

eJournal of Tax Research

Volume 13, Number 1

March 2015

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Building trust through leadership: A longitudinal study on Inland Revenue's response to, and learnings from, the

1. INTRODUCTION

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

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

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

2. BACKGROUND

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

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

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

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

- waiving penalties for late filing.

2.1.2 What is good compliance?

A critical component of an efficient and effective tax system is voluntary compliance, that is, taxpayers proactively comply with their tax obligations. For this research, good compliance³ is when an Inland Revenue customer files their tax return on time and pays tax owing on time and in full. Examples⁴ of good compliant attributes include a SME business owner who:

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

2.1.3 What are the risk factors?

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

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

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

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

3. RESEARCH OBJECTIVES AND METHODOLOGY ⁵

A responsive tax regime is seen in the research literature (on disasters⁶) as a key building block in re-development after an adverse event. By late 2011, there was anecdotal evidence⁷ that the Canterbury earthquakes were having an impact on small business compliance behaviour. The longitudinal study will identify what the long-term tax implications are for Canterbury and the rest of New Zealand, and develop a framework⁸ from the learnings for responding to future large-scale adverse events. Because there is very little international literature on the impact of adverse events or disasters on SME tax compliance behaviour, a large component of the study is exploratory.

The purpose of the research is to:

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

3.1 Outcomes

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

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

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

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

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

3.2 Year 1

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

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

3.3 Year 2

In-depth individual interviews were conducted with 39 stakeholders from a range of business sectors, government agencies and professional bodies, as well as 11 with Inland Revenue staff¹⁰ identified by the project advisory group and research team. The participants were all Christchurch-based, and were knowledgeable and experienced in their respective sector of activity. They also had a good understanding of SMEs within the sector.

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

⁹ The population base used is SMEs who were active on 4 September 2010. Using this data has the benefits of being able to take both historic and

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

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

Other key impacts of the earthquakes on SMEs are:

- 40 per cent of SMEs still trading experienced a decrease in their business income since before the earthquakes, 40 per cent have experienced no change in their business income and 18 per cent have experienced income growth. SMEs in earlier stages of recovery are more likely to have experienced a decrease in business income (81% in 's

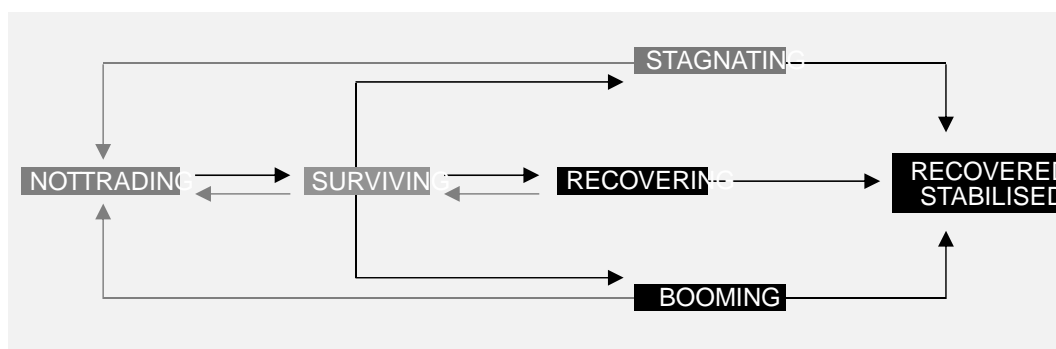
Figure 2: Year 2 recovery model¹³

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

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

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

- Recovered/Stabilised: Very few SMEs are in this stage, which is characterised

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

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

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

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

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

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

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

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

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

- those in earlier ('surviving' or 'recovery') stages of recovery from the

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

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

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

The qualitative research findings suggest that there are slightly different views on what constitutes 'hidden economy activity', with a range of perceptions from deliberate cash payments and non-declaration of income through to accidental

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

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

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

In the qualitative research, SME owners suggested Inland Revenue use a softer/lenient approach during the survival phase as most SMEs are struggling. This includes educating and informing SMEs about a

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

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

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

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

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

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

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

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

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

5.2 Assistance to tax agents

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

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

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

6. LEARNINGS

6.1 A new sense of normality in Christchurch

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

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

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

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

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

They expect that these campaigns would increase compliance and reduce participation in the hidden economy. Stakeholders and Inland Revenue staff feel that, today, non-compliance has become even more unacceptable, as the destructive earthquakes were

6.2 SMEs' creativity and innovation have flourished

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

It has provided a springboard for smart, innovative people to create their own companies. So, we've got quite a lot of individuals who might have

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

6.6 Learnings for a tax administration:

- Visibility and proactivity are important.
-

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

7.2 Learnings for tax administrations for future adverse events

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

Once SMEs have returned to a more regular business pattern (recovering and recovered), most SME participants believe that the tax authority should be tougher and more proactive in dealing with the hidden

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

SMEs may recover to a point where their financial position matches or even exceeds that prior to the adverse event. Some tax agents have suggested that SMEs that are

9.2 Appendix 2: Methodology

Research questions

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

<p>In what ways and to what extent have the earthquakes impacted on SME tax compliance?</p>	<p>What is the mechanism by which the earthquakes have an impact on SME tax compliance?</p>	<p>How have the actions of Inland Revenue affected that impact?</p>	<p>How should Inland Revenue act to get the best compliance result when adverse events occur?</p>
<p>What are the recovery times before ‘business as usual’ is restored?</p>			
<p>How can Inland Revenue identify/ recognise signs of ‘normality’ (pre-quake activity)? (This will include a comparison between ‘old normal’ and ‘new normal’).</p>			
<p>How long does it take to return to SME compliance behaviour at pre-quake levels, if at all?</p>			
<p>To what extent have the Canterbury earthquakes changed SMEs’ attitudes and behaviours</p>			

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

Sample

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

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

In the final sample:

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

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

Quantitative research

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

Questionnaire development

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

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

Base: All SME respondents

Source: Inland Revenue sample

Response rates

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

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

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

Notes to the reader

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

- Debt history status (currently in debt, used to be in debt, never in debt) – as per Inland Revenue's records in December 2010.
- Business size (sole trader, 1-5 employees, 6-19 employees, 20+ employees) – as per Inland Revenue's records in December 2010.
- Location (CBD)TJ-2w[(as)9.8resJ16.C0005 Tc.50w[Tw[(r7nc(hichwa7(,)4.7 c0.0w[-2)50Ital)5., ichwa7e of les bur6.C003(-)4()JT07.287n

10. QUALITATIVE METHODOLOGY FOR YEAR 2 RESEARCH

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

1 Sample

The project advisory group and research team identified 39 stakeholders and 11 Inland Revenue staff as instrumental to this

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