'TRUST ME, I'M THE TAXMAN': THE ROLE OF TRUST IN NURTURING COMPLIANCE

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Abstract

Why an institution's rules and regulations are obeyed or disobeyed is an extremely important question for regulatory agencies. This paper discusses the findings of an empirical study that shows that the use of threat and coercion as a regulatory tool—in addition to being more expensive to implement—can actually produce the opposite behaviour from that sought. Using survey data collected from 2301 taxpayers accused of tax avoidance, it will be demonstrated that variables such as trust are just as important for determining compliance. If people trust the motives of authorities, they are more likely to view those authorities as acting fairly, to consider them legitimate, and to defer to their decisions voluntarily. It is therefore argued that to effectively shape desired behaviour, regulators will need to move beyond motivation linked purely to deterrence. Strategies directed at reducing levels of distrust between the two sides may prove particularly effective in gaining voluntary compliance with an organisation's rules and regulations.

'Trust me, I'm the taxman': The role of trust in nurturing compliance

Kristina Murphy

Introduction

In June 1998 the Commissioner of Taxation announced that the Australian Taxation Office (Tax Office) was implementing a series of initiatives aimed at combating aggressive tax planning[1]. Part of their crackdown on aggressive tax planning involved issuing amended assessments in early 1998 to tens of thousands of taxpayers involved in mass-marketed tax-effective schemes. The Tax Office maintained that taxpayers who became involved in aggressive tax planning by investing in these schemes did so for the 'dominant purpose' of obtaining a tax benefit, and because of that the anti-avoidance provisions of Part IVA of the *Income Tax Assessment Act 1936* applied. Scheme investors were told they had to immediately pay back taxes with interest and appropriate penalties, or they would run the risk of facing the full extent of the law. The majority of tax scheme investors chose not to comply with the Tax Office's demands.

Before examining why such a large number of scheme investors resisted the Tax Office's demands that they pay back their taxes, this paper will begin by presenting some background information discussing the history of the rise of tax effective schemes in Australia and the Tax Office's response to it. The aim of the present study will then be outlined, followed by a review of some of the psychological literature that potentially offers insights into why such a large number of scheme investors refused to pay back their taxes.

[1] Aggressive tax planning refers to the situation where there is a reasonable probability that a particular tax return stance will not be upheld by an audit and subsequent legal challenge. Thus, 'an aggressive position is a risky choice due to the uncertainty of its final disposition' (Hite & McGill, 1992, p. 400).

Background

The rise of the tax scheme market

The Tax Office's concern in the area of aggressive tax planning arose out of its analysis of internal and external information that showed a dramatic increase in the number of taxpayers involved in tax scheme arrangements between 1994 and 1998. This coincided with an increase in the amounts being claimed as tax deductions. As can be seen in Figure 1, this surge in growth occurred in the 1995/96-income-year, with deductions growing from $54 million in the 1993/94-income-year to over $1 billion in the 1997/98-income-year.

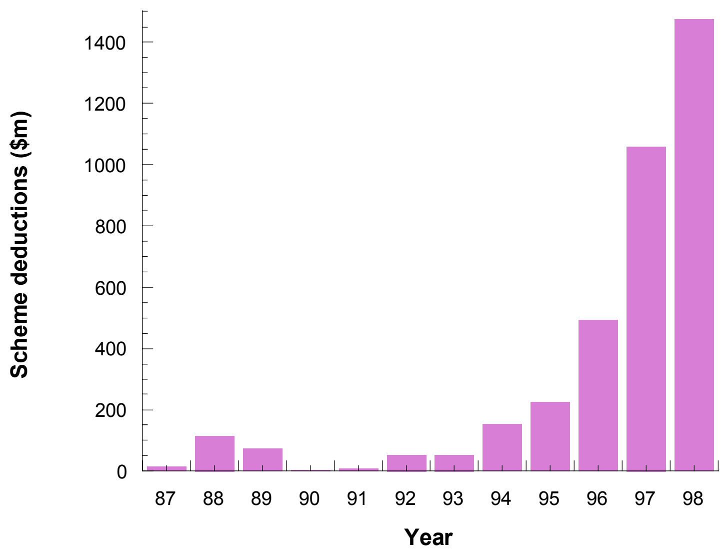

Figure 1: Growth in claimed scheme-related deductions from 1987 to 1998 (*Source: ATO correspondence).*

The Tax Office's concern over mass marketed schemes was further heightened when analysis of some of these scheme arrangements produced a better understanding of the way they were structured. In the Tax Office's view, the fundamental compliance problem or 'tax mischief' common to these schemes, related to their financing, and not necessarily their commercial nature or business activity (for an example of a franchise scheme see Appendix A). According to the Tax Office, many participants' investments were largely funded through tax deductions and relatively little private capital was at risk. As a result the Tax Office formed the opinion that tax schemes posed a serious problem to the integrity of the tax system (for a detailed discussion of the Tax Office's view see ATO Submission No. 845 to the Senate Economics Reference Committee, 2000). By taking action against the investors, the Tax Office saw it as a way of discouraging future marketing and investment in such arrangements[2].

Investor reaction towards the Tax Office's debt recovering action came as somewhat of a surprise to the Tax Office. The majority of investors claim that the schemes they invested in had been sold to them, sometimes by their accountants, as a way that they could legally minimise the tax they were required to pay while still being involved in a viable long-term investment (see Murphy, 2002a). Consequently many investors believed that they had done nothing wrong by investing in these schemes. Thus, up to four years after the Tax Office's initial attempts to recover scheme related debts the majority of scheme investors had still refused to pay back their tax debts. In fact, at the time of starting fieldwork for this study in January 2002, fewer than 50% of scheme investors had entered into settlement arrangements with the Tax Office to pay back their taxes[3]. With investors' debts increasing by the day, the reasons behind their subsequent non-compliance is of theoretical interest both to psychologists and policy makers and will be the focus of the present study (see also Murphy, 2002a).

Trust and compliance

The issue central to being able to engage in effective social regulation is having an accurate understanding of why people are motivated to accept third-party decisions and rules. The 'rational choice' model of the individual has previously dominated the formulation of public policy in areas as diverse as criminal justice, welfare policy, and taxation. The model argues that people are motivated to maximise their personal gains and minimise their personal losses in social interactions and that they will react to authorities

[2] A total of 56 329 investments were made by approximately 40 000 investors and the average tax debt per investor has been reported to be $75 000 (Senate Economics References Committee, 2001).

[3] In February 2002, however, the Tax Office announced a settlement offer to investors whereby the interest and penalties on their scheme related debts would be abolished. Investors were given until 21 June 2002 to decide if they would accept the offer. The settlement offer has been highly successful for the Tax Office. As

and rules from a self-interested, instrumental perspective (Tyler & Kramer, 1996). In the taxation context, for example, the rational choice model suggests that taxpayers carefully assess opportunities and risks, and disobey the law when the anticipated fine and probability of being caught are small in relation to the profits to be made through non-compliance. Advocates of this view therefore believe that harsh sanctions and penalties should be used when dealing with non-compliant taxpayers.

Recently, however, there has been a convergence toward questioning the adequacy of the rational choice model—with its individualistic, materialistic focus—as a model for understanding social interaction in natural settings and as a basis for social policy (for example, Cook & Levi, 1990; Tyler, 1990). The model does not satisfactorily explain the high levels of voluntary compliance observed in many situations. If people were simply rational actors motivated purely by self-interest, one would expect that compliance with rules and regulations would be significantly lower than what is currently observed. For example, the probability of being severely punished for avoiding taxes is low and from a rational choice perspective, most people should frequently try to avoid paying their taxes. However, research has in fact shown that taxpayers are generally compliant even when the chance they will be audited for avoiding their taxes is very slim (Braithwaite, Reinhart, Mearns & Graham, 2001; Smith & Kinsey, 1987). Findings such as these suggest that attitudes and moral obligations, rather than (or in addition to) purely economic calculations or fear of punishment, are important in explaining compliance behaviour.

In recent years, the importance of trust in organisational relations has been increasingly recognised (for example, see Bianco, 1994; Braithwaite, 1998; Braithwaite & Levi, 1998; Brown, 1994; Kramer & Tyler, 1996; Putnam, 1993; Tyler, 2001)[4]. So too has the role that trust plays in influencing compliance with an organisation's rules and regulations (for example, Braithwaite & Makkai, 1994; Shapiro, 1987, 1990). In fact, Braithwaite and Makkai (1994) suggest that trust actually nurtures compliance. Support for this view comes from a number of empirical studies that have explored the relationship between trust and

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of 21 June 2002, 87% of investors have been reported to have taken up the offer to settle under these terms (Source: ATO correspondence).

[4] Trust, here, can be defined as the phenomenon that enables individuals to take risks in dealing with others or to act in ways that seem contrary to standard definitions of self-interest.

compliance (for example, Kim & Mauborgne, 1993; Scholz & Lubell, 1998; Tyler, 1990; 1998; Tyler & Degoey, 1995; 1996). These studies show specifically that trust does play an important role in determining acceptance and compliance with an organisation's rules and regulations.

For example, in a study of multinational corporations, Kim and Mauborgne (1993) were interested in determining what motivated top level executives of subsidiaries to comply with corporate strategic decisions. Using a longitudinal survey methodology[5], Kim and Mauborgne found that if the executives trusted head office management, there was an overall positive effect on their compliance with corporate strategic decisions. Tyler and Degoey (1996) were also interested in exploring whether trust influenced voluntary acceptance of decisions. They interviewed citizens of San Francisco about their views of a regulatory agency charged with enacting water conservation policies during a water shortage. They found that the regulator's trustworthiness was the major factor shaping citizens' willingness to accept their decisions. Tyler and Degoey also showed that within a variety of contexts and groups, trust consistently influenced feelings of obligation to obey organisational rules and laws. In another study, Scholz and Lubell (1998) specifically tested the link between trust and tax compliance. Using data collected from a national survey of 299 taxpayers in America, Scholz and Lubell showed that taxpayers' trust in government and trust in other citizens significantly influenced their levels of tax compliance, with decreases in trust resulting in higher levels of self-reported non-compliance with tax obligations. Scholz and Lubell also obtained actual Internal Revenue Service (IRS) audit-based estimates of non-compliance. It was found that the frequency of non-compliance reported in the survey was very similar to the IRS estimates, except for deductions, where it was lower for the survey data collected.

Perception that a regulatory agency is untrustworthy has also been shown to be a function of whether regulators distrust those from whom they are demanding cooperation and compliance. Braithwaite and Makkai (1994) argue that if those being regulated are treated as trustworthy, they will repay this respect with voluntary compliance to fair rules (see also Fisse & Braithwaite, 1993). Braithwaite and Makkai (1994) attempted to examine this question empirically by studying compliance in the Australian nursing home industry. Over a 20-month period, 410 nursing homes were inspected with the aim of determining whether or not they complied with 31 nursing home standards. During an initial inspection, each nursing home was given a compliance rating against each of these 31 standards. Eighteen months later, a follow up inspection was conducted on 341 out of the initial 410 homes. Braithwaite and Makkai found that if inspectors were initially seen to be treating nursing home managers with trust, compliance was more likely to improve in the two years following the initial inspection.

How can regulators nurture trust?

Previous research, therefore, suggests that trust plays an important role in nurturing compliance with an authority's rules and decisions. Not only does this appear to be the case among individuals, but it also appears to be the case in the corporate sector. A regulatory strategy that combines a preference for trust in the first instance may therefore prove to be particularly effective in gaining individual and corporate compliance. However, before advocating this view, one must first be able to understand and explain the drivers of trust. For example, what can a regulatory authority do to improve trust among those being regulated? And what type of factors can lead to a decrease in trust? Questions such as these need to be answered first before policy makers can implement more effective strategies aimed at increasing compliance.

Some of the answers to these questions can be found in the psychological literature on citizen obedience to authority. For example, several researchers (for example, Levi, 1998; Tyler, 1997; Tyler & Degoey, 1996) argue that the key to creating trust is to act in ways that citizens will experience to be fair. This argument is the core conclusion of the literature on procedural justice.

[5] This methodology involves repeatedly following up respondents over time.

Procedural Justice

Procedural justice concerns the perceived fairness of the procedures involved in decision-making and the perceived treatment one receives from the decision maker. The procedural justice literature demonstrates that people's reactions to their personal experiences with authorities are rooted in their evaluations of the fairness of procedures those agencies use to exercise their authority (Lind & Tyler, 1988; Tyler, 2000, 2001; Tyler & Blader, 2000). In fact, there is evidence to show that people who feel they have been treated fairly by an organisation will be more likely to trust that organisation and be inclined to accept its decisions and follow its directions (Lind & Tyler, 1988; Tyler & Degoey, 1996). It has also been found that people are most likely to challenge a situation collectively when they believe that the procedures are unfair (Tyler & Smith, 1998). This does not mean that outcomes are irrelevant. Outcomes do influence reactions to experiences with third parties, and they strongly influence satisfaction with the outcome. However, both the willingness to accept outcomes and feelings about the decision-maker are dominated by reactions to the process (for example, Casper, Tyler & Fisher, 1988; Lind, Kulik, Ambrose & de Vera Park, 1993).

The 'group value approach' in the procedural justice literature specifically highlights the importance of an authority's interpersonal respect and neutrality in its dealings with others, in addition to its perceived fairness (Tyler, 1989; 1994; 1997; Tyler & Smith, 1998; see also Murphy, 2002a). One's judgment about whether or not an authority is motivated to treat them in a fair way, to be concerned about their needs, and to consider their arguments has been shown to be the primary factor that people consider when evaluating authorities (Tyler & Degoey, 1996; Tyler & Lind, 1992). If people believe that an authority is 'trying' to be fair and to deal fairly with them, they trust the motives of that authority and develop a long-term commitment to accepting its decisions.

Research has also shown that being treated politely, with dignity and respect, and having genuine respect shown for one's rights and social status, all enhance feelings of fairness (Tyler & Degoey, 1996). Individuals are also influenced by judgments of the neutrality of decision-making procedures (Tyler, 1997; Tyler & Degoey, 1996). Neutrality includes assessments of honesty, impartiality, and the use of fact, not personal opinions, in decision-making. People basically seek a level playing field in which no one is unfairly advantaged. As they are seldom in the position to know the correct outcome until it is actually made, they focus on the evidence that the procedures are even-handed. So in summary, if individuals trust the motives of authorities, feel that they behave neutrally, and feel treated with respect and dignity, they are more willing to voluntarily defer to authorities and obey their decisions.

The Present Study

The aim of this paper is to explore whether trust plays a role in compliance with rules and decisions in the taxation context. When considering the mass-marketed schemes issue, it can be seen from a legal standpoint that scheme investors have not been compliant with their obligations under tax law[6]. Of interest to the present paper, however, is why such a large number of investors chose to resist the Tax Office's subsequent decision to recover tax owing on disallowed scheme deductions. Was the resistance a result of decreased trust in the Tax Office, or was it simply a result of economic rationalism? Each of these questions will be addressed by using data collected from a survey of 2301 scheme investors.

Method

Survey data was collected over a six-month period from January to July 2002. *The Australian Tax System Survey of Tax Scheme Investors* (Murphy, 2002b) was posted to a random sample of 6000 tax scheme investors who had been selected from Tax Office case files (for detailed information on the survey's methodology see Murphy & Byng, 2002a). The initial survey package was posted to each taxpayer in the sample on 7 January 2002 and comprised a covering letter, the questionnaire and a reply-paid envelope. The covering letter explained the intent of the study, specifically that the researchers were interested in hearing from taxpayers whose tax assessments had been amended by the Tax Office. The

[6] Several court cases relating to various tax effective schemes have been conducted over the past few years. The ones that have been decided upon have all agreed with the Tax Office's interpretation of tax law (that is, that scheme related tax deductions are not allowed under Part IVA of the Income Tax Assessment Act).

letter also guaranteed participants strict confidentiality of responses, and referred potential respondents to a 1-800 free-call number should they have any questions.

In order to protect investors' privacy, the Tax Office was responsible for all mailings of the survey and reminder letters[7]. No date was nominated for the return of questionnaires and investors who agreed to participate were asked to return their completed questionnaires in a reply-paid envelope to The Australian National University (ANU) for analysis. This procedure ensured that researchers at the ANU did not have access to the names or addresses of sampled investors. It also ensured that the Tax Office did not have access to any individual taxpayers' survey responses.

After six mailings, 2301 completed surveys had been received. When adjusted for out-of-scope taxpayers who had died or had moved address, a response rate of 43.2% was obtained.

Findings

The survey data consisted of scheme investors' responses to a variety of questions designed to measure their views of the Tax Office and the Australian tax system. Also measured were the possible reasons why taxpayers invested in tax minimisation schemes and why there was such widespread taxpayer resistance to the Tax Office's debt recovery procedures. However, for the purposes of this study, only the variables that measured aspects of trust and procedural justice will be examined (for those interested in other findings from the survey see Murphy & Byng, 2002b)[8].

[7] The survey process was modelled on the Dillman Total Design Method (Dillman, 1978), which involved following up non-respondents over a period of time (that is, sending out reminder letters). The follow-up of non-respondents after the first mailing was accomplished using an ID number attached to each survey booklet, which was in turn linked to the sample name at the Tax Office. As each survey booklet was returned to the ANU, the ID number was marked off. A list of marked-off ID numbers was then given to an officer at the Tax Office so that no further mailing was made to that sample point. At the time of the next mailing any sample point not marked off was sent another survey reminder.

[8] All individual items used to measure various constructs in this paper were factor analysed prior to running regression analyses. It was found that all but two items loaded clearly, and as anticipated, on their respective factors (procedural justice, trust, resistance and outcome favourability). The two items that did not load onto their respective factors were deleted from any further analysis.

Trust in the Tax Office

Scheme investors' level of trust in the Tax Office was first analysed. Using Braithwaite's (1997) measure of institutional trust, modified for use in the taxation context, it was found that scheme investors' level of trust had a mean slightly below the midpoint (M = 2.42, SD = 0.69) on a five point rating scale (the details of all scales used in this paper are presented in Appendix B). This result indicates that scheme investors tended to be somewhat distrusting of the Tax Office.

In order to ascertain whether scheme investors' trust in the Tax Office was unusually low, their level of trust was compared to taxpayers in the general population[9]. As can be seen in Figure 2, scheme investors' trust in the Tax Office (M = 2.42, SD = 0.69) was substantially lower than the trust exhibited by taxpayers from the general population (M = 3.14, SD = 0.70). The difference between the two groups was found to be statistically significant, $t = 34.9$, $p < 0.0001$. When further questioned about their trust in the Tax Office, 89% of the scheme investors indicated that their trust had been adversely affected by the Tax Office's actions to amend their tax returns.

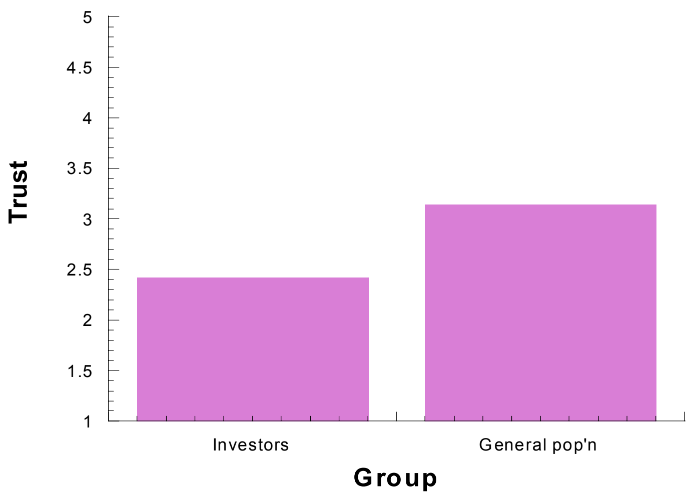

Figure 2: A comparison of investors and the general population on their level of trust in the Tax Office (scores on a 1 to 5 scale, with a higher score reflecting more trust).

[9] A total of 2286 taxpayers from the general population were surveyed prior to the Investors' Survey by my colleagues at the Centre for Tax System Integrity, The Australian National University.

Predicting resistance

Earlier, I indicated that I was interested in determining whether the resistance exhibited by the majority of tax scheme participants towards the Tax Office was a result of their decreased trust in the Tax Office, or whether it was simply a result of economic rationalism. In order to answer this question, a hierarchical regression analysis[10] was performed using 'trust', and 'outcome favourability' as predictors of 'taxpayer resistance'.

'Outcome favourability' is a self-interest variable and it measures how often Tax Office decisions have been favourable to investors[11]. If investors were likely to be motivated by economic rationalism one would expect this self-interest variable to have a greater effect on taxpayer resistance than 'trust'. To measure taxpayer's level of resistance towards the Tax Office, respondents were presented with six statements asking them to rate how they viewed the Tax Office. Resistant taxpayers are likely to view the Tax Office with antagonism because they feel the Tax Office pushes taxpayers around. Further, they are likely to believe that people should take a stand against the Tax Office. According to Braithwaite (1995), those who score highly on this measure are predisposed to non-compliant conduct.

In order to control for demographic differences between respondents, the background variables 'sex', 'age', 'personal income' and 'family income' were used as predictors of 'taxpayer resistance' in the first step of the hierarchical regression analysis. Table 1 shows that the regression analysis failed to explain a significant portion of the variance in Step 1 (see adjusted R^2 value), indicating that the demographic variables did not have any effect on taxpayer resistance.

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[10] Regression analyses are a set of statistical techniques that allow one to assess the relationship between one dependent variable and several independent variables (Tabachnick & Fidell, 1989). For example, can taxpayer resistance be predicted from several independent variables such as trust, outcome favourability, age and so on? In hierarchical regression, rather than inserting all independent variables into the model at once, the independent variables (that is, the predictors) enter the model in an order specified by the researcher. By doing this, each independent variable can be assessed in terms of what it adds to the model at its own point of entry.

[11] Favourability in the taxation context usually refers to economic favourability.

In order to identify the unique contribution offered by the two more important predictor variables, 'outcome favourability' was entered separately into the regression model at Step 2, followed by 'trust' in Step 3. Table 1 presents the results for this analysis.

Table 1: Hierarchical regression analysis showing antecedents of taxpayer resistance towards the Tax Office

	Step		
Predictor	**1**	**2**	**3**
Age	0.02	0.06**	0.06**
Sex	-0.03	-0.01	-0.01
Personal income	-0.01	-0.01	-0.03
Family Income	-0.02	-0.03	-0.00
Outcome favourability		-0.36***	-0.14***
Trust in the Tax Office			-0.53***
R^2	0.00	0.13	0.36
Adjusted R^2	0.00	0.12	0.36
R^2 change	0.00	0.12	0.23
F change	1.11	297.93***	746.93***
df	4, 2092	1, 2091	1, 2090

Note: predictor entries are standardised regression coefficients (β).
**p < 0.01. ***p < 0.001

As can be seen in Table 1, when the self-interest variable 'outcome favourabilty' was entered into the model at Step 2, it was found that this item alone could explain 12% of the variation in taxpayers' resistance (see adjusted R^2 value). In fact, it was found that this variable had a significant negative effect on taxpayer resistance ($\beta = -0.36$, $p < 0.001$), indicating that those who were more likely to think that Tax Office decisions were favourable to them tended to be less resistant towards the Tax Office. A somewhat surprising result in Step 2 of the analysis was that unlike in Step 1, the demographic variable 'age' now has a significant positive effect on taxpayer resistance ($\beta = 0.06$,

$p < 0.01$). While it is unclear why age now had an effect on taxpayer resistance, the finding indicates that older investors are more likely to be resistant towards the Tax Office. No other items predicted taxpayer resistance at Step 2.

As expected, when 'trust' was entered into the regression model at Step 3, it was found to have a significant negative effect on taxpayer resistance ($\beta = -0.53$, $p < 0.001$). This finding suggests that those who have lower levels of trust in the Tax Office are more likely to be resistant towards the Tax Office. Also of interest is the finding that upon entry into the model, 'trust' uniquely explained 23% of the variation in taxpayers' resistance (see R^2 change value).

When considered together, the findings suggest that 'age', 'outcome favourabilty' and 'trust' predict 'taxpayer resistance'. However, before drawing any conclusions, it should first be noted that 'trust' was found to have a greater effect on taxpayer resistance than either 'age' or 'outcome favourability'. This was determined by comparing the size of the regression coefficients at Step 3; 'trust' can be seen to have the largest regression coefficient ($\beta = -0.53$, $p < 0.001$)[12]. Inspection of R^2 change values at both Steps 2 and 3 (0.12 versus 0.23, respectively) also indicate that the entry of 'trust' as a predictor at Step 3 affected the model much more than did the entry of 'outcome favourability' at Step 2. While the findings do not deny self-interested action, they do indicate that the resistance exhibited by the majority of tax scheme participants towards the Tax Office was more likely to be a result of their decreased trust in the Tax Office[13]. The implications of this important finding will be discussed later in the General Discussion.

Predicting Institutional Trust

In the analysis performed earlier, it was found that scheme investors' trust in the Tax Office had been detrimentally affected by their involvement in tax schemes. The regression analysis performed above also showed that taxpayers' level of trust significantly predicted

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[12] Size of regression coefficients are determined by their absolute value.

[13] An additional hierarchical regression analysis was run using investors' actual debt level (in $)—rather than 'outcome favourability'—as a more objective measure of economic self-interest. When using this item the

taxpayer resistance. In particular, it was found that those taxpayers who had lower levels of trust were more resistant towards the Tax Office. The specific reasons why investors' level of trust in the Tax Office was detrimentally affected by their involvement in tax schemes was therefore of interest.

In order to the test Tyler's (1997) theory that perceptions of procedural unfairness decrease trust, another hierarchical regression analysis was conducted. In Step 1 of the regression analysis, the background variables 'sex', 'age', 'personal income' and 'family income' were used to predict 'trust'. Like in the regression model above, these variables were included to control for demographic differences between survey respondents.

In Step 2 of the regression analysis, the instrumental measure of 'outcome favourability' was introduced as a predictor of 'trust'. Five relational items that measure facets of procedural justice were then introduced as a group of predictors in Step 3 of the regression analysis. These items were (1) 'ATO is fair', (2) 'neutrality', (3) 'respect', (4) 'consultation by the ATO', and (5) 'trustworthy treatment from the ATO'[14]. 'Outcome favourability' was entered into the model before the procedural justice items because Tyler (1997) claims that perceptions of fair treatment affect trust more so than favourable economic outcomes. If Tyler (1997) is correct in his assumption, the R^2 change value should be greater between Steps 2 and 3 of the model than between Steps 1 and 2. The results from this regression analysis can be found in Table 2.

As can be seen in Table 2, the regression analysis failed to explain a significant portion of the variance in Step 1 (see adjusted R^2 value). This indicates that the demographic variables did not have any effect on trust. In contrast, Steps 2 and 3 both explained significant portions of the variance (17% and 42% respectively). Analysis of the regression results will therefore mainly focus on the more complete third step.

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results were the same as the analysis presented in the main text; it was found that investors' debt level and trust still predicted taxpayers' resistance.

[14] Given that items 4 and 5 are thought to be precursors to feeling respected (Braithwaite et al., 2001), they were considered to be particularly important in this context.

Table 2: Hierarchical regression analysis showing antecedents of trust in the Tax Office

	Step		
Predictor	**1**	**2**	**3**
Age	0.05	-0.01	0.01
Sex	0.02	-0.00	0.00
Personal income	-0.03	-0.03	0.01
Family Income	0.04	0.05	0.01
Outcome favourability		0.41***	0.08***
ATO is fair			0.36***
Neutrality			0.30***
Respect			0.04*
ATO consultation			0.10***
Trustworthy treatment from ATO			0.08***
R^2	0.00	0.17	0.59
Adjusted R^2	0.00	0.17	0.58
R^2 change	0.00	0.17	0.42
F change	1.58	414.02***	410.80***
df	4, 2061	1, 2060	5, 2055

Note: predictor entries are standardised regression coefficients (β).
*p < 0.05. ***p < 0.001

Upon further inspection of Table 2, it can be seen that 58% of the variation in trust can be explained by the self-interest and procedural justice variables together (see adjusted R^2 value at Step 3). All of the procedural justice variables were found to have a positive effect on trust. For example, the relational item 'neutrality' had a positive effect on trust ($\beta = 0.30$, $p < 0.001$), indicating that respondents who believed the Tax Office was neutral in their decision-making procedures were more likely to have higher levels of trust. Likewise, those who were more likely to think the 'ATO was fair' ($\beta = 0.36$, $p < 0.001$), those who were more likely to feel the 'ATO respected them' ($\beta = 0.04$, $p < 0.05$), those who felt that the 'ATO consults with the public' about various tax issues ($\beta = 0.10$,

$p < 0.001$) and those who felt they got 'trustworthy treatment from the ATO' ($\beta = 0.08$, $p < 0.001$) were also more likely to have higher levels of trust in the Tax Office.

When it came to the self-interest variable 'outcome favourability', it was found that this item also had a significant positive effect on trust ($\beta = 0.08$, $p < 0.001$). This indicates that those who were more likely to think that Tax Office decisions were favourable to them were also more likely to have higher levels of trust in the Tax Office. As in the first regression analysis performed in this paper, this finding again suggests that self-interest does play a significant role. However, as can be seen by the magnitude of the change in R^2 between Steps 1 and 2 and between Steps 2 and 3 (0.17 and 0.42, respectively), and also by the size of the regression coefficients in Step 3, the self-interest variable did not have the strongest effect on trust. In fact, in general, perceptions of fair treatment appear to have affected investors' trust more so than having received favourable outcomes[15].

Summary of findings

The study reported in this paper examined why such a large number of tax scheme investors chose not to comply with the Tax Office's subsequent decision to recover tax owing on disallowed scheme deductions. Specifically, the study was interested in exploring whether trust played a role in this non-compliance. To summarise, it was found that scheme investors' level of trust in the Tax Office was substantially lower than that of the general population. It was also found that trust did play a role in the resistance exhibited by tax scheme investors, and this outweighed the role played by economic self-interest. Finally, when examining why investors' level of trust in the Tax Office was low, it was found that perceptions of unfair treatment appeared to have affected investors' trust more so than having received an unfavourable outcome.

[15] An additional hierarchical regression analysis was again conducted, replacing 'outcome favourability' with investors' actual debt level. Unlike in the analysis presented above, this more objective measure of economic self-interest did not significantly predict taxpayers' trust in the Tax Office. All five procedural justice items still predicted taxpayers' trust.

Discussion

While the law will always involve elements of coercion, the legal system has, at best, a limited ability to compel people to obey the law. Knowing what motivates people to obey and defer to decisions and rules is therefore important. As discussed in the introduction to this paper, the 'rational choice' model of the individual has previously dominated the formulation of public policy in many areas. This view suggests that people are motivated to maximise their personal gains and minimise their personal losses. Those advocating such a view therefore believe that non-compliance can only be dealt with by handing out harsh sanctions and penalties.

The situation surrounding the mass-marketed schemes issue demonstrates, however, that the use of threat and legal coercion as a regulatory enforcement tool—in addition to being more expensive to implement—can actually be counter-productive (see also Ayres & Braithwaite, 1992; Bardach & Kagan, 1982; Hawkins, 1990). The Tax Office's initial use of threat and legal coercion with 40 000 tax scheme investors in fact appeared to produce the opposite behaviour from that sought. Instead of complying, tax scheme investors actively resisted the Tax Office's repeated attempts to recover tax owing on their scheme related tax debts.

When attempting to explain why investors did not comply with the Tax Office's directives to pay back tax, the present study showed that taxpayer trust in the Tax Office played a very important role in explaining their behaviour. Specifically, the findings suggested that trust, rather than economic self-interest, was the major predictor of investor resistance towards the Tax Office, with those who were less trusting of the Tax Office being more resistant. This finding is important as it questions the appropriateness of the 'rational choice' model as a basis for effective regulation. Instead, the results argue that to effectively shape desired behaviour, regulators will need to move beyond an enforcement strategy linked purely to deterrence.

Moving towards a more effective model of regulation

Doubts about the effectiveness of a deterrence-based model of enforcement are not new. In fact, for the past decade, many contemporary regulatory theorists have been arguing that the most effective way in which to achieve genuine acceptance of regulations is not by an exclusive reliance upon legal coercion but rather through the use of strategies that attempt to bring the best out of those being regulated (for example, Ayres & Braithwaite, 1992; Braithwaite, 1993; Cherney, 1997; Sparrow, 2000). These theorists argue that regulatory agencies risk discouraging civic virtue if they engage in aggressive prosecution for relatively minor offences, because those being regulated are likely to feel that their past good faith efforts at compliance have not been acknowledged. Coupled with the findings of the present study, it is therefore proposed that a regulatory strategy that is directed at reducing levels of distrust between the two sides may prove particularly effective in gaining voluntary compliance with an authority's rules and decisions (see also Braithwaite & Makkai, 1994; Cherney, 1997).

As prisoner's dilemma games illustrate, the more likely one is to trust, the more likely trust will be reciprocated (Dasgupta, 1988; Gambetta, 1988)[16]. This result was also found in the present study. The perceived trustworthy treatment given by the Tax Office towards scheme investors was found to significantly predict investors' trust in the Tax Office. In other words, those investors who were less likely to feel that the Tax Office treated them as trustworthy were also less likely to trust the Tax Office in return. Findings such as these suggest that regulators may be able to use the responsive nature of trust to encourage relevant individuals or industries to enter into cooperative relationships, which in turn will ensure greater compliance with regulatory goals. This is because trust appears to be a resource like no other; it is not depleted through use but rather through lack of use (Gambetta, 1988). Hence, the more that regulatory interactions are based on trust the more likely regulators will be able to nurture the development of reciprocal trust relationships[17].

[16] In a prisoner's dilemma game two accomplices are held in separate rooms. Each is told that if they implicate their partner they will get off without any penalty. If one remains silent but the other confesses, the silent partner will be severely punished. If, however, they both remain silent they will both be let off lightly. The extent to which either prisoner trusts one another will determine the result.

[17] Although the present study used data collected from taxpayers accused of tax avoidance, the reader should not feel that the ideas discussed in the paper are limited to the taxation context. Rather, it is conceivable that a

The added advantage of adopting a regulatory strategy based on trust is that it would involve an efficient use of resources. Treating others as trustworthy in the first instance will elicit a more co-operative approach from the regulatee, more information is likely to be forthcoming about their practices and possibly about areas of non-compliance, and it will engage the regulatee in best practice decisions for securing compliance (Black, 2001). If such a strategy works, both sides avoid expensive enforcement and litigation procedures and more resources are left to expand regulatory coverage. In such a situation, society will gain the benefits of greater compliance at low cost to the economy.

Additional support for a trust-based model comes from examining the effects of the Tax Office's most recent approach to dealing with the schemes issue. The Tax Office's new approach indicates that a strategy that places trust in the foreground can actually be effective in gaining voluntary compliance. In February 2002, the Tax Office took on a more responsive role by first acknowledging that investors had been the victims of aggressive marketing and bad advice (thus, trust in investors' honesty was brought to the foreground). Second, those that had been the victims of aggressive marketing and bad advice were given a concession on their scheme related tax debts. This concession came in the form of a settlement offer, whereby culpability penalties and interest on each scheme related debt were abolished. As part of the deal, investors were also given a two year interest free period in which to repay their debts. Investors were given until 21 June 2002 to decide if they would accept the offer. This strategy resulted in the Tax Office receiving a flood of settlement acceptances and as of 21 June 2002, 87% of scheme investors had agreed to settle their debts with the Tax Office (Source: ATO correspondence).

Some readers may look at the scheme investors' response to the Tax Office's final settlement offer and conclude that they were ultimately influenced by economic self-interest. I would argue, however, that this was not the case. Prior to the Tax Office's final settlement offer, both interest rates and culpability penalties were reduced to approximately 5% each. Debts under that settlement offer were therefore not much higher than for the final offer. It was only when the Tax Office abolished culpability penalties and

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strategy based on trust would be equally applicable to any field of regulation, including those that regulate both individuals and large corporations.

acknowledged that investors were the victims of aggressive marketing and bad advice (thus considering them to be trustworthy) that investors agreed to settle. Additional support for this claim also comes from examining the regression results presented earlier. ‘Taxpayer resistance’ was not found to be related to the level of income investors earned. Those who were wealthy, and who might be expected to pay off their debts more easily, held the same attitudes and opinions towards the Tax Office as those who were less wealthy (investors’ debt level was not related to their income level; $\underline{r} = 0.19$).

So why is it that the Tax Office’s most recent strategy appears to have worked? Research indicates that people are concerned about being well regarded by others. For example, most Australian taxpayers express pride in being a member of the group called ‘honest taxpayers’ (Braithwaite et al., 2001). Being accused of purposeful tax avoidance implies dishonesty and untrustworthiness, which in turn can be perceived as a threat to one’s reputation. By being responsive to scheme investors, and finally giving them some benefit of the doubt, the Tax Office’s gesture acted to bring the majority of investors back into the system voluntarily.

It would be naïve, however, to think that a strategy based purely on trust would be effective in all cases (see Ayres & Braithwaite, 1992: Chapter 2). A strategy based purely on trust fails to recognise that there are some people who would take advantage of being presumed to be trustworthy. A regulatory strategy that combines a preference for trust with an ability to switch to a policy of distrust is therefore likely to be the most effective (see also Braithwaite & Makkai, 1994). This dynamic strategy could enable regulators to try trust first and escalate to more interventionist forms of regulation (for example, more severe sanctions) if abuse of trust occurs and persists. By having the threat of punishment in the background, it reinforces to individuals that a regulator’s attempts at cooperation should be listened to.

When escalating to more interventionist forms of regulation, however, it needs to be kept in mind that people are also strongly concerned about issues of fair treatment, neutrality and respect in forming their opinions about the way a regulator handles their situation. As the findings of the present study demonstrate, if sanctions or punishments are perceived to be procedurally unjust[18], regulators also run the risk of undermining trust. Thus, in order to create and maintain trust, regulators will need to acknowledge the importance of procedural justice in their dealings with future non-compliers, and make a commitment to implement and nurture the principles of justice and fairness. Regulators need to consider how they would want to be treated if their roles were suddenly reversed.

Conclusion

While this paper has not been the first to critique a regulatory strategy based on threat and legal coercion, it has been one of the first to provide convincing empirical evidence to support a regulatory strategy based on trust. In particular, the findings from the present study have shown that if taxpayers feel poorly treated by a tax authority as a result of their infractions, this can lead to a decrease in taxpayer trust. This decrease in trust can then go on to affect their willingness to comply, and can in fact lead to active resistance towards a regulatory authority. It has been proposed here that by using a strategy based on trust, regulators will be able to prevent widespread resistance towards their decisions, while at the same time nurturing the good will of those with a commitment to compliance.

[18] For example, scheme investors claim that the financing structures used in many of the tax schemes have been utilised by the 'big end of town' for over 20 years, incurring only sporadic application of Part IVA (see Senate Economics References Committee, 2002). A large proportion of investors therefore feel that the 'big end of town' has gained preferential treatment from the Tax Office, and that the law has been applied inconsistently between the two groups.

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Appendix A

To date, three categories of mass marketed schemes operating in the Australia have been identified by the Tax Office (Australian Taxation Office, 2000). These include, (1) round-robin schemes, including non-recourse financing, often in agriculture, afforestation and franchises; (2) certain film schemes, with guaranteed returns that are, in effect, a return of part of the invested funds; and (3) employee benefit arrangements that have tax benefits as their main purpose. It is only the first two types of scheme that are of relevance to the present study.

An example of a round-robin scheme is the franchise scheme 'Oracle'. Oracle offered investors the opportunity to invest in a business that promoted and presented personal development and educational workshops. By making an initial cash outlay of $10 000 and borrowing $30 000 from Oracle's financing company, investors could claim an immediate tax deduction of $40 000. This would therefore lead to some investors, depending on their original income level, to receive a tax refund from the Tax Office of up to $19 400 (Source: Oracle International Pty Ltd Prospectus, p. 3). From here, $10 000 of the $19 400 went into paying the initial $10 000 set up fee. In some cases, investors were therefore able to pocket the remaining $9400.[19] Several aspects of the investment were of concern to the Tax Office. One major concern was that the loan of $30 000 was repayable only from the proceeds of the business. If the business made no profit investors would not be required to repay the loan. Therefore, unlike many other investments (for example, negative gearing of property), there was no risk to the investor. In addition, some scheme investors made a profit from their tax return (in some cases the profit was as high as $9400). Another concern for the Tax Office related to the nature of the deduction made. Specifically, only a fraction of the $40 000 claimed as a tax deduction went into the underlying activity. For many scheme arrangements, the majority of the money raised went into financing the management fees.

[19] It should be noted, however, that the majority of investors did not personally receive anywhere near this amount, or alternatively, they channelled the whole amount back into the business.

Appendix B

Below is a complete list of the measures used in the analyses of the present paper. It also details the original scale formats, the recoding of the data if applicable, reliability coefficients of each scale, and the mean score obtained on each scale.

Institutional Trust

A measure of Valerie Braithwaite's (1997) institutional trust, modified for use with the Tax Office, was constructed by combining responses to all seven items. This particular scale measured investors' level of trust in the Tax Office and it was found to have a Cronbach's alpha reliability coefficient of 0.86. Mean score = 2.40

> Think of the Tax Office and what it has been doing over the past few years. To what extent do you agree or disagree with the following statements. The Tax Office …

- Has misled the Australian people (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*; reverse coded)
- Acted in the interests of all Australians (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- Turned its back on its responsibility to Australians (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*; reverse coded)
- Is trusted by you to administer the tax system fairly (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- Takes advantage of people who are vulnerable (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*; reverse coded)
- Meets its obligations to Australians (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- Is open and honest in its dealings with citizens (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)

Change in trust

Measured through one item developed by Murphy (2002). Mean score = 1.43

- As a result of your amended tax return, do you have more or less trust in the Tax Office? (1 = *a lot less trust*, 2 = *less trust*, 3 = *no change*, 4 = *more trust*, 5 = *a lot more trust*).

Procedural Justice

Measured through five multi-item scales representing procedural justice – three adapted from Tom Tyler (1997) (scales a-c below) and two adapted from John Braithwaite and Toni Makkai (1994) (scales d-e below).

(a) Neutrality

Cronbach's alpha = 0.60. Mean score = 2.49

- The Tax Office gives equal consideration to the views of all Australians (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- The Tax Office gets the kind of information it needs to make informed decisions (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- The Tax Office is generally honest in the way it deals with people (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)

(b) Tax Office is fair

Cronbach's alpha = 0.80. Mean score = 2.15

- The Tax Office considers the concerns of average citizens when making decisions (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- The Tax Office cares about the position of taxpayers (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- The Tax Office tries to be fair when making their decisions (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)

(c) Respect

Cronbach's alpha = 0.71. Mean score = 3.13

- The Tax Office respects the individual's rights as a citizen (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- The Tax office is concerned about protecting the average citizen's rights (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)

(d) Trustworthy treatment from the Tax Office

Cronbach's alpha = 0.59. Mean score = 2.37

- The Tax Office treats people as if they can be trusted to do the right thing (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- The Tax Office treats people as if they will only do the right thing when forced to (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*; reverse coded)

(e) Consultation

Cronbach's alpha = 0.64. Mean score = 1.98

- The Tax Office listens to powerful interest groups, not to ordinary Australians (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*; reverse coded)
- The Tax Office is more concerned about making their own job easier than making it easier for taxpayers (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*; reverse coded)
- The Tax Office consults widely about how they might change things to make it easier for taxpayers to meet their obligations (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- The Tax Office goes to great lengths to consult with the community over changes to their system (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)

Resistance

Measured through a multi-item scale based on the work of Valerie Braithwaite (1995). Cronbach's alpha = 0.67. Mean score = 3.72

- It's impossible to satisfy the requirements of the Tax Office completely (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- The Tax Office is more interested in catching you for doing the wrong thing, than helping you do the right thing (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- It's impossible not to let the Tax Office push you around (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- If you don't cooperate with the Tax Office, they will get tough with you (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- Once the Tax Office has you branded as a non-compliant taxpayer, they will never change their mind (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)
- As a society we need more people wiling to take a stand against the Tax Office (1 = *strongly disagree*, 2 = *disagree*, 3 = *neither*, 4 = *agree*, 5 = *strongly agree*)

Outcome Favourability

Measured through two items taken from Tom Tyler's (1997) instrumental judgment index. Cronbach's alpha = 0.70. Mean score = 2.57

- How often do you agree with the decisions made by the Tax Office? (1 = *almost never*, 2 = *on occasion*, 3 = *sometimes*, 4 = *mostly*, 5 = *almost always*)
- How often are the decisions of the Tax Office favourable to you? (1 = *almost never*, 2 = *on occasion*, 3 = *sometimes*, 4 = *mostly*, 5 = *almost always*)

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