



Microfoundations of small business tax behaviour: A capability perspective

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Abstract

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

Key words

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

Introduction

In relation to tax regulation, small businesses are considered at risk of being non-compliant compared to other taxpayers as they have more opportunities to evade taxes (Kamleitner, Korunka and Kirchler, 2012; Kirchler, Niemirowski and Wearing, 2006; OECD, 2004). In small businesses, the owner-managers' behaviour is strongly connected to the success of their business and in turn their personal income. Taxation is unlikely to be a key area of expertise of small business owners, but taxation outcomes are likely to be of importance due to the close link between business performance and personal financial reward (Kamleitner *et al.*, 2012). Small business owners' frequent reliance on cash transactions (Morse *et al.*, 2009), their comparably low public profile with a smaller market and customer base (Schaper, Volery, Weber and Gibson, 2013) together with the need to self-assess and self-report their income (Richardson and Sawyer, 2001) provides a potential opportunity for non-compliance (Kamleitner *et al.*, 2012). Further, small business owners often face a range of taxes ranging from their personal income tax to business taxes, sales and payroll taxes which require sound knowledge of the tax system to ensure compliance. Lastly, compliance has been predominantly portrayed as a burden and cost to small businesses and the claim that the cost of complying is disproportionately high for smaller compared to large businesses has been well supported (Schoonjans, van Cauwenberge, Reekmans and Simoens, 2011; Chittenden, Poutziouris, Michaelas and Watts, 1999; Chittenden, Kauser and Poutziouris, 2003; 2005; Kauser, Chittenden and Poutziouris, 2008; Pope and Abdul-Jabbar, 2008).

Although small business tax compliance has attracted the interest of researchers for many years, the findings remain fragmented. Instead, the existing literature emphasises a variety of determinants of tax compliance that reflect a similar variety of disciplinary perspectives such as economical, political and socio-psychological perspectives (Kamleitner *et al.*, 2012; Kirchler, 2007; Batrancea, Nichita and Batrancea, 2013). Empirical findings on the determinants of tax compliance are mostly mixed which is indicative of a wider methodological problem – the prevailing use of self-reported compliance behaviour or compliance intentions by small businesses owners instead of factual compliance. Lastly, the dynamic and changing nature of small business compliance has not been sufficiently

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3 acknowledged to date. Only recently, Kitching, Hart and Wilson (2015) called for regulation to be
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5 considered as a dynamic force that allows for variations in how firms respond. In this study, we argue
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7 that tax compliance behaviour is a result of the dynamic interaction between the firms' capability, the
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9 owner-mangers' experiences with and perception of the tax system as well as the external
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11 environment.

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

35 36 37 **Small business tax compliance**

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40 Previous studies of small business tax compliance have tended to avoid definitional matters as most
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42 studies focus on perceived and self-reported compliance as compared to factual compliance. There
43
44 seems to be no agreed definition of tax compliance as the line between compliance, avoidance and
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46 evasion is often blurred due to the complexity of the tax system, the lack of clarity to the taxpayer and
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48 different administrative requirements (Slemrod, 2004). According to Kirchler (2007, p.21) tax
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50 compliance refers to "taxpayers' willingness to pay their taxes". From this psychological perspective,
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52 tax compliance is defined rather broadly with a focus on the individual's willingness. This willingness
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54 to comply is driven by individual perceptions of e.g. fairness of the tax system or the opportunity to
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56 evade as well as individual decision frames related to the cognitive costs of compliance (Kamleitner *et*
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3 *al.*, 2012). In contrast, from a law enforcement perspective, tax compliance is much more narrowly
4 defined as the full payment of all taxes due (Braithwaite, 2009).
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7 **Review of research on small business tax behaviour**

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10 Previous research on the tax compliance behaviour of small firms can be broadly categorised into two
11 types of studies:
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14 *Compliance cost studies*

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17 Since the pioneering work of Cedric Sandford who examined the compliance costs of Value Added
18 Tax (VAT) and other taxes in the UK more than forty years ago, a large number of compliance cost
19 studies have been undertaken in developed as well as developing countries around the world (for an
20 overview see Lignier, Evans and Tran-Nam, 2014). Business owners, it is argued, face an opportunity
21 cost in diverting scarce resources away from productive, profit-generating activities in order to
22 discover, interpret and comply with regulatory obligations (Kitching *et al.*, 2015). The claim that this
23 cost is regressive i.e. that small businesses incur higher proportionate compliance costs than larger
24 firms, either in terms of time or as a proportion of turnover, has been well supported (Smulders,
25 Stingling, Franzsen and Fletcher, 2012; Schoonjans *et al.*, 2011; Chittenden *et al.*, 2003; 2005;
26 Kauser *et al.*, 2008). A large element of compliance costs is fixed and small businesses are said to be
27 unable to spread these costs across large-scale operations due to their lack of internal resources with
28 which to handle regulations and, because of their lower asset base, are less resilient to regulatory
29 changes. There is, however, no consensus on the size of these costs due to variations in how small
30 business is defined, the specific regulations covered, sample sizes and composition, the methods of
31 calculating costs and undertaking comparisons with large enterprises – all of which render
32 generalisation or international comparisons difficult. Moreover, emphasis is placed on those costs that
33 can be quantified easily or, alternatively, attempts are made to force qualitative phenomena such as
34 psychological costs into a quantitative cost-benefit framework (Kauser *et al.*, 2005; Chittenden *et al.*,
35 2005). Therefore, the majority of these studies treat compliance as a cost or constraint. The limited
36 number of studies that also explore the benefits associated with tax compliance, identified cashflow
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3 benefits (Pope, 1993; Pope and Rametse, 2001; Tran-Nam *et al.*, 2000; Chittenden *et al.*, 2005;
4 Blackburn *et al.*, 2005) as well as managerial benefits such as improved record keeping and
5 knowledge of profitability (Lignier, 2009; Hansford and Hasseldine, 2012) of the business. Although
6 these studies avoid treating regulation purely as a cost or constraint, they stop short of identifying why
7 some firms manage to generate benefits from complying with tax regulation while others don't.
8 Quantifying such costs and benefits is, however, extremely difficult, particularly where these are
9 intangible and/or likely to accrue over a long period of time.
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17 *Determinants of tax compliance*

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20 Tax compliance has been looked at from predominantly three perspectives: an economical, a political
21 and a socio-psychological perspective (Kirchler, 2007; Batrancea *et al.*, 2013). From an economic
22 perspective tax compliance behaviour is driven by audit probability, fines, tax rates and income.
23 Recent reviews by Batrancea *et al.* (2013) and Maciejovsky, Schwarzenberger and Kirchler (2012)
24 suggest that empirical results on the impact of these economic determinants on tax compliance is – at
25 best – mixed. Small businesses owners like other taxpayers are therefore not fully rational utility
26 maximisers whose behaviour is a reaction to financial cost and benefits consideration. Overall, it is
27 clear that the phenomenon is simply too complex to be explained by economic variables only. From a
28 political perspective tax compliance behaviour is driven by fiscal policy and the complexity of the tax
29 law and tax system (Kirchler, 2007; Batrancea *et al.*, 2013). Increased complexity means that
30 taxpayers do not have sufficient control to ensure that all required tasks are successfully completed
31 because of a lack of awareness and understanding of the regulatory processes and systems (Langham,
32 Paulsen and Charmine, 2012). For small businesses complex filing procedures were found to be a key
33 driver of tax non-compliance (Atawodi and Ojeka, 2012). But the uncertainty caused by complex tax
34 laws and systems also has another effect – it increases the use of accountants, tax agents and other
35 professionals to provide expert advice. The importance of this relationship between small businesses
36 and accountants has been well documented in the extant literature (Blackburn and Jarvis, 2010;
37 Gooderham *et al.*, 2004; Mole, 2002; Perry and Coetzer, 2009). From a socio-psychological
38 perspective, tax compliance behaviour is driven by a range of cognitive and affective factors. First,
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3 small business owners' attitudes towards tax tend to be less favourable as they frequently frame taxes
4 as a loss of something that once belonged to them as in the case of VAT in the UK that was
5 predominantly perceived as money they owned rather than money they collected (Adams and Webley,
6 2001; Webley, 2004). Overall findings are mixed and attitudes alone are not a sufficient predictor for
7 tax compliance behaviour (Kirchler, 2007). Second, while findings on the relationship between
8 general knowledge and level of education and tax compliance are mixed, tax-specific knowledge
9 results in an increase of compliance as the knowledge about taxation helps small business owners
10 understand its importance while at the same time act as a deterrent (Kamleitner *et al.*, 2012). The
11 problem, however, is that small businesses owners frequently lack tax-specific knowledge
12 (McKerchar, 1995). Third, fairness perceptions of the tax system are a key driver of tax compliance
13 (Wenzel, 2002) and research has suggested that small business owners have a heightened sense of
14 being unfairly treated by tax authorities and the tax system (Adams and Webley, 2001; Tan and Veal,
15 2003) which in turn increases the likelihood of tax evasion (Webley, 2004).

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

39 40 41 42 43 44 45 46 47 48 49 **A capability perspective on small business tax compliance behaviour**

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52 Dosi *et al.* (2000, p.3) noted that the organisational capability concept is like “an iceberg in a foggy
53 Arctic sea, one iceberg among many, not easily recognised as different from several icebergs nearby”.
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56 Despite more than a decade of research on organisational capability – mainly within the strategic
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3 management and organisational theory literature – the concept still lacks clarity (Schreyoegg and
4 Kliesch-Eberl, 2007; Helfat and Winter, 2011; Felin, Foss, Heimeriks and Madsen, 2012). In the
5 broadest sense capabilities refer to a firm’s capacity to purposefully deploy a combination of
6 resources and processes to achieve a desired goal (Amit and Schoemaker, 1993). This definition
7 implies that organisational capability is a multi-level construct and that the combination of resources
8 and processes is not only bound to a specific context (Schreyoegg and Kliesch-Eberl, 2007), but also
9 dynamic to meet the demands of a constantly changing environment (Teece, Pisano and Shuen, 1997;
10 Eisenhardt and Martin, 2000; Zollo and Winter, 2002; Winter 2003). It is the result of an
11 organisational learning process in which informal and formal processes have been gradually linked to
12 resources to develop distinct and reliable behavioural patterns (Schreyoegg and Kliesch-Eberl, 2007).
13 Research has distinguished between dynamic capabilities and operational capabilities to reflect the
14 firm’s capacity to adapt to changing environments compared to just maintain current operations
15 (Teece, Pisano and Shuen, 1997; Eisenhardt and Martin, 2000; Winter, 2003; Helfat and Peteraf,
16 2003). But in the context of an ever-changing-world, the line between operational and dynamic
17 capability becomes increasingly blurry (Helfat and Winter, 2011). For Eggers and Kaplan (2013)
18 capabilities are developed from prior experiences that are transformed into routines as a result of
19 managerial cognitions and interpretations. Routines form the “building blocks of capabilities, with a
20 repetitive and context-dependent nature” (Dosi, Faillo and Marengo 2008; p1167). As “patterns of
21 actions” (Eggers and Kaplan 2013, p.302), routines underpin organisational stability through inertia as
22 well as change through organisational learning (Parmigiani and Howard-Grenville, 2011)

23 24 25 26 27 28 29 30 31 32 33 34 35 36 37 38 39 40 41 42 43 44 45 *Microfoundations of organisational capabilities*

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47 While it has long been acknowledged that organisational capability is a source of firm heterogeneity
48 (Nelson and Winter, 1982), it is still very much a black box. To open the black box, a focus on the
49 microfoundations of capabilities has emerged in the strategic management literature. Felin *et al.*
50 (2012, p.1355) for example called for an increased exploration of the microfoundations of
51 organisational capability by “specifying the underlying components, or parts, of routines and
52 capabilities, and their interaction, the mechanisms connecting the parts to the collective constructs in
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3 time and space, and the boundary conditions for this line of inquiry". In their review, the authors
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5 suggest that the microfoundations of organisational capability consist of three building blocks - (1)
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7 individuals, (2) processes and interactions, and (3) structures – as well as interaction effects between
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9 these building blocks. Individual-level foundations include for example behavioural elements,
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11 attitudes, beliefs and cognitions as well as skills and experience. The microfoundations of processes
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13 and interactions consist of elements related to the methods of coordination and integration as well as
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15 technology and human ecology. Structure-level foundations, such as for example resources, provide
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17 the organisational conditions that enable or constrain capability development. An individual's
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19 organising logic, however, affects how the firm's resources are deployed, stressing the importance of
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21 managerial cognitions and the interactions effects between individual and structure-level foundations.
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23 While it is acknowledged that it is the interaction effects that contribute to the assembly of
24
25 capabilities, the nature of these interaction effects and the assembly process itself are not further
26
27 specified. Eggers and Kaplan (2013) suggest that more attention needs to be paid to managerial
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29 cognitions and their role in assembling these building blocks into capabilities.
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31 32 *Importance of managerial cognitions*

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35 It has long been argued that organisational capabilities lie within the firm's management (Helfat and
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37 Peteraf, 2003; Teece, 2007) and managerial cognitions and interpretive processes are therefore crucial
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39 to understand the assembly of organisational capabilities (Ambrosini and Bowman, 2009). According
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41 to Eggers and Kaplan (2013), however, the literature has been almost silent about the nature of these
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43 cognitions. They suggest that capabilities can be developed as a result of managerial awareness of a
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45 problem or an unmet need in the market that needs to be addressed. Assembly also depends on the
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47 manager's perceptions of what the organisation is capable of and how the current capabilities compare
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49 to organisations that they regard as similar and relevant to their own. Similarly, managerial cognitions
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51 impact on the deployment of capabilities. Similar firms can deploy different capabilities as a result of
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53 differences in their managers' perception of the environment (Aragon-Correa and Sharma, 2003).
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55 Organisational capabilities might even be ineffective if managers perceive that they don't fit the
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57 environment (Eggers and Kaplan, 2013). We therefor argue that organisational capabilities don't
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necessarily translate into compliance, but that the relationship between capability and compliance is moderated by managerial cognitions and consequently their decisions how to deploy the organisation's capabilities.

Methodology

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

Theoretical sampling

The research comprises face-to-face, semi-structured interviews with 42 small business owners, employing less than 50 staff. The research design followed the University's Code of Ethical Conduct for Research, Teaching and Evaluation, was peer reviewed and consequently judged to be low risk. The first step of our theoretical sampling approach (Corbin and Strauss, 2008) was to select businesses with a high and low compliance status. New Zealand Inland Revenue's administrative data

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3 of  registered small business - defined as businesses employing less than 50 staff - provided the
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5 sampling frame for this study. This allowed us to get factual tax compliance data compared to self-
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7 reported compliance data that has been predominantly used in previous research. Tax compliance was
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9 defined as having Goods and Services Tax (GST) and Pay-As-You-Earn (PAYE) returns filed and
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11 payments made on time i.e. within seven days after the due date. From the sample the top 25 percent
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13 and the bottom 25 per cent were selected to represent businesses with a high and low compliance
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15 status respectively. At the time of data collection and analysis, researchers were 'blind' as to the
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17 compliance status of businesses; that is the categorisation was not revealed until after all the
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19 interviews had been completed and data analysed. This ensured that the researchers did not introduce
20
21 any bias that might have been acquired from prior knowledge of respondents' tax compliance. Over
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23 the course of enquiry, firm size and industry sector were used as additional sample criteria. We did
24
25 not aim for a representative sample to generalise the findings for the broader small business
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27 population. Instead, the purpose of the chosen sampling approach was to allow us to explain the
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29 dynamic nature of the relationship between organisational capability and compliance.
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31 32 *Sample description*

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35 Of the 42 respondents 74 per cent were male with an average age of 50 years. Slightly more than one
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37 quarter of respondents had previous business experience. In relation to the firms they operated, 12 per
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39 cent were self-employed, 43 percent employed five or less staff and 45 per cent employed between six
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41 and 49 staff. This size categorisation is in line with the OECD's definition of small firms (OECD,
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43 2005). Slightly less than half of the firms generated an annual turnover of less than  1 million, 21
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45 per cent between NZD 1 and 5 million and 19 per cent generated more than NZD 5 million. The
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47 remaining respondents did not disclose their annual turnover. The vast majority of firms operated as
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49 limited liability companies with only 24 per cent operating as sole traders or in partnerships. With
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51 regards to industry, the sample was almost equally split with about one quarter of firms from
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53 construction, manufacturing, primary production and services industry. Lastly, 55 per cent of the
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55 sample had a high compliance status.
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Development of interview schedule

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

Collecting data using semi-structured interviews

Small business owners were initially contacted by phone to seek their participation in the research. This was done by a third-party provider to ensure adequate sampling of businesses with high and low compliance status without compromising the blinded research approach. Interviews were then conducted by the authors on the organisation's premises and averaged around one hour. In all cases notes were made during and immediately after the interview to capture issues raised at the time and to record immediate thoughts and ideas of the researcher. Informed consent was obtained and with the permission of the respondents the interviews were recorded and transcribed. The transcript was shared with the interviewee to give opportunity to amend and augment the initial responses or to withdraw the transcript completely.

Data analysis

Data collection and analysis was an iterative process to allow continuous triangulation between theory and data (Yin, 2009). The first step was to write up a descriptive case summary for each interview to 'allow for the unique pattern of each case to emerge' (Eisenhardt, 2002, p.18) and to capture the diversity of small business tax compliance behaviour. We then followed Corbin and Strauss's (2008) approach of systematically comparing data to build a theoretical framework. Using inductive data coding, we coded interviews using in vivo codes or short descriptions that were then grouped into 11 first-order concepts. Links between first-order concepts were then identified by using constant comparisons which led to five second-order themes. Comparing concepts and relationships between

individual interviews allowed us to identify two aggregate dimensions that served as the basis of our emerging theoretical framework. As a last step we assigned each firm a capability rating – high capability versus limited capability – using the six previously identified concepts of the aggregate dimension small business capability to manage tax regulation. This allowed us to further refine our theoretical framework by identifying the interactions and mechanisms between the microfoundations of capability as well as between capability and compliance. Table 1 depicts the data structure for small business tax compliance behaviour.

Table 1: Data structure and research questions

First-order concepts	Second-order theme	Aggregate dimension	Research question
Management experience	Individual level microfoundations	Small business capability to manage tax regulation	Capability assembly: What are the micro foundations of small business capability to manage tax?
Financial and tax knowledge			
Record keeping and tax filing processes	Processes and interaction microfoundations		
Interaction with accountants and tax advisors			
Structure of support network	Structural level microfoundations		
Resource capacity			
Necessary part of doing business	Owner-managers' perceptions of taxation	Managerial cognitions	Capability deployment: What are the factors that determine the relationship between small business capability and tax compliance?
Burden and cost			
Driver of good management practices			
Economic conditions	Owner-managers' perceptions of changes in the external environmental		
Regulatory conditions			

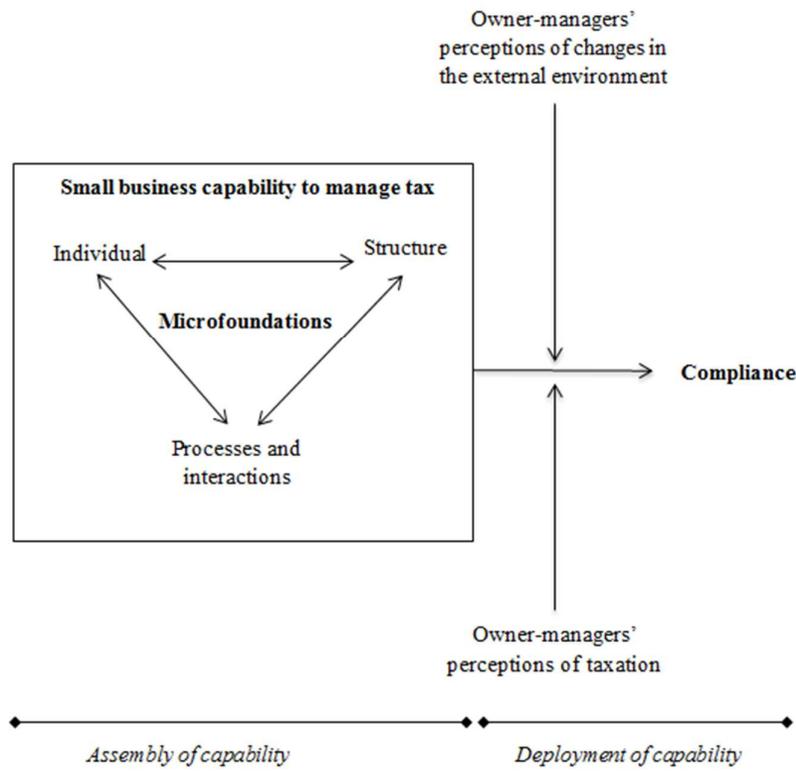
New Zealand regulatory context

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

A model of small business tax behaviour: Results and discussion

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

Figure 1: A model of small business tax behaviour



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

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

Individual level microfoundations

Managerial experience has previously been found to be an important predictor of small firm growth (Storey, 1994) as well as self-employment success (Robinson and Sexton, 1994). Results of this study extends those findings to small business tax behavior as results showed that managerial experience was an important microfoundation of the small business capability to manage tax regulation. Experience was predominantly developed through senior management roles in large firms or previous founding experience. An example of a respondent with high levels of managerial experience is a 55 year old owner of an IT consultancy company who has got a track record as a business founder. "I've been involved in five IT start-up businesses, as a director and in some cases chair of the board."

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3 (#27) This contrasts to a 53 year old manufacturer of water pumps who had no previous management
4 experience and struggled to manage the tax obligations in his business. *“I used to work for a company*
5 *and they made me redundant and at the same time they wanted to outsource this manufacturing, so I*
6 *put my hand up and said, “I’ll do it.” (#108).*

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

29 30 31 32 33 34 35 36 37 38 39 40 41 42 43 44 45 46 47 *Processes and interactions microfoundations*

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50 Managing tax regulations tended to become a routine task for respondents who had formal and
51 automated record keeping and tax filing processes in place. Formalisation and automatization was
52 frequently supported by technology i.e. specialised software solutions which gave rise to managerial
53 benefits (Pope and Rametse, 2001). The routines resulting from those processes reduced ad-hoc
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3 approaches and variations which in turn helped meeting tax obligations. *It's a good discipline for*
4 *businesses. No journals with things written in and rubbed out and all that (#55). If you have your*
5 *[software] system in place to meet the requirements, you meet the requirements – it's not an issue*
6 *(#65). In contrast, manual record keeping and filing processes were considered to be more error*
7 *prone. You can see which ones you've got to deal with first instead of me thinking well that's a little*
8 *one I can pay that. Meanwhile there's probably a big one that I should pay that's older (#38). The use*
9 *of technology-solutions did not only formalise the record keeping and tax filing process, but changed*
10 *the nature of the respondents' interaction with their accountants and tax advisors by becoming less*
11 *reliant on them. With regard to taxation external accountants and tax advisors were a key source of*
12 *information and advice. A typical strategy for respondents, who lacked financial and tax knowledge,*
13 *was to contract accountants "to do the books" and externalise the responsibility for and control of*
14 *compliance. An example is a husband and wife operated professional building maintenance business*
15 *that was struggling to comply with their tax obligations. The owner was a cabinet maker by trade and*
16 *started the business after he was made redundant by his previous employer. He relied heavily on his*
17 *accountant with no understanding of his tax requirements. The accountant tells us what we pay each*
18 *month. We take everything for that month over to them and then they just calculate what we've done,*
19 *what we haven't done and then they say right you've got to pay x amount of dollars this month. I drop*
20 *a cheque with them and they send it in for us. (#31). This contrasts with a 42 year old owner of a*
21 *commercial contract plumbing firm that employs seven staff. He established formal record keeping*
22 *and tax filing processes to better manage his financial and tax obligations. We do all our own*
23 *bookwork here up to trial balance. It gives us an idea all the way through, so that I know more*
24 *accurately where we're at. (#42). The changes in social interactions with accountants and tax agents*
25 *increased the learning rate of respondents which overall led to improved financial and tax knowledge.*
26 *According to Evans et al. (2005) poor record keeping does not necessarily translate into compliance*
27 *problems and the relationship between the two is more complex than previous research has*
28 *acknowledged. In our model, record keeping is only one of the identified microfoundations and the*
29 *overall capability to manage tax depends on the linkages between microfoundations (Felin et al.,*
30 *2012).*

Structural level microfoundations

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

The firms' resource capacity was another microfoundation of the capability to manage tax regulation and it was often the result of the owner-managers financing and organizing logic. Small business owners prefer to fund their operations internally using own savings and earning rather than using debt or third party equity (Hussain and Scott, 2015). The majority of businesses in our sample ran on their operating cash flow and a bank overdraft with only limited additional resources. While respondent often claimed to understand their tax obligations, tight cash flow and liquidity problems, were a main constraint on the small firms' capability to meet their tax obligations. An example is a 50 year old, self-employed male who specializes in fixing laminate bench tops for insurance companies. Tight

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3 cash flow and no bank overdraft facilities have meant that the respondent has struggled to meet tax
4 obligations and at some stage he even borrowed money from his mother to pay on time. *Sometimes*
5 *it's quite tight with money but I've never had an overdraft per se, although once or twice I've had a*
6 *big tax bill and I've just sent the cheque away hoping that some money will come in the next couple of*
7 *days. (#12).* The logic behind these financing preferences is frequently driven by the business
8 owners' desire to have full control over the business and being independent in the decision-making
9 (Chell, 1985) which subsequently affects the broader organizing logics and the firm's development.
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11 The smaller the firm, the more likely it is that the owner-manager is responsible to deal with all
12 aspects of the business which was often described as "debilitating" and "tiring" (#63). With
13 businesses that were able to grow, however, this issue reduced in importance. As the firms' resource
14 capacity grew, the owner-managers were able to employ staff that helped with meeting tax
15 obligations. Without these resources, often 'silent' personnel such as the owner's spouse or other
16 family members who assist with those tasks, but are often not suitably qualified. An example is a 34
17 year old niche manufacturer of sheet metal for the yachting industry. Since start-up in 2007 the
18 business has been steadily growing and currently employs eight staff with recruitment for more staff
19 ongoing. *I have a really good office manager who works on MYOB and does all of that for me, she*
20 *does the GST returns etc. and I check things at the end of each month. She has made a huge difference*
21 *to the business because before that my wife - she's a school teacher - and I would do it and we are*
22 *both novices at accounting, we would be here at 11pm at night doing accounts and we said "this is*
23 *stupid", so we hired Linda and it's one of the best things that I have done. (#17)*
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44 Overall, results showed strong interlinkage between the individual-level, process-level and structural-
45 level microfoundations which have not been considered in previous research. While the
46 microfoundations have all been identified previously as drivers of tax compliance, it is the complex
47 interlinkages between them that explain why findings on single drivers of small business compliance
48 have often been mixed. To achieve high levels of organisational tax capability, it is not enough to
49 have an experienced and knowledgeable owner-manager, but it also needs the relevant structural
50 resources, organisational processes and social interactions.
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3 **What are the factors that determine the relationship between small business capability and tax**
4 **compliance?**
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8 The results indicate that the capability to manage regulation and compliance are two separate issues.
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10 While a positive relationship between those two concepts might be assumed, our findings suggest that
11 a high level of capability to manage regulation does not necessarily translate into compliance and
12 similarly, a low level of capability does not mean that firms are automatically non-compliant. We
13 identified four distinct behavioural patterns of firms based on their level of capability to manage
14 taxation and the actual compliance outcome that we discuss in detail below. First, however, we
15 discuss the factors that impact on the relationship between capability and compliance.
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23 *Owner-managers' perceptions of taxation*
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26 Respondents held different perceptions and felt differently about taxes based on their past experiences
27 as well as individual and social norms. One group of respondents considered taxation to be "*just part*
28 *of doing business*" (#89) i.e. a necessity that comes with being business and is accepted as such
29 without any particularly positive or negative connotations. "*You have to play the game and work*
30 *within the rules, then you don't have a problem*" (#56). Other issues such as market conditions,
31 competition or customer demand were of much more strategic relevance, whereas tax compliance was
32 often considered an operational foundation for being in business. The second group perceived taxation
33 to be a burden and cost to the business or as a 54 year old owner of an architectural practice with 16
34 staff said - "*a pain in the arse*" (#83). Respondents voiced negative associations with taxation and
35 compliance, which was often generalized across the wider spectrum of regulations. Lastly, the third
36 group perceived taxation to be beneficial because managing tax obligations helps them developing a
37 routine and becomes part of good business practice. An example is a 58 year old manufacturer of
38 fencing posts employing 15 staff. "*If you keep it up to date and review it regularly it becomes an*
39 *attitude to what you do.*" (#56). Previous research has portrayed small business owners predominantly
40 as considering tax obligations as burdensome, costly and a painful loss (e.g. Schoonjans *et al.*, 2011;
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3 Lignier *et al.*, 2014; Kamleitner *et al.*, 2012), but our results confirm that the positive and neutral
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5 perceptions of taxation are just as real.
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8 *Owner-managers' perceptions of changes in external environmental*

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11 Besides the owner-managers' perceptions of taxation, changes in the external environment were
12
13 another factor that impacted on the relationship between capability and compliance. The two key
14
15 changes that were identified were perceptions of changes in economic and regulatory conditions. The
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17 global financial crisis and its resulting recession was the most significant recent change in economic
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19 conditions that respondents identified. Businesses in our sample frequently operated on a tightly
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21 controlled cash flow. Reduction in demand, late or no customer payments together with reduced credit
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23 availability left a number of businesses struggling to meet their financial obligations. As a result,
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25 some ended up prioritising payments – typically paying staff before paying taxes. An example is the
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27 owner of a tiling business who states: *The economic downturn - I had to keep my compliance up, but I*
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29 *still had wages to pay. I got into a very precarious state. (#33)*. This illustrates that depending on the
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31 owner-managers' perception of the environment, they assemble and deployed the firms' capabilities
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33 differently (Aragon-Correa and Sharma, 2003). Achieving fit seemed to 

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35 Regulatory changes such as roduction of new regulation or changes to existing regulation were
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37 another key influencing factor. In the New Zealand context the introduction of KiwiSaver provided an
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39 interesting regulatory change that is directly related to taxation. KiwiSaver is a voluntary work-based
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41 serving scheme that was launched in 2007, but since went through a number of subsequent changes. It
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43 is administered by the employer through the Pay-As-You-Earn (PAYE) returns. Some respondents
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45 commented that its introduction did not only increase the administrative cost of compliance but also
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47 potential filing and payment errors which resulted in non-compliance. *I had trouble with KiwiSaver,*
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49 *you know, how it's calculated and what not sort of thing (#25)*. Lignier (2009) found that changes to
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51 tax regulations are often triggers for behaviour change and record keeping practices. While those
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53 adaptation processes might have significantly increase compliance costs (Lignier *et al.*, 2014), it does
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55 not mean that they negatively affect compliance. This shows that compliance costs might not be a
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57 good proxy for actual tax compliance. The changes in external conditions caused some businesses to
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3 face a novel problem and challenged their owner-managers to adapt their resources and routines i.e.
4 their capabilities (Miller *et al.*, 2012). Results showed that some respondents were better at adapting
5 than others, pointing towards the dynamic nature of tax compliance behaviour. Previous research has
6 argued that capabilities suitable for stable environment might not be suitable for disruptive
7 environments (Ambrosini *et al.*, 2009) and the results from this study suggest that future research into
8 small business tax compliance might benefit from a dynamic capabilities perspective.
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16 **Patterns of small business tax behaviour**

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

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31 For the first group of business owners low capability to manage tax regulation resulted in a low
32 compliance status which was to be somewhat expected. The perception of taxation as mostly a burden
33 and cost and only in some cases as a necessity of being in business reinforced the relationship
34 between capability and compliance. Further, the previously discussed changes in the external
35 environment caused some of those already struggling businesses to get into rather precarious
36 situations. This illustrates that organisational capabilities were ineffective and did not fit the
37 environment (Eggers and Kaplan, 2013). An example (#47) is the 37 year old owner of an engineering
38 and welding firm who started the business because he was '*sick of*' his previous managers. He had no
39 previous business or management experience and limited financial and tax knowledge. As a result his
40 accounting practices were very basic and he heavily relied on his accountant. He considered tax
41 compliance a cost and burden to the business and expressed sentiments of being let down by the
42 government in general. Work has almost completely dried up as a result of the recession and he had to
43 make staff redundant. He is unable to meet his tax obligations and struggles to stay afloat. This
44 behavioural pattern corresponds with the 'conventional wisdom' (Kitching *et al.*, 2015) of small
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3 businesses as being resource constraint and therefor facing higher compliance costs (Schoonjans *et*
4 *al.*, 2011; Chittenden *et al.*, 2003; 2005; Kauser *et al.*, 2008) and are more at risk of being non-
5 compliant (Kamleitner *et al.*, 2012). Our results, however, shows that this is only one possible pattern
6 of small business tax behaviour.
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10 11 *High capability – high compliance*

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14 For this second group of business owners high capability to manage tax regulation translated into a
15 high compliance status. This link was reinforced by the owner-mangers' perceptions, but interestingly
16 it was not only positive or ambivalent representations that had an impact. We encountered cases like
17 the previously mentioned architectural practice (#83) that expressed very negative views about the
18 complexity of tax regulation and the burden it represents for businesses. *I mean there's no point in*
19 *running small business in this country because the tax system is too complex.* The owner-manager
20 employed a chartered accountant, so that he did not 'notice' the compliance costs. *The compliance*
21 *cost, I mean I don't notice it. It's just sort of built in.* This highlights that small business owners'
22 negative perceptions do not necessarily translate into non-compliance if capability to manage is high.
23 The owner-managers might dislike the tax system and authorities in general, but as Ahmend and
24 Braithwaite (2005) argue might still be law-abiding citizens at the same time and therefor seek help
25 from accountants and tax advisors (Blackburn *et al.*, 2010). More importantly, this shows that
26 perceptions do not necessarily translate into actual behaviour, confirming that agent perceptions do
27 not exhaust all regulatory effects (Kitching *et al.*, 2015).
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44 *High capability – low compliance*

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47 The third group presents an interesting case of businesses that had a low compliance status despite
48 being capable of managing tax regulations. We encountered cases where the economic recession as
49 change in external environment undermined the link between capability and compliance despite
50 generally positive attitudes towards taxation. In other cases, it was the owner-mangers negative
51 perceptions of taxation that prevented the business from being compliant despite their high level of
52 capability. Finally, in some cases it was a combination of both – owner-managers' perceptions of
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3 taxation and changes in external environment – that affected the relationship between capability and
4 compliance. One example (#56) is a traditional manufacturer employing 15 staff that operated
5 internationally. Due to the firm’s strong international focus, the business had to navigate a more
6 complex regulatory environment and the owner-manager employed a general manager who was
7 responsible for running the day-to-day operation including all compliance related matters. Taxation
8 was considered a necessity and being compliant was important for the respondent to minimise the risk
9 of ‘*disruption*’ to the business. The business got caught up in the economic downturn that severely
10 affected its key markets overseas and they were unable to adjust fast enough. As a result, the
11 respondent had to cut staff hours and struggled to meet the ongoing tax obligations. This pattern
12 illustrates that organisational capabilities don’t automatically translate into compliance, but that the
13 relationship is moderated by managerial cognitions and consequently the owner-managers’ ability to
14 assemble organisational capabilities and/or their decisions how to deploy them (Aragon-Correa and
15 Sharma, 2003; Eggers and Kaplan, 2013).
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29 30 *Low capability – high compliance*

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33 Lastly, the fourth group represented some outliers of ‘accidentally’ compliant businesses despite
34 having only limited capability to manage tax regulation. These respondents were self-employed -
35 being for example subcontractors in the construction industry - and traded only on a small scale that
36 resulted in relatively simple tax obligations. An example (#7) is a home-based engineer who became
37 self-employed over 20 years ago when his employer went into liquidation and he took over the
38 equipment as part of his redundancy and some of the customers. He is now semi-retired, but tries to
39 keep enough work to ‘*stay alive*’, but in recent years his turnover fell even below the threshold for
40 needing to register for GST.
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49 50 **Conclusions and implications**

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53 This study provides an in-depth, micro-level insights into small business tax behaviour. It is the first
54 study that we are aware of that has examined the nature of small business tax compliance behaviour
55 that builds on actual rather than self-reported compliance data.
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3 Small business tax behaviour has received surprisingly little attention (Kamleitner *et al.*, 2012). This
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5 study has helped to open the black box of small business tax behaviour by identifying the
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7 microfoundations and understanding the interlinkages between the individual, processes and structural
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9 factors. We responded to Felin *et al.*'s (2012) call for research that identifies the complexities in how
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11 managers – or in our case owner-managers, enact these processes in practice. Further, our findings
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13 point to the importance of distinguishing between capability and compliance. While compliance is
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15 only a measure of demonstrated action, the concept of capability expresses the broader potential to act
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17 and allows for a more nuanced understanding of small business tax behaviour.

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20 Our study provided a conceptual model for understanding the dynamic relationship between the small
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22 firms capability to manage regulation and its tax compliance. We operationalised capability using a
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24 microfoundations perspective and identified six factors at the individual level, the structural level and
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26 the process level. Undoubtedly, we have not identified all relevant microfoundations in our study.
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28 However, by identifying specific microfoundations, we view this study as a first step to better
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30 understand the heterogeneity associated with small business tax behaviour. The four different
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32 behaviour patterns that we identified are a strong testament of and the importance of considering the
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34 dynamic nature of compliance behaviour.

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

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52 There are several avenues for future research. First, our model provides the basis for a quantitative
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54 study with specific measures for each of the identified microfoundations to expand generalisability.
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56 Second, it could be used to investigate the compliance behaviour in relation to other types of
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3 regulation such as health and safety or employment regulation to see to what extent our model is more
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5 widely applicable to small business regulation. Third, the proposed model could be extended by
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7 considering additional factors such as the role of learning.
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10 Due to the size and significance of the SME sector for national economies, small business owners are
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12 a crucial part of national tax systems. The findings of this study provide a number of implications –
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14 specifically for policy makers and regulators who are concerned with the enforcement of tax
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16 regulation. Regulators and tax advisors can use the identified microfoundations to develop capability
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18 profiles of their clients that go beyond classifications based upon firm size, sector, turnover.
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20 Depending on high or low capability profiles, regulators and tax advisors can develop different
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22 support mechanisms. Most importantly, however, findings point to the importance of better
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24 understanding the impact of managerial cognitions and how small business owners adapt their firms'
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26 capabilities as a result of those cognitions. Induction programs and trainings ght help raise
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28 awareness and understanding of the dynamic nature between capability and compliance, so that
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30 regulators and tax advisors can develop more tailored solutions that fit the different behavioural
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32 patterns of small businesses.
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