

IMPROVING TAX COMPLIANCE IN THE CASH ECONOMY

April 1998

Commissioner of Taxation
PO Box 900
CIVIC SQUARE ACT 2608

Dear Mr Carmody

The Cash Economy Task Force is pleased to present its second report, *Improving Tax Compliance in the Cash Economy*.

The nature of the activities undertaken in the cash economy makes it difficult to quantify its size and impact on revenue. Notwithstanding this, the Task Force believes that there is sufficient evidence to conclude that tax evasion by participants in the cash economy is a significant problem that denies the Australian community billions of dollars in revenue each year that could be funding improvements in welfare, health, education and other government programs. The cash economy also imposes significant costs to business in the form of unfair price competition.

The Task Force has recommended that the ATO adopt a new administrative approach to address the problems presented by the cash economy. In coming to its conclusions the Task Force has developed a general framework within which the cash economy should be considered. This general framework, which the Task Force has called the Compliance Model, complements the principles which are expressed in the Taxpayers' Charter.

The Compliance Model recommends an approach to compliance improvement which encourages voluntary compliance by the community through a more cooperative and participative regulatory environment. The Compliance Model requires the ATO to be more open and accountable in its enforcement activities and develop more targeted strategies which do not add costs to compliant taxpayers without having a significant impact on compliance.

The Task Force would like to acknowledge the capable support that has been received from staff of the Australian Taxation Office. Their contributions and guidance have been invaluable.

Finally, the Task Force members wish to thank you for the opportunity to contribute to the ATO's strategy development in relation to reducing tax evasion by participants in the cash economy.

The Task Force presents the report for consideration and looks forward to your response.

Yours sincerely

David Butler
Chair
Cash Economy Task Force
3 April 1998

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TERMS OF REFERENCE

1. The Task Force will examine the cash economy with a view to determining what it is, what the likely compliance issues are, and to develop a view about what additional steps can be taken by the Australian Taxation Office (ATO) to address tax evasion in the cash economy.
2. The Task Force will provide a preliminary report on its findings to the Commissioner of Taxation by the end of February 1997.
3. The Task Force will meet on an ongoing basis (possibly 6 monthly) from its first meeting on 4 December 1996 to review progress, and determine future activity. (Meetings of the Task Force may be scheduled on an as-required basis.)
4. Matters to be taken into consideration by the Task Force include:
 - voluntary compliance: what may cause taxpayers to not voluntarily comply, and how can non compliant behaviour be corrected;
 - what is currently being done to improve compliance; and
 - are current enforcement techniques effective in today's environment and will they be effective in the future.
5. In undertaking this activity, the Task Force will give consideration to existing research and relevant overseas experiences.
6. Future reports on progress will be provided to the Commissioner of Taxation as and when required.

TASK FORCE MEMBERSHIP

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The Task Force wishes to thank all of the Australian Taxation Office officers who have made a contribution to this report.

ACRONYMS AND ABBREVIATIONS

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
AFP	Australian Federal Police
ATO	Australian Taxation Office
AUSTRAC	Australian Transactions Reports and Analysis Centre
CGT	Capital Gains Tax
DEETYA	Department of Employment, Education, Training and Youth Affairs
DIMA	Department of Immigration and Multicultural Affairs
DPP	Director of Public Prosecutions
DSS	Department of Social Security
FBT	Fringe Benefits Tax
FTR Act	Financial Transactions Report Act 1988
GDP	Gross Domestic Product
HIA	Housing Industry Association
ITAA	Income Tax Assessment Act 1936
MBA	Master Builders Australia Inc
NTLG	National Tax Liaison Group
PAYE	Pay As You Earn
PPS	Prescribed Payments System
PRS	Problem Resolution Service
RBA	Reserve Bank of Australia
RPS	Reportable Payments System
SBI	Small Business Income Group
SICMAA	Springvale Indo Chinese Mutual Assistance Association
TAA	Taxation Administration Act 1953
TFN	Tax File Number

EXECUTIVE SUMMARY

Background

The Commissioner of Taxation established the Cash Economy Task Force (the 'Task Force') in November 1996. The objective of the Task Force is to examine the nature of the cash economy, to determine what the likely compliance issues are and to develop a view about what additional steps can be taken by the Australian Taxation Office (ATO) to address tax evasion in the cash economy.

The Task Force presented its first report to the Commissioner of Taxation in May 1997. In the report the Task Force identified a number of key structural elements that influence behaviour in the cash economy. It noted that the ATO needs to better understand these structural elements, and their interrelationships, in order to develop an holistic and systemic approach to the problems caused by the cash economy.

However, given the complexity of the problems presented by the cash economy, the ATO can not address all the issues alone. The Task Force suggested that the ATO needs to work cooperatively with tax practitioners, industry and community groups to develop effective solutions.

The first report proposed that the ATO focus on the following key areas in addressing the cash economy:

- Undertaking research in conjunction with tax practitioners, industry and community groups and other government agencies to better understand the structural issues and motivating factors that support the cash economy;
- Developing more effective and better targeted compliance improvement initiatives to increase community confidence in the taxation system;
- Implementing a community communication program to publicise the costs to the community of the cash economy and to challenge community perceptions that "not paying tax on cash is OK";
- Evaluating a range of policy proposals that may improve the effectiveness of the ATO in dealing with the cash economy;
- Working cooperatively with tax practitioners, industry and community groups and other government agencies on cash economy initiatives; and
- Ensuring ATO staff have adequate skills and access to training to deliver compliance improvement and enforcement programs.

The Task Force put forward a range of priority initiatives under each of these areas to improve the ATO's immediate and long term effectiveness in dealing with the cash economy.

The Commissioner of Taxation responded to the first Task Force report in June 1997. In addressing this report the Commissioner announced the implementation of a range of initiatives aimed at maximising the public impact of cash economy work. He announced a significant redeployment of field resources, from 300 to 900 staff, to increase the ATO's presence in cash industries and develop Task Force initiatives. He also established national and regional projects in high risk cash industries.

The ATO also commenced consultations with tax practitioners and industry and community groups seeking their feedback on factors contributing to the cash economy and gaining their support to assist in changing industry practices and community attitudes. Programs to better integrate ATO activities with those of Centrelink and other government agencies were also initiated.

At the same time, the Commissioner announced a broadening of the membership of the Task Force to gain wider community and industry input to address the many influencers of behaviour in the cash economy that are outside the direct control of the ATO and tax professionals.

The Task Force reconvened in September 1997 to review progress since its first report and to seek input from new members. Extensive one-on-one interviews were undertaken by the ATO with Task Force members and a Task Force workshop was conducted on 25-26 November 1997 to refine a package of administrative, policy and communication proposals designed to improve the ATO's effectiveness in dealing with the cash economy.

The Task Force re-emphasised the necessity for the ATO to have an effective and systemic approach to the cash economy. In the first instance the ATO should focus its attention on improving community support for its efforts to deal with tax evasion and ensuring equitable administration of the taxation system. The main issues for the ATO in the short term include;

- gaining a detailed understanding of the dynamics influencing the cash economy;
- building partnerships with the community;
- developing a more structured approach to compliance improvement;
- introducing incentives to encourage taxpayers to do the right thing; and
- enforcing compliance through a greater variety of, and more flexible, sanctions to better cater for individual circumstances.

Overall, the Task Force considered that a mix of strategies is required to address tax evasion in the cash economy. Importantly, the mix needs to be tailored to the issues and dynamics of particular industries and cash practices. To ensure that this is achieved the Task Force recommended that the ATO develop a model of compliance behaviour, which complements the Taxpayers' Charter, to help guide the development of compliance improvement strategies in the cash economy.

Setting the Scene

The Task Force notes significant progress by the ATO in dealing with the cash economy since the first Task Force report was released. The ATO has increased its field presence three fold and has commenced national and regional projects which target a wide range of businesses with significant cash dealings, including those to which the Prescribed Payments System (PPS) and the Reportable Payments System (RPS) apply.

The Commissioner has also acknowledged that increasing the ATO's field presence is not the only answer. The ATO is particularly concerned by the apparent widespread acceptance in the community that "not paying tax on cash is OK". To address this concern the ATO is enhancing its knowledge base to better understand the motivations influencing tax evasion in the cash economy. This is being done by improving the use of information obtained from ATO business systems and field activities, by conducting market research into community perceptions of the cash economy and by forming partnerships with other government agencies, tax practitioners, and industry and community groups.

For the first time, questions relating to the cash economy have been included in the ATO Corporate Survey of taxpayer attitudes to the taxation system which is conducted every six months through AC Nielsen-McNair. This research supports the view that there is widespread acceptance in the community that not paying tax on cash income is OK. The research also showed that the community believes there is no certainty that the ATO will detect tax evasion through the cash economy.

Tax evasion in the cash economy poses many challenges for the ATO. The Task Force believes that the ATO recognises the challenges and is implementing initiatives that address them. If the ATO continues to adopt a systematic, dynamic and cooperative approach it will significantly improve tax compliance in the cash economy.

Understanding Compliance

In its first report, the Task Force defined the cash economy as "income that is not recorded in the books from which the tax return is prepared". While this definition is broad enough to include a wide range of practices such as barter, electronic commerce or misdescribed expenses, the Task Force decided to focus its attention initially on cash income derived from business and employment, whether legal or illegal in nature.

The nature of the activities undertaken in the cash economy makes it difficult to quantify its size and impact on revenue. Academic studies estimate the cash economy to be between 3.5% and 13.4% of GDP. The Task Force believes that the cash economy is a significant problem and imposes significant costs to the community in terms of lost revenue and unfair price competition.

The Task Force notes that the ATO has commenced research programs aimed at increasing its understanding of the size and impact of the cash economy on the Australian community and of the structural elements influencing the cash economy. This includes intelligence gathering from cash economy projects and undertaking joint research with the Australian Bureau of Statistics (ABS) and the Department of Social Security (DSS).

An important outcome from this research should be a better understanding of the costs to industry and the community of lost government revenue and unfair price competition as a result of tax evasion in the cash economy. This understanding must be used to change community attitudes about the cash economy and the fairness of the tax system.

Research should also be undertaken within industries to understand the dynamics that influence particular industries, determine why systemic cash practices designed to evade tax occur and to develop methods to detect these practices. In this regard, a more outward approach by the ATO in working with groups within the Australian community who are effected by tax evasion in the cash economy will assist to identify high risk industries and practices. This, in turn, will enable the ATO to be more responsive to market forces and develop flexible regulatory regimes which recognise differences in market segments. The Task Force notes that this work has commenced in the industries currently being addressed by the ATO.

A better understanding of the structural elements impacting on particular market segments will assist the ATO to administer a tax system which is more supportive of small business. This understanding will enable the tax regime to be more responsive to the requirements of particular industries. Therefore, in high risk areas the level of ATO intervention may need to be greater (for example, to combat sales tax fraud in personal computer retail trade) while in low risk areas the tax system could be less regulated and compliance costs reduced.

The Task Force considers that the complexity of the structural components of the cash economy and their interrelationships will require the implementation by the ATO of an integrated strategy. As a result, it has assisted the ATO in the development of a compliance model to guide strategy development. The model is based on "best practice" regulatory strategies discussed in the literature and applied to varying degrees in other organisations like the Australian Competition and Consumer Commission (ACCC). This model attempts to articulate an hierarchical approach to the administration of the tax system which would maximise voluntary compliance while gaining community support for firm action to be taken against non compliance.

The Task Force believes that consistent application of the compliance model will assist the ATO implement initiatives that complement the Taxpayers' Charter. The model requires the ATO to foster a more cooperative and participative regulatory regime and to become more open and accountable in its enforcement activities. For example, the implementation of stronger enforcement measures by the ATO, on an industry or a taxpayer, will be supported by evidence that lesser measures have proved unsuccessful in changing compliance behaviour. This is consistent with the key messages expressed in the Taxpayers' Charter.

Adoption of the compliance model implies that ATO strategies are aimed at encouraging voluntary compliance through approaches like education and convenient and efficient service delivery. While the emphasis is on voluntary compliance the ATO will have access to an escalating enforcement regime with a hierarchy of sanctions. Therefore, the ATO will apply swift and severe sanctions when the need arises. The approach does not imply that the ATO is going soft on evasion.

Building Community Partnerships

There is evidence that much of the non compliance in the cash economy involves high volume low dollar value transactions, often motivated by business or individual financial survival. In these

circumstances tax evasion is often rationalised by participants and others and not seen as wrong. The ATO needs to be sensitive to the impact that its enforcement activities are having if it is to gain the support of the community. It should recognise that ensuring compliance in some cases may in fact result in less business activity, a loss of employment or higher prices.

Industry associations and representatives have been supportive of the work of the ATO which focuses on ensuring that all income payments, in particular cash payments, are being recorded. This includes an increased focus on reporting and record keeping practices and the development of the industry ratios. These initiatives aim to assist firms to rectify bad business practices thereby enabling the business to achieve its commercial potential and reducing the need for proprietors to not declare all cash income.

The Task Force confirms that a key lever that encourages industry associations to support these moves is the real threat tax evasion poses to honest businesses in the form of unfair price competition. It is imperative for the ATO to understand the dynamics of different industries and work with industry to develop well targeted strategies. This will require the community gaining confidence in the professionalism and integrity of the ATO's operations.

The Task Force recognises that the Taxpayers' Charter is an important initiative that will assist the ATO build better partnerships with the community. The Charter is an active expression of how the ATO will operate when it interacts with the community. Adherence to the principles in the Charter will ensure that the ATO administers the tax laws in a fair and professional manner thereby giving the community confidence in its operations. This includes treating taxpayers according to their individual circumstances. Importantly, the ATO must ensure that the concepts behind the compliance model are integrated with the principles in the Taxpayers' Charter.

The Task Force believes that changing community attitudes regarding tax evasion in the cash economy is an essential part of any long term solution and that this will require the ATO to operate with a higher degree of openness and trust with the community. Building partnerships and communication strategies which focus on raising community awareness about the extent and costs of tax evasion in the cash economy are seen by the Task Force as critical if the ATO is to challenge community attitudes about the cash economy and change taxpayer behaviour.

The communication task for the cash economy is complex and will require a sophisticated approach to defining and delivering key messages. The Task Force therefore believes that the ATO needs to undertake extensive market research before it can carry out a broad based community educative program. A critical aspect of this approach is the need to establish a cooperative relationship with "champions" or advocates in the private sector who can convey to the community the importance of paying tax and explain the costs of tax evasion.

In the short term the focus should be on direct communication with key people and the use of industry or community newsletters for information and updates. The Task Force supports the ATO's focus on building partnerships with tax professionals, industry associations and community groups as a means of remaining abreast of developments, challenging community attitudes and changing behaviour. Moreover, by involving others in its decision making the ATO will be better positioned to foster confidence in its ability to develop an effective and systemic approach to improve compliance in the cash economy.

Encouraging and Supporting Compliance

The Task Force considers that there are currently few real or perceived benefits to be gained from declaring all cash income or in reporting tax evasion by others. The Task Force has examined a number of proposals which are aimed at supporting good compliance, including introducing less stringent tax return and record keeping requirements and allowing amnesties for particular industries. The ATO should explore opportunities to apply these approaches.

The Task Force has also examined proposals to compensate businesses for their compliance costs, provide rebates for expenditure on household services and run consumer lotteries to encourage businesses and consumers to record cash transactions. The Task Force is not yet convinced that any of these approaches is viable. However, the Task Force considers that the ATO should continue to identify and evaluate additional proposals that may provide incentives for taxpayers to comply.

The Task Force considers that the possibility of providing incentives is highest in industries which pose a low risk of tax evasion as the potential costs to the community through revenue loss will be minimised. A key indicator of which industries may pose a low risk is the level of regulation within the industry and the requirement for independent reporting. Effective regulation within the industry fosters good business practices and generally ensures that businesses maintain adequate records.

The nature of cash means that the ATO needs to develop strategies to encourage taxpayers and third parties to maintain better records. Good record keeping is an important element of running a successful business and can provide better financial control, increased profitability and provide future business directions.

Better records should also increase the visibility of cash by creating an audit trail and will optimise the integrity and usefulness of the industry benchmarks being developed by the ATO. One of the most effective counter measures to money laundering and tax evasion is for citizens and organisations to take steps to establish the identity of the people they transact with and to keep adequate records of the transactions such as invoices and receipts.

The ATO, however, must ensure that its record keeping requirements are not too onerous and conform, as much as possible, with standards relating to good business practices. This may require the ATO tailoring record keeping requirements and other tax obligations for different industries.

The ATO should continue to investigate opportunities to reduce the compliance burden for particular industries and taxpayers. This could include using levers such as differential requirements for record keeping, reporting and other tax obligations based on the compliance history and the level of risk, to reward good compliance and manage poor compliance.

The Task Force notes that the ATO has developed, in conjunction with tax agents and professional groups, identikits of various cash industries in the form of financial ratios and industry benchmarks. These should be advanced to a stage where they can help firms to improve their management practices.

In addition, the benchmarks could be used by the ATO and tax practitioners as a guide to identify taxpayers who may need further assistance or monitoring. If the benchmarks are developed to their

full potential they will assist the ATO to better target enforcement strategies which do not impose costs on compliant taxpayers without having a major impact on tax evasion.

Enforcing Compliance

The Task Force is concerned that the range of enforcement options available to the ATO is not wide enough to deal with the different motivations that influence taxpayer behaviour. The Task Force has examined a number of additional enforcement options.

The Task Force considers that the reporting requirements prescribed in the *Financial Transactions Report Act 1988* (FTR Act) are of great value to the Australian Transactions Reports and Analysis Centre (AUSTRAC) and the ATO in combating tax evasion and money laundering in the cash economy. It believes there is merit in considering upgrading the current reporting requirements under the FTR Act to achieve a more flexible scheme of monitoring which more readily meets the core purposes of the FTR Act.

Withholding and reporting systems also help to overcome the anonymity of cash. The Task Force acknowledges the cost effectiveness of withholding and reporting systems. However, it needs to be recognised that they impose obligations on businesses that do the right thing. Any proposals to extend withholding or reporting systems need to demonstrate that the burden imposed on third parties is justified in terms of the benefits of increased compliance, taking into account reductions in unfair price competition within the industry and increased revenue.

An effective tax administration must have the capacity to deliver swift and appropriate punishment where taxpayers demonstrate that they are unwilling to comply. Therefore, the ATO is encouraged to review sanctions with the aim of developing a more flexible sanction regime (both in variety and in their application) while at the same time making the sanctions for serious offences more certain and severe.

For lesser offences the ATO is encouraged to acknowledge past "good" behaviour when applying penalties and to introduce non-financial sanctions which are educative or supportive in nature.

The ATO should consider the introduction of on-the-spot fines for prescribed offences, such as failure to keep adequate records. This could be done in industries where, for example, the nature of records required is clearly spelt out by the ATO and accords with recognised business practices. Such an approach could obviate the need for expensive and time consuming prosecutions.

Once the ATO has a high degree of confidence in industry benchmarks it should examine the potential for using them to base default assessments in circumstances where taxpayers have failed to retain appropriate records of their transactions.

In some cases it may be necessary for government to consider extending the statutory requirements for people to record details and report cash transactions. For example, more onerous reporting requirements could be stipulated by the ATO where there are risks identified which will impose significant costs to the Australian community. This may be necessary in industries where there is a history of systemic non-compliance even where they may impose additional costs on compliant taxpayers.

Compliance Improvement in the Cash Economy

There is no simple innovation that will provide a quick fix solution to the problems presented by the cash economy. Long term solutions to tax evasion in the cash economy require the ATO to gain an understanding of the underlying structural reasons impacting on compliance behaviour and the development of appropriate systemic treatments. To gain support for its approaches, the ATO will need to build partnerships with tax professionals, industry associations and community groups.

The Task Force acknowledges that the ATO is committed to upholding the Taxpayers' Charter and has implemented numerous initiatives to facilitate an improved relationship with the community based on mutual respect and trust. In particular, the Task Force notes that the establishment of ATO service standards, a code of conduct for ATO staff dealing with taxpayers and a complaints handling process to manage and resolve taxpayer problems will help ensure that the ATO acts professionally on all tax matters.

The Task Force, however, believes that there remains a concern in the community that the ATO fails to adequately treat taxpayers according to their individual circumstances. There is also a perception that the ATO often is seen to implement standard solutions that do not recognise the peculiarities of specific market segments. This results in ATO administrative solutions adding cost to compliant taxpayers while making little impact on the non compliant. The Task Force believes that a "broad brush" approach will not address the problems presented by the cash economy.

The compliance model has been developed to alleviate these concerns. The model advocates an hierarchical approach to the administration of the taxation system. This approach requires a flexible regulatory regime with a wide range of enforcement options which can be applied on an escalating basis of severity.

Implementation of the compliance model will enable the ATO to develop more targeted compliance improvement strategies which address particular industry issues and practices but do not unnecessarily increase compliance costs for the general community. This implies that regulation should be responsive to different industry structures and conduct.

If the compliance model were to be implemented consistently the community would perceive the ATO as fair and professional, even though very tough when it needs to be, and more likely will gain sufficient confidence in the ATO's administration of the tax system to support proposals to address tax evasion in the cash economy.

The main principles underlying the compliance model are:

- understanding taxpayer behaviour;
- building community partnerships;
- increasing flexibility in ATO operations to encourage and support compliance; and
- more and escalating regulatory options to enforce compliance.

The recommendations in this report have been framed in the context of the approach advocated in this model of compliance behaviour.

RECOMMENDATIONS

CHAPTER 2 - UNDERSTANDING COMPLIANCE

- Recommendation 2.1* *The ATO conduct research to better understand the costs of the cash economy to the Australian community and identify ways to promote the importance of tax to the Australian community.*
- Recommendation 2.2* *The ATO undertake market research to determine attitudes of high risk industry participants and the general community to typical cash practices.*
- Recommendation 2.3* *The ATO undertake research into high risk cash economy taxpayer populations to identify the causes of noncompliance and opportunities for compliance improvement initiatives.*
- Recommendation 2.4* *The ATO adopt the compliance model to guide strategy development in addressing the cash economy.*

CHAPTER 3 - BUILDING COMMUNITY PARTNERSHIPS

- Recommendation 3.1* *The ATO integrate the concepts behind the compliance model with the principles expressed in the Taxpayers' Charter.*
- Recommendation 3.2* *The ATO adopt a phased approach to communication which addresses the peculiarities of different market segments.*
- Recommendation 3.3* *The ATO ensure that the key cash economy messages are well targeted to generate and sustain community support for the ATO.*
- Recommendation 3.4* *The ATO build partnerships with credible groups within the Australian community who are affected by the cash economy and involve partners in its decision making about the cash economy.*
- Recommendation 3.5* *Enhance linkages between the ATO and state revenue authorities .*

CHAPTER 4 - ENCOURAGING AND SUPPORTING COMPLIANCE

- Recommendation 4.1* *The ATO ensure that client contact is consistent with the service standards and code of conduct expressed in the Taxpayers' Charter.*
- Recommendation 4.2* *The ATO review its communication with taxpayers to improve the quality and tone. Communications should acknowledge the assistance provided by taxpayers in complying with their tax obligations.*
- Recommendation 4.3* *The ATO develop a methodology whereby it can obtain direct and timely feedback from taxpayers on the professionalism of its operations.*
- Recommendation 4.4* *The ATO refine its help and education role and tailor it to particular industries.*
- Recommendation 4.5* *The ATO explore opportunities for conducting public education programs on good record keeping to complement the record keeping reviews and real time reviews currently undertaken.*
- Recommendation 4.6* *The ATO:*
- (a) in consultation with industry specify record keeping requirements for particular industry groups;*
 - (b) work with industry and community groups to promote the benefits of recording cash transactions other than for taxation purposes.*
- Recommendation 4.7* *The ATO work with industry and community groups to maximise the benefits from the industry benchmarks.*
- Recommendation 4.8* *The ATO recognise past "good" behaviour when imposing penalties or deciding to escalate enforcement.*
- Recommendation 4.9* *The ATO further explore opportunities for introducing differential record keeping and taxation reporting requirements.*
- Recommendation 4.10* *The ATO continue its research to identify cost-effective incentives that motivate taxpayers and third parties to declare cash income and document or report cash transactions.*
- Recommendation 4.11* *Targeted amnesties be considered as part of an integrated approach to improving compliance in the cash economy.*

Recommendation 4.12 *The ATO work with business to develop innovative industry specific regulatory solutions.*

CHAPTER 5 - ENFORCING COMPLIANCE

Recommendation 5.1 *Consideration be given to amending the FTR Act to broaden the cash dealer categories and the range and level of report types. Any consideration to amend the FTR Act should be accompanied by consultation with industry bodies and their representatives.*

Recommendation 5.2 *AUSTRAC data be more strategically utilised by the ATO to identify high risk cash transactions.*

Recommendation 5.3 *Extending withholding and reporting requirements to additional high risk industries ought to be considered where the benefits of increased compliance—taking into account reductions in unfair price competition within the industry and increased revenue—outweigh the burden imposed on third parties.*

Any proposal to extend obligations should be undertaken in consultation with industry.

Recommendation 5.4 *The ATO publicise enforcement activities and results in industry and community publications.*

Recommendation 5.5 *The ATO should review the perceived effectiveness of its approach to securing prosecutions and convictions for tax evasion. The ATO should consider working with the judiciary to emphasise the community costs of tax evasion*

Recommendation 5.6 *The ATO to review the appropriateness of current sanctions with a view to increasing the range of sanctions available to the ATO and develop:*

(a) a more flexible regime for minor offences; and

(b) more severe sanctions for serious offences.

Recommendation 5.7 *The imposition of on-the-spot fines for prescribed offences should be further explored by the ATO.*

Recommendation 5.8 *The ATO does not use industry benchmarks to raise default assessments until it is confident that the benchmarks are credible.*

- Recommendation 5.9* *The ATO explore opportunities to make current record keeping requirements more onerous for taxpayers who have had significant omissions of cash income detected by the ATO.*
- Recommendation 5.10* *Compulsory education be introduced to complement current enforcement strategies.*
- Recommendation 5.11* *The ATO consider naming serious tax offenders in the Commissioner's annual report.*
- Recommendation 5.12* *The ATO monitor the research being done on re-integrative shaming theory and consult with relevant experts towards its application to tax offences.*

CHAPTER 6 - COMPLIANCE IMPROVEMENT IN THE CASH ECONOMY

Recommendation 6.1 Implementation of the compliance model be accompanied by an effective training program for staff and management of the ATO.

CHAPTER 1: SETTING THE SCENE

Background

In its first report the Task Force highlighted the significance and complexity of the issues posed by the cash economy and suggested a package of priority initiatives to improve the ATO's immediate and long term effectiveness in dealing with the cash economy.

The Task Force considers that the ATO has made significant progress in implementing initiatives to improve compliance in the cash economy. Since the first report the ATO has redeployed additional staff to work on cash economy initiatives, commenced numerous national and regional cash economy projects aimed at detecting cash practices in high risk industries and developed financial ratios in consultation with tax practitioners and the business community.

Increased Field Presence

The ATO has successfully redeployed additional field staff to be engaged in cash economy initiatives, increasing numbers from 300 to over 900. These staff will visit more than 40,000 small businesses in the current financial year in industries with significant cash dealings.

Cash Economy staff are engaged on national and regional projects which are focussed on industries that have been identified by the ATO as high risk cash industries. In addition, staff are engaged in other activities such as providing advice to new business, enforcing lodgement compliance, information matching, audits, serious evasion and prosecutions which are being undertaken to support a nationally consistent approach to each national and regional cash economy project.

New Field Approach – Real Time Reviews

Prior to the cash economy initiative the ATO had a number of programs in place to improve compliance in the cash economy. These programs were:

- a record keeping program which is primarily an educative initiative to encourage more complete and comprehensive record keeping practices by small business;
- a serious evasion program which is targeted at the most serious evaders utilising a range of audit techniques to detect undeclared income;
- a prosecution investigation program which investigates offences against the taxation laws; and
- a special investigation program which is directed at auditing taxpayers engaged in illegal activities.

As part of the cash economy initiative a new field approach called real time reviews has been introduced. This approach was developed as part of a regional pilot in the restaurant and cafes industry. The approach has now been adopted for national implementation in the Building & Construction and Restaurant & Cafes projects.

Real time reviews have been designed to bridge the void between record keeping reviews (education emphasis) and full audits (enforcement).

The approach involves frequent yet irregular visits to cash businesses to ensure that 'essential records' are maintained. This enables the ATO to establish benchmarks during the review period for key business ratios like the gross profit ratio (GPR) and average weekly sales (AWS). Depending on the nature of the business sporadic cash counts may be conducted to verify sales takings. In most instances, the business will be monitored over a 3 month period. However, the number of visits conducted by the ATO during the three month period may amount to only a few days. This will minimise the burden imposed on the taxpayer.

The ratios established during the review period are used by the ATO as a guide to determine the compliance level of the business in the first instance by comparing them with figures returned in the previous year. Depending on the level of variation the business may be informed by the ATO that the review is completed, a follow-up visit will be conducted or the review period will be extended. Where there are significant variations with no satisfactory explanation the ATO may instigate a full audit or other enforcement action.

Cash Economy Projects

The ATO has endorsed national projects relating to the cash economy in the following industries:

- Building & Construction;
- Clothing;
- Fruit & Vegetables;
- Prescribed Computer Goods;
- Restaurants & Cafes;
- Road Transport; and
- Taxis.

It is envisaged that these projects will achieve improved lodgement compliance, increased cash income included in tax returns, increased community support and increased public confidence in the ATO's administration of the tax system.

The learnings from the national projects will guide the development of future approaches to dealing with non-compliance in the cash economy. These approaches include the refinement of industry ratios, the development of new field approaches and optimising the ATO's income matching capabilities.

The Task Force believes that the industry based approach adopted by the ATO will provide the greatest potential leverage through industry associations and other key industry players (for example, suppliers, customers, workers). An industry approach will also develop effective communication networks and will enable the development and integration of industry benchmarks into ATO compliance improvement approaches.

A brief description of the approaches being adopted by the ATO in each of the national projects is provided below together with a discussion of the main findings to date.

Building & Construction

A key objective of the project is to assess the effectiveness of the Prescribed Payments System (PPS) to influence cash practices in the industry. Learnings from the project will be applied to refining the current PPS system and identifying opportunities for extending withholding obligations to other high risk areas, where market distortions are occurring in consultation with industry associations and their representatives.

Due to the size of the industry five sub-industries have been selected in the first instance by the ATO for targeted attention to support the broad approach to the industry. The ATO envisages that other sub-industries will also be targeted as more information is obtained.

Field activities will involve visits to building sites and direct contact with major payers and payees. The payees will be identified from visits to building sites and through using external databases with a focus on those dealing with the householder or domestic market.

The ATO has consulted with industry associations who are supportive of the approach to achieve a 'level playing field' so that cash operators are not able to gain a competitive advantage over businesses that do the right thing.

ATO activities to date have identified evidence of:

- workers in the industry not having tax file numbers;
- non-lodgment of tax returns (one subcontractor had not lodged for 8 years);
- cash not properly recorded;
- invoice splitting (labour and materials on separate invoices);
- failure to remit/deduct amount under the PPS;
- payment of cash wages;
- cashing cheques in licensed clubs to avoid payments showing up in business records.

Clothing

Prior to the introduction of the Reportable Payments System (RPS) in the clothing industry, in December 1994, the ATO had undertaken intensive audit activity aimed at lifting compliance in the industry. This was a slow, very labour intensive process and whilst success in individual audit cases was achieved, general industry compliance remained low. The audits provided substantive evidence of wide scale evasion in the industry via understatement of income and non lodgment of returns.

Since the introduction of the RPS, the ATO has uncovered evidence in the clothing industry of significant deliberate evasion through the use of false invoicing and the use of 'shell' entities to launder cheques. 'Shell' entities are usually companies whose directors are young unemployed people unconnected with the clothing industry. These companies normally operate for a short period (usually only a few months) before being closed down and replaced by another similar entity. Recently, the ATO has discovered that instead of using companies as "shell" entities the promoters of cheque laundering arrangements have been using the TFNs and names of individuals to conceal the identities of the recipients of the clothing income.

The strategies employed by the ATO to deal with this activity have centred on prosecution of those involved in such schemes. Successful prosecutions have been launched against promoters of these activities and gaol terms have been imposed. For example, a Brisbane couple was recently gaoled

for 3 years for defrauding the Commonwealth. The couple defrauded the ATO in excess of \$59,000 and was responsible for also defrauding the DSS in excess of \$47,800 and DEETYA \$51,200.

In addition to prosecution activity, the ATO has used a combination of the provisions of the *Income Tax Assessment Act 1936* (ITAA) to impede 'shell' activity. Where bank accounts of shells are detected balances can be monitored, current year assessments issued and accounts are garnisheed to the value of deposits. It is significant and perhaps indicative of the problem that very few account operators seek an explanation from the ATO when funds have been removed from their accounts.

As part of the Cash Economy clothing project the ATO will be assessing the effectiveness of the RPS in this industry and considering the potential to refine its application so it is better tailored to address the problems posed by the clothing industry. At the same time the ATO is evaluating a range of new solutions, including one that has been presented by the community (refer to case study 4.2).

Fruit & Vegetables

The RPS was implemented in the fruit and vegetable industry on 1 March 1997. A phasing-in period of 4 months applied from that date, to allow industry participants to become familiar with their new obligations and deal with the resulting paper work.

As at 13 October 1997, 74 percent of the estimated payers in the industry had been registered on RPS. The ATO is undertaking further work to achieve a 100 percent target.

By the end of October 1997, 1,068 educational visits had been undertaken of payers in the industry, such as green grocers, market wholesalers and growers. It has been established by the ATO that the majority of payers visited had an understanding of the requirements of the RPS. The visits have identified a marked improvement in record keeping practices and an increase in the number of receipts issued, although in some cases the recording of cash is still of concern.

The ATO will undertake revisits to those payers who are not keeping the appropriate records to fulfil their RPS obligations, to ensure compliance with the requirements. Where appropriate, full audits will be conducted.

Prescribed Computer Goods

The ATO commenced a compliance project in the computer industry following complaints by a number of retailers to the ATO and to government about serious and widespread evasion of sales tax on personal computers and printers at the wholesale and retail levels.

Initially, the ATO spoke to those retailers who made complaints to determine the perceived nature and extent of the fraud within the industry. ATO staff also consulted large computer manufacturers and distributors and industry associations to obtain their perspective.

The messages coming from the legitimate members of industry were that the ATO needed to have a greater field presence, prosecute the offenders quickly, tighten up registrations and deregister those abusing the system, and change the law. Their biggest concern was that the fraudulent operators had a competitive advantage over legitimate operators and were driving the legitimate operators out of business.

The ATO examined the levels of sales tax collections from the industry and an independent study of turnover and revenue in the computer industry and determined that there was still a significant loss to revenue as a result of wholesale sales tax fraud involving personal computers and related goods. Budget estimates revealed that with legislative change the ATO could recoup \$55 million in the first financial year and \$80 million in each of the following 3 financial years.¹

Over the last two years, a significant number of audits have been conducted by the ATO. This activity has resulted in close to \$20 million in assessments being raised, many refunds being refused and a large number of fines being imposed by the court. This supports industry claims that there is a significant problem in the industry.

As more information became available about the nature and extent of the fraud, this industry became a national priority for the ATO. Specific funding for this project was included in the 1997 Federal Budget and the project was classed as a government initiative and given the highest priority.

Legal opinion suggested that the existing taxation legislation is not adequate to prosecute many of those who, on the face of it, were culpable. The legislation did not place any responsibility on the people who were benefiting from the fraud. Further, the ability of the Commissioner to deny or cancel registrations was extremely limited. As a result the ATO obtained the approval of the Assistant Treasurer to consult with other agencies, to conduct targeted industry consultation and to develop legislative proposals.

Following extensive consultations a legislative proposal involving a radical change to the administration of the sales tax system for computer goods was approved by Parliament on 31 March 1998. The key elements of the proposal are:

- targeted personal computer goods will only be able to be imported free of sales tax by an accredited person;
- targeted personal computer goods will only be able to be purchased free of sales tax by an accredited person, an always exempt person or some exempt end-users;
- accreditation will only be granted to persons who can satisfy a number of criteria;
- where a person purchases targeted personal computer goods free of tax by quoting a Sales Tax Registration Number, the seller will be required to seek authorisation (similar to that used by credit card firms) from the ATO prior to completing the transaction;
- where an accredited person or a retailer purchases goods from a non-accredited person on a tax-paid basis, the accredited person must withhold the tax payable on those goods and remit it to the ATO; and
- the introduction of a range of new offence provisions in the law.

The proposal also included a significant change to ATO systems and the introduction of an Integrated Voice Response (IVR) system to facilitate real time communication with clients to minimise compliance costs and inconvenience to business operations.

Restaurants & Cafes

This project intends to cover establishments engaged in providing meals for consumption on the premises, as well as retailing of cooked meals ready to be taken away for immediate consumption.

¹ Budget Statements 1996-97, Budget Paper No. 1, Statement 4 – Revenue: p4-6.

The ATO aimed of the project is to encourage business to comply by observing current business practices in relation to cash handling and record keeping. The approach being adopted focuses on real-time reviews.

A three month trial of the proposed strategy to be implemented nationally commenced in mid July 1996. The strategy involved frequent yet irregular visits to a selected sample of taxpayers. Taxpayers were requested to keep required business records which were used to analyse their gross profit ratios and average weekly sales during a three-month review period. Where appropriate, "cash counts" were also conducted to confirm the accuracy between actual takings and till tape information.

Results of the pilot project showed an average increase in sales of the sample businesses by 14.85 percent, or an equivalent of \$45,000 per taxpayer per year. Of the businesses selected, 44 percent had showed significant improvements in their sales and gross profit ratio.

Road Transport

The primary objective of the road transport project was to improve compliance with PPS in the road transport industry. The project was also undertaken to update ATO approaches to data analysis and information matching. Learning from this project could then be applied to other cash economy projects.

The primary focus of the project is:

- industry research:- this includes gathering data from external organisations like the RTA.
- lodgement comparison activities
- obtaining payer registration from unregistered payers identified through industry research.
- reviewing relevant documentation prescribed under the PPS:
- using Payment Summaries and Payee Declaration information to match data, initiate follow-up action and full account reconciliations.

The ATO's activities confirmed that a substantial majority of motor vehicle registrants identified from external data bases are 'in the system', and meet their lodgment requirements.

Records of existing variation, exemption and reporting exemption certificate holders were reviewed to ensure compliance. The ATO has determined that the vast majority of clients with current exemption/variation certificates are compliant (over 80%) with their obligations to lodge returns and pay outstanding taxes. Where non compliance was detected the ATO either revoked or cancelled exemption /variation certificates or conducted follow up action to ensure future compliance.

Given the results, this project has been concluded. The ATO will, however, continue to monitor performance in the industry.

Taxis

The Taxi Industry Project commenced nationally in July 1994. It is a key cash economy initiative as it demonstrates a promising approach to compliance improvement. The project has the following main objectives:-

- Develop a tax collection system for taxi drivers;
- Improve cooperation between the industry and the ATO;
- Increase lodgement of returns;
- Decrease non disclosure of taxi income;
- Clarification of the law; and
- Improve record keeping in the industry.

The ATO has undertaken a broad range of communication strategies to improve the attitude and level of cooperation between the taxi industry and the ATO. This has included regular articles in the regional industry magazines, information seminars at taxi depots, distribution of information flyers on relevant taxation issues, ATO involvement in taxi driver training courses, ATO contact officers in each state to assist with taxation enquires, and regular discussions with various industry associations.

During the 1995 and 1996 financial years the ATO invested substantial resources in this project. Almost 7,000 taxi operators' and drivers' taxation affairs were reviewed or audited, and the following direct outcomes were achieved:-

Increase in taxable income	\$53.195M
Increase in tax assessed	\$ 9.063M
Increase in penalty and interest	\$ 2.668M

The overall effect of this project was much greater than the above audit results. Through liaison with the industry, clarification of grey areas of the law, improvements in record keeping, and a comprehensive publicity strategy there has been a substantial increase in the level of taxable income returned by the industry.

Analysis of taxation returns lodged by the industry for the years ended 1992 to 1996 has established that as at 31 December 1996 the taxable income returned by the taxi industry had increased by \$488.1M. After adjusting for economic effects, the increase in taxable income that can be attributed to action undertaken by this project is \$183.0M. This represents an increase in net tax payable of \$61.4M.

The project included research to develop a taxi profile for the years ended 30 June 1995, 1996, and 1997. This research has established that the most reliable profile for a taxi operator is taxi vehicles takings per kilometre. This has resulted in the following national benchmarks—which take into account taxi fare increases in all states—for the industry being developed;

Year ended 30 June 1995	\$0.69 per km
Year ended 30 June 1996	\$0.71 per km
Year ended 30 June 1997	\$0.74 per km

Where a taxi operator has not kept proper records these benchmarks can be used as a basis for estimating the gross income derived by the vehicle. The Taxi Industry Project teams are currently using these benchmarks to select taxi operators for audit reviews and as a reasonable basis for raising default assessments when the taxi operator has returned a very low gross income and has not kept proper records.

A major problem in the taxi industry prior to the commencement of this project was the failure of taxi operators to keep proper records of their taxi income. As a result, Taxation Ruling TR96/11 was issued in April 1996. This taxation ruling provides guidelines for the recording of taxi takings. These guidelines have been widely publicised within the industry, and the project auditors have observed a substantial improvement in the taxi taking records kept by most taxi operators.

The ATO has also invested significant resources on law clarification in the taxi industry. At this stage of the project, many of the grey areas of the law affecting the taxi industry have been clarified or are awaiting determination by the courts.

Industry Benchmarks

The ATO is striving to adopt a more open approach in its operations and believes that much can be gained from sharing information about financial and other industry benchmarks with the community and in particular with industry bodies and tax professionals. The ATO is discussing a number of options with industry and the community generally and will develop and progressively release a range of information as it becomes available.

Tax agents and professional bodies together with the Cash Economy Task Force have suggested that the ATO publish a range of ratios to assist tax professionals to work with their clients to increase voluntary compliance in the business community, particularly in cash industries. In response to this, the ATO has calculated preliminary ratios for some of the sub industries within the following industry groups:

- Building and Construction;
- Fruit and Vegetable growers, wholesalers and retailers;
- Clothing manufacturers and wholesalers;
- Hospitality;
- Road Transport; and
- Taxi industry.

Ratios include average gross profit, net profit and wages to turnover and have been calculated using information from tax returns. These calculations were compared with published information and found to be comparable. The wages to turnover ratio in particular will provide a relevant measure to those industries where cash wages are common.

The ratios can be used as a guide, but they are not definitive benchmarks. There will be a range of legitimate reasons why businesses will vary from the industry norms. Similarly businesses whose ratios fall within the average ranges may for various reasons have compliance problems. It is inappropriate to use these ratios in isolation as an indicator of compliance levels but they may be useful as a guide when considered in conjunction with a range of other information.

Tax advisers can use these figures to identify businesses which vary significantly from industry norms. If this is the case, they can make enquires to determine if there are legitimate reasons, or if action should be taken to correct problems and improve business practices, in particular record keeping. The ATO plans to publicise this information in the business community and business owners may find it useful in assessing the performance of their business.

The ATO will conduct ratio comparisons and using this together with other information may seek clarification from those taxpayers whose ratios fall significantly below the industry norms.

The ATO has received very positive feedback on this initiative and many helpful suggestions on how this information can be refined to make it more meaningful have been received from professional bodies and the business community.

The information contained in tax returns is limited and the benchmarks that can be calculated from this information are similarly restricted. The ATO is keen to develop the concept of industry benchmarking beyond that which can be generated from tax returns. In doing this it will use the intelligence gathered from field work and from consultation with tax professionals and with industry to broaden the range of information that can be made available. This approach has already been applied in the taxi industry.

In the building and construction industry the ATO is looking to establish standard hourly rates which can be compared with those published by industry bodies. It is also analysing the typical levels of cash in certain building and construction sub-industries. Other areas that may be considered include:-

- the proportion of contractors and wages;
- how much of a contractors income is from PPS sources;
- the proportions of cash purchases compared with credit and cheque purchases;
- levels of expenditure on materials compared with gross income; and
- gaps in the percentage of time worked (or idle time) which may identify potential cash jobs.

Similar analysis will be done in the restaurant industry and where the ATO is able to identify consistent trends it will publish the information. This work will be done in consultation with industry bodies and the community.

Communication Strategy

Questions relating to the cash economy were included for the first time in the ATO Corporate Survey of taxpayer attitudes to the taxation system which is conducted every six months through AC Nielsen-McNair.

More than half of the people polled say they know a lot of people who think it is OK not to pay tax on cash earnings and almost a quarter personally think that it is OK being paid in cash for a job and then not reporting it in their tax return.

Interestingly, the results have revealed that taxpayers are more tolerant of workers cheating on their tax through the cash economy than when business does. This reveals the real dilemma for the ATO in dealing with the cash economy - while taxpayers understand that it is wrong for business to hide cash income, they are happy to promote the practice when they are offered cash wages, or a discount if they pay cash for a good or service.

Over half of the survey respondents thought that the number of people who don't pay tax on cash earnings is increasing and that there is little certainty that these people will be caught by the ATO.

The findings reinforce what the Commissioner has described as the community's 'split personality' on the cash economy.

The Commissioner said that:

“On the one hand, we realise there are victims of the cash economy - we pay more because they are not paying and legitimate businesses fold because of unfair competition from those engaged in the cash economy.

On the other hand, the community willingly participates in it, perhaps because we get an immediate financial benefit - a lower cash price - or because we take sympathy on someone and want to help them out.”

The results also showed that 38 percent of respondents were aware of the crackdown on the cash economy announced last year. While promising, this result shows that the ATO still has a long way to go to improve perceptions of its effectiveness in dealing with tax evasion.

More recently the ATO has engaged a market researcher to assist with the development, refinement, long term implementation and evaluation of a communication strategy for the cash economy.

Building Partnerships

The ATO has commenced a number of programs that are designed to increase community confidence in its ability to address the challenges presented by the cash economy and administer the tax system in a professional manner. These programs are described below.

Inter-Agency Cooperation

An inter agency Cash Economy Working Group has been meeting on a monthly basis to improve coordination by Government agencies of joint field activities, data exchange and information sharing. This Group include representatives from ATO, Centrelink and DIMA. The forum has also met with representatives from DEETYA and the DPP.

In September 1997, Centrelink officers were outposted for a three month trial period to each of the Box Hill, Chermside and Newcastle ATO Branches. The aims of this arrangement were to establish a closer working relationship between the two Agencies for joint case work and to take advantage of the ATO's focus on the cash economy which is also a high risk area for Centrelink.

Overall, the channels of communication between the two Agencies have been greatly improved and there is a greater understanding of the respective compliance activities and roles of each Agency. Each of the national leaders of cash economy projects have met with representatives from Centrelink to determine whether and to what extent there is scope for the project to either work with officers from Centrelink and/or better share information.

The potential for increasing the number of joint prosecutions involving ATO, DIMA and DSS is being explored.

Tax Practitioners

Tax practitioners play an essential role in promoting the benefits of good record keeping and fostering compliance with taxation laws in the small business community. The ATO has begun to work cooperatively with tax practitioners in developing and implementing compliance improvement initiatives and tools which can assist tax practitioners in the provision of services to their clients and the improvement of the accuracy of the returns lodged. For example, the ATO has consulted widely with tax practitioners and others on the development of the financial ratios.

Industry and Community groups

The ATO recognises that industry bodies and community groups have a large role to play if community attitudes about the cash economy are to change. As part of the cash economy projects the ATO will be liaising with relevant stakeholders to outline the processes being implemented and the outcomes being sought.

An important element of the building and construction project is the establishment of good relationships with industry bodies and the unions. For example, meetings have already been held with the HIA and MBA. They are supportive of the ATO approach to achieve a level playing field so that cash operators are not able to gain a competitive advantage over compliant businesses.

The ATO is also currently evaluating a community proposal to address non-compliance and the exploitation of outworkers in the clothing manufacturing industry (refer to case study 4.2).

Tip Offs

Tip offs are reports of evasion which are received by the ATO from the community. A significant quantity of the information received from these tip offs relates to cash transactions. As part of the cash economy projects concentrated use of this information is being made.

Reducing Complexity in the Tax System

A Small Business Deregulation Task Force was established by the government to review the compliance and paper burden imposed on small business. The Small Business Deregulation Task Force found that taxation was the most prominent issue raised with over 50 percent of the public submissions referring to various aspects of tax requirements. Problems with fringe benefits tax (FBT) administration, the complexity and number of taxes, record keeping requirements, issues in relation to the administration of capital gains tax (CGT), sales tax and payroll tax were all raised as concerns.

Whilst many small business operators accept the need to pay their fair share of tax, they see the system as too complex in terms of the number of taxes, the uncertainty of the law and the frequency of changes. For these reasons they want simplicity and certainty in relation to taxation.

The Cash Economy Task Force is pleased to see the implementation of many of the Small Business Deregulation Task Force's recommendations is well underway.

Single Entry Point for Business

In its first report, the Cash Economy Task Force proposed that the ATO examine streamlining business registration requirements by for example, introducing registration requirements for all new businesses at the point when they commence operations rather than at lodgment of their first tax return and examine introducing one common TFN or Business Registration Number across all Federal and State agencies.

These approaches were aimed at reducing the compliance burden imposed on small business. For example, one common business number would mean that a business would only need to provide common information such as name and address to government once.

To an extent, these proposals have been addressed by the Government's response to the Small Business Deregulation Task Force recommendations.

The ATO is also closely involved with other agencies in the development of proposals for the Business Entry Point and the Single Registration Process for business.

The Task Force believes that these proposals have significant benefits for small business in the form of reduced compliance costs.

Professional Workforce

The Small Business Income (SBI) Group has commenced a national project aimed at developing appropriately targeted business skills for its staff. The first phase of this project benchmarked the skill and knowledge levels of a selected group of SBI staff across all business areas including cash economy.

Through this process SBI has started to build a picture of its workforce that identifies critical areas of business knowledge, skills, responsibilities and leadership values; risk areas as well as how to measure and assess what they do well and what they should be doing. This project has also enabled SBI to identify gaps for further investigation.

SBI is intending to undertake a more rigorous analysis of the data to identify those areas where it needs to improve or more effectively target its human resource strategies. Over the next few months SBI will be developing a range of recruitment, development and skilling strategies in collaboration with the cash economy teams.

CHAPTER 2: UNDERSTANDING COMPLIANCE

Background

Historically, the ATO has conducted the majority of its research and analysis using internal intelligence obtained from its transaction systems and field activities with lesser analysis of external data being undertaken.

In the first report to the Commissioner of Taxation, the Task Force recommended that the ATO work more closely with industry and community groups and undertake further research to better understand the structural issues and motivating factors that support the cash economy. It also recommended that the ATO undertake joint research with the (ABS) into the extent and nature of undeclared income.

In response to the Task Force recommendations the ATO has commenced research programs, aimed at increasing its understanding of the extent and nature of the cash economy and of the structural elements influencing the cash economy.

The ATO has conducted an extensive review of compliance literature, encompassing both Australian and international studies, which has enabled it to identify a range of motivational drivers influencing tax evasion in the cash economy.

In addition, the ATO is negotiating research programs with the ABS to identify the extent and nature of undeclared income. This research is aimed at identifying the costs to the community of undeclared income, including its impact on the national accounts.

The ATO is also in the process of planning joint research with DSS. Initially, this research will focus on the self-employed and their living standards. Opportunities for expanding the scope of this research will also be examined.

What is the Cash Economy?

In the first report the Task Force defined the cash economy as ‘income that is not recorded in the books from which the tax return is prepared’. This includes non-declared business and employment income derived from legal and illegal activities and includes evasion by those who keep records and lodge tax returns and those who do not. While the definition is broad enough to include a wide range of practices the Task Force decided to focus its attention initially on cash income.

The Task Force has emphasised that transactions involving cash payments and receipts are not in themselves illegal. What is illegal, is where cash transactions are not declared for tax, social security and other purposes (child support, superannuation). Importantly, it needs to be recognised that it is also illegal to not record cash transactions.

The Task Force considers that much of the non compliance in the cash economy relates to high volume, low dollar value transactions often motivated by business or individual financial survival. However, there is also some large scale tax evasion in the cash economy. The level of tax evasion is

unequally spread throughout the population and varies with type of income, amount of income and with attitudes toward laws and government.

The Task Force is concerned that personal and household services (for example, child care, appliance repairs and installations, gardening, car repairs etc) appear to be amongst the fastest growing sectors in the economy. The ATO needs to monitor developments in this sector to determine the extent to which this trend poses a risk to the tax system. In addition, the ATO should work with legitimate providers of these services (for example, franchisors) to better understand the dynamics of the industry and survey community attitudes towards tax evasion in this sector.

Costs of the Cash Economy

Justice Oliver Wendell Holmes (1927) observed that ‘taxes are what we pay for a civilised society’. After all, the primary purpose of the tax system is to fund schools, roads, hospitals, welfare and other government programs and community services which are designed to build a better Australia.

Based on the level of revenue collected the governments must make a decision about what programs and services they can afford. Community compliance with tax laws directly affects the ease with which governments can raise further revenue for these purposes, or simply maintain its current revenue.

There have been attempts in Australia and elsewhere to measure the size of the cash economy in Australia but there is currently no official or reliable estimate of its size or of the revenue foregone. In its first report the Task Force commented that academic studies estimate the cash economy to be between 3.5 percent and 13.4 percent of GDP. Using 1995/96 GDP figures as a base and an effective tax rate of 23 percent, these studies suggest that the annual amount of revenue foregone could be between \$3.9 billion and \$15.1 billion.

While the ATO and other government agencies have a real interest in addressing the cash economy it should be a concern for all Australians. The above estimates suggest that the cash economy denies the Australian community billions of revenue dollars each year putting essential government services such as social security and health at risk. The cash economy also imposes significant costs to the community through welfare fraud and avoidance of superannuation, worker's compensation and child support obligations.

The cash economy puts honest business at a competitive disadvantage, and in some cases out of business. Honest business is unable to compete for work with those who operate in the cash economy because of unfair price competition. Also, good and reliable staff may be lost due to the attraction of cash wages.

In the long run, even those who operate in the cash economy pay a price. Case study 2.1 highlights that in the long run business operators who pocket the cash are unable to determine the effectiveness and true worth of their operations nor identify growth opportunities.

Case Study 2.1 Cash costs too high in the long run

In a recent media release, Curt Rendall, Chairman of the Institute of Chartered Accountants Small Business Committee, said that;

"...PAYE taxpayers and small business doing the right thing should also recognise the threat that the cash economy poses for them. It means they either have to shoulder an unfairly high tax burden, or do without services the government can't pay for.

The greatest problem that the Tax Office faces is the dilemma of hypocrisy among taxpayers.

98 percent of people would say that it's important everyone pays their fair share of tax. But on the other hand, a Tax Office survey has found 23 percent of people think its OK to get paid in cash, and not declare the income.

Many PAYE taxpayers, and small business themselves, think its OK to have one price for a product or service and a lower price 'for cash.' But in the long run everybody suffers.

The PAYE taxpayers, while they think they are getting a bargain for their house-painting or plumbing, will end up paying more anyway, as the Australian Taxation Office tries to raise more revenue for the government to make up for the tax lost in hidden cash transactions.

And the small businesses who pocket the cash are not doing their business any good in the long-term. They can't track their cost of business, growth rates and profits properly while they're dodging the taxman. That money could have been used to grow the business, diversify into other investments and build a solid foundation for future generations.

Taking cash out of the business also reduces the value of the business when it comes time to sell. Buyers will only pay what they see in the books.

The only wins for those doing business in the cash economy are short-term and selfish."

(Media Release: The Institute of Chartered Accountants in Australia, 16 February 1998)

Taxpayers, as part of the community, have a right to expect that people will meet their tax obligations so that there is an appropriate contribution by all to the provision of community services and the taxation burden is fairly distributed. Too often the important community role performed by taxation is ignored.

Most people who make donations to charities feel positive about it. However, it appears that very few taxpayers send a cheque to the ATO with the same positive feeling. Ask the same taxpayers

whether they are happy to contribute to the provision of educational and hospital facilities, better roads or the Olympic teams and the response will usually be more positive. The slogan ‘Taxes, building a better Australia’ was developed by the ATO in response to such perceptions but it has not really become part of the national psyche. (Coleman and Freeman, 1994)

The ATO needs to create positive attitudes about the payment of tax and the fact that taxes provide public goods and welfare benefits. One possible approach may be for the ATO to set out for taxpayers the allocation of revenue to various items.

The Task Force believes that decreasing the current level of tax evasion in the cash economy is a socially desirable goal. However, it believes that the ATO needs to have realistic expectations regarding the amount of tax evasion it can cost effectively combat. It may not be cost effective for the ATO to uncover and punish most tax evasion on its own and it therefore has to develop strategic partnerships with taxpayers and associations (community and professional) representing taxpayers who are unfairly effected by tax evasion.

Recommendation 2.1

The ATO conduct research to better understand the costs of the cash economy to the Australian community and identify ways to promote the importance of tax to the Australian community

Influencers Of Taxpayer Behaviour In The Cash Economy

The Task Force identified in its first report that in many cases there are structural issues that help to entrench tax evasion. It concluded that the ATO needs to identify the major structural elements of the cash economy before determining the compliance issues and recommending steps to address those issues.

The Task Force identified the major structural influencers on the cash economy as:

- the nature of cash;
- industry practice;
- taxpayer motives;
- widespread acceptance that non-disclosure of income is OK;
- risk/reward trade-off;
- the absence of incentives to do the right thing;
- ATO effectiveness;
- the role of tax practitioners and the judiciary in encouraging compliance; and
- context and complexity of government laws and regulations.

Without an understanding of the structural influencers it is possible that ATO efforts to tackle the cash economy will prove ineffective. An approach which relies simply on detecting non-compliance and imposing sanctions on detected non-compliers will tend to be short term in effect and increasingly resource intensive for the ATO. It will also place an unreasonable compliance burden on good compliers.

Taxpayer attitudes towards taxation and the ATO

Recent ATO commissioned studies² reveal that the major factors influencing small business attitudes to tax compliance were complexity and lack of fairness. The tax system was considered so complex and time consuming that taxpayers felt they did not have enough knowledge to feel secure about the accuracy of their records and returns despite their best intentions. The payment of taxes and receipt of welfare were perceived as inequitable, public funds were being wasted and government lacked accountability for how public money was spent.

Small business owners were afraid of, resented and lacked trust in the ATO, which was perceived as having no real identity. Some ATO staff were seen as being threatening, uncommunicative and lacking in empathy. Small business maintained there was no flexibility in the system, it placed unrealistic expectations on business, penalties were too heavy, there was a presumption of guilt, and there was no recognition of good behaviour.

Whilst there was recognition that the ATO was responsible for upholding the law, the main concern of small business owners was the survival of their business. The lack of reward for effort and risk, the inequity of the system and the common feeling that the ATO took money that small business "owned" was seen as justification for "dipping".

The Australian research on tax compliance and non compliance is incomplete as it still lacks understanding of the human dimension that underlies tax compliance or non compliance. For example, Wickerson (1995) comments that "audit based (dollar) compliance data need to be supported by more qualitative data which can indicate the general nature and causes of detected non-compliance. Tax administrations need such qualitative data in order to determine how best to respond to the non-compliance within the particular population."

As mentioned above, results from the recent ATO corporate survey suggests that the ATO faces a real challenge if it is to address the cash economy. It appears taxpayers are prepared to turn a blind eye and willingly participate in the cash economy.

These results indicate that much more needs to be done to influence community perceptions and improve tax compliance in those sectors that participate in the cash economy.

² 'National Business Auditee Survey - 1992, ATO; 'Small Business Market Review, Market Consultation', ATO, 1996; 'Stepping into the Shoes of Small Business, A Review of the Small Business Market', ATO with the Small Business Community, 1996; 'Small Business Attitudes to Tax Compliance', A Pilot Research Study, Dangar Research Group Pty Limited for the ATO, 1996

Recommendation 2.2

The ATO undertake market research to determine attitudes of high risk industry participants and the general community to typical cash practices.

Understanding Taxpayer Behaviour

An extensive review of the compliance literature by the ATO has identified some commonly mentioned factors impacting on a taxpayer's compliance decisions. An appreciation of these factors, and their interrelationships, will help the ATO address the structural influencers on the cash economy identified by the Task Force in its first report.

The research to date has revealed that taxpayer compliance decisions can be affected by factors which can be broadly categorised as psychological, sociological, economic and industry. The business profile adopted by the taxpayer can also influence compliance.

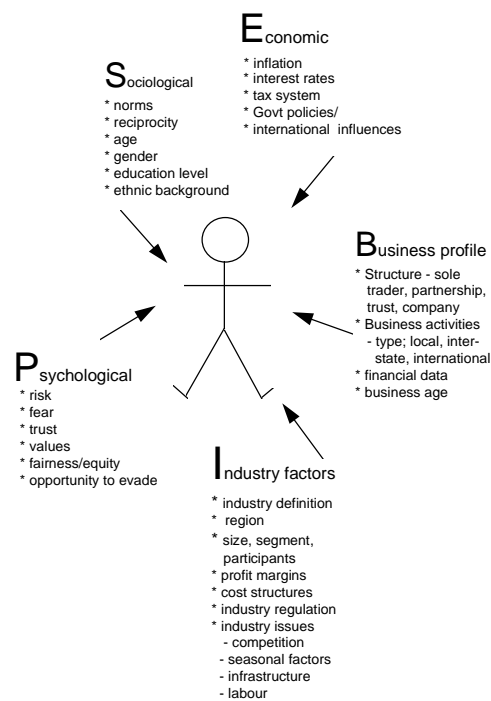


Figure 2.1: A taxpayer is influenced by a multitude of factors

The Task Force considers that none of these factors stand alone as the sole reason for a taxpayer's behaviour, and equally, it is not possible to identify which factors in combination may influence the behaviour of any one particular person. However, it is possible to identify a combination of factors that is more likely to influence behaviour for certain categories of taxpayers.

Coleman and Freeman (1994), in a study of non-compliance in the small business sector, state that cultural differences continue to have great influence. Issues such as age, gender, class, lifestyle, time and place have a major influence on behaviour. Users of market research have become increasingly aware of the need to understand the culture of a market segment.

The Task Force is aware that the ATO has undertaken a significant number of audit-based and other projects designed to increase its understanding of the structural elements influencing the various industries comprising the cash economy. A number of these projects have also addressed various factors influencing the compliance behaviour of small businesses.

This research has been influential in a number of ways. In particular, it has helped the ATO to better appreciate both the wide diversity of environments, issues and participants comprising the cash economy and the need to develop alternative ways of 'segmenting' this market for strategic and program-delivery purposes. For example, the research has enabled the ATO to develop an understanding of the complexity and interrelationships of the factors which impact on taxpayers in the clothing industry. This is illustrated below in case study 2.2.

Case Study 2.2 Clothing Industry

The industry generally operates on a tiered structure based on the stage of production undertaken (eg, cutting, sewing trimming etc) with loose contractual arrangements established between the various levels. The industry is characterised by the following features:

- significant proportion of home based work;
- a tradition and expectation of cash payments at lower levels;
- limited level of capital required;
- transient nature of industry workers and organisers;
- ethnic / cultural backgrounds;
- exploitation of outworkers;
- high unemployment and limited recognised skills of outworkers for other work;
- low levels of understanding of the tax system and / or of industrial relations law;
- fraudulent claims on the Social Security system; and
- low level of adherence to any form of government regulation.

The cumulative effect of these factors is a regime of entrenched non-compliance at the lower levels of the industry. It is apparent from the above factors that tax is not the major consideration of participants in the industry. These factors can not be looked at in isolation and it is the interrelationship between the various factors which needs to be understood.

With the probable exception of the top tier of the industry (ie, the larger retailers and established major manufacturers), a number of motivational factors combine to contribute to the non compliant

behaviour of the majority of individual participants in the middle to lower tiers of the industry. Some of the primary factors would be:

- *Sociological*
ethnic background
educational level
language skills
- *Psychological*
opportunity to evade
values
- *Industry factors*
lack of regulation
cost structures
labour availability
- *Economic*
level of
unemployment

These factors are not consistent across all participants in the clothing industry and they may be present to varying degrees at different times. As a result of these peculiarities innovative approaches need to be developed by the ATO which take account of the different motivations of the participants. Some of these approaches may in fact lie outside the tax system.

Case study 2.2 demonstrates that in many instances there are a multitude of factors which combine to influence a taxpayer's compliance decision with tax only playing a minor role.

There is no easy answer about what causes certain behaviour toward either tax compliance or non-compliance. Furthermore, the same individuals in a different context can vary their attitudes and behaviour concerning tax compliance and non-compliance. The ATO must recognise that human beings have many values and attitudes that are often multi-dimensional and may at times appear to be contradictory.

The challenge for the ATO is to better understand the factors, and their interrelationships, that impact on taxpayer behaviour so that it can develop targeted strategies which impact on the non compliant without adversely affecting compliant taxpayers.

Recommendation 2.3

The ATO needs to undertake research into high risk cash economy taxpayer populations to identify the causes of non compliance and opportunities for compliance improvement strategies.

Developing A Model Of Compliance Behaviour

The work of Dr Valerie Braithwaite (1994) on motivational postures and trust norms, and Professor Ian Ayres and Professor John Braithwaite (1992) on strategies for regulation suggests that improved tax compliance in the cash economy is more likely to be achieved if the ATO understands taxpayer motivations and develops a holistic approach which has both a hierarchy of regulatory strategies of varying degrees of interventionism and a hierarchy of sanctions. A brief summary of this work is contained in Appendix 1.

Dr Valerie Braithwaite indicates that the many competing factors impacting on the taxpayer cause the taxpayer to adopt a particular posture or stance. Underlying each stance are beliefs, values and

attitudes which influence the behaviour of a taxpayer. These stances indicate the degree of acceptance or rejection a taxpayer has towards the ATO and can be summarised as follows:

1. managerial accommodation or initiation: the taxpayer includes the regulatory requirements in their management plans and actively complies, and may encourage others to do so;
2. capture or conformity: the taxpayer accepts the regulatory requirements, and has faith in the ATO;
3. resistance: there is confrontation between the taxpayer and the ATO;
4. disengagement: withdrawal of the taxpayer from the regulatory process.

Taxpayers in the first and second categories are generally compliant, while those in the third and fourth categories are non compliant. The way an industry approaches its taxation obligations may be determined by the make-up of the participants in that industry. An industry comprising a significant number of disengagers will require a different ATO approach to regulation than an industry made up of primarily initiators.

It is difficult, if not impossible, to determine why a taxpayer has behaved in a particular way at a certain time. The challenge for the ATO is to increase its understanding of the various factors and how they influence taxpayer behaviour. An increased understanding will assist the ATO to develop ways to encourage the motivation to do the right thing and to constrain the motivation to be non compliant.

Figure 2.2 illustrates the connection between the various factors that can impact on a taxpayer and how these factors determine the stance of the taxpayer.

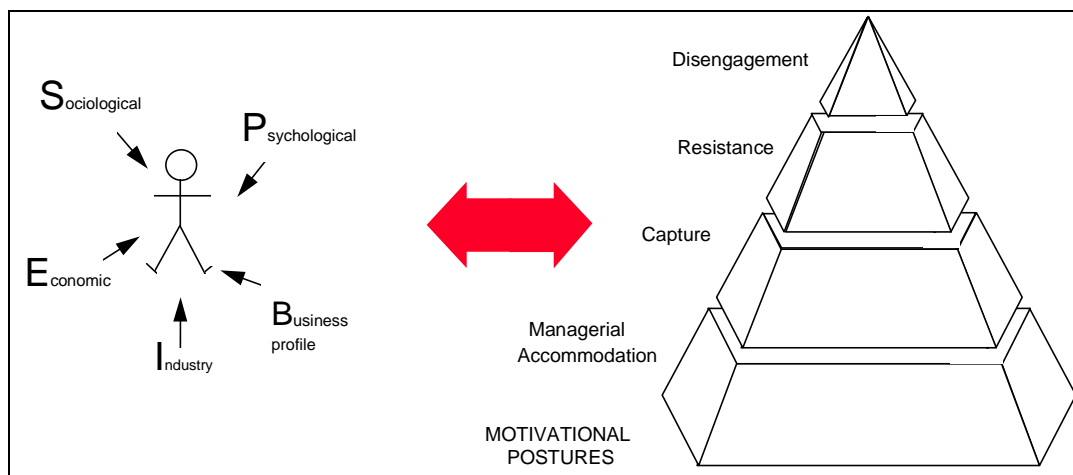


Figure 2.2: Factors impacting on the posture or stance adopted by a taxpayer

Dr Braithwaite regards the degree to which a regulator and regulatees agree on goals and how best to achieve them is an important factor in the acceptance or rejection of a regulator. Dr Braithwaite's work implies that if the ATO is regarded as trustworthy, procedurally fair and respectful of citizens it can motivate taxpayers to comply with their obligations.

One way of encouraging compliance has been suggested by Professor Ian Ayres and Professor John Braithwaite (1992) using a pyramid of regulatory strategies. This is depicted below in figure 2.3.

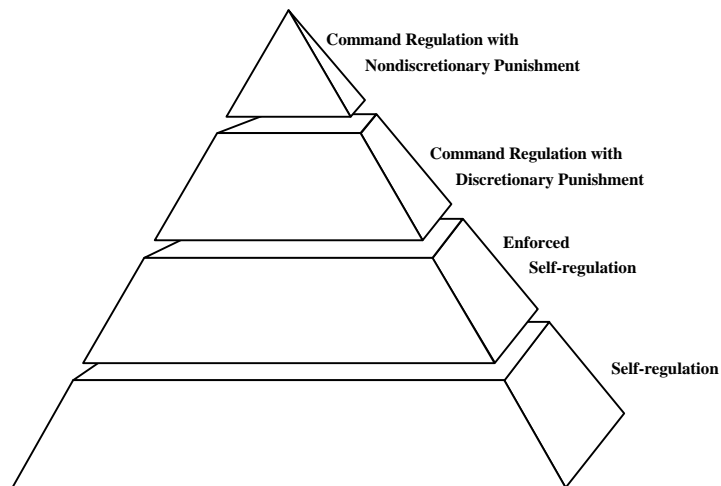


Figure 2.3: Pyramid of regulatory strategies
 (Source: Ian Ayres and John Braithwaite, 1992)

A regulator's preferred strategy is self-regulation as it imposes the least burden on everyone. Those taxpayers, or industries, who are unwilling to comply or are tempted to exploit the privilege of self-regulation must understand that the government is willing to increase its regulatory strategy.

The regulator's preferred approach should be to encourage self regulation, only moving up in the regulatory pyramid if taxpayers abuse the system.

The highest level or strategy in the pyramid demonstrates a commitment by the regulator of an intention never to give in. Ayres and Braithwaite (1992) propose that the existence and knowledge of the capacity of the government to get as tough as needed would encourage a more voluntary regulatory climate.

The 'Compliance Model'

The work of Dr Valerie Braithwaite, on motivational postures and trust norms, and Professor Ian Ayres and Professor John Braithwaite, on strategies for regulation, has strongly influenced the design of a compliance model which could be applied by the ATO to improve voluntary compliance.

The model, which complements the Taxpayers' Charter, acknowledges that the ATO's approach to enforcement has a critical part to play in the taxpayer compliance equation. It also recognises that the ATO's regulatory approach defines the credibility of the ATO and, therefore, influences the ATO's ability to increase community confidence in its operations.

The model advocates an hierarchical approach to compliance improvement which suggests that, in the first instance, ATO strategies are aimed at encouraging voluntary compliance through approaches like education and convenient and efficient service delivery. The ATO will, however, have access to an escalating enforcement regime with a hierarchy of sanctions which will be

accessed when there is evidence that measures to encourage voluntary compliance have been unsuccessful in changing compliance behaviour.

The Compliance Model is depicted in Figure 2.4 below. The left hand side of the pyramid represents the stances that can be adopted by taxpayers as described in the work of Dr Valerie Braithwaite. The right hand side presents the pyramid of regulatory strategy which is described in the work of Professor Ian Ayres and Professor John Braithwaite.

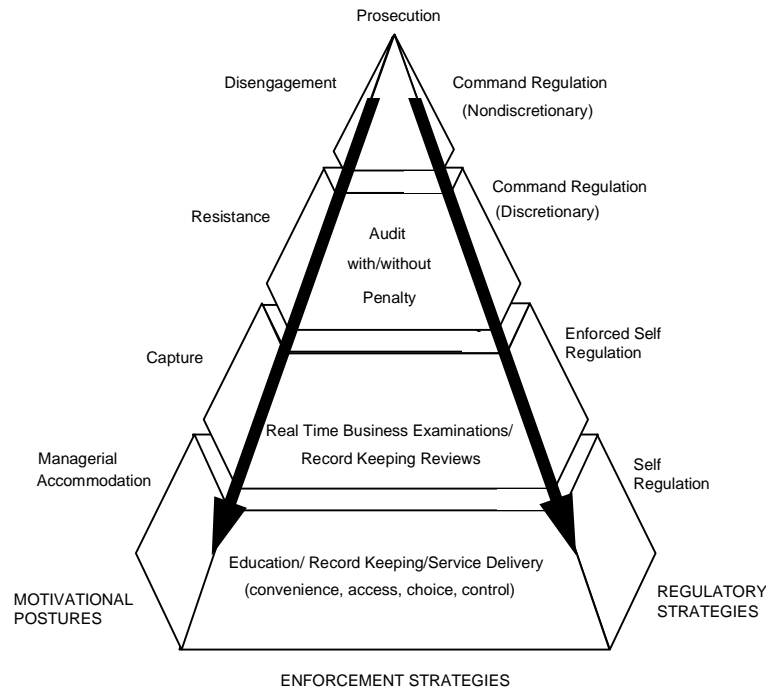


Figure 2.4: The 'Compliance Model'

The strategies on the centre face of the pyramid illustrate the strategies which could be applied to an industry. The levels and methods of enforcement listed in figure 2.4 are a demonstration only of the way a hierarchical approach could work. The ATO must consider expanding the options at each level of regulation to ensure that taxpayers are given every opportunity to comply at the lower level before they are moved up to the next level.

The ATO's preferred approach is to develop and apply strategies that encourage self regulation, or voluntary compliance, emphasising cooperation and the building of relationships between the ATO, individual taxpayers, and third parties. The arrows in the compliance model represent the desirability of the ATO to apply strategies that encourage a downward movement of taxpayers from resistance to the preferred self regulation.

The ATO will, however, have access to and move to stronger enforcement methods if and when compliance resistance is met. The top of the pyramid depicts the ability and willingness of the ATO to escalate enforcement. The threat of such severe action is real but is kept in the background, but the existence and knowledge of the capacity of the ATO to get as tough as needed will encourage

more voluntary regulation. The ATO must communicate that it will be cooperative but if there is not cooperation in return, it has the power and is brave enough to use its heaviest punishment.

The Task Force considers that different strategies will apply to different industries. The challenge for the ATO is to determine the most effective mix of strategies and level of escalation for each industry.

The compliance model advocates an hierarchical approach to compliance improvement. This suggests that instead of the current routine application of enforcement strategies and penalties, that enforcement begin primarily through service delivery, education and record keeping and progress to stronger methods (for example, audits) if and when compliance resistance is met.

The Task Force believes that the most effective approach to maximise voluntary compliance in the cash economy is for the ATO to adopt an hierarchical approach to regulation. The main elements for such an approach are:

- understanding taxpayer behaviour;
- building community partnerships;
- increased flexibility in ATO operations to encourage and support compliance; and
- more and escalating regulatory options to enforce compliance.

Recommendation 2.4

The ATO adopt the compliance model to guide strategy development in addressing the cash economy.

CHAPTER 3: BUILDING COMMUNITY PARTNERSHIPS

Background

The cash economy represents a major cost to the Australian community in lost revenue and an unfair shouldering of the tax burden by those taxpayers who comply with their obligations.

The problems presented by the cash economy are enormous. The complexity of the issues means that the ATO can not address the problem on its own. The ATO needs to develop an integrated strategy that includes support from other government agencies, tax practitioners, industry and community groups so that it can challenge community perceptions regarding the cash economy.

The challenge for all of these players is to work together to influence community attitudes. The Task Force considers that the ability of the ATO to build relationships with tax professionals, industry associations and community groups is vital to the changing of community attitudes. This includes establishing a cooperative relationship with "champions" or advocates in the private sector who can convey to the community the importance of paying tax.

Building community partnerships should be an intrinsic part of achieving a greater ATO presence in the community. The ATO should focus on building networks to improve intelligence and community understanding.

There are two parts to building community partnerships. The first is to raise awareness of the problems and costs associated with the cash economy so that the ATO can gain the support of the community. This needs to be addressed as part of the ATO's cash economy communication strategy.

The second part is to work together with professional and community bodies to develop solutions to the problems of the cash economy. The benefits of this approach can be seen from the results of the industry ratios that have been developed in conjunction with tax professionals and have been well received by the business community.

Taxpayers' Charter

The Taxpayers' Charter was developed by the ATO in consultation with its staff, the general public, business and community groups, tax practitioners and other government agencies. The Charter is a key tool in building a better relationship between the ATO and the community and giving the community confidence in the ATO's operations.

The federal tax system operates for the benefit of the community and is based on taxpayers cooperating with the ATO and voluntarily complying with their legal obligations. The ATO has a responsibility to assist taxpayers to understand their rights and obligations, and to meet acceptable standards for service delivery. The ATO also has a responsibility to deal with taxpayers who do not meet their obligations under the law. The Charter helps set in place the relationship the ATO seeks with the community in performing its task - a relationship based on mutual trust and respect.

The Charter is intended to bring together the legal rights that the law provides for taxpayers as well as the components of a fair approach to tax administration. This will help ensure everyone understands their rights and the fair approach as well their legitimate expectations of standards of service and how they can complain if they are not satisfied. In short, the Charter is intended to govern the way in which the ATO interacts with taxpayers.

The Charter reinforces the ATO's commitment to be more client focussed whereby it looks to better understand and address the issues impacting on compliance and compliance costs. The emphasis for the ATO is on improving voluntary compliance under a self-assessment system, being more open and accessible and working with the community.

Recommendation 3.1

The ATO integrate the concepts behind the compliance model with the principles expressed in the Taxpayers' Charter.

Targeted Communication Strategy

The aim of the communication strategy is to reverse what appears to be a widespread acceptance in some sections of the community that 'not paying tax on cash is OK'. A crucial aspect of this will be the need to ensure that the ATO is seen to be fair and equitable as well as effective in dealing with tax evasion.

Before any communication strategies can be developed for the cash economy it is necessary for the ATO to learn about taxpayers who participate in the cash economy. Given the multitude of factors that can impact on participants in the cash economy, the ATO needs to focus on market segmentation not only in different industries and types of businesses but also on other factors like size, cultural background and number of years in business.

Specific communication strategies should be directed to the different market segments. Taxpayers engaged in the cash economy are so diverse and the backgrounds of participants are so varied that a strategy which is successful with one group may be ineffective with another.

The main areas which the Task Force believes are of prime relevance in developing communication strategies to address the cash economy are:

- Specifying the nature of the problem and how it may be changing and what that means for the community;

- Recognising differences in people's motivation for being involved in the cash economy;
- Focus on particular cash practices that lead to tax evasion;
- Understanding the impacts of the cash economy beyond the tax system;
- Identifying the factors that influence the behaviour of people.

The main objectives for the communication strategy should be to inform key audiences of activities and results of the cash economy initiatives and promote an understanding of its aims and objectives. This should enable the ATO to gain support for these initiatives from key stakeholders and counter misinformation and misconceptions surrounding the cash economy.

In order to challenge community attitudes and encourage changed behaviours the ATO will need to establish a cooperative relationship with key audiences in order to improve compliance and work with them to develop solutions.

Therefore the main themes which the communication strategy should convey to the community with regard to the cash economy are as follows:

- the ATO is working with industry and the community;
- this is a community problem not just an ATO problem;
- a good business maintains good records and pays its fair share of tax;
- the system is fair when people comply;
- the Tax Office will treat people fairly and reasonably, and those who contribute will be acknowledged; and
- those failing to comply will face swift and severe sanctions.

To be successful in addressing the problems posed by the cash economy, the communication strategy needs to promote positive attitudes about the payment of tax and the fact that taxes provide public goods and welfare benefits.

Implementation of the Communication Strategy

A phased approach that focuses on the ATO building relationships and providing information and support is recommended. Consistent with the project based approach being adopted by the ATO to address the cash economy, the first phase of the communication strategy should acknowledge the need to be visible in key industries where progress is occurring and to build and maintain relationships.

This industry based approach that has been adopted by the ATO for national projects should be used to pilot a range of communication activities in different industries and different regions to determine the most effective strategy. Critical to success is the need to ensure consistency of message and effort and to capitalise on industry support in a timely way.

Whilst the first phase would involve some media liaison, the preferred communication approach is on direct communication with key people and the use of industry or community newsletters for information and updates.

Results from market research should be used to determine the most effective follow-up strategy.

Recommendation 3.2

The ATO adopt a phased approach to communication which addresses the peculiarities of different market segments.

Challenges - A question of balance

The Task Force is attracted to a communication campaign based on increasing the community's moral obligation to pay tax is most likely to succeed in influencing compliance with tax laws. However, there is academic research that cautions this approach (Thurman et al, 1984). This research argues that this well intentioned approach can be compromised by an individual's ability to rationalise non compliance to reduce or neutralise the guilt associated with these deviant behaviours.

An example of this process would be a person who is considering not declaring income may feel guilt about defrauding the community (after a moral obligation media campaign). To reduce this guilt, the person decides that the government wastes money collected in taxes.

There are several neutralisation strategies which can be used by different individuals. Seven broad strategies identified in the literature are:

1. Denial of Responsibility - removes culpability from the non compliant individual by placing the blame on others.
2. Denial of Injury - denies that deviant behaviour really has negative consequences on others.
3. Denial of Victim - acknowledges negative consequences of behaviour but believes that the victim deserves these negative consequences.
4. Condemnation of the Condemners - projects blame upon law-makers and law enforcers as creators of unjust laws which should not be obeyed.
5. Appeal to Higher Loyalties - the individual reduces feelings of guilt by justifying deviant behaviour as a response to non conventional social order.
6. Metaphor of the Ledger - the individual anticipating non compliant behaviour believes this behaviour is not representative of their overall good nature.
7. Defence of Necessity - the individual views their deviance as the only choice in a given set of circumstances.

Any program which focuses only on one message while neglecting rationalisation behaviour of individuals could potentially have a negative effect. For example, a moral appeal to the public

designed to increase tax compliance might backfire by providing a neutralisation strategy justifying tax evasion, namely, if everyone else is cheating on their taxes, why shouldn't I?

Therefore, any communication campaign emphasising a moral obligation to pay tax would also need to address the various neutralisation strategies which may be used to minimise the effects of guilt.

Recommendation 3.3

The ATO ensure that key cash economy messages are well targeted to generate and sustain community support for the ATO.

Building Community Partnerships

Building community partnerships should be an intrinsic part of a greater ATO presence in the community. The ATO should focus on building networks to improve intelligence and community understanding.

The ATO can not address all the problems of the cash economy on its own. Therefore, it needs to seek the involvement of the community in its decision making and direction setting. There are already a range of consultative forums that contribute to the administration of the taxation system. For example, the National Tax Liaison Group focuses on national issues while others, like the Cash Economy Task Force, focus on particular segments of the tax paying community.

Given that ATO resources will always be limited, third party assistance is essential if the ATO is to maximise voluntary compliance. Assistance from third parties is essential for the detection and investigation of the cash economy. By involving interest groups in the regulatory process the ATO can enhance communication and minimise conflict.

Interest groups can provide data, interpretation and perspectives which might otherwise not be drawn to the attention of decision makers. For example, the ATO could be informed of particular compliance problems and regulatory inadequacies. This type of information would enhance the range of policy options that are available to the ATO. By presenting information at consultative forums, interest groups can contribute to balanced and objective decision making.

Financial transactions reporting is a prime example of third party participation in the regulatory process, with the role of the banker being transformed from that of customer's servant to that of part of the regulatory apparatus. Essentially, banks and other defined cash dealers are required by law to systematically report transactions in excess of a certain amount, and other transactions which might appear suspect, to regulatory authorities. Similarly, immigration authorities routinely require that international airlines screen passengers to ensure that they possess valid travel documents.

Building strategic relationships to help in developing ATO understanding of taxpayer motivations will enhance the ability of the ATO to be responsive to different industries and to gain support for strategies which address particular industry issues and practices.

Australians are all better off if everyone pays their way - and especially if they are in business because then everyone in the industry is able to compete equally. Paying one's way is better achieved cooperatively than coercively, through dialogue and understanding rather than through force used to crush resistance and ignorance.

Dialogue, or maintaining relationships with others, provides feedback to the ATO on its performance and helps maintain integrity and perceptions of fairness and trust. It is important that the ATO act with integrity to generate respect and increase perceptions of fairness and trustworthiness. Fair and consistent behaviour by the ATO, trust in the ATO, and agreement with the ATO's aims will increase the likelihood of the community having confidence in the ATO's operations.

The majority of taxpayers do comply with their taxation obligations. By using the strength of the community, such as well known businesses, industry organisations, taxation agents, agencies from other levels of government, and the support of the majority of people who are compliant taxpayers, the ATO will be able to encourage others to comply.

Identifying Partners

A major component of the Communication Strategy is the establishment of a network between the ATO and the community. The ATO cannot work on the cash economy alone and will require the support and cooperation of industry and the community. Messages from peers are most effective and the public support of key opinion leaders and stakeholders will greatly assist the ATO.

The challenge for the ATO will be to identify the most appropriate partners to act as 'champions' and advocates. The partners chosen will depend on the market segment and could range from successful businessmen to tax practitioners and even to a taxpayer with a good compliance record.

The Australian Customs Services has been successful in identifying partners to assist it perform its enforcement role as demonstrated in the following case study.

Case Study 3.1: Australian Customs Services (ACS) Community Program

Frontline and **Customs Watch** are community participation programs which the ACS runs to obtain information which may be relevant to any illegal activity, in particular drug related activity.

Frontline

Frontline is a cooperative program between the ACS and industry groups involved with international trade and transport. The program draws on the knowledge of people in the industry to help prevent illegal activities. In brief the program asks industry after training by the ACS, to report any suspicious or unusual activities to Customs.

The program has been operating since 1991, has over 650 members, and is regarded as very successful. The success of the program is measured by the number of referrals (1,638) and the positive results (398) from those referrals

A further success measure is the strong internal support for the program.

Customs Watch

Customs Watch is a community participation program which encourages the public to **Watch Out For Australia** and report any unusual or suspicious activities in their area to Customs Watch on a 24 hour free phone 1 800 number.

The initiative relies heavily on the public being familiar with their own environment and being the best judge of anything unusual.

This program has strong regional ownership and is largely delivered regionally with a National overview.

Launched in 1995 Customs Watch has been very successful. The success has been measured by the:

- extent to which the message and phone numbers get into the public domain, in excess of 3,000 calls.
- quality of the information coming in
- positive results over 100 to date

Information received as a result of Customs Watch is also in some instances relevant to other agencies and is passed on to them.

The Frontline and Custom Watch programs run by Customs demonstrate that industry and the community are prepared to support initiatives aimed at improving the living standards of the Australian society. These programs have been instrumental in raising awareness and generating support for Customs.

One of the significant differences, however, between what Customs is dealing with and the challenges of the ATO is the nature of our problems and the community attitudes to what each

agency does. The notion that ‘not paying tax on cash is OK’ does not have the same emotive appeal of catching heroine and cocaine importers or native flora and fauna smugglers.

The ATO must find and work with credible third parties (industry associations, professional bodies, agencies at all levels of government, tax agents, and so on) that are willing to participate and cooperate in developing an effective regulatory regime. These groups then may be able to convince others with whom the ATO has little legitimacy.

‘Scholz (1991b), Ayres and Braithwaite (1991), and Weimer (1992) have emphasised the potential benefits of regulatory agencies working through credible third parties, such as industry associations, professional bodies and trade unions, with which regulatees have ongoing relationships. Such third party organisations often have a substantial interest in preventing the types of non compliance which put their compliant members at a commercial or financial disadvantage.’ (Wickerson, 1995:182).

Recommendation 3.4

The ATO needs to build partnerships with credible groups within the Australian community who are affected by the cash economy and involve partners in its decision making about the cash economy.

While the ATO has developed links with tax practitioners and industry and community groups and other Federal agencies it has not specifically addressed the potential for developing partnerships with state regulatory agencies like the State Revenue Offices to assist in addressing the cash economy.

The Task Force considers that there is opportunity for the ATO and state revenue authorities to work together in relation to group tax and pay-roll tax compliance as the collection of both of these taxes can be compromised by cash transactions. A combined approach would also be beneficial to the taxpayer and reduce the compliance burden imposed of providing information to the government agencies.

Recommendation 3.5

Enhance linkages between the ATO and state revenue authorities.

CHAPTER 4: ENCOURAGING AND SUPPORTING COMPLIANCE

Background

The traditional approach for revenue authorities has been to focus on fear as the motivation for compliance. More recently, the ATO has balanced this approach with the view that generally people will comply if they understand their obligations and it is easy for them to do so. For example, TaxPack and record keeping reviews have been introduced by the ATO to assist taxpayers. In addition, the ATO has increased its focus on assisting new businesses in all matters relating to taxation. The objectives of this assistance is to encourage taxpayers to develop a range of compliant behaviours and sound business habits.

The Taxpayers' Charter is another important initiative that will help the ATO gain community confidence in its operations. Treating taxpayers according to their individual circumstances is a key theme of the Charter. If the community perceives the ATO to be fair and professional, compliance will improve.

As part of the cash economy initiative the ATO has released identikits of various cash industries such as segments of the building and construction industry, restaurants and taxis. These identikits, which have been sent to tax agents, are benchmark ratios of businesses and can be used by tax practitioners to work with their clients to increase voluntary compliance in cash industries. They will also be used as one of the tools to help guide ATO field activities.

However, the Task Force considers that there are still few real or perceived benefits to be gained by declaring all cash income or in reporting tax evasion by others. The ATO still needs to formulate further incentives that will encourage taxpayers to comply with their obligations.

Incentives may be conferred upon a specified target of regulation to induce compliance (for example, a taxpayer) or upon third parties for assistance in achieving compliance (for example, tax practitioners and industry associations). Incentives can be material in nature or they can entail a non-material consideration. Material incentives are by definition costly. Non-material incentives, on the other hand, have the advantage of encouraging a taxpayer to focus on the moral rather than material aspects of compliance.

As with other regulatory mechanisms, incentives are unlikely to be universally applicable or desirable. The ATO needs to be mindful of the strengths and weaknesses of any incentives and identify situations where they may be employed to greatest advantage to achieve voluntary compliance.

Valuing Taxpayers Who Do The Right Thing

The Task Force suggests that the ATO needs to focus on simple approaches like providing acknowledgment to taxpayers for good compliance. The Task Force considers that if taxpayers feel that their good compliance performance is appreciated by the ATO they are more inclined to comply with their legal taxation obligations.

Acknowledgment could be as simple as the tone of the voice of the ATO staff dealing with a taxpayer or tax agent, or a letter thanking the taxpayers for their assistance in ensuring that their tax obligations have been fulfilled.

Follow-up contact with taxpayers who have been visited by the ATO (for record keeping reviews, audits etc) thanking them for their efforts to comply and asking if they require any additional assistance is also seen as an important part of improving taxpayers attitudes towards meeting their obligations. This approach would help taxpayers feel that they are recognised as an individual rather than a number. Also taxpayers would feel that the ATO is aware of them.

This type of approach should begin to challenge the ‘us and them’ mentality which currently exists between the community and the ATO. This will encourage the community to volunteer information about their own affairs or their concerns about tax evasion knowing that their assistance is appreciated and valued.

The Task Force recognises that the above mentioned measures are consistent with the standards of service contained in the Taxpayers’ Charter. However, new initiatives like the Taxpayers’ Charter and Standards of Conduct for the Tax Profession will only be successful if all parties adhere to them and make them work.

Recommendation 4.1

The ATO ensure that client contact is consistent with the service standards and code of conduct expressed in the Taxpayers’ Charter.

Recommendation 4.2

The ATO review its communication with taxpayers to improve the quality and tone. Communications should acknowledge the assistance provided by taxpayers in complying with their tax obligations.

The ATO's commitment to the Taxpayers' Charter is demonstrated in initial results from the Problem Resolution Service (PRS) which was introduced in conjunction with the Charter. The initial results from the PRS indicate that the ATO internal review mechanism is effective in resolving disputes. The impact of these results needs to be better understood by the ATO and utilised to enhance its performance when dealing with taxpayers.

The number of complaints, however, has been relatively low. The ATO should develop programs that give taxpayers a better understanding of their rights under the Charter. Promoting the fairness of treatment received by taxpayers should act as a positive inducement to the community.

In addition to the PRS, the ATO should take steps to ensure that it obtains direct and timely feedback from taxpayers as a basic part of its day to day operations. For example, follow-up contact with taxpayers visited by ATO field officers should be made to assess the professionalism of staff and the impression they have left with taxpayers.

Recommendation 4.3

The ATO develop a methodology whereby it can obtain direct and timely feedback from taxpayers on the professionalism of its operations.

Business Assistance

New business

Each year around 200,000 new businesses start up across Australia. Each of them is faced with fulfilling a wide range of obligations including the completion of registration forms, securing permits, signing leases and arranging insurance and finance.

Their taxation responsibilities alone could include applying for a tax file number, lodging an income tax return, registering as a group employer, establishing an acceptable set of business records and deciding on a suitable business structure. They may be involved in Prescribed Payments, Sales Tax, or Fringe Benefits Tax. They could also be affected by Superannuation Guarantee or need to know about Reportable Payments.

The ATO has recently established New Business teams to provide assistance to the new business person in all matters relating to taxation. The objective of the New Business area is to encourage people in business to develop a range of compliant behaviours and sound business habits. Many of these practices are consistent with the efficient operation of any business and will significantly contribute to the successful operation of the enterprise.

The assistance provided by New Business teams can take on a variety of forms including Bizstart seminars, publications and the provision of technical advice (all free of charge). The ATO website – ATO Assist – also has a variety of information for small business people.

The Task Force believes that it is important for the ATO to make contact with new businesses in cash industries as soon as possible to provide the necessary support and advice as the business is

being established. This approach will assist in developing a relationship of trust and respect between the business person and the ATO and will reduce the possibility of new businesses developing unacceptable business practices which can adversely effect business performance and place compliance at risk.

Helping and educating

The ATO has Small Business Advisers who are able to visit people in their own home or business premises. The Adviser is able to provide assistance and advice on matters ranging from registration, record keeping and payment requirements to the expenses that can be claimed on tax returns. The Business Adviser is also able to provide ongoing support and advice either by phone or personal visit on the range of taxation matters affecting the new business person.

The ATO's helping and education role is an important positive strategy. It can improve both community perception and voluntary compliance. When the ATO's helping role is emphasised the community may see the ATO as fair and approachable even if people do not accept that all of their obligations are reasonable.

The Task Force considers taxpayers will respond positively to relatively unintrusive educational strategies which are designed to foster improved compliance. The challenge for the ATO is to further develop and apply its knowledge about business so that it can better target and address the educational needs of particular types of taxpayers.

Simply promoting the advantages of obtaining business and tax advice when visiting businesses would benefit the ATO and taxpayers. The aim of this approach would be to demonstrate to business that effective financial advice can generally improve the performance of the business and alleviate the need to participate in the cash economy. It would also help break down taxpayer attitudes that the ATO is not genuinely interested in the health of small businesses.

In addition, the ATO should consider sponsoring small business tax advice services tailored to cater for particular market segments, which could be conducted by tax practitioners, industry associations or community groups.

The Task Force considers that the ATO should also evaluate the merit of developing, or sponsoring the development of, booklets and computer software packages for industries which outline the typical tax obligations which apply to businesses in particular industries. These would complement the range of material which is currently prepared by the ATO to assist business meet their tax obligations

Recommendation 4.4

The ATO refine its help and education role and tailor it to particular industries.

Record Keeping

Some form of record keeping is essential for all business operations and is one of the most important elements of running a successful business. For example, research into small business in Australia shows concluded that one of the reasons that small businesses fail is inadequate, inaccurate or non-existent books and records.

The extent, nature and detail of the records maintained will depend on the type of business and the information required.

Records provide feedback on the effectiveness and profitability of operations on a regular basis. Good records enable a business to analyse growth and identify new opportunities. More importantly, good records provide evidence for the true value of a business. With regard to taxation, good records lead to more accurate reporting of income and expenses in business tax returns.

Record keeping is an essential element of business meeting its tax obligations. Taxpayers are required to retain records which are relevant to the calculation of their taxable income, including records that verify claims for deductions. Where a taxpayer does not comply with the record keeping requirements they are liable for a fine or conviction under the ITAA and the TAA.

From a practical perspective, where a business keeps good records it is quite likely that when these records are taken to the tax agent at the end of the year, the tax agent will have all the information needed to accurately complete the tax return. If good records are not kept there are numerous adverse consequences for the taxpayer including the accountant preparing an inaccurate tax return and the taxpayer having to spend a lot of time and energy trying to recreate the records.

The ATO undertakes a record keeping program to improve the quality of reporting by taxpayers. Currently this program is focussed on new businesses. The program is primarily an education initiative that seeks to improve business practices and to increase taxpayer compliance by encouraging more complete and comprehensive record keeping practices by small business operators. A major objective of real time reviews is also to ensure proper record keeping practices are in place.

Importantly the ATO should ensure that its record keeping programs and real time reviews take into account the practical operations of business to ensure the record keeping advice provided is relevant to different types of taxpayers. Industry participants should be invited to work with the ATO on tailoring record keeping advice for particular market sectors.

The Task Force considers that the ATO should further promote the benefits to be obtained from good record keeping practices and consider introducing additional education programs (for example, public tax workshops on maintaining books and records). In particular, the ATO should explore opportunities to enlist tax professionals and industry representatives to conduct these promotional and educational programs.

Recommendation 4.5

The ATO explore opportunities for conducting public education programs on good record keeping to complement the record keeping reviews and real time reviews currently undertaken.

Recommendation 4.6

The ATO:

- (a) in consultation with industry specify record-keeping requirements for particular industry groups.**
- (b) work with industry and community groups to promote the benefits of recording cash transactions other than for taxation purposes.**

Industry Benchmarking

For the first time the ATO has released financial ratios of various cash industries such as building and construction, restaurants and taxis. The ATO has released this information to give professional bodies, industry associations and tax agents a better understanding of their industry. For example, this information can assist business operators and their advisers identify areas for improved management practices such as identifying high cost items, poor return on assets. The ATO also uses this information to understand the characteristics of different types of businesses. This helps the ATO in its risk management, education and compliance activities.

Feedback received by the ATO from tax agents has been positive as shown by case study 4.1 below.

Case Study 4.1 Accountant supports the benchmarks

One firm of chartered accountants, Grant Thornton, is delighted with the benchmarks. A tax partner with the firm, Mr Jim Morrison, said that public benchmarks had been around for a long time, but were based on small sample sizes. The value of the ATO's benchmarks is that they are based on an enormous sample size and therefore should be more reliable than public benchmarks.

He said that these benchmarks would be useful in assessing the performance of a small business. "These benchmarks could become very valuable. The ATO is doing the business community a considerable service by releasing this information."

(Financial Review, 1st Edition, Tuesday 10 February 1998; p22)

The ATO has indicated that the current financial ratios are preliminary figures and it will be working with professional bodies and the business community to maximise their usefulness. This includes releasing benchmarks for a further range of industries and calculating geographic breakdowns and turnover ranges.

The Task Force is reassured by the ATO's acknowledgment that the financial ratios are just one of the tools that should be used to decide which businesses warrant further attention. The ratios should not be used in isolation and other factors need to be taken into account when applying the ratios. For example, is the economy depressed or is the business located in an area with high unemployment?

At present, industry benchmarks focus on relatively few industries where the ATO believes cash is a major component of trading. However, there are numerous opportunities to expand both the coverage and type of benchmarks.

Recommendation 4.7

The ATO work with industry and community groups to maximise the benefits from the industry benchmarks.

Increased Flexibility In Compliance Strategies

The ATO already has in place and makes use of various compliance strategies, such as penalties, audits and, infrequently, prosecutions. However, the enforcement strategies currently used are not applied consistently on an escalating basis of severity. Also, they tend to be applied in a routine manner without taking into account taxpayer's particular circumstances.

There are few options for either the ATO staff or the taxpayer if taxpayers do not fulfil their obligations by the due date. Enforcement strategies tend to be applied in a routine manner without taking into account circumstances which may create difficulty for individual taxpayers or for particular industries to meet their taxation obligations.

The compliance model, which advocates an escalating range of options and sanctions, requires the ATO to make the assumption that the majority of people are 'good citizens' and would be willing to comply if they understood the tax system and were treated fairly and with trust. Positive reinforcement for compliance will help to reinforce the benefits of cooperation. It also requires the ATO to put in place, and to make it known, that if its trust is breached the ATO will strengthen enforcement methods as necessary.

The compliance model requires that the ATO forgive past poor behaviour - a taxpayer should not be labelled and continually persecuted just because they were punished in the past if they now agree to voluntarily comply. In most instances, they should simply be subject to the same enforcement approaches as any other taxpayer. Where there is a high risk of further offences they could be subject to monitoring or increased supervision.

The ATO needs to work with those taxpayers who generally set out to do the right thing to make it easier for them to meet their responsibilities and to make it harder for others to avoid them.

The Task Force considers that most taxpayers generally set out to do the right thing. The ATO could recognise past "good" compliance behaviour when assessing whether penalties or further enforcement activities are appropriate. For example, where the ATO discovers inadvertent errors during an examination of a taxpayer's affairs, the focus should be on ensuring future compliance and not on imposing penalties. Follow-up contact to ensure that errors are no longer being made could be more effective than a one-off adjustment and penalty.

Recommendation 4.8

The ATO recognise past "good" behaviour when imposing penalties or deciding to escalate enforcement.

The Task Force considers that to deal effectively with tax evasion in cash businesses it may be necessary for the ATO to require more information to be lodged with tax returns and required to be kept in business records (for example, to enable financial ratio analysis). This may involve additional items to be completed on the return form, attachments of specific schedules or attachment to financial statements.

Rather than applying differential reporting requirements across the board, it may be more appropriate to require additional information from taxpayers whose returns appear abnormal when compared to similar type and size businesses or at least from taxpayers who have been found to be non compliant. This appears to be the thinking behind the Blue and White tax returns in Japan that reward good compliers with reduced reporting requirements.

The ATO should consider relaxing regulatory requirements for taxpayers with exemplary compliance records. For example, taxpayers or industries which have a history of compliance, have an approved compliance program in place, or which subject themselves to a regular compliance audit by an independent assessor would be eligible for less onerous record keeping obligations and allowed to complete a simpler return form.

Recommendation 4.9

The ATO further explore opportunities for introducing differential record keeping and taxation reporting requirements.

Incentives For Recording Cash Transactions

The Task Force considered several proposals aimed at increasing the visibility of cash transactions by creating auditable records which would be available to tax officers looking to identify understated income.

These ideas included proposals to compensate businesses for their compliance costs. One proposal suggested financial payment to businesses that meet the tax obligations they incur as third parties, such as PAYE, PPS remittances and lodgment of stationery. The Task Force does not support this

approach. Provided government makes genuine attempts to keep the costs of regulation to a minimum, business operators should be prepared to fulfil their lawful obligations. However, the ATO has a role to ensure that its approach to administration keeps the compliance costs for third parties to a minimum. In any case, the introduction of a ‘fee for service’ would require additional administration and more interaction between business and the ATO.

A proposal designed to encourage consumers to insist on receipts for cash transactions suggested that the government allow for lotteries to be run that would offer prizes to holders of receipts. Another proposal involved the government allowing tax rebates for expenditure on household services. The Task Force is not yet convinced that any of these approaches is viable.

These proposals may result in a greater recording of cash transactions and, to some extent, may also dissuade businesses from not declaring income. However, unless there are cost effective ways for the ATO to access these transactional records, these proposals will not assist in income matching activities. The Task Force is not yet confident that the cost to government of providing incentives and the costs to business and government of introducing the infrastructure necessary to capture and process transactional records are justified in light of the potential benefits.

The Task Force considers that the ATO should continue to identify and evaluate additional proposals that may provide incentives for taxpayers to comply.

In the meantime the ATO needs to better promote that one of the most effective counter measures to money laundering and tax evasion is for citizens and organisations to take steps to establish the identity of the people they transact with and to keep adequate records of the transactions such as invoices and receipts. Consumers should also be informed of the importance of keeping invoices or receipts of transactions to protect claims under warranties or for defective goods and services.

Recommendation 4.10

The ATO continue its research to identify cost effective incentives that motivate taxpayers and third parties to declare cash income and document or report cash transactions.

Targeted Amnesties

Tax amnesties seek to obtain improved compliance outcomes, generally in return for indemnity from prosecution or whole or partial remission of monetary penalties that would otherwise apply. Tax amnesties are usually instituted to seek improved outcomes in terms of:

- taxpayer registration;
- lodgment of tax documents (e.g. income tax returns);
- reporting of correct information in tax documents (e.g. unreported income, overclaimed expenses); or
- payment of outstanding taxes.

Amnesties have also been used in other areas of public administration, including social security overpayments, immigration offences and firearm registration.

Tax compliance literature indicates that an amnesty must offer incentives, and that these incentives should contain both reward and consequence components — reward for taking up the amnesty offer, and consequences for not taking up the offer. As mentioned above, the reward component is generally a reduction or elimination of penalties that would normally apply to non compliant behaviour. The consequence component is generally a credible threat that, after the amnesty, non-compliant behaviour will be detected and dealt with severely. In the United States, state taxing authorities have generally held amnesties just prior to increasing enforcement activity or making significant changes to the tax system (in particular, the introduction of more severe penalty regimes).

While there is no direct evidence about their impact on the cash economy, there is evidence that amnesties can play a significant positive role in improving compliance given the right conditions.

An amnesty targeted at the cash economy could cover:

- unreported cash receipts;
- false records;
- failure to lodge returns;
- outstanding tax payments; and
- compliance with Sales Tax, PAYE, PPS and RPS obligations.

Experience suggests that including social security, studies assistance and perhaps other government programs in a wider-than-tax business amnesty could provide significant benefits to business, the government and ultimately the community. It seems desirable to include social security at least in an amnesty for the cash economy.

Naturally, taking advantage of the amnesty would not prevent a business from being subsequently audited. In fact, it is important to ensure that a proportion of businesses using an amnesty are subjected to subsequent scrutiny to ensure that the amnesty is not used to deflect ATO attention

away from serious non-compliance. It would be expected, however, that businesses using an amnesty would make the most of the opportunity to 'come clean', and subsequent scrutiny should find no significant non-compliance.

The success of an amnesty is dependent on the ATO's ability to detect and follow up those taxpayers who do not participate in the amnesty. Therefore, prior to the amnesty the ATO should conduct extensive research and benchmarking and should also encourage community tip-offs in order to enhance the ATO's follow-up effectiveness.

Accordingly, the Task Force supports the use of targeted amnesties to address non compliance in the cash economy provided the ATO can mount effective communication and enforcement activities.

The Task Force considers that:

- the most appropriate approach for the ATO would be to offer amnesties on an industry basis where that industry has been the subject of a comprehensive risk assessment;
- there should be a specific limited time frame imposed;
- up-front activity be conducted to identify the problem and demonstrate the ATO's intention to follow-up;
- to be effective the amnesty would need to be across the whole of government; and
- it is imperative that the amnesty is supported by an effective communication strategy.

Recommendation 4.11

Targeted amnesties be considered as part of an integrated approach to improving compliance in the cash economy.

Industry Self Regulation

The Task Force does not believe that the ATO is solely responsible for dealing with tax non compliance. For example, in many cases the victims of tax evasion are other businesses and their employees who are subject to unfair price competition.

Industry and community groups should be encouraged to develop their own solutions to the problems posed by the cash economy that affect them. The ATO could provide important support to help such initiatives succeed.

An example of a community proposal is demonstrated in the following case study.

Case Study 4.2 - Innovative community solution in the clothing industry

The Springvale Indo Chinese Mutual Assistance Association has proposed to establish a clothing industry cooperative which could contract directly with wholesalers for the supply of garments. The cooperative would distribute the work among its members who would undertake the various tasks associated with clothing manufacture (some elements, such as pressing, where there is a requirement for substantial capital equipment, may be sub-contracted to other parties). In this way the current informal structure involving a significant number of "middlemen" could be obviated thus allowing the homeworkers to be realistically compensated for their efforts with the normal rights of employees being respected.

While it is not the ATO's role to implement the cooperative proposal, the Task Force believes that the ATO could investigate how it could assist to encourage, influence or promote, the establishment of such arrangements in the industry.

The Task Force considers that the accreditation requirements, currently before the Parliament, to combat sales tax fraud in the PC retail trade is another innovative approach that recognises that specific industries may require specific solutions. The Task Force acknowledges that this approach, with its increased compliance burden on innocent taxpayers and more onerous legislation, is only possible because of the industry requests for its implementation but considers that it demonstrates the benefits that can be achieved by working closely with industry.

Recommendation 4.12

The ATO work with business to develop innovative industry specific regulatory solutions.

CHAPTER 5: ENFORCING COMPLIANCE

Background

The Task Force concluded in its first report, 'that there is a growing perception that the rewards to be gained from engaging in the cash economy outweigh the risks of getting caught'. The factors contributing to such a perception include:

- the nature of cash provides the opportunity for evading tax as it is difficult to trace;
- the level of ATO visibility in the community (particularly contact with taxpayers) is low;
- infrequent publicity of prosecutions for tax offences; and
- penalties for tax evasion are not perceived as severe as there is little likelihood of a gaol sentence or public criticism;

The Task Force's opinion is supported by the results from the latest ATO corporate survey which indicate that more than half of the population believe that an increasing number of cash transactions are being concealed from the ATO and that these transactions are unlikely to be caught. This research confirmed that taxpayers tolerate and even reinforce tax evasion at its most basic level - through the cash economy.

The Task Force is also concerned that the range of enforcement options available to the ATO is not wide enough to deal with the different motivations that influence taxpayer behaviour. The ATO needs to identify additional enforcement options so that it can more appropriately respond to the different circumstances that affect taxpayer behaviour. Taxpayers also need to have greater certainty that enforcement options will be applied consistently, escalating only where lesser options have proved unsuccessful in changing compliance behaviour.

Widening Financial Transaction Reporting Requirements

There will always be opportunities to use cash and new payment technologies in ways that avoid the reporting requirements prescribed in the *Financial Transactions Report Act 1988* (FTR Act). However, these reporting requirements are of great value to the Australian Transactions Reports and Analysis Centre (AUSTRAC) and the ATO in combating tax evasion and money laundering in the cash economy. To maximise the effectiveness of financial transaction reporting there is merit in considering upgrading the current reporting requirements under the FTR Act. The Task Force has examined a number of areas where there may be value in extending financial reporting to achieve a more flexible scheme of monitoring for 'transaction activity' types which more readily meet the core purposes of the FTR Act.

In considering any proposal to extend the FTR Act reporting requirements, the following approaches could be adopted to:

- broaden the current cash dealer categories;
- broaden the range and level of report types; and
- maximise the use of the data.

The Task Force believes that careful consideration should be given to extending financial reporting requirements under the FTR Act in the following areas:

- Extend the range of cash dealer definitions provided in the FTR Act so that potentially any business that handles large volumes of cash may be considered to be a cash dealer. In the first instance the definition should be expanded to include all car dealers and travel agents. The range of cash dealer definitions could be extended to other categories on a priority basis as further evidence is collected on cash practices.
- Broaden the FTR Act to require cash dealers to report credit card and smart card transactions which exceed the \$10,000 limit imposed for significant transactions.
- Broaden the FTR Act to require reporting of certain negotiable instruments because of concerns that the international transborder movement of travellers cheques, bank drafts, bearer bonds and other negotiable instruments provides opportunities for tax evasion and money laundering.
- Any extension in the range of reports in relation to non-account customers of cash dealers should be accompanied by identification requirements consistent with those that apply currently to the opening of bank accounts (ie. 100 point verification).
- Require cash dealers to report TFN details in conjunction with reports where the TFN is held (for example, banks) by the cash dealer. Where a TFN is not held, a unique identifier like an ACN, passport number, or drivers' licence number could be provided.
- Require the identification of persons involved in International Funds Transfer Instruction Reports to be provided to AUSTRAC under the FTR Act.
- Solicitors be required to report suspect transactions and not just significant cash transactions (equal to or greater than A\$10,000) to which they are party.

The Task Force believes that consideration of any of the above proposals should be accompanied by extensive consultations with industry groups and their representatives, and any other groups within the Australian community, upon whom the proposals may impact.

Recommendation 5.1

Consideration be given to amending the FTR Act to broaden the cash dealer categories and the range and level of report types. Any consideration to amend the FTR Act should be accompanied by consultation with industry bodies and their representatives.

In addition to extending the FTR Act reporting requirements processes aimed at improving integrity of AUSTRAC data need to be refined. The Task Force considered that this may include the secondment of ATO staff in the short term or implementing approaches whereby ATO field staff check compliance with FTR requirements.

Recommendation 5.2

AUSTRAC data be more strategically utilised by the ATO to identify high risk cash transactions.

Withholding and Reporting Systems

Withholding systems are effective tax collection mechanisms due to their inherent ability to collect tax at the point income is earned, promote voluntary compliance through third party reporting and ensure stable and timely cash flows to government. Reporting systems also assist to prevent tax evasion by requiring the reporting of income payments to the ATO by the person making the payment.

The ATO currently has two systems in place to try to obtain payment information from taxpayers who are not covered by the Pay As You Earn (PAYE) system.

The Prescribed Payments System (PPS) was introduced to collect income tax at source from certain prescribed payments for work or services in specified industries such as building and construction, road transport and cleaning. Industries were identified for inclusion on the basis of a history of poor compliance and a high level of cash transactions.

The Reportable Payments System (RPS) was introduced in 1994 as a way of preventing tax evasion in other high risk industries that were not captured by PPS. RPS was introduced in the clothing and fishing industries in late 1994, extended to smash repairers in late 1995 and from 1 March 1997 applies to fresh fruit and vegetable suppliers.

The targets of both systems are similar - industries with a poor record of tax compliance, particularly in terms of omitted income.

The Task Force considers that there are currently several impediments limiting the effectiveness of PPS and RPS. These include:

- the limited coverage of industries by PPS and RPS; and
- the apparent incongruity of the community maintaining two systems that ostensibly perform the same functions, but are administered differently.

The Task Force acknowledges the cost effectiveness of withholding and reporting systems. However, it needs to be recognised that they impose obligations on businesses that do the right

thing. The systems work because these businesses help bring to account the income of others in their industry who may fail to declare it. Any proposals to extend withholding or reporting systems need to demonstrate that the burden imposed on third parties is justified in terms of the benefits of increased compliance, taking into account reductions in unfair price competition within the industry and increased revenue.

The Task Force believes business will support increased obligations provided they are confident that the unfair commercial advantage enjoyed by non compliant taxpayers is removed.

Consistent with the compliance model, the ATO may need to consider innovative ways of modifying the PPS and RPS requirements so that payments in additional industries can be captured. Generic solutions across industries may not be appropriate in every case.

The apparent incongruity of having different systems that perform the same functions may be reduced if, as a general principle of tax administration, it is accepted that reporting systems, with or without withholding at source, are an appropriate response to systemic non compliance. This principle would suggest that the introduction and removal of specific withholding or reporting obligations should be responsive to the level of compliance.

Any extension of withholding or reporting systems to additional high risk areas should be based on an analysis of:

- Levels of non-compliance within industry;
- Nature of the non compliance;
- Cost/benefit ratio for industry;
- Ability of payers to report electronically;
- Industry support for arrangements - what's in it for them;
- Demographics of industry – diversity; and
- Sophistication of payers' record keeping systems.

Recommendation 5.3

Extending withholding and reporting requirements to additional high risk industries ought to be considered where the benefits of increased compliance - taking into account reductions in unfair price competition within the industry and increased revenue - outweigh the burden imposed on third parties.

Any proposal to extend obligations should be undertaken in consultation with industry.

Increased Visibility Of Enforcement Activities

The ATO can increase visibility in various different ways. One option for the ATO is to increase visibility by increasing enforcement activity in high risk areas. The ATO has adopted such an approach in the cash economy by redeploying additional staff in a range of high cash industries.

Increasing enforcement activity is, of course, always subject to the resource constraints on the ATO and the need to deal with a variety of compliance risks. The Task Force acknowledges that the resources which have already been allocated by the ATO to address the cash economy is a positive response to the enormous problems it represents. By adopting an industry based approach the ATO should maximise leverage from its enforcement activities.

The ATO needs to complement direct enforcement activity with indirect measures aimed at reducing taxpayer perceptions that the rewards for tax evasion are outweighed by the risks. Leverage can be obtained from publicising, on a regular basis, case studies and other enforcement results in industry association publications and accounting and business journals. The case studies could contain detailed profiling of tax evasion practices detected during field visits.

Publicising enforcement activities and results in industry and business publications should 'personalise' the enforcement activity and ensure industry participants are conscious of the fact that the ATO has the strategies to detect and punish non-compliance. The publication of case studies may also encourage taxpayers to come forward with information concerning non compliant taxpayers in their industry knowing that the ATO has effective strategies in place to "level the playing field" and deal with competitors that are obtaining an unfair advantage.

The strategies that the ATO adopts in particular industries also need to be publicised. This information can outline why particular industries are being looked at and explain the approaches that will be followed.

An approach which communicates at the outset the strategies being employed by the ATO and the likely consequences of detection could help lessen the 'us and them' mentality which currently exists between taxpayers and the ATO. If taxpayers are kept fully informed of the ATO's approaches they should not be surprised or aggrieved by the consequences if they are found to be non compliant.

Recommendation 5.4

The ATO publicise enforcement activities and results in industry and community publications.

Role of the Judiciary

The judiciary has an important role to play, as a final arbiter, in assisting the community to combat the cash economy. In particular, the effectiveness of ATO strategies aimed at curtailing tax evasion rely on the judiciary imposing penalties that reflect the seriousness of tax evasion.

In a recent court case a Victorian County Court Judge, Judge Neesham, said that ‘the community is fed up with people who don't face up to their tax responsibilities.’ Judge Neesham went on to say that ‘to defraud the Commonwealth is not to defraud some abstract concept; it is to deliberately defraud one’s neighbours. They are the people who are forced to carry the burden, whereas dishonest people ... seek to avoid the liability placed upon them.’ He went on to say that the penalties imposed should act as a deterrent to others.

The above comments reflect that at least some elements of the judiciary do take tax evasion seriously and consider it a crime against the community. Such support from the judiciary will complement efforts by the ATO to reduce tax evasion.

The ATO should continue to pursue offences through the courts and should seek penalties that are commensurate with the nature of the offence. Successful convictions should convey to tax evaders that the community is not prepared to tolerate taxpayers who fail to comply with their tax obligations.

Recommendation 5.5

The ATO review the perceived effectiveness of its approach to securing prosecutions and convictions for tax evasion. The ATO should consider working with the judiciary to emphasise the community costs of tax evasion.

More and Escalating Regulatory Options

The Task Force considers that the ATO's preferred strategy should be to promote voluntary compliance as it imposes the least burden on everyone. However, taxpayers or industries who are unwilling to comply or are tempted to exploit the privilege of voluntary compliance must understand that the ATO is willing to increase the level of enforcement.

Where the situation requires, the ATO must have the capacity, and be prepared to, deliver swift and effective punishment. Therefore, the ATO is encouraged to review sanctions with the aim of developing greater variety in its sanctions and at the same time making the penalties more certain and severe for prescribed serious offences.

According to Ayres and Braithwaite (1992), the greater the perceived power of a regulator the greater the likelihood of persuading taxpayers to engage in voluntary compliance. Tougher

penalties for the most serious offences would help establish the ATO's credibility and 'aura of power' provided the ATO is seen to be able to consistently apply these penalties.

The imposition of sanctions should be dependent on taxpayers' circumstances and each taxpayer should be treated as an individual. The aim is to make the system fairer and simpler and acknowledge past performance.

Recommendation 5.6

The ATO review the appropriateness of current sanctions with a view to increasing the range of sanctions available to the ATO and develop:

- (a) a more flexible regime for minor offences; and**
- (b) more severe sanctions for serious offences.**

The Task Force has examined a number of proposals that may help provide the ATO with a greater variety of enforcement options.

On-The-Spot Fines

On-the-spot fines for failure to keep adequate records may be a way of increasing the likelihood of taxpayers receiving a penalty for non compliant behaviour. There would need to be very specific requirements outlined before fines could be introduced so as to avoid arbitrary imposition of the fines. Guidelines would also need to be created which specify the obligations and liabilities of the taxpayer and the tax agent.

Fines could, for example, be introduced in the taxi industry for inadequate record keeping as Taxation Ruling TR 96/11 outlines the record keeping requirements which need to met by that industry. It would be possible to impose fines for specific behaviour which does not comply with the requirements of the Ruling. This approach could be extended to other cash industries as consultation with industry and feedback from field work identifies the appropriate records to be kept for each industry.

To ensure fines are not open to abuse or undermine taxpayer trust in the ATO, an independent body could be established to review the fine which has been imposed. This could be comprised of industry peers.

If fines are to be introduced there would need to be extensive consultation with industry associations and representatives to identify the specific rules governing their imposition.

Recommendation 5.7

The imposition of on-the-spot fines for prescribed offences should be further explored by the ATO.

Default Assessments

The Task Force considers that there is the potential for the ATO to use industry benchmarks as proxy income measures to establish a tax liability. Such measures have already been developed for the taxi industry. Using proxy income measures to raise default tax assessments may be appropriate where a business fails to maintain reasonable records. For the ATO to take this step, it will need to ensure the benchmarks are sufficiently accurate and have credibility with industry and tax professionals.

Recommendation 5.8

The ATO does not use industry benchmarks to raise default assessments until it is confident that the benchmarks are credible.

Prescribed Records

A further alternative would be for the ATO to introduce more onerous reporting requirements for taxpayers or industries who have had significant omissions of cash income detected during field visits. The purpose of requiring these records would be to increase the capacity of the ATO to identify cases of undeclared income. The additional compliance costs would also act as an additional deterrent to non compliance.

The prescribed record keeping requirements could include the ATO mandating the use of approved accounting hardware (for example, cash registers) or computer software to ensure cash transactions are recorded by non complying taxpayers.

The Task Force emphasises that the cash economy presents itself differently depending on the industry or the situation. Therefore, any proposal prescribing the nature of the records to be maintained should be developed on an industry-by-industry basis. It is unlikely that the ATO could implement common requirements across all cash industries without unnecessarily increasing the compliance burden on taxpayers who are currently fulfilling their legal obligations.

Recommendation 5.9

The ATO explore opportunities to make current record-keeping requirements more onerous for taxpayers who have had significant omissions of cash income detected by the ATO.

Compulsory Education

As an alternative to financial sanctions, first and minor offenders could be required to attend compliance seminars and training which are conducted by the ATO or by alternative service providers specified by the ATO (for example, tax practitioners). Attendance would be compulsory (similar to community service penalties) and taxpayers would be advised that failure to attend or repeat offences will be more severely punished.

Recommendation 5.10

Compulsory education be introduced to complement current enforcement strategies.

Naming Tax Offenders

Publicising taxation prosecutions and penalties is argued to be effective in shaming taxpayers into compliance. It is also regarded as having a substantial community impact and therefore acting as an important deterrent to other taxpayers. The National Crimes Authority publicises offenders in its Annual Report. The ATO could adopt this approach and publish the names of taxpayers who have committed serious tax evasion offences in the Commissioner's Annual Report to Parliament.

Recommendation 5.11

The ATO consider naming serious tax offenders in the Commissioner's annual report.

Reintegrative Shaming

The ATO should also consider reintegrative shaming programs similar to that which is being trialed for drink driving offences in the ACT and not only focus on public shaming. Public shaming by itself may have a negative effect as some taxpayers may consider the shaming as unfair. Any re-integrative program would need to involve 'respected' public figures and assist the offender to re-enter the tax system.

The reintegrative shaming theory states that effective sanctioning involves the combination of disapproval of a wrongful act combined with affirmation of the person as a worthy citizen. If disapproval is combined with rejection of the person then sanctioning is unlikely to have the desired effects. Indeed a resistance approach is more likely.

Studies involving juvenile delinquency and nursing home regulations (Makkai and Braithwaite, 1994) have supported the Reintegration Shaming Theory.

Early findings from the Reintegrative Shaming Experiment (RISE) Project currently being conducted at the Australian National University show that people who feel ashamed and sorry about their drink driving offence are those who are aware that others disapprove of them, who have respect for those who are showing disapproval and who are being given the message that even though they have committed this offence they are worthy people who have a positive contribution to make to their families and their community.

Recommendation 5.12

The ATO monitor the research being done on reintegrative shaming theory and consult with relevant experts towards its application to tax offences.

CHAPTER 6: COMPLIANCE IMPROVEMENT IN THE CASH ECONOMY

Background

The problems presented by the cash economy are significant. Expectations of improvement need to be realistic. A level of tax evasion through the cash economy is inevitable. The community needs to consider what level of tax evasion is acceptable.

The complexity of the structural components impacting on the taxpayer, and their interrelationships, will require a long term commitment to the implementation of an integrated strategy. An approach which relies simply on detecting non compliance and imposing sanctions on detected non compliers will tend to be short term in effect and increasingly resource intensive.

To address these issues the Task Force recommends that the ATO implement the compliance model to guide strategy development. The model is integrative and recognises that the ATO needs to develop a holistic and systematic approach to the cash economy. Implementation of the model will enable the ATO to gain an understanding of the underlying structural reasons that lead to tax evasion in the cash economy and the development of appropriate long term solutions.

Implications for ATO Business Operations

The ATO's challenges are to increase compliance while reducing compliance costs, to be efficient and adaptable, and to increase community confidence in its operations.

The compliance model presented in this report is an enabling tool to assist the ATO to better understand compliance behaviour in the cash economy. With a better understanding of what is happening in the market place, the ATO will be able to develop a more effective regulatory strategy for the cash economy which conforms with the Taxpayers' Charter. In this way the ATO can develop solutions that recognise the particular circumstances of taxpayers and the impact of its actions on behaviour rather than the 'one size fits all' solutions that have been prevalent to date.

A strong contention of the compliance model is that the behaviour of the ATO can influence the compliance behaviour of the community. That is, if the ATO takes steps to give the community confidence in the professionalism and integrity of its operations compliance should improve. This notion corresponds with much of the intention of the Taxpayers' Charter.

The community expects fairness and individual treatment. The ATO needs to recognise and differentiate between those trying to do the right thing and those who intentionally disregard their taxation obligations. This will require the ATO to be firm, but also fair, in bringing to account those who are not meeting their obligations.

Adoption of the compliance model does not imply that the ATO is 'going soft' on evasion. While the emphasis is on voluntary compliance, the ATO will have access to an escalating enforcement regime with a hierarchy of sanctions. The ATO's aim is to develop a more flexible method of operation (both in variety and application) while at the same time ensuring that sanctions for serious offences are more certain and severe.

This approach does not mean that all taxpayers will be treated exactly the same. The range of strategies and speed of escalation will be dependent on the particular circumstances of an individual or industry. This reinforces the importance for the ATO that the application of the pyramid be flexible so that it can be responsive to particular industry attributes.

Importantly, the ATO needs to be sure that those already in the system have full knowledge of their obligations and have been given every opportunity to comply. The ATO must be sure that previous good behaviour, or a history of poor behaviour, is acknowledged and taken into consideration in current dealings. The use of stronger enforcement measures on an industry or individual taxpayer will be supported by evidence that lesser measures have proved unsuccessful.

Figure 6.1 depicts the interaction between factors impacting on a taxpayer, the Taxpayers' Charter and ATO enforcement strategies. An understanding of this relationship will assist the ATO to integrate the compliance model into its operations.

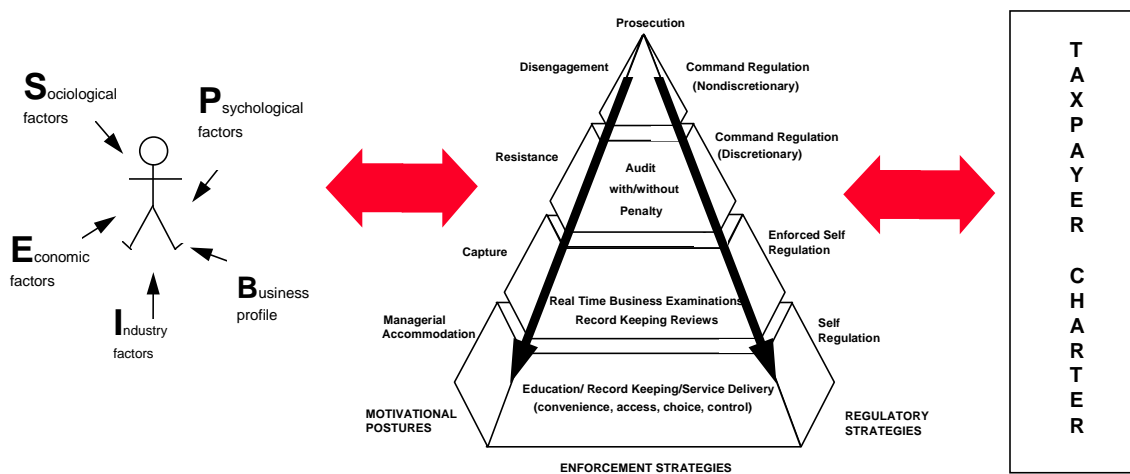


Figure 6.1: Integrating the Compliance Model into ATO operations

A preferred strategy of the Task Force is the need for the ATO to build partnerships with taxpayers through consistent and reasonable behaviour that takes account of their particular needs and concerns. Again there is clear synergy between this thinking and the objectives of the Taxpayers' Charter.

The ATO can not address all the problems that exist in the cash economy on its own. The Compliance Model recognises that encouraging voluntary compliance is the most effective regulatory strategy in most instances.

To encourage voluntary compliance, the ATO needs to enlist the help of tax professionals, industry, government agencies at all levels, and the community and develop networks to ensure that the ATO possesses information so that it can readily adapt to market trends.

By encouraging industry and community participation in ATO decision making the ATO will be able to obtain valuable assistance to achieve voluntary compliance and is more likely to gain community support for proposals to address tax evasion in the cash economy.

In order to influence community attitudes and perceptions regarding the taxation system, an hierarchical enforcement strategy such as the one proposed by the compliance model requires change from within the ATO. This includes ATO staff acting with integrity so that community perceptions of the ATO can be changed. If the ATO is able to foster perceptions of fairness, both procedural and distributive, trust in the institution, and agreement with its mission it may increase the likelihood that citizens will want to cooperate with the ATO and therefore voluntarily comply with their obligations.

Application of the compliance model requires ATO staff to treat taxpayers according to their individual circumstances and this will increase the responsibilities of staff when exercising their judgement. Management will need to ensure that staff have access to appropriate policies, procedures and systems. This will provide challenges for staff and management of the ATO.

The effectiveness of the compliance model is dependant on the level of commitment of the ATO and its staff in making it work. If the ATO is to foster a workforce whose attitude and behaviour in all dealings with the community will be consistent with the principles and practices encapsulated in the compliance model and the Taxpayers' Charter, it will need to undertake a comprehensive program of involvement, education and training.

Recommendation 6.1

Implementation of the compliance model be accompanied by an effective training program for staff and management of the ATO.

Appendix 1 - Theoretical Framework of the Compliance Model

The work of Dr Valerie Braithwaite, on motivational postures and trust norms, and Professor Ian Ayres and Professor John Braithwaite, on strategies for regulation, has strongly influenced the development of the compliance model which could be applied by the ATO to improve voluntary compliance in the cash economy.

Taxpayer Motivations

Dr Valerie Braithwaite describes four motivational postures which outline the degree of acceptance or rejection a regulatee has towards the regulator:

- managerial accommodation - incorporation of regulatory standards into management plans;
- capture - acceptance by regulatees of standards, faith in regulators;
- resistance - a confrontational approach;
- disengagement - withdrawal from the regulatory process.

Those with a posture of capture and managerial accommodation are generally compliant, and resisters and disengagers are non compliant.

The degree to which a regulator and regulatees agree on goals and how best to achieve them is an important factor in the acceptance or rejection of a regulator. In her work on postures within the regulatory community, Dr Braithwaite (1995) believes consideration should be given to the social bonds of trust and respect in the development of shared understandings about legislation and compliance.

Dr Braithwaite (1996) states that being trusting and trustworthy are valued in our society, are motivational, and governments that are regarded as trustworthy, procedurally fair and respectful of citizens generate social trust through establishing a social bond or a shared identity.

People are influenced by exchange trust norms or communal trust norms (V. Braithwaite, 1996). Those with exchange trust norms value the importance of social standing and propriety, and regard an organisation as trustworthy if it is predictable, consistent and competent. Those with community trust norms value personal growth and inner harmony and a positive orientation, and regard an organisation as trustworthy if it uncovers their needs, shows concern for their well-being, foresees their difficulties, shares their aspirations, respects them and treats them with dignity. However, for a government to be regarded as trustworthy it must exhibit behaviour which includes both types of norm.

Dr Braithwaite maintains that strategies for improving compliance vary differently for:

- those who see themselves as good citizens and those who see themselves as game players
- those who feel insulted, treated disrespectfully, and those who have been treated with respect
- those who see the regulator as a game player looking after his/her own interests and those who see the regulator as a good citizen acting with integrity.

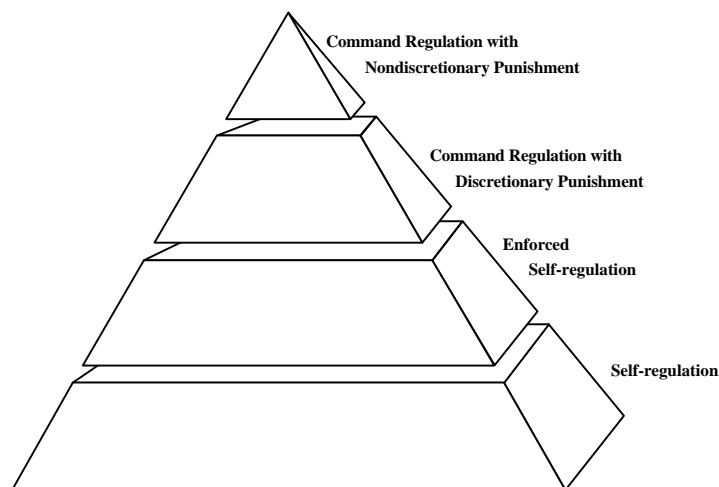
Ideally, if the regulator has integrity and is seen to have integrity, if others are good citizens and the regulator sees them as good citizens, and if regulator and regulatee treat each other with respect, people will try to comply because it is the right thing to do.

However, assumptions that an individual's motives are simple, selfish in a material sense, and stable are incorrect. Individual's motives are complex, constantly fluctuating, and mostly unknown to others. The challenge is not to identify the unidentifiable, but how to encourage the motivation to be a good citizen and constrain the motivation to stray.

Regulation Regime

One way of encouraging compliance was suggested by Professor Ian Ayres and Professor John Braithwaite (1992) using a pyramid of regulatory strategies:

- self-regulation
- enforced self-regulation
- command regulation with discretionary punishment
- command regulation with non discretionary punishment.



Pyramid of regulatory strategies
(Source: Ian Ayres and John Braithwaite, 1992)

Most of the regulatory action will be at the base of the pyramid making use of persuasion and self-regulation. A regulator's preferred strategy is self-regulation as it imposes the least burden on everyone. Those taxpayers, or industries, who are unwilling to comply or are tempted to exploit the privilege of self-regulation must understand that the government is willing to increase its regulatory strategy. The highest level or strategy in the pyramid demonstrates a commitment by the regulator of an intention never to give in. Ayres and Braithwaite (1992) propose that the existence and knowledge of the capacity of the government to get as tough as needed would encourage a more voluntary regulatory climate.

According to Ayres and Braithwaite (1992), the success of a regulator can be predicted by its ability to be responsive to different industry structures and its ability to be a "benign big gun". The benign big gun is the 'nuclear weapon' of a regulator - the threat of an action that is severe and invincible. This threat is real but is kept in the background. It is most effective when used in conjunction with a hierarchy of lesser sanctions. "That is, regulators will be more able to speak softly when they carry big sticks (and crucially a hierarchy of lesser sanctions). Paradoxically, the bigger and more various are the sticks, the greater the success regulators will achieve by speaking softly" (Ayres and Braithwaite, 1992:19).

A study of Australian regulatory agencies who had enormous powers but never, or hardly ever, used them (for example, the Reserve Bank), suggested that "the greater the heights of punitiveness to which an agency can escalate, the greater its capacity to push regulation down to the cooperative base of the pyramid." (Ayres and Braithwaite, 1992).

Regulators must communicate that if there is not cooperation, they have the power and are brave enough to make life more difficult for non-compliers. Individual personalities matter less if everyone knows that the role of a regulator is to be cooperative first and then to introduce sanctions as cooperation breaks down. Widely known rules and enforcement practices make it possible for individual regulators to be cooperative at the grass roots level. Everyone knows that there are heavy punishments there in the background should negotiation and cooperation break down. The strongest enforcement powers and tools need to be in place and visible. The ATO as an institution, rather than as a group of individuals, must be seen to have an aura of power.

A regulator has to be responsive to the actions and motivations of those being regulated. Responsive regulation requires the government to be responsive to different industry structures and the effectiveness of an industry in making private regulation work. That is, government should recognise that different industry structures will be conducive to different degrees and forms of regulation. Government should be attuned to the differing motivations of regulated actors (Ayres and Braithwaite, 1992:4).

Ayres and Braithwaite (1992) introduce the phraseology tit-for-tat (TFT) as representative of the notion of responsive regulation. Tit-for-tat mixes punishment and persuasion, and comprises of three stages: cooperation; toughness; and forgiveness (Ayres and Braithwaite, 1992:5). Their theory (1992:40) is that success in cooperative regulation is predicted by:

- use of a tit-for-tat strategy;
- access to a hierarchical range of sanctions and a hierarchy of interventionism in regulatory style;
and
- height of the pyramid (the punitiveness of the most severe sanction).

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