

PROSECUTING NON-LODGERS: TO PERSUADE OR PUNISH?

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This series of working papers is designed to bring the research of the Centre for Tax System Integrity to as wide an audience as possible and to promote discussion among researchers, academics and practitioners both nationally and internationally on taxation compliance.

The working papers are selected with three criteria in mind: (1) to share knowledge, experience and preliminary findings from research projects; (2) to provide an outlet for policy focused research and discussion papers; and (3) to give ready access to previews of papers destined for publication in academic journals, edited collections, or research monographs.

Series Editor:
Tina Murphy

Abstract

Prosecution in the court is one of the Australian Taxation Office's (Tax Office's) last resort enforcement procedures for the small numbers of taxpayers who fail to lodge a tax return. The Tax Office has generally assumed that prosecution will obtain lodgment of the return being sought and, via deterrence, improve longer-term compliance behaviour in the prosecuted individual. This paper examines these assumptions by relating tax return data to the outcomes of court cases of prosecuted individuals. The results show that prosecutions were only moderately successful in obtaining lodgment and that lodgment rates (for prosecuted taxpayers) reduced significantly in subsequent years. Nevertheless, these lodgment rates were still three to four times greater than those of taxpayers who were selected for prosecution but did not receive the summons issued to them. There were also reasonable levels of lodgment when a summons was withdrawn at the request of the taxpayer, suggesting that a full prosecution is not required in every case. The results also show that a large fine is linked to lower levels of lodgment.

Prosecuting non-lodgers: To persuade or punish?

*Robert Williams*¹

Introduction

The main tax collected by the Australian Taxation Office (Tax Office) is income tax, and the main payers of income tax are individuals. In order to establish the amount of income earned, and to assess the amount of tax owed, the Commissioner of Taxation requires all eligible people to lodge a statement of earnings in the form of an annual income tax return. This requirement is enshrined in the *Income Tax Assessment Act 1936*, and failure to comply is a breach of the Act. While the vast majority of people ‘voluntarily’ comply with the requirement to lodge a return, a small minority do not. For those who fail to respond to all normal letters and reminders, prosecution in the courts is one of the Commissioner’s last options for obtaining compliance. While such individuals represent less than 0.1% of the total taxpaying population, they are nevertheless significant, as any suggestion that a small group of people do not lodge is detrimental to the integrity of the tax system as a whole.

This paper investigates the effectiveness of prosecution as an approach for obtaining lodgment of a tax return, its effect on the future compliance behaviour of people who have been prosecuted and, by implication, its effect on maintaining the integrity of the tax system. The results obtained suggest that prosecution is only moderately successful in obtaining lodgment and that the compliance effect reduces with time. They also suggest that severity of punishment is not correlated with compliance levels and that it may be the fact of being punished that is the important factor in determining compliance response.

Background

The Tax Office is moving away from a purely deterrent regulatory framework towards a graduated suite of responses that are tailored to compliance behaviour. The notion of

¹ This paper was written while the author was on secondment to the Centre for Tax System Integrity from the Tax Office.

graduated responses is encapsulated in the Tax Office Compliance Model (see Figure 1). This is a modified form of the regulatory pyramid described by Ayres and Braithwaite (1992) that has been adapted for a taxation context.

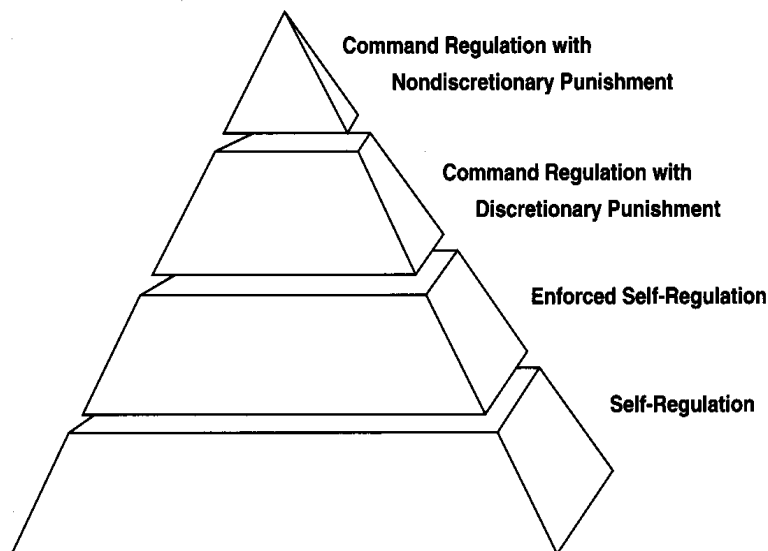


Figure 1: The Tax Office Compliance Model.

Citizens classified as self regulators are those who voluntarily comply in response to education or persuasion. Those in the command regulation categories are usually less ready to comply and, accordingly, receive a firmer regulatory intervention. Interventions are intended to move taxpayers ‘down the pyramid’ to self-regulation. The benefit to the Commissioner of achieving this outcome is not only improved compliance but also reduced costs, as the stronger the sanction required the more labour-intensive and costly the treatments become. To illustrate, education will cost roughly the same whether there are seven million or eight million taxpayers, while audit or prosecution in court necessarily involves work on a case-by-case basis. The narrowing at the peak of the pyramid implies that fewer and fewer people occupy the higher categories. This is consistent with the pattern of behaviour found in Tax Office clients, where approximately 98% of taxpayers are in the self-regulation categories, at least in relation to lodging their tax returns.²

² Research commissioned by the Tax Office showed that, for 1997, 1.9% of taxpayers were rated as medium lodgment risk which means some sort of compliance intervention was necessary. A further 0.04% were rated as high risk, meaning that a more severe intervention, such as a prosecution, was needed. The remainder complied without intervention (Commissioner of Taxation, 2000).

While responsive regulation recognises that a suite of responses are required to move people ‘down the pyramid’ it largely leaves it up to the regulators to determine the practical interventions for achieving this outcome. In his recent book, *The Regulatory Craft* (2000), Malcolm Sparrow provides a framework for solving regulatory problems such as the non-lodgment problem faced by the Tax Office. His view is that regulators should stop thinking about regulatory responses in terms of their existing ‘toolbox’ rather than in terms of the problems to be solved. The danger of a tool-based approach is that the tool, rather than being the means to an end, becomes an end in itself. An analogy could be the use of fines to deter people from speeding – fines are a tool designed to limit high-speed accidents, but eventually the writing of speeding tickets becomes the aim of police.

Sparrow also argues that concentration on tools can lead to an emphasis on low complexity/high turnover cases at the expense of complex/high cost cases. This is undesirable as it erodes the ability to respond to difficult cases and this ‘erodes confidence in the law from other more compliant individuals’. Sparrow suggests that instead of using routine responses to regulatory issues, regulators should clearly identify the problem, analyse the relevant data, and then design the appropriate response to the problem.³ This response can be entirely novel and may or may not include existing tools and programs. In Sparrow’s terms, this paper will examine the ‘problem’ of non-lodgment or, more precisely, the failure of taxpayers to provide information about their income, and the ‘tool’ of prosecution.

Prosecution in the courts is one of the strongest sanctions available to the Tax Office and it is used on only the most reluctant taxpayers. While prosecution is used for the more serious offences, such as fraud and serious evasion, it is used on a large scale to deal with non-lodgment of tax returns.⁴ It is generally assumed by the Tax Office that prosecution will produce immediate compliance in the prosecuted individual, as well as deter future non-compliant behaviour. The capacity to prosecute is also believed to produce a wider deterrent effect that keeps other taxpayers at the cooperative end of the compliance model. These assumptions appear to have been untested to date. To help address these questions two types of data are examined here: first, quantitative data on people prosecuted for failing to lodge their 1997 tax return in the Sydney region and their lodgment records over a three-year

³ Sparrow found that regulators feel intuitively that this is what they are already doing but closer examination shows that it is rarely the case.

⁴ Records of the work done by IHP are not kept centrally so they were unable to say exactly what proportion of their work is in the area of non-lodgment; however, it is understood to form the bulk of their work.

period; and second, semi-structured interviews conducted with Tax Office In-House Prosecutions Unit (IHP) staff in Victoria. The return and lodgment record data have an advantage over other tax compliance data in that non-lodgment is a clearly defined act that is neither subjective nor based on a self-report. The only issues to resolve in relation to lodgment are whether a return is required or not, and whether the due date has passed. If the return is required and it is not lodged by the due date, then non-compliance has occurred. Non-compliance becomes more serious when all the relevant letters and reminders have been sent by the Tax Office.

The current compliance management process

There are several steps prior to a prosecution for non-lodgment. A typical lodgment enforcement action will take the following course, with occasional variations.

The Australian financial year ends on 30 June and tax returns are due by 31 October for people preparing their own returns, or by 31 March for those on a tax agent lodgment program.⁵ As mentioned above, most returns are lodged voluntarily by the due date, but some taxpayers fail to do so. Those who fail to lodge eventually come to the attention of the Lodgment Enforcement Unit, and it is the task of this unit to secure lodgment of the return.

In the majority of cases a reminder is computer-generated and sent to the taxpayer's 'address for service', which is often the tax agent's address.⁶ The reminder may be followed up with a telephone call, but this policy varies from office to office and from time to time. The 'soft letter' is followed by a 'hard letter', which is a final notice under section 162 of the Income Tax Assessment Act. Again, this is sent to the 'address for service'. If the taxpayer does not respond to the section 162 notice, they have committed the offence of 'failure to comply with requirements under taxation law' under section 8C of the *Taxation Administration Act 1953*. At this point the case is referred to the Tax Office's IHP and a summons is issued. IHP handles the prosecution for the Tax Office and its prosecutors attend court on the

⁵ A lodgment program gives tax agents extra time to lodge their clients' returns as it is recognised they cannot complete all returns by 31 October.

⁶ In Australia a tax preparer is known as a tax agent. Roughly 80% of individual returns are prepared by tax agents, who may be trained accountants. They have a special legal relationship with the taxpayer that requires the Tax Office to make any queries of the taxpayer through the agent in the first instance. If a taxpayer has an agent, it is the agent's address which becomes the 'address for service', otherwise it is the taxpayer's own address.

Commissioner's behalf.⁷ The Director of Public Prosecutions (DPP) delegates the power to prosecute to IHP and the staff act according to the Director's guidelines (1998).

The summons is usually given to a commercial process server to deliver and the summons is either properly served or it is not.⁸ In a significant proportion of cases the taxpayer cannot be located or otherwise avoids service. If the summons is properly served there are two possible outcomes: the summons will be voluntarily withdrawn by the Tax Office or the case will go to court. The Tax Office's policy on withdrawal of a summons is quite strict and it would be considered only in rare cases. If the case progresses to court, there are again two possible outcomes: the magistrate will dismiss the case or the defendant will be found guilty. If found guilty, there are different levels of penalty that can be applied. The least severe is a good behaviour bond under section 19B of the *Crimes Act, 1914* which is guilty but without a conviction entered.⁹ The next most severe is a conviction, a fine, and a court order demanding lodgment of the return(s) within 28 days. A conviction under section 8C is considered to be a quasi-criminal conviction because there is no jail term attached, and it does not technically create a criminal record.¹⁰

Lodgment details are checked again some time after the section 8C hearing and, if the return has not been lodged by the nominated date, the taxpayer may be prosecuted again, this time under section 8H of the *Taxation Administration Act (1953)*. This charge is the failure to comply with the court order issued in regard to the section 8C offence. It is a full criminal offence and attracts fines of up to \$5000 and/or imprisonment for a period not exceeding 12 months. There are further charges, but these represent less than 1% of cases referred to IHP, and will not be discussed here.

The penalties shown in the legislation are maximum penalties only and there is considerable variability in the level of fines imposed. According to experienced Tax Office prosecutors who were interviewed for this report, fines vary from state to state, from court to court, and from magistrate to magistrate. The variation appears to depend on whether it is a first

⁷ IHP officers are spread around the country and deal with cases on a local or regional basis.

⁸ A service has to be done in accordance with Regulation 170 of the Income Tax Regulations. A summons can be personally served on the taxpayer or on someone at their address, or it can simply be left at the address for service.

⁹ There is also a good behaviour bond with conviction, but this appears to be rare.

¹⁰ For instance, a section 8C conviction would be insufficient to disbar a solicitor from practising.

offence, whether a tax agent was involved, whether the taxpayer attends court,¹¹ whether they are represented, whether they defend the case, and the attitude of the magistrates, although there is no known systematic set of data to support this. Fines are generally lower if the return is lodged before the court hearing. Importantly, some taxpayers lodge a return as soon as they receive a summons, but they may still be prosecuted as, technically, the offence committed was the failure to comply with the section 162 notice and not the failure to lodge a return. Thus it is possible for a taxpayer to lodge a return and still be prosecuted, in a sense, for not lodging.

It is also important to note that if a taxpayer is prosecuted they cannot be charged a late lodgment penalty. A late lodgment penalty is imposed by the Tax Office on most late returns and is charged at the Treasury bond rate plus 8%. It is calculated on the amount of tax owing for the whole period the return was outstanding.¹² Some prosecutors believe that people who will receive a large tax assessment may actually prefer to be prosecuted, as court fines can be a fraction of the late lodgment penalty they would otherwise receive.

The Lodgment Enforcement Unit is the main source of prosecutions for individual taxpayers, although there is lodgment work generated by the Child Support Agency (CSA) and the Small Business Income Tax (Small Business) area. There are a number of competing priorities in selecting cases for prosecution. While the decisions about which cases will be sent to IHP are made in these referring areas, prosecutors decide which cases they will actually take on. In most instances the decision to proceed to prosecution is based on factors such as the importance placed on the case by the referring area, the age of the final notice,¹³ the number of returns outstanding, whether a debt will be raised, the level of income of the taxpayer, their compliance history, and the amount of work already on hand.

However, cases referred by CSA receive different treatment. CSA is attached to the Commonwealth Department of Family and Community Services and acts to redistribute income to custodial parents from non-custodial parents via the tax system. CSA is particularly keen to obtain lodgment of returns as the income declared on the return is used to

¹¹ The majority of cases are heard *ex parte*, that is, in the absence of the taxpayer being prosecuted.

¹² In 1997 the penalty rate was 17.8% per annum and in 1998 it was 16.8% per annum.

¹³ The final notice has to be actioned within 12 months or it becomes 'stale'.

determine the level of child support payments. CSA has an agreement with the Tax Office that gives its cases priority over others in relation to prosecution.

Method

The initial data were supplied by the Tax Office, in accordance with established data security and handling procedures, and were current at July 2000. These data relate to all people in New South Wales and Victoria who were issued a summons for their 1997, 1998 or 1999 tax returns. These data were supplemented by records obtained directly from Sydney Local Court appearance lists (known as bench lists) maintained by the Tax Office. These lists contained information about whether the summons was correctly served, whether the taxpayer was convicted or not, and the severity of the sanction. Due to the relatively low number of prosecutions for the 1998 and 1999 returns,¹⁴ it was decided to examine only prosecutions for the 1997 returns. The court data collected related only to prosecutions for the 1997 return¹⁵ conducted by the Sydney IHP between 23 June 1998 and 30 June 2000. The final sample contained 528 records. Lodgment records for 1997, 1998 and 1999 were obtained for this group to see what medium-term effect on lodgment behaviour the prosecutions achieved. The data were de-identified to ensure privacy was maintained.

Results

Of the 528 taxpayers in the group, 45.5% eventually lodged a 1997 tax return. This was in spite of a substantial group of 38.5% not receiving the summons issued to them.¹⁶ If the people who did not receive a summons are excluded, the overall lodgment rate becomes 63.9%. It is probable that only those people who received a summons were aware they were being prosecuted. With this in mind, we can consider the people who received their summons to be the treatment group, and the people who did not receive one a comparative non-treatment group. Unfortunately they cannot be a control group because we cannot assume they received the same initial reminders and contacts as the treatment group, due to

¹⁴ Lower numbers of prosecutions for these returns can be attributed simply to the fact that they were not as overdue as the 1997 returns. The numbers for these years will build progressively over time.

¹⁵ There are a number of instances where returns for more than one year were being demanded. These were included as 'multiple-year' prosecutions, provided 1997 was one of the years being demanded.

¹⁶ There are many reasons for non-serving such as incorrect address on the notice, death, hospitalisation, long-term travel, or deliberate avoidance of the process server.

their apparent untraceability. It is also possible that some additional factor, such as itinerancy or leaving the country, explains both why they do not lodge and why they could not be served a summons.

In the sample of 528, the fines per return outstanding were as low as zero and as high as \$2000 for a single-year section 8C conviction. The median section 8C fine was \$400 for a single year, and the median fine for a section 8H conviction was \$1200 for a single year. When more than one year is outstanding, the median per year increased to \$800 and \$1500 per year respectively. So, not only did the total amount of the fine increase for a multiple year, the average fine per year did also. The largest single fine imposed was \$9000 for nine years outstanding on a section 8C offence, but this was later reduced to \$3200 on appeal.

The vast majority of prosecutions were for the lesser section 8C offence ($n = 477$). As the people charged with an 8H offence have already been convicted for an 8C offence, they are *prima facie* less compliant. Hence the 8C group and the 8H group will be analysed separately. Unfortunately the 8H group is small ($n = 51$) and the data must be interpreted with caution.

Table 1 looks at people who have been convicted of the lesser section 8C charge, the levels of penalty imposed on them, and their rates of lodgment over a three-year period. Note that people who received a good behaviour bond have been combined into one category as it was impossible to determine from the bench lists whether they received a bond with conviction or a bond without conviction. Dismissed and withdrawn summonses have been combined for the same reason. Fines have been grouped into three categories: small (less than \$500), medium (\$500 to \$1500) and large (more than \$1500).

Unfortunately, inadequacies in the data make it impossible to tell whether the taxpayer lodged the 1997 return before or after the prosecution was finalised, and there is almost certainly a proportion of people who lodged when they first received their summons. These people would be more likely to be found in the summons withdrawn/dismissed category and the small fine category, as they are generally treated leniently by magistrates. Similarly, people with a relatively poor compliance history would be over-represented in the large fine category because magistrates tend to treat them less leniently.

Table 1: Relationship between section 8C prosecutions and lodgment

Result category (n)	Percentage of 1997 returns lodged	Percentage of 1998 returns lodged	Percentage of 1999 returns lodged
Summons not served (199)	19.1	26.1	21.1
Summons withdrawn or dismissed (67)	71.6	67.2	43.3
Good behaviour bond (17)	68.0	92.9	42.9
Convicted and received a small fine (66)	80.3	65.2	47.0
Convicted and received a medium fine (70)	61.4	74.3	51.4
Convicted and received a large fine (58)	53.4	65.5	46.6

The data in Table 1 suggest that the prosecution process may be having an effect as people who have been served a summons lodge at three to four times the rate of those who have not, at least for that year. While lodgment rates slip to just below the 50% mark two years later in most 'served' categories, the rate of lodgment for the served group is still more than twice that of the non-served group.

The most favourable initial compliance response appears to come from a small or medium fine, but by 1999 there is little difference between any of the served categories. A good behaviour bond is most effective in the 1998 year, but lodgment rates fall away noticeably in the 1999 year. It is interesting to note that large fines are linked to a significantly lower rate of lodgment in the first year. This could be due to an over-representation of people with multiple-year prosecutions. However, the large fine/low lodgment relationship remains even when the multiple-year cases are removed. Hence it may be that a large fine initially produces a worse compliance outcome than a medium or small fine. On the other hand, we cannot rule out the possibility that taxpayers in the large fine category had a history of non-compliance and the fines they received were increased accordingly.

As the lodgment rates converge over time the differences in severity of punishment do not seem to have a sustained effect on behaviour, either positive or negative. Hence it could be argued that the severity of punishment is unimportant in determining medium-term compliance. Perhaps it is the fact of receiving a sanction *per se*, rather than the severity of the sanction, that produces the compliant response.

While all types of sanction are more successful, in varying degrees, than no sanction, it should be remembered that a large proportion of taxpayers have failed to lodge at all. In other words, for a significant number, sanctions did not result in compliance.

Table 2 shows lodgment rates for section 8H prosecutions. Section 8H offences are more serious than section 8C offences and, consequently, no one has received a small fine. There is the additional category of warrant, being a warrant for the arrest of the taxpayer. Note that the sample is very small ($n = 51^{17}$).

Table 2: Relationship between section 8H prosecutions and lodgment

Result category (n)	Frequency (%) of 1997 returns lodged (n)	Frequency (%) of 1998 returns lodged (n)	Frequency (%) of 1999 returns lodged (n)
Summons not served (13)	0.0 (0)	7.7 (1)	0.0 (0)
Summons withdrawn or dismissed (4)	50.0 (2)	50.0 (2)	25.0 (1)
Bond (3)	33.3 (1)	66.6 (2)	33.3 (1)
Medium fine (14)	50.0 (7)	35.7 (5)	14.3 (2)
Large fine (13)	30.8 (4)	15.4 (2)	15.4 (2)
Warrant (3)	33.3 (1)	66.6 (2)	33.3 (1)

Lodgment rates are significantly lower than for section 8C cases. While the sample is too small to draw firm conclusions there appears to be less likelihood that a taxpayer will lodge following a second prosecution. Perhaps people who already had been prosecuted found the

¹⁷ One case was lost due to a coding error.

idea of a follow-up prosecution less of a deterrent. Then again, it could be that the people who are prosecuted twice and still do not lodge their tax returns are the most intractable in the entire taxpaying population and sanctions may simply have no effect on them.

Logistic regression predicting lodgment

The dependent variable in the data is dichotomous, that is, there are only two possible outcomes. The first possible outcome is that the return was lodged; the second is that it was not. In order to determine the relative importance of the independent variables in predicting this outcome a logistic regression analysis was carried out. The analysis showed that there are four factors in the data that have significant explanatory capacity: a) offence type (section 8H or 8C); b) whether the summons was served; c) use of tax agent; and d) whether the taxpayer received a refund in the previous year. When combined, these factors explain 37.6% of the variation.¹⁸ The analyses reported in Tables 3a and 3b show the importance of these variables and also show the significance of being a client of CSA. Those who were clients of CSA were less likely to lodge their tax return, although this effect disappeared when the other variables were entered into the model. Each of these dependent variables is dichotomous. Note that the logistic regression relates to 1997 returns only as there was no apparent relationship between the variables and levels of lodgment in 1998 and 1999.

Table 3a: Logistic regression results

	Model 1		Model 2	
Predictors	B coefficients	Wald statistic	B coefficients	Wald statistic
Child Support Agency	-0.648	11.50**	-0.433	3.63
Offence type			1.176	10.55**
Summons served			1.986	76.85**
Use of tax agent			1.349	37.66**
Refund in previous year			-0.557	6.79**
Nagelkerke R²		0.03		.382**

* = significant at the 0.05 level. ** = significant at the 0.01 level.

¹⁸ Nagelkerke R Square was .376

Table 3b: Classification table for 1997 lodgment returns

Observed	Predicted		
	1997 lodgment		Percentage Correct
	Yes	No	
1997 lodgment			
Yes	169	70	70.7
No	75	213	74.0
Overall percentage			72.5

Nagelkerke $R^2 = .382$

Chi-square = 177.40**

These results can be interpreted as follows:

a) *Offence type* ($H=0$, $C=1$). The more serious section 8H cases have a significantly lower likelihood of lodging than section 8C cases.

b) *Summons served* (Not served = 0, served = 1). Serving a summons has a significant impact on likelihood of lodgment. Those who receive a summons are more likely to lodge than those who do not.

c) *Use of tax agent* (No agent = 0, agent = 1). If the taxpayer has a tax agent, lodgment is more likely to occur. Service of summons and presence of agent are moderately correlated (.26), indicating that it is easier to serve the summons when a taxpayer has a tax agent. Nevertheless, the findings show that having a tax agent improves the likelihood of lodgment, after controlling for whether or not a summons was served. It is unclear how to interpret this finding, but it could be that having a tax agent indicates a higher level of engagement in the tax system in the first instance. It could also be that tax agents are responsible for the problem in some cases by not passing on warning letters to their clients. It is also possible that people, on receiving a summons, consulted an agent to help them lodge a return.

d) *Refund in previous year* (No refund = 0, refund = 1). This is an unexpected result. People who receive a refund in one year are usually salary and wage earners, and this generally means they could expect to receive a refund in subsequent years (the 1997 return in this instance). It would seem that people who received a refund in a previous year would be more than willing to lodge their tax return. However, this outcome might be explained by 'refund in previous year' and 'Child Support Agency' relationship being slightly correlated (.16). If a

person with a CSA relationship has an outstanding child support debt their tax refund can be seized by the agency, and this might provide a disincentive to lodge.

Interviews with IHP staff

To help understand the quantitative data from New South Wales, seven semi-structured interviews were conducted with selected IHP staff in the Victorian region.¹⁹ The interviews were conducted in October 2000 and were recorded.

The interviews revealed that there was a significant prosecution workload. Staff felt they had only a limited amount of discretion about the cases they took on and so attempted to do most or all of them. One unit in Victoria had up to 500 cases at any one time and only three prosecutors to deal with them.

Due to inadequacies in the case recording systems only the number of prosecutions completed is recorded. The amount of debt raised, for example, does not count and is not recorded. This means that two small debt cases would count as a higher achievement than one large debt case. This creates an incentive to follow the simple high turnover cases at the expense of the more difficult cases. One officer said that they ‘look for the thin files’ because this will help get numbers up (Interview 5). The case recording systems also do not record work done outside the actual prosecution. Thus if lodgment could be obtained by, say, making a phone call, this would not be counted as a success. This encourages staff to pursue a prosecution even if other alternatives for obtaining lodgment are available to them. The DPP guidelines state that ‘a prosecution should not proceed if there is no prospect of a conviction being secured’ (1998, p 3). Some prosecutors take this to mean that they should only pursue cases they are assured of winning, and this further encourages them to undertake straightforward cases. When they do tackle the harder or bigger cases, they come up against people who have the resources and knowledge to slow the cases down. Officers avoid such cases because they keep documented success statistics down.

Most of the staff identified the non-service of summonses as a major issue for IHP, although they thought it was less of a problem in their region. The researcher suggested that this

¹⁹ Prosecution methods are consistent across regions so views of Victorian staff should not vary greatly from their northern colleagues.

problem could be overcome by a phone call before issuing the summons. Such a phone call would serve two purposes: it could save time and cost in relation to sending summonses to the wrong address; and it could also serve as a final reminder to people who have not received the appropriate warnings from their tax agents. There was general agreement with this idea, but most officers were adamant it needed to occur in the referring areas, at least partly because of a perceived legal requirement that they not contact taxpayers themselves.²⁰ The case referral guidelines suggest that phone contact should be made, but it appears that referring areas sometimes do not make sufficient effort in this regard. One IHP officer complained that a lot of files came over with the notation 'contact attempted', as though that was considered sufficient (Interview 7). The officer suggested that lodgment enforcement people should be encouraged to go out and visit when phone contact fails. That said, it is possible that the difficulty in contacting clients is actually an indication of the type of taxpayer subject to prosecution in that they may be more itinerant than the average person. It could also suggest problems in the Tax Office's tracing process.

Some of the interviewees were reluctant to blame referring areas for their problems. Inexperienced staff members in referring areas did not know the proper procedures and difficult cases were sent to IHP, making it a 'sort of dumping ground for problem cases' (Interview 7).²¹ The Tax Office internal procedure document on case referral, *Quality decision making in relation to lodgment compliance* (Commissioner of Taxation, 1999), recognises this problem. It states that 'the outcome we seek is to deter an unthinking production line approach to the management of lodgment cases which result(s) in inappropriate escalation of cases for prosecution and the unnecessary incurring of legal expenditure'.²² These guidelines reflect the intention of the compliance model and it is hoped they will be increasingly incorporated into future work practices. Still, one senior prosecutor said it was not sufficient to simply give more guidelines to the referring areas because they were already swamped. He suggested that prosecutors need to work with them, to advise them, and to select the more deserving cases (Interview 1). Such cooperation would mean an

²⁰ The guidelines state that granting an extension of time after a final notice has been issued will invalidate the notice. Some staff seem to have taken this to mean that they cannot initiate any type of contact with taxpayers who have received a final notice.

²¹ The starkest example of this is a Child Support Agency case that was referred for prosecution because the Child Support Agency staff member did not know how to raise a section 167, or default, assessment.

²² *Quality decision making in relation to lodgment compliance*, Commissioner of Taxation, 1999, p. 2.

increase in the number of more complex cases, but a decrease in the high turnover cases. It was recognised that this move would need support from senior managers.

IHP staff believe that the prosecution process encourages the broader community to remain compliant, and they felt this occurs by spreading knowledge via court appearances. It was pointed out that only a handful of lawyers and defendants witness court cases, and that not many people would learn of prosecution through this process. Two officers mentioned that the Tax Office was now endeavouring to get stories in the press, but experience has shown that routine lodgment prosecution are rarely considered newsworthy.²³ Even if a report did make the papers, the Tax Office would still have to rely on people reading the item. This suggests there is no real mechanism for creating a broad awareness in the community about prosecution, and what its significance might be. Two things support this view: interviewees reported that taxpayers are occasionally surprised when they are prosecuted; and another officer said they had to work hard to convince taxpayers that the offence they had committed was 'serious' (Interview 3).

The quantitative results were discussed with staff and it was suggested that a more flexible attitude to withdrawing summonses might be appropriate, especially for those people who had already lodged a return. For instance, it is possible that taxpayers react badly because they had lodged a return and were still punished, in their eyes, for not lodging. There was some variation in staff responses to this dilemma but most felt they had no choice but to proceed, because the late lodgment penalty is waived immediately the summons is issued. If the summons is withdrawn and the taxpayer escapes a court fine they receive no financial sanction at all, and this could lead to abuse of the system. This appears to be an important anomaly. At one time a withdrawal of a summons meant that internal penalties could be reapplied, but the introduction of Section 8ZE of the *ITAA* put a stop to this. Apparently a Justice in a Hobart case said that the Commissioner could seek the penalty under section 161 instead, but so far this has not been tested. Some prosecutors thought this anomaly also created an incentive for higher income earners to seek prosecution, as it means their late lodgment penalty would be waived.

²³ At least in major cities, although this is not the case in regional centres.

The previously mentioned problem with the case recording system also makes officers reluctant to withdraw summonses, as court costs and fines are something tangible that can be documented.²⁴ Staff did not know how many of the people who had been prosecuted actually paid their fines, as the fines are paid to the court and the court could not provide this information. It is therefore possible that people do not pay their fines and it is difficult to imagine the deterrence effect this might be having. Taxpayers can also approach the court and ask for the fine to be converted to community service. Further to the other computer system problems, an important point raised was that the compliance model could work effectively only when there is full and correct information about a taxpayer's compliance history. Without this it is difficult to make correct judgements about whether taxpayers should be escalated up or down the compliance model. It was suggested that current systems are inadequate for this purpose.

In spite of being influenced to pursue simple cases, IHP officers have embraced the compliance model and feel that their work lies at the top of the regulatory pyramid. Interestingly, this gives them the scope to reject cases from the referring areas. Staff have rejected some cases when they do not meet their idea of high non-compliance criteria, but only on a few occasions. This does not extend to CSA where staff have the understanding that it is not possible to reject cases due to the agreement. This frustrates them as CSA cases are often people on welfare and they feel that there are more deserving and productive cases than these.²⁵ A senior prosecutor suggested this problem could be overcome by greater use of section 167 assessments. This section of the Income Tax Assessment Act allows the Commissioner to raise an assessment without a return and, as information about welfare payments is available from other sources, a return would become unnecessary. Earlier prosecution guidelines (IT Ruling 2246) discouraged this practice because many taxpayers would subsequently provide their correct income details and this meant 'double handling'. On the other hand, correct income details are what the Tax Office is seeking, and perhaps this procedure should be compared to prosecutions on a cost-benefit basis.

²⁴ One person said it was demoralising to go through all the work of setting up a case and then not proceed with it, and that you should always proceed on cases you are going to win.

²⁵ However, when a senior Child Support Agency officer was told about this he said that the Child Support Agency were not interested in prosecuting welfare recipients because fines only eroded the taxpayer's capacity to pay child support. This may point to communication problems between or within the Child Support Agency and IHP.

Another point that was regularly mentioned was that prosecutors have lower job classifications, and therefore lower salaries, than their colleagues in other areas, in spite of the high levels of responsibility of the position.²⁶ As one officer put it, ‘we are in court day after day making decisions on behalf of the Commissioner’ (Interview 1). The high level of responsibility and stress of the job, and the lower salary, make it difficult to attract and keep good staff because ‘if you pay peanuts you get monkeys’ (ibid). As a result of this, and of an office-wide draining of experienced staff into the new tax lines,²⁷ IHP are struggling with low staff numbers and inexperienced prosecutors. Unfortunately, there has been no corresponding reduction in the amount of work coming in. One officer put it this way: ‘the factory grinds on but there are no people in the factory. The other areas still put their case in and expect it will work its way through’ (Interview 1).

Analytic conclusions

The effectiveness of prosecution for obtaining lodgment, and its effect on future compliance behaviour, can now be examined in light of the findings. It appears that being prosecuted does moderately improve compliance for some taxpayers, but the effect is not universal. Of the taxpayers who received their summons 63.9% lodged their 1997 tax return, but lodgment rates slipped to 46.9% after two years. These figures are lower when non-served cases are included as the non-served group is lodging returns at a substantially lower rate. If one assumes that those who received a summons are similar on other compliance-related variables to those who did not, serving a summons appears to be significantly better than doing nothing.

There is considerable variation in lodgment rates between fine categories with, perhaps most notably, large fine cases lodging at significantly lower rates than small fine cases in the first year. Brehm and Brehm (1981) found that citizens who feel that the level of punishment is unjustified can display a behaviour, known as reactance, which is diametrically opposed to that being sought, and we could be seeing evidence of this here. On the other hand the convergence of lodgment rates indicates that the compliance effect produced by the severity of punishment, either positive or negative, fades with time. This may support the hypothesis

²⁶ Staff at the public service grade of ASO4 level do the prosecution work. For the same level of responsibility, staff could expect to be one or two grades higher in the Tax Office’s new GST line.

²⁷ Required by a government-sponsored review of the Australian taxation system.

that being sanctioned is the critical variable, rather than variation in the severity of the sanction, in governing compliance behaviour. Notably the summons-withdrawn category shows very similar results to a full prosecution despite being a much gentler intervention. This may suggest that we can regard receiving a summons as itself being a sanction. The summons could be thought of as the initial lower level sanction in the prosecution process, with the court 'appearance' and fine as the secondary higher level sanctions.

As to the role of prosecution in maintaining the integrity of the taxation system, the findings are necessarily more speculative. However, we can still draw some cautious conclusions. For instance, prosecution may not be as effective a deterrent as one might hope because there is not a universal belief that failing to lodge a tax return is a serious offence. This is supported by Broadhurst and Indermaur (1982) who found that, in terms of seriousness, respondents ranked tax evasion only 22 out of 27 offences. Non-lodgment of returns was not specified as an offence in that study but one might assume it would be considered less serious than evasion. This may explain why some people do not see the lodgment of their tax return as a major issue, and why others could feel that the punishment of prosecution is too severe for the crime. Of course this conclusion only relates to non-lodgment and not to more serious offences where, presumably, prosecution would still be viewed as appropriate.

The poor compliance outcomes for section 8H prosecutions suggest that people who have already been prosecuted will not comply in response to a second prosecution. This may indicate that it is the *threat* of the prosecution that is acting as a deterrent and, once this threat has been realised, it loses its effect. Ayres and Braithwaite (1992) have argued that regulators should 'walk softly while carrying a big stick'. Knowing that one could be prosecuted for non-compliance is an incentive for moving down the pyramid and complying and once prosecuted the taxpayer loses the incentive to cooperate. This explanation is consistent with the results found here, but further work would be required to confirm this. Still, it may not be sufficient just to threaten prosecution as 'idle threats' are quickly seen as such and can undermine compliance (ibid). Understanding the apparent lack of effectiveness of subsequent prosecution is important for the Tax Office as a significant number of people do not lodge in response to the initial prosecution and something will have to be done to ensure they do not fall out of the system.

Another reason the deterrent effect of prosecution may be lessened is that the majority of people do not attend their court hearings. If the court case takes place in their absence the experience is less unpleasant and the effect is reduced accordingly. Further, once a person learns that they can be prosecuted without leaving their lounge room, future prosecutions may have less of a deterrent effect on them. There is also less chance to establish communication and perhaps encourage these citizens back into the system when they do have to engage with the Tax Office. Tyler (2001) found that people are more likely to comply if they are treated fairly and that their perceptions of fair treatment were enhanced if they felt their views were heard and taken into consideration. Hence it might be that establishing communication is one of the key leverage points in improving compliance. As the process is currently set up it is possible, if the summons is not served on the taxpayer personally, for the whole prosecution to take place without actually speaking to the taxpayer. In extreme cases the whole process can even be completed without their knowledge, and it would be interesting to explore what effect this might have on the taxpayer.

Intuitively it would seem that prosecution may not be as effective as a broad deterrent on the mainstream taxpayer as one might initially assume, as it seems that only those people who attend court receive any real information about it. On the other hand one could argue that a lack of widespread information about non-lodgment prosecution, and by implication the knowledge of a group that does not lodge willingly, is actually positive for compliance in the broader population, since compliant taxpayers will not have their faith in the system undermined. Moreover, it is not even necessary for the bulk of the population to know about prosecution as they are already voluntarily compliant in the main. Only those who have failed to lodge, or are at risk of doing so, need to be made aware of its existence. If details of prosecution are clearly communicated to them at the lodgment enforcement stage, it could still act as a deterrent to those taxpayers.

It will be interesting to follow this group of citizens over the next year or two to see what happens to their lodgment rates. It may also be worthwhile to replicate this research in another state to see if the results hold there. A different approach to the data may also be useful as a considerable amount of the variation is still to be explained. For instance, Tyler (2001) has found that perceived fairness of procedures accounts for a substantial amount of the variation in compliance. Unfortunately this factor could not be investigated in this paper as the data were unsuitable. Additional research is planned that will look into the experiences

and motivational postures of taxpayers who have been prosecuted, and their perceptions of procedural fairness will be examined. It might be useful to revisit the data analysed here in the light of that research.

Making the compliance model work: Policy and administrative challenges

Prosecution appears to have become a routine response in the case of non-lodgment. Increasing the number of prosecutions, rather than obtaining the correct details of a taxpayer's income, appears to have become the aim. There are a number of factors contributing to this, including an assumption that prosecution will obtain lodgment; cases being referred to IHP that probably shouldn't be; problems with the legislation in regard to waiving penalties; problems with case recording systems; and a processing culture brought about by high workloads.

The following are suggestions for making prosecution work more effectively and more in accordance with the compliance model.

1. The primary policy implication is around section 8ZE and the anomaly created by the obligatory waiving of late lodgment penalties once a summons has been issued. In the current situation, taxpayers who receive a summons and then lodge are still prosecuted because they will otherwise escape any financial penalty. Taxpayers who lodge their returns should be de-escalated down the pyramid rather than up to prosecution. Prosecuting when a taxpayer is cooperating is contrary to the responsive philosophy of the compliance model. This needs to be addressed either by legislative amendment or by pursuing alternatives, such as seeking a penalty under section 161. A solution to this problem would also remove the apparent cost advantage incentive for high income earners to seek prosecution.
2. Further to point 1, late lodgment penalty has the advantage over fines of being collected via the tax system rather than through the courts, and this could be beneficial for revenue reasons. It also places control of penalties in the hands of the Tax Office, which means they can be managed more strategically and in accordance with the compliance model.

3. It is noteworthy that a summons is itself effective as a sanction, and a withdrawn summons is roughly as successful as a completed prosecution. Perhaps this could be considered as a standard response particularly for those who have lodged in advance of the court hearing date. The potential for withdrawal can also be a useful leverage point to obtain lodgment from less recalcitrant taxpayers. As a policy a withdrawal has the added advantage of showing people trust, of engaging them in the system, and moving them down the compliance pyramid. Even if the results were marginally worse than a full prosecution, a withdrawal is cheaper, does not impose the same costs on the taxpayer-funded court system, and does not give a lot of 'little' people a court record. It may be a better strategy for these reasons. Further, the lodgment rates for a withdrawn summons could possibly be enhanced by appropriate use of written reprimands and other sanctions. This policy might also prevent desensitising some people to the prosecution process.
4. Non-service of summonses is a major problem for IHP. It is possible that this sample has an abnormally high level of non-service, but any non-service of a summons is inefficient, costly, and has significant negative implications in terms of obtaining lodgment. Phone contact before referral to IHP is very important. Phone contact can limit the number of summonses sent to the wrong address, and it will also act as a direct reminder to people who have not received or paid attention to earlier notices, perhaps due to problems with their tax agent. As Tyler demonstrates, communication with taxpayers is an important leverage point in influencing behaviour. It should be impressed upon the referring areas of the Tax Office that establishing contact is important. Perhaps referring areas should be encouraged to visit the taxpayer, gather information about the case, and give a very personal final warning, should phone contact fail. As an extreme solution, IHP could simply refuse to take cases where no contact has been made.
5. At present the bulk of people who fail to respond to prosecution are not followed up, possibly on the assumption that they would have already lodged. Section 8H can be used but the data suggest that it is not very effective. Some new tool or response, such as a personal visit or call centre, may need to be developed. Perhaps section 167 assessments could be raised more regularly. While this may lead to 'double handling' in some instances, it should result in the correct details being obtained, and that is ultimately the desired outcome.

6. The data suggest that larger fines are linked with lower rates of compliance. While the data do not allow us to rule out the possibility that it is a social selection effect, it is possible that reactance could be pushing some taxpayers out of the system and making them more non-compliant in the medium term. However, it would be fair to say that this probably represents a fairly small group and the effect reduces with time. Either way the data suggest that the most effective fine may be a small to medium one in the first instance.
7. There is an unknown effect on the compliance response of fines imposed because a number of people do not pay their fines. A monitoring system showing who has paid or not paid their fines would allow further follow-up of non-payers, as well as the development of a better understanding of the relationship between financial penalty and compliance. Further work is also required to understand exactly which aspects of the prosecution process are acting as deterrents. This could be used to enhance effectiveness. This will require dialogue with people who have previously been prosecuted. It is recommended that additional research be commissioned in this area.
8. The division between the IHP and Lodgment Enforcement Unit means the two areas are dealing with the one 'problem'. Unfortunately, combining the areas is not possible as they were deliberately separated to satisfy DPP independence policies. As an alternative, prosecution staff and managers could be encouraged to work more closely with the staff of referring areas to advise on what are suitable and strategic cases for prosecution. Establishment of coordinating forums should also be considered if they do not already exist. Prosecutors also need to better understand that they do have discretion to reject cases that do not meet compliance model criteria. They should be encouraged to use this discretion regularly, as it might lead to more rigorous work on the cases that are referred to them.

9. A new case reporting system is needed in which all IHP's actions and successes can be recorded. The new system should remove the unintentional incentive to pursue simple cases. A new system is due by mid 2001 and is expected to help in this regard. An improved reporting system is also necessary to allow staff to correctly determine taxpayer compliance history so that they can treat taxpayers appropriately and in accordance with the compliance model.
10. CSA cases need to be judged on their merits and only those that are at the top of the compliance model should be prosecuted. Communication between or within CSA and IHP in relation to prosecution expectations could be improved. The client contact principles promoted in *Quality decision making in relation to lodgment compliance* (Commissioner of Taxation, 1999) are also recommended for action within CSA.

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