tax experiment design, i.e., the optimal strategy was not full tax evasion. There was no incentive for participants to try to maximise or minimise any one payment method; instead, payment preferences would determine how participants allocated their 'virtual' funds to meet obligations.

5. KEY FINDINGS

This section synthesises the key findings from the four data collection methods used for this project. As previously stated, the project used a mixed method approach to reach its three groups of SMEs with different debt status,¹⁶ whereby the qualitative interviews identified key themes and the quantitative survey measured these themes.¹⁷ The results compare the responses from the three groups and these are presented under five broad themes: awareness of late payment penalties; reasons for late payments; thresholds and debt tipping points; the role of non-financial sanctions and incentives; and the role of Inland Revenue (the tax administration). When applicable, the views of the tax agent group are presented separately.

¹⁵Experiments are typically conducted in an environment where there are no penalties for non-compliance, and minimal third-party impact from decisions made. This reduces the need to behave ethically, and potentially may weaken the validity of experimental research.

¹⁶SMEs with debt, SMEs with cleared debt (had a history of debt but are no longer in tax debt), SMEs that have never been in debt, and tax agents.

¹⁷Proportions stated relate to findings from the survey, unless otherwise specified.

5.1 Awareness of late payment penalties

In the majority¹⁸ of cases, penalties influence payment, and discourage it in a minority of cases. For SMEs who have never been in debt, it is the mere existence of penalties that influences payment (rather than the specific details about the penalties). The majority of SMEs said the penalties are influential in making sure they pay their business tax by the due dates. This is because they want to avoid any additional or unnecessary cost to their business. Just one fifth of SMEs commented specifically on the size of the penalties or the interest rate; e.g. that the penalties can build up quickly, or that the penalties could impact on their business.

Data from the tax agents were useful in providing another perspective. The most common reason provided by tax agents for SMEs' making payments is that SMEs simply do not want to pay penalties. Nearly all tax agents said the penalties are at least quite influential (but less likely than SMEs to say the penalties are very influential) in making sure SMEs pay their tax by the due dates. Just over a quarter of tax agents stated the penalties are very influential because of the size of the penalties, the interest rate, or because the penalties can build up quickly. Tax agents' reasons for saying the penalties are not influential included a perception that the penalties are not severe enough, that SMEs don't have the money to pay, that paying other bills is more important, and that businesses aren't aware of the penalties.

Results indicate that most SMEs are aware there are financial penalties for late payment of business tax. Most SMEs reported that they are aware that interest accrues on any unpaid amount and that penalties and interest are calculated on the total unpaid amount, including any unpaid penalties. There appears to be a complex relationship between awareness of sanctions (penalties and interest) and compliance. For example, awareness and imposition of penalties and interest can increase compliance in the early stages of the tax debt being incurred. But increased awareness due to receiving additional information by Inland Revenue about the applied sanctions does not make a difference for long term debt. SMEs felt by this stage there is very little they can do and further information can have a detrimental effect with SMEs more likely to feel a sense of hopelessness. There are relatively few differences in knowledge of the penalty system by debt status (i.e., currently in debt, history of debt, or never had debt).

There is a lack of detailed knowledge and understanding of late payment penalties. Although most SMEs in the research were aware there are financial penalties for late payment of business tax and see them as influential, they lacked specific knowledge of how they were applied. For example, less than a third of SMEs said they are aware that on the day following the due date a penalty of 1% is applied, with only 15% being aware that after the seventh day following the due date a penalty of 4% is applied and 23% aware that a 1% penalty is applied per month on any unpaid amount. Just over one quarter (of SMEs) was aware that the interest rate is around 9%. Nearly one fifth believed the penalty for late payment is still 10%.

¹⁸ In the survey findings, 'most' refers to more than 80%, 'majority' refers to more than 50% and less than 80%, and 'minority' refers to less than 50%.

5.2 Reasons for late payments

The main causes of tax debt include administrative mistakes or cash flow problems. For SMEs that have never been in debt, the reasons tend to relate to an error on the part of the business, such as not being aware of or forgetting the date, or some other error.¹⁹ SMEs with a debt history tended to attribute their most recent late payment to not being aware of or forgetting the due date, or external circumstances beyond their control. On the other hand, SMEs currently in debt tended to attribute their late payment to poor cash flow. These SMEs were also more likely than average to say they used the money for other expenses.

In terms of mitigating the impact of potential late payment, more than two thirds of SMEs who have been late with a payment had no contact with Inland Revenue prior to the due date. Further, more than two thirds of SMEs were aware they can contact Inland Revenue in advance to avoid some penalties, but SMEs currently in debt are less likely to be aware of this. Most tax agents believed SMEs miss the due dates for tax payment primarily due to a lack of cash flow.

Importantly, the majority of SMEs make changes to practices and processes as a result of making a late payment. The cause and simplicity of the tax debt has a direct correlation with changes to business practices – the more simple the cause of the debt, the more likelihood of change (and vice versa). Results show that two thirds of SMEs that have missed a recent payment said they have made a change to their practices or processes as a direct result of having missed a payment. The types of changes made were wide ranging, and tended to relate to the key reasons for late payment.

SMEs currently in debt (for whom short-term cash flow was the primary reason for late payment) are most likely to say they now set funds aside to ensure they make payments or that they keep a closer eye on their obligations and finances. SMEs with tax debt caused by long-term cash flow difficulties and more complex financial issues in their business are likely to be more restricted in the immediate, simple, straightforward changes they can make. They will need to make more substantial changes to avoid this situation in the future, (e.g., generating more revenue, improving debtors' management and better management of finances). The potential for change to the businesses practices and processes depends on a number of factors such as the economy, overall debt level of the business, the ability to generate income and whether they can realistically trade out of difficulties.

SMEs with a debt history (who tended to say they were not aware of or had forgotten the due date) were more likely than SMEs currently in debt to say they have set up a reminder to ensure they do not miss due dates in future. SMEs with tax debt caused by

¹⁹In the 2004 Colmar Brunton research (commissioned by Inland Revenue), the two main reasons for paying late in the past among current compliers were administrative error by business and cash flow problems.

administrative errors said they made straightforward changes to business practices and processes to ensure it doesn't happen again, for example, reminders of due dates and improved administrative practices.

Findings from the tax experiment provided insight into how SMEs prioritise the payment of debt. As part of the experiment decision-makers were required to trade-off various competing payment priorities under different penalty regimes. Paying employee wages consistently received the highest average priority rating, regardless of the threat of implications. Payments to Inland Revenue rated second (with PAYE rating higher than GST). The behavioural differences observed between small and larger sized SMEs are quite notable, suggesting that different compliance strategies may be required for different sized businesses.²⁰

Perception of fairness of the penalties was explored with participants. SMEs were evenly divided on this issue, with about half of the participants perceiving Inland Revenue financial penalties as fair when it comes to financial penalties for late payment. As would be expected however, perceived fairness varies by debt status. For example, SMEs with a debt history and SMEs that are currently in debt were more likely to perceive the financial penalties as being unfair for businesses.²¹

The most common reasons for perceiving penalties and interest as unfair included that they are high, or concern that they can compound and get out of control. Reasons for perceiving penalties and interest as fair included that they are a lever to obligate SMEs to pay on time, and that they are needed to encourage compliance. There is a strong sentiment that on-going penalties are unfairly harsh for those who are making an attempt to pay, and in this situation the penalties undermine the ability to comply. There is, however, support for the continued application of interest rates (more than the banks' loan rates) for unpaid amounts.

Analysis of the tax agent data showed that their views were also divided about whether the system is fair or unfair; half of tax agents believed the penalties are fair.²² Reasons for saying the financial penalties are fair included that it is a business's obligation to pay on time, that the interest rate is fair, and that the penalties are an incentive for businesses to pay on time. Reasons for saying the financial penalties are unfair centre mainly on a view that the penalties or interest rate is too high, or that penalties can build up and become out of control. Overall all these views are similar to that of the SMEs themselves.

²⁰ Previous research (CRA, 2009) found that participants perceive tax debt as different from other forms of debt and this may be a factor when SMEs cannot meet all their payment obligations. In the Colmar Brunton (2004) survey, non-complier businesses (who at least 'occasionally' experience cash flow difficulties) were asked to rank their payment priorities. They ranked staff first followed by supplier and IR third. Whereas complier respondents ranked IR first, followed by staff and supplier third.

²¹ 55% of SMEs never in debt, 45% with cleared debt and 40% of SMEs with debt rated the current financial penalties for late payment as fair.

²² 38% of tax agents believe they are unfair, and 11% believe they are both fair and unfair.

Results show that attitudes and behaviours vary across the SME customer groups. Importantly financial (and business) aptitude marks the difference between those SMEs that have never been in tax debt and SMEs that have experience of tax debt. This highlights the need for Inland Revenue's appropriate and effective management of tax debt to consider the difference between SMEs that have tax debt caused by administrative error (but ability to pay), tax debt caused by short-term cash flow, and on-going cash flow difficulties associated with reduced ability to pay.

Another important finding is that SMEs are not gambling that tax debts will be written off. Most SMEs with tax debt believed that their tax debts will not be written off other than through bankruptcy. They have a perception that Inland Revenue uses bankruptcy as a tool of last resort. They want to avoid this, believing that, given an improvement in the economy, they may be able to trade their way out of their financial difficulties. However, SMEs that are not in debt perceived bankruptcy and tax debt written off as an 'easy option' taken by SMEs in debt. They would prefer that Inland Revenue recovers some tax debt rather than none. To this extent, they support the waiver of penalties (but not interest) so that SMEs have the ability to make inroads into the tax amount owed.

5.3 Penalty thresholds and debt tipping points

One of the main objectives of the research was to examine perceptions of penalty thresholds by SME business groups. The survey sought to determine the point at which penalties encourage SMEs to make their payments by the due dates (the penalty threshold). Analysis of the data demonstrates there are penalty thresholds and debt tipping points. In relation to penalty thresholds, half of SMEs surveyed said that penalties and interest of just 1% at eight days would encourage them to pay by the due dates; three quarters (75%) of SMEs say that penalties and interest of 3.3% would encourage them to pay by the due dates;²³ and most (86%) SMEs say penalties and interest of 5.2% (build-up at eight days under the existing system) would encourage them to pay by the due dates.

Exploration of the penalty threshold and SME annual turnover revealed that there is an inverse relationship between penalty threshold and annual turnover. A comparison of SMEs based on their annual turnover and the percentage of tax bill that would be paid at the threshold at which 75% of SMEs would be encouraged to pay at eight days is shown in Table 3 below.

²³ SMEs were asked to think about the value of their average GST bill and imagine that the bill remained unpaid for seven days past the due date. Once a realistic GST bill had been determined, SMEs were asked to think about the penalties and interest that would build up over seven days, and to tell us what penalty dollar value would be so low that the penalty would not encourage them to pay off the debt.

Table 3: Percentage of tax bill by SME annual turnover

% of SMEs tax bill	Annual turnover
6.5%	up to \$50 thousand
3.8%	\$50,001-\$100 thousand
2.0%	\$100,001-\$500 thousand

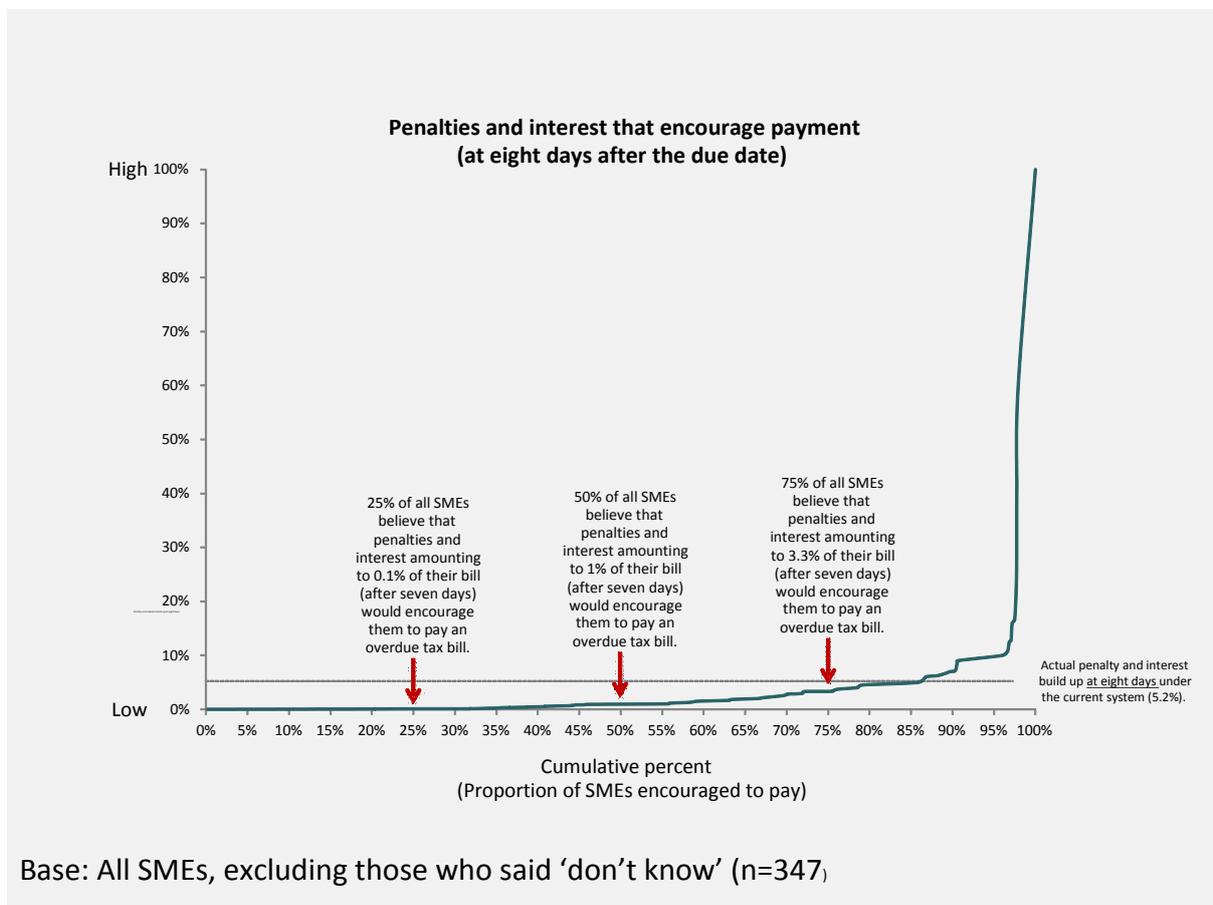


Figure 1: Proportion of participants encouraged to pay at each penalty and interest value.²⁴

The figure above shows the proportion of all SMEs that would be encouraged to pay at each penalty and interest value. The horizontal line represents the penalty and interest build-up at eight days under the existing system (5.2% at eight days). At this point most SMEs say they would be encouraged to pay by the due dates. The results

²⁴ The diagram is from the Colmar Brunton (August 2011) quantitative technical report.

are consistent with responses about knowledge of how penalties and interest are applied, that for many SMEs the mere existence of a penalty encourages them to pay their tax by the due dates.

The research also sought to determine the amount at which debt becomes unmanageable for SMEs, and potentially threatens their ability to do business (the debt tipping point). The quantitative results suggest at around \$10,000 (total GST debt, including core debt, penalties and interest) people felt that they would not be able to pay off the amount. The results suggest that these median tipping points do not vary by debt status (i.e. SMEs with debt, SMEs with cleared debt, SMEs that have never been in debt).

In addition to the above dollar amounts, there are a number of other factors that influence the debt tipping points. For example, when penalties and interest have compounded to the extent that they are 50% or more of the original tax amount owing; the repayment amount that businesses can afford out of current revenue is so little that it is only addressing penalties and interest and not the original balance of tax owed; other business and personal debt (e.g. employee wage costs, suppliers, bank interest and other costs) contribute to SMEs inability to pay tax debt; there is a cumulative tax debt across several tax types; and the total amount owing is out of proportion with yearly income.

As can be seen in the tables 4, 5 and 6 below, across all SMEs the median tipping point is a total debt of \$10,000.²⁵ This tipping point remains relatively constant except for larger SMEs that have an annual turnover between \$500,001 and \$100 million, or six or more employees. The median tipping points for these SMEs are \$28,965 and \$40,000, respectively.²⁶

²⁵ The researchers felt it would not have been possible in a telephone survey to ask SMEs to differentiate (in a hypothetical future scenario) between core debt and debt owed due to the accumulation of penalties and interest charges. These tables are from the Colmar Brunton (August 2011) survey technical report.

²⁶ Inland Revenue's (2011) report 'The Habitual Non-complier Tier 2 Analysis' looks at a wider (tier 2) group of those who are habitually late. The data of debt comparisons between habitual non-complier customer group categories shows the debt mid-point amounts for 'self-employed' is \$12,411 and 'other business' is \$11,436.

Table 4: Debt tipping point by annual turnover

	All SMEs	Annual turnover			
		Up to \$50,000	\$50,001 to \$100,000	\$100,001 to \$500,000	\$500,001 to \$100 million
Base (n=)	251	41	57	88	62
10 th percentile	\$2,000	\$1,000	\$1,800	\$4,000	\$6,115
25 th percentile	\$5,000	\$2,000	\$5,000	\$5,948	\$10,000
50th percentile (median)	\$10,000	\$10,000	\$10,000	\$12,000	\$28,965
75 th percentile	\$30,000	\$20,000	\$20,000	\$38,680	\$180,000
90 th percentile	\$100,000	\$50,000	\$34,000	\$62,822	\$500,000

Base: All SMEs, excluding those that said 'no amount would be too high' or 'don't know'.

By annual turnover, findings indicate an interest scale could be an effective approach rather than a one size fits all. Smaller SMEs are more vulnerable to incurring debt and it appears they have a higher threshold to incurring debt.

Table 5: Debt tipping point by number of employees

	All SMEs	Number of employees		
		Sole trader	1 to 5 employees	6 or more employees
Base (n=)	251	71	124	56
10 th percentile	\$2,000	\$2,000	\$2,453	\$7,036
25 th percentile	\$5,000	\$3,628	\$5,000	\$15,406
50th percentile (median)	\$10,000	\$10,000	\$10,000	\$40,000
75 th percentile	\$30,000	\$20,000	\$20,000	\$180,114
90 th percentile	\$100,000	\$100,000	\$50,000	\$500,000

Base: All SMEs, excluding those that said 'no amount would be too high' or 'don't know'.

Table 6: Debt tipping point by debt status

	All SMEs	Debt status		
		Never had a debt	Has a history of debt	Currently has debt
Base (n=)	251	56	79	116
10 th percentile	\$2,000	\$1,000	\$3,000	\$2,000
25 th percentile	\$5,000	\$4,485	\$7,027	\$4,418
50th percentile (median)	\$10,000	\$10,000	\$10,332	\$10,000
75 th percentile	\$30,000	\$20,000	\$50,000	\$28,569
90 th percentile	\$100,000	\$50,000	\$150,000	\$78,176

Base: All SMEs, excluding those that said 'no amount would be too high' or 'don't know'.

When the thresholds and other additional factors are taken into account, there is a small window of opportunity where the tax administration can intervene for impact before the debt tipping point is reached – this is the best time to intervene to reduce the risk of debt. This is illustrated in figure 2 below.

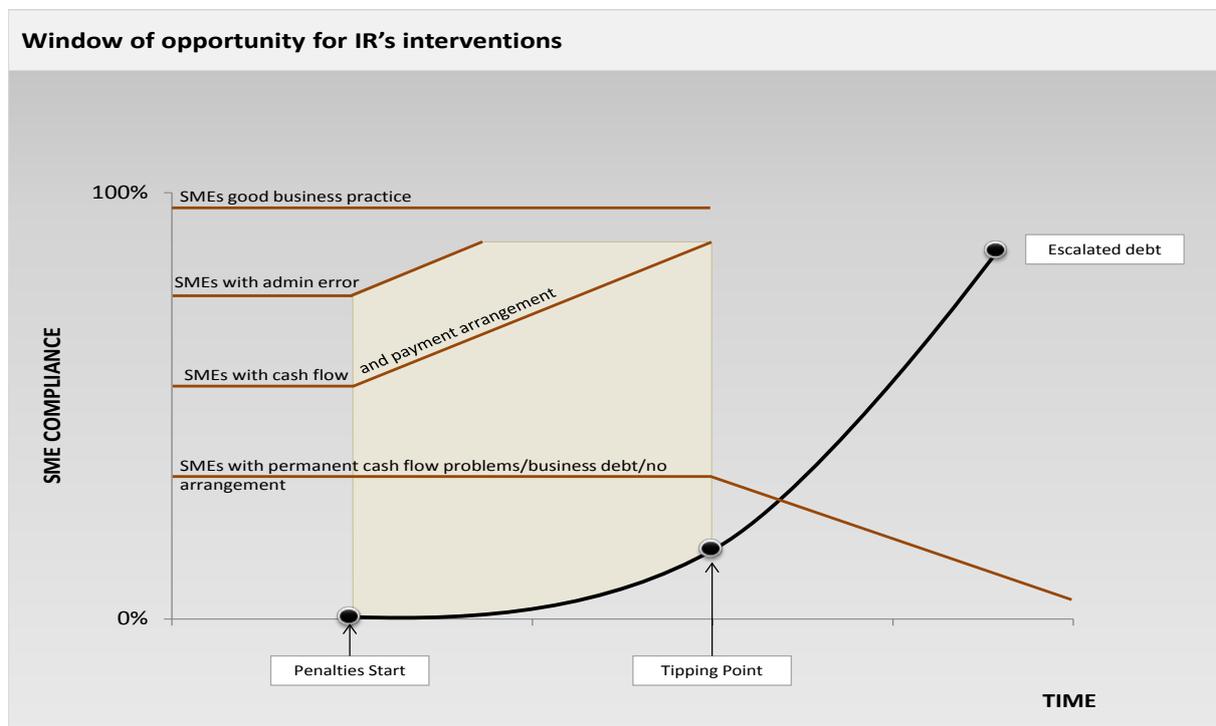


Figure 2: Window of opportunity before tipping point²⁷

²⁷ The diagram is from the Colmar Brunton (October 2011) qualitative technical report.

5.4 The role of non-financial sanctions and incentives

A key objective of the research was to gauge the impact that non-financial sanctions and incentives might have on reducing the risk of debt. Research participants were asked their views on five hypothetical non-monetary sanctions and incentives and whether they thought they would be effective in encouraging SMEs to pay their outstanding tax. These included improved notification, credit reporting, an annual practising certificate, travel restrictions, and information on statements to show how penalties and interest build up.

Results indicate that non-monetary sanctions and incentives could be somewhat effective. Across all SMEs in the survey, travel restrictions, improved notification, and credit reporting received the highest effectiveness ratings. The majority of SMEs and tax agents believed that all five sanctions and incentives would be at least somewhat effective in encouraging on-time payment. However the perceived effectiveness of each non-monetary incentive and sanction differs considerably by sub-group. For example, SMEs that have never been in debt and tax agents tended to favour the more punitive options, such as travel restrictions and credit reporting, whereas SMEs with a debt history tended to rate improved notification as the most effective incentive, followed equally by travel restrictions and credit reporting.

When explored in-depth, interviewees thought that notification in itself would only partly effective. The full leverage comes from the dialogue and Inland Revenue's ability to waive penalties in return for a payment arrangement. Furthermore, notification and showing how penalties and interest build up over time are not effective for people who have long-term/large debt with insufficient revenue to enter into a payment arrangement. In this situation, the notification contributes to the tipping point leading to inaction.

In relation to travel restrictions and certificate of compliance, interviewees thought travel restrictions would be difficult to enforce, and a certificate of compliance is an ineffective incentive. Both SMEs and tax agents suggested that it would be difficult to have a clear criterion as to when and how travel restrictions apply (e.g. business or pleasure) and which directors of the business it would apply to. SMEs that are not in debt generally supported travel restrictions for SMEs in debt who 'just want to holiday', but they did not support travel restrictions for those who need to travel for their business. Results suggest travel restrictions would be ineffective for SMEs that have debt – they say they cannot afford to travel so it would not work as a punitive measure.

Credit reporting is perceived to be an effective tool and works as a sanction in much the same way as penalties. The threat of credit reporting would need to be used early (while the debt can still be managed) to warn SMEs of the consequences of not contacting and making arrangements with Inland Revenue for the repayment of outstanding tax. However, just like accumulated penalties and interest, credit reporting will contribute to the tipping point and will add to the business's inability to trade out of difficulty. Consequently, it is likely to be a short step from credit reporting

to bankruptcy for some SMEs. SMEs that are not in debt would welcome the protection offered by the credit reporting of businesses with substantial debt.

Generally, participants considered improved notification and information to show how penalties build up would be most effective when combined with the current financial penalties and interest. The tax experiment showed that smaller sized businesses are more sensitive to sanctions than larger SMEs, and that a combination of financial and non-financial sanctions would be effective for this group.

5.5 The role of the tax administration (Inland Revenue)

Research findings indicate that the tax administration can play an instrumental role in preventing future tax debt. Overall, SMEs recognised that it is their responsibility to manage their business and comply with their tax obligations. However, SMEs thought that Inland Revenue taking a more proactive role in the management of tax debt would be effective; especially targeting those in early debt and those that have a history of debt.

Currently Inland Revenue notifies SMEs in debt that penalties and interest are applying, that they can enter into a payment arrangement and that they can phone the Department. However, this communication process is not maximising the leverage that Inland Revenue has for effective intervention to prevent, manage or limit tax debt. SMEs who were interviewed perceive that Inland Revenue currently prevents or limits tax debt almost solely through information and sanctions (with some payment arrangements). While on the one hand the debt is serious enough to impose penalties and interest, SMEs are also getting the message that it is not urgent or of sufficiently high priority for Inland Revenue to actively contact SMEs and instigate standard debt collection practices.

Those with a high level of financial management skill (and who meet their tax obligations) tend to perceive Inland Revenue's role as tax collection only. Responses in the qualitative research showed that some SMEs will contact the Department because they are generally proactive in dealing with business issues and ring to find out what they can do (they may also have the ability to pay). More contact may be generated if more SMEs are made aware earlier of payment arrangements and the possible waiver of penalties. At this point they are likely to have small or short-term debt and the cash flow reserves to enter into payment arrangements.

Those with a poor level of skill and/or extenuating circumstances (e.g. affected by a downturn in the economy) tended to suggest a greater role should be taken by the tax administration to prevent and/or manage tax debt. These SMEs are likely to need proactive management from Inland Revenue. They are likely to have large or long-term debt, have already incurred substantial penalties and interest, business financial difficulties and/or a 'mind-set' of not dealing with issues.

Overall survey results show that increased awareness of payment options and the waiver of penalties are likely to increase contact with Inland Revenue by SMEs at

risk. For example, more than two thirds of all SMEs surveyed said they were aware they can contact Inland Revenue in advance to avoid some penalties. SMEs currently in debt were less likely than average to be aware of this. More than two thirds of SMEs who have been late with a payment had no contact with Inland Revenue prior to the due date. Those who were not aware of the options said they would have contacted the Department had they known they could avoid some penalties.

There is a strong argument from SMEs and tax agents for Inland Revenue to manage tax debt through a more urgent, standardised business debt collection practice which would consist of early, personalised contact (by telephone from a dedicated debt collection team), dialogue, negotiation of the payment terms in return for avoiding negative consequences and then the consequences introduced if the business makes no attempt to pay (penalties, credit reporting and bankruptcy).

6. DISCUSSION

The issues regarding SME tax debt are complex and it would be naive to imagine that there can be a magic bullet that can fully address the growing level of tax debt. While the research has identified a number of opportunities for changes to policy and practices, any changes will require a sustained and consistent approach.

Most SMEs pay their tax on time, but some SMEs are at particular risk of incurring debt. This research included both debtor and non-debtor participants to better understand what determines compliance behaviour. It also identified tipping points and thresholds when penalties and interest become so large the SME debtor is unable to continue to make repayments. These indicate the importance of early intervention.

Key findings indicate that a ‘wrap around approach’ to early intervention would be more effective than one that is more ‘linear’. For example, notifying and educating SMEs who are late with their payments will not help those SMEs who do not have the capacity to make payments and a coordinated approach is likely to produce more effective outcomes. This approach would need to include early identification,²⁸ notification, and education, along with a long-term sustainable payment schedule that is closely monitored. The research identified the use of Inland Revenue’s discretionary power to waive penalty charges is an effective lever and this, along with the threat of non-financial sanctions, will provide a more effective approach to managing SME tax debt.

This section draws on findings from this research and other national and international studies to discuss mechanisms for reducing long-term tax debt. These include using financial and non-financial sanctions, penalty thresholds and debt tipping points, and conclude with the role Inland Revenue can play along with these tools.

²⁸ In-depth profiling is currently being undertaken by Inland Revenue to help identify key groups that are vulnerable and require early intervention.

6.1 Intervening to reduce risks with current sanctions

The majority of SMEs thought that penalties are influential in making sure they pay their business tax by the due dates. However, in-depth knowledge of the penalty rules does not necessarily equate to good compliance behaviour. Most SMEs were aware of financial penalties for the late payment of business tax, but the research highlighted a lack of detailed knowledge of how the sanctions were applied. For example, only a quarter of SMEs were aware of the current interest rate.

SMEs with debt or who have a history of debt were no more knowledgeable than SMEs that have never been in debt. Increased knowledge of the penalty rules would more likely benefit SMEs currently in debt or with a history of debt in the early stages of the tax debt being incurred, but less so for SMEs who have never been in debt. Knowing that penalties exist is enough for this group to ensure they comply.

These findings are similar to that identified in the CRA (2009) research 'Attitudes towards payment of debt and compliance'. In that research it was found that the majority of participants assumed there would be some sort of adverse financial consequence, such as interest, but awareness was low about how charges are calculated.

Inland Revenue's Finance and Planning's (January 2011) report 'Compliance & Penalties Post-Implementation Review: Customer Compliance Evaluation' concludes that the introduction of non-payment penalties appear to have had some success by encouraging customers into instalment arrangements. However, it noted that further analysis is required to establish whether customers have adhered to these payment arrangements. The report acknowledged that those who enter into instalment arrangements are those more vulnerable to being unable to make tax debt payments.

This current research looked at how penalties and interest encourage payment of tax. As highlighted in the findings, it is the fact that penalties merely exist (and not how they are applied) that is a deterrent for most SMEs, and in particular those that have never been in debt. The Irish Revenue (2009) 'Survey of Small and Medium Sized Business Customers' also found that knowing there were sanctions was one of the factors respondents gave that encouraged them to pay their taxes on time.

Overall, it is correct to assume that in the majority of cases penalties and interest encourages compliance and in a minority of cases they are less effective in encouraging compliance. The research showed that the current sanctions encourage payment of tax debt in the early stages but cease to become effective motivators the older the debt becomes.

The research suggests that the current penalties and interest offer very effective leverage to prevent debt and to manage debt within the first few weeks after a late payment (before the debt escalates). Beyond that window of opportunity, continued

application of penalties and interest without proactive (and effective) intervention from the tax administration becomes less effective. Proactive intervention, in combination with not imposing penalties when taxpayers comply with instalment arrangements, is likely to be effective.

There would appear to be no need to change the penalty or interest rates, but rather targeting the existing sanctions more effectively to different SME groups. Inland Revenue is undertaking segmentation analysis using its administrative data to help identify SMEs at risk of incurring tax debt.

6.2 The role of other types of sanctions and incentives to help Inland Revenue intervene to reduce risk

Social or personal norms are important drivers of compliance. The OECD (2010) 'Understanding and Influencing Taxpayers' Compliance Behaviour' report confirms that although the success of deterrence strategies can be linked to fear of detection or severity of punishment, it is also linked to norms, and deterrence is more effective where strong positive social norms exist. It proposes that revenue bodies consider the use of non-monetary penalties as a 'social cost' response to non-compliance behaviour.

This was a focus for the current research where participants were asked about the potential effectiveness in encouraging SMEs to pay their tax by the due date of five non-monetary sanctions and incentives – improved notification, credit reporting, an annual practising certificate, travel restrictions and information on statements to show how penalties and interest build up. The improved notification, more information on the statements and an annual practicing certificate were an attempt to see if these hypothetical options could be used to influence normative behaviour.

A longer term approach to improve compliance levels would be to have performance measured more by impact on taxpayer behaviour than output measurement. The optimal system may need to strike a balance between punitive elements (penalties and interest charges for late payment) and assistance from Inland Revenue to help ensure payments are made by the due dates (such as improved notification and more information on statements).

The research suggests that the introduction of credit reporting is likely to work in similar ways to penalties and interest, in that it would give Inland Revenue effective leverage within the first few weeks of debt. However, credit reporting will also work in the same way that accumulated penalties and interest do – making it less likely for the debt to be repaid once the SME has accumulated penalties and interest and a bad credit rating. Overall, the research suggests that the threat of credit reporting should be introduced early, in combination with more proactive interventions from Inland Revenue.

Previous research by Inland Revenue (2003) 'Reducing the Tax Compliance Costs of Small Business – Final Qualitative Research Report' found that businesses would like the penalties and interest system to take account of good past history. The report also

noted that businesses wanted Inland Revenue to be flexible; they wanted more tolerant treatment in terms of penalties and interest for those who had good records. These issues came up again in the current research, in particular by SMEs who have never been in debt. Participants suggested that SMEs with a good track record should have some leniency (e.g. no penalty) if they have a one-off late payment (e.g. an administrative error). Interestingly, it appears that some SMEs are not aware of an amendment which was introduced in 2008 in which a range of policy changes were made to late filing and payment penalties and to voluntary disclosures. A grace period was introduced for consistently compliant customers who make a late payment or filing. It provides that Inland Revenue will notify a taxpayer the first time their payment is late, rather than imposing an immediate late payment penalty, and setting out a further date for payment. If payment is not made, penalties are then imposed. The evaluation (Inland Revenue, January 2011) investigating the impact of the 2008 initiatives reported that the granting of a grace period does not seem to affect the likelihood of customers paying their returns on time that is, they do not pay sooner or later than before their introduction.

SMEs (not in debt) and tax agents also suggest that if the tax administration wants to look at compliance incentives it would need to be a financial incentive to pay on time, rather than an annual practising certificate. The research also suggests that the most effective route to reducing risk is through Inland Revenue more effectively managing the existing interventions and adopting standard debt collection practices which consist of proactive, early and personalised intervention from staff who are skilled in negotiating and agreeing outcomes.

6.3 Identifying ‘at risk’ SMEs through sanction thresholds and debt tipping points

One of the main objectives of this research was to identify if there were thresholds and tipping points in regard to the current sanctions – that is, are there recognisable points where sanctions cease to be incentives to paying tax and actually become a barrier? The research identified that the current sanctions would encourage most SMEs to pay by the due date. It also identified factors when these sanctions become unmanageable across all SMEs. These factors can be used as ‘red flags’ by Inland Revenue to help better target its interventions for at risk SMEs.

6.4 Triggers for debt

The ‘triggers for debt’ identified in this research support previous findings and research from other tax jurisdictions. The two main reasons that emerged for late payment of tax are administrative errors and cash flow (short-term and long-term). These causes of tax debt are also found in other tax jurisdictions’ research (ATO, 2008; CRA, 2009; UK HMRC; 2008) and identified in Colmar Brunton’s (2004) research for Inland Revenue.

In regard to decision-making and triggers to debt, the UK HMRC (2008) research also found that many debtors described how the misalignment between tax due dates and business invoicing dates caused short-term problems. This was also raised in the interviews, with participants suggesting changes to income tax timeframes

(provisional and terminal) to smooth out payments, and aligning the due dates for each tax type.²⁹

Paying tax owed was seen by participants as important. But the tax experiment showed that when it came to resource allocation decisions and prioritising outstanding debt, businesses ranked meeting employee wage costs above other bills. There is an assumption by those interviewed that small business is vital to the New Zealand economy, and that the Government needs small business earning revenue and employing people. Therefore, it will want to avoid bankrupting small businesses and causing additional burdens of unemployment and reliance on government benefits.

SMEs with long-term or high tax debt said they are not gambling on tax debts being written off. However, there was a hope that back penalties (and possibly some interest), as well as future penalties will be wiped, so that the original tax debt repayment is achievable. They often referred to as ‘burying their head in the sand’ when they felt they were unable to pay their tax debt or meet their instalment repayment obligations.

A group of motivational postures have been identified by Braithwaite (2002) as important in the context of taxation compliance - one of these is disengagement. This is where individuals and groups have moved past the point of challenging the tax authority. For these people the tax system and the tax office are ‘off the radar’. The objective is to be socially distant and blocked from view. Disengagement would be a ‘by-product’ of the tipping point with tax debt. The tax administration would need to be cognisant of early warning signs and act before the SME reaches their threshold, and therefore the point of no return (tax becomes uncollectable).³⁰

6.5 The role of the tax administration (Inland Revenue)

Most SMEs in the research recognise that it is their responsibility to meet their tax obligations on time and it is the tax administration’s responsibility to collect tax and impose consequences if tax is not paid by the due date. However, the findings indicate that a tax administration can achieve the appropriate balance of help versus consequences. Currently Inland Revenue provides information to businesses on its website with a section focusing on the needs of new businesses. In addition, The Department provides information to trade associations and other organisations dealing with businesses.

Many people interviewed emphasised the need for ‘debt prevention education’ for new businesses. Interviewees also identified the need for SMEs to be up-skilled in good business and money management skills to ensure that tax obligations are met in full and on time.

²⁹ Participants also referred to seasonally-related revenue that can lead to short-term cash flow problems.

³⁰ Inland Revenue is using new technology and its campaign management teams to contact debtors in the days after the due date, to help get debt matters resolved earlier so that penalties and interest would be minimal.

Inland Revenue's role is primarily a tax collection agency and is not supposed to be an organisation whose aim is to coach business people to gain better business skills. Although some participants may see Inland Revenue not acting in line with government's policy to encourage economic growth, some participants understood that the Department is not in a position to make specific recommendations to an individual business.

The issue for Inland Revenue will be how it can clarify its role as government's principle revenue collector to its SME customers and at the same time provide a tax system that encourages communication and compliance.

6.6 Issues of fairness

Issues of unfairness and inflexibility were identified for Inland Revenue as far back as 2005 in a literature review on SMEs. The review identified in the 2003 'Reducing the Tax Compliance Costs of Small business – Final Qualitative Research Report' that small businesses felt they needed to use tax agents because of the complexity of the tax system and fear of being penalised should they make mistakes in doing the tax themselves.

Sanctions can become ineffective motivators to tax compliance when they are perceived as unfair. The most common reasons in the current research for believing the financial penalties are unfair centre around the perception that penalties and rates are high, or a concern that the penalties and interest can compound and get out of control. In addition, delays in collection can affect levels and timeliness of resources available to the Government; and can provide an unfair competitive advantage for those who withhold tax payments to improve their cash flow.

As previously highlighted in the key findings, about half of the survey participants perceive the financial penalties as fair. SMEs never in debt view the current scheme as 'more fair' than the other SME groups. Reasons given as why sanctions are fair are similar to those in the UK HMRC (2008) research. Participants in the UK study recognised that a system of interest and penalties for non-payment of tax is necessary in order to ensure all taxpayers are treated fairly. They also perceived that percentage interest payments, in line with those of other financial institutions (such as banks), to be the fairest sanction for non-payment. Participants in the current research saw incurring interest on outstanding tax owed was fair. But they emphasised that SMEs that have entered into payment arrangements should not have on-going and compounding penalties. This is perceived as unfair because penalties and interest contribute to the tipping points and the erosion of the likelihood that the tax debt will be paid.

On one hand the issue of whether SME tax customers perceive the penalty rules as fair or not appears to be more of an issue for compliant behaviour than SMEs having in-depth knowledge of how penalties are applied. However, early communication with at risk SME groups (SMEs with early debt or a past history of debt) to raise awareness of how penalties are calculated, and a sustainable repayment schedule should help increase the perception of fairness in this group.

As discussed previously, Inland Revenue's Finance and Planning's (January 2011) report acknowledged that those who enter into instalment arrangements are those more vulnerable to being unable to make tax debt payments. The CRA (2009) research highlighted a lack of awareness that partial payments can be a viable option for final tax payments. Respondents in that research believed that CRA will not work with people to develop a payment schedule, but rather insist on receiving the full amount immediately. This belief resulted in participants saying that instead of filing on time and making partial payment at the deadline, they will delay filing and pay the entire amount late.

The current research extends this understanding and indicates that providing specific information about the penalties and payment options is likely to have some influence on SMEs with a debt history, or who are currently in the early stages of debt to contact the tax administration in advance. More than two thirds of SMEs that were not aware of payment options (and who have made a late payment in the last three years) say they would have contacted Inland Revenue had they known they could avoid some penalties.

Results suggest that providing information in the early stages, having a dialogue about payment options early in the process, and the possibility of avoiding penalties is likely to encourage more SMEs (especially those at risk of being late with their tax payments) to contact Inland Revenue before payment is due, thus preventing some debt from occurring. However, there is a debt tipping point beyond which penalties and interest are ineffective, if not obstructive for debt collection.

7. CONCLUSION

There are two elements to mitigating risk; the first is when and how to intervene to reduce risk. The other element is the risk of making ineffective choices about what these interventions are because there is a lack of good information. This research addresses both elements.

This project explored factors underlying SME debt attitudes and behaviour, and identified evidence-based opportunities for changes to policy and practices. These will help Inland Revenue reduce the risk of making ineffective changes to current practices and to reduce the number of SMEs incurring high levels of debt, the length of time SMEs are in debt, and the number of SMEs in debt.

The research indicates that penalties and interest are influential. Improving awareness and knowledge of penalties would be effective in preventing or limiting tax debt in the early stages of tax debt, but there are thresholds and tipping points. These suggest that, rather than changing the penalty rules, Inland Revenue can use the existing sanctions more effectively. This would include better targeting of SMEs at risk, early dialogue, and ensuring that staff are skilled in negotiating and agreeing viable repayment agreements.

The introduction of credit reporting is likely to work in similar ways to penalties and interest, and could be used in combination with more proactive actions. In particular, the threat of non-financial sanctions can be raised as part of the early dialogue if SMEs do not adhere to payment arrangements.

Reasons for Inland Revenue's current interventions not making inroads into the tax debt problem are complex and arise from a combination of issues. This includes issues such as better trained front line implementation staff, staff approaches being consistent, that not all in-house systems are appropriate for the problem, and even how the penalties are applied. Another important factor this research highlighted is the lack of SME knowledge about regulation obligations. More than two thirds of SMEs were not aware of payment options and the possibility of avoiding penalties.

The research also identified how Inland Revenue can play an instrumental role in reducing future tax debt. While SMEs recognise that it is their responsibility to manage their business and comply with their tax obligations, Inland Revenue can use its ability to waive penalties to encourage SMEs to enter into payment arrangements earlier rather than later.³¹

Research (Battisti et al, 2011) investigating SMEs capability to manage regulation argues that capability to manage any type of regulation is closely related to the capability to manage the business in general.³² The World Bank 2010 (Doing Business) report states that New Zealand is one of the easiest countries to start a new business but Inland Revenue tax data and Statistics New Zealand data show that SMEs are most vulnerable to fail in the first year. There could be a connection between the ease of set up, and the lack of knowledge of regulation obligations.

As raised at the beginning of the discussion, the complexities of the issues are such that it would require a collaborative, sustained and consistent ('wrap-a-round') approach by those in operations, policy and communications to make an impact on the debt problem and reduce the debt risk. Evidence properly assessed and applied is key to selecting and implementing effective programmes (Gluckman, 2011). No single intervention will in itself lead to a step change in outcomes; making a substantive difference over time will take an integrated and consistent approach involving new approaches and interventions.

³¹Based on the findings from this research, Inland Revenue is trialling a TXT (SMS) messaging campaign with different messages for SMEs who have a history of debt, currently in debt and those that paid their tax obligations on time. Letters are also being developed to show how penalties and interest can 'pile up' if payment is not made on time. Inland Revenue is also using the research to better understand how and when to intervene. The research suggests that the most effective route to debt management and recovery is through adopting standard debt collection practices which consist of proactive, early and personalised intervention from staff that are skilled with negotiating and agreeing outcomes with SME customers. IR is also exploring further the feasibility of using non-financial sanctions as another tool to help mitigate the risk of SMEs incurring long-term and high levels of tax debt.

³²The report also argues that while compliance is a measure of demonstrated action, the concept of capability expresses the broader potential to act. It allows for a more nuanced understanding of how SME owners manage regulation.

REFERENCES

- Ahmed, E. & Braithwaite, V. (2005). Understanding small business taxpayers: Issues of deterrence, tax morale, fairness and work practice. *International Small Business Journal*, 23, 539-568.
- Allingham, M. & Sandmo, A. (1972). Income tax evasion: A theoretical analysis. *Journal of Public Economics*, 1, 323-338.
- Australian Taxation Office. (2008). Understanding the characteristics of micro business tax debtors. ATO.
- Ayres, I. & Braithwaite, J. (1992). Responsive regulation: Transcending the deregulation debate. New York; Cambridge: Cambridge University Press.
- Battisti, M. Deakins, D. & Perry, M. (2011). SME capability to manage regulation. New Zealand Centre for Small & Medium Enterprise Research, Massey University.
- Braithwaite, V. (Ed.). (2002). Taxing Democracy. Aldershot: Ashgate Publishing Ltd.
- Braithwaite, V., Murphy, K. & Reinhart, M. (2007). Threat, motivational postures and responsive regulation. Special issue on responsive regulation and taxation. *Law and Policy*, 29(1), 137-158.
- Braithwaite, V. & Wenzel, M. (2008). Integrating explanations of tax evasion and avoidance. In A. Lewis (ed.), *The Cambridge Handbook of Psychology and Economic Behaviour*. Cambridge: Cambridge University Press, 304-331.
- Canada Revenue Agency. (2009). Attitudes towards payment of debt and compliance. Final Report. Prepared by Sage Research for Canada Revenue Agency.
- Coleman, C. & Freeman, L. (1997). Cultural foundations of taxpayer attitudes to voluntary compliance. *Australian Tax Forum*, 13, 311-336.
- Coleman, C. & Freeman, L. (1994). The development of strategic marketing options directed at improving compliance levels in small business. *Australian Tax Forum*, 11, 347-67.
- Colmar Brunton. (October 2011). Prevention and management of SME tax debt: Final report of qualitative research findings Technical report prepared for Inland Revenue.
- Colmar Brunton. (August 2011). Business tax late payment penalties and interest charges: report on a survey of SMEs and tax agents. Technical report prepared for Inland Revenue.
- Colmar Brunton. (2004). Presentation slides on research commissioned by Inland Revenue on a nationwide telephone survey with 857 businesses on understanding the

growing levels of outstanding returns and debt and developing high level solutions that encourage taxpayers to comply.

Denzin, N. & Lincoln, S. (2003). *Collecting and interpreting qualitative materials*. Thousand Oak, London, New Delhi: SAGE Publications Inc.

Denzin, N. & Lincoln, S. (2000). (Eds.). *Handbook of qualitative research*. London: Sage.

Feld, L. & Frey, B. (n.d.) *Deterrence and Tax Morale: How Tax Administrations and Taxpayers Interact* <http://www.oecd.org/dataoecd/9/51/2789923.pdf>

Feld, L. & Tyran, J. (2002). Tax evasion and voting: An experimental analysis. *Kyklos*, 55, 197–222.

Frey, B. & Feld, L. (2002). *Deterrence and morale in taxation: An empirical analysis. Working paper No. 760*. CESifo, August.

Gluckman, P. (2011). *Improving the transition: Reducing social and psychological morbidity during adolescence. A report from the Prime Minister's Chief Science Advisor*. Auckland: Office of the Prime Minister's Science Advisory Committee.

Hall, B. (1992). From margins to centre? The development and purpose of participatory research. *American Sociologist*, Winter, 15-28.

Inland Revenue. (November 2011). *Briefing for the Incoming Minister of Revenue – 2011*. Inland Revenue.

Inland Revenue. (September 2011). *Social norms discussion document*. National Research Unit.

Inland Revenue. (February 2011). *Tax debt research: A strategic approach. The National Research Unit discussion paper and research plan*. National Research Unit.

Inland Revenue. (January 2011). *Compliance and penalties post-implementation review: Customer compliance evaluation*. Finance and Planning.

Inland Revenue. (2011). *The habitual non-complier tier 2 analysis*. Inland Revenue.

Inland Revenue. (2010). *Meta-analysis: A synthesis of findings from the external factors, demographics, and compliance by Locations project*. National Research Unit.

Inland Revenue. (2009). *Annual Report*. Inland Revenue.

Inland Revenue. (2005). *Literature Review: Inland Revenue Research on Small and Medium Enterprises*. National Research Unit.

Inland Revenue. (2003). *Reducing the tax compliance costs of small business – Final qualitative research report*. National Research Unit.

Irish Revenue. (2009). Survey of Small and Medium Sized Business Customers 2008: Results and Analysis.

Kirchler, E., Muehlbacher, Kastlunger & Wahl, I. (2007). Why pay taxes? A review of tax compliance decisions. *Working Paper 07-30*. International Studies Program. Andrew Young School of Political Studies, Georgia State University.

McKerchar, M. (1995). Understanding small business taxpayers: Their sources of information and level of knowledge of taxation. *Australian Tax Forum*, 12, 25-41.

Murphy, K. & Tyler, T. (2008). Procedural justice and compliance behaviour: The mediating role of emotions. *European Journal of Social Psychology*, 8(4), 652-668.

Murphy, K., Tyler, T. & Curtis, A. (2009). Nurturing regulatory compliance: Is procedural justice effective when people question the legitimacy of the law? *Regulation & Governance*, 3(1) 1-26.

O'Brien, R. (2001). An overview of the methodological approach of action research. In Roberto Richardson (Ed.), *Theory and Practice of Action Research*. João Pessoa, Brazil: Universidade Federal da Paraíba. (English version) Available: <http://www.web.ca/~robrien/papers/arfinal.html> (Accessed 20/12/2010).

OECD. (2010). Understanding and influencing taxpayers' compliance behaviour. Forum on Tax Administration: Small/Medium (SME) Compliance Subgroup. Information Note. Centre for Tax Policy and Administration, Organisation for Economic Cooperation and Development.

Smith, Vernon, L. Microeconomic Systems as an Experimental Science. (1982). *The American Economic Review*, 72(5), 923-955.

Srinivasan, T. (1973). Tax evasion: A model. *Journal of Public Economics* 2, 339-346.

Tashakkori, A. & Teddlie, C. (2003). *Handbook of mixed methods in social & behavioral research*. Thousand Oaks, CA: SAGE Publications.

Torgler, B. (2007). *Tax compliance and tax morale: A theoretical and empirical analysis*. Cheltenham, U.K.: Edward Elgar Publishing Limited.

Torgler, B. (2002), Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments. *Journal of Economic Surveys*, 16: 657-683. doi: 10.1111/1467-6419.00185

Tyler, T. (2006). Restorative justice and procedural justice: Dealing with rule breaking. *Journal of Social Issues*, 62(2), 307-326.

Tyler, T. (1990). *Why people obey the law: Procedural justice, legitimacy and compliance*. New Haven, Conn.: Yale University Press.

UK HM Revenue & Customs. (2008). Late payment of tax: Motivations & sanctions. Research report No. 63. Final Report for HM Revenue & Customs by Ipsos MORI.

Wenzel, M. (2004). The social side of sanctions: Personal and social norms as moderators of deterrence, *Law and Human Behavior*. 28: 547-567.

World Bank Doing Business. (2010). Measuring business regulations. World Bank.