

CENTRE FOR TAX SYSTEM INTEGRITY



Moving towards a more effective model
of regulatory enforcement in the
Australian Taxation Office

Kristina Murphy



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MORE EFFECTIVE MODEL OF
REGULATORY ENFORCEMENT IN
THE AUSTRALIAN TAXATION
OFFICE**

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THE CENTRE FOR TAX SYSTEM INTEGRITY WORKING PAPERS

The Centre for Tax System Integrity (CTSI) is a specialised research unit set up as a partnership between the Australian National University (ANU) and the Australian Taxation Office (Tax Office) to extend our understanding of how and why cooperation and contestation occur within the tax system.

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.

Abstract

In 1998 the Australian Taxation Office (Tax Office) introduced a new regulatory model into the organisation to improve their long-term compliance enforcement strategies. Many tax authorities around the world have expressed interest in the ATO Compliance Model and some (for example, UK, New Zealand) have since introduced similar models into their organisations. The ATO Compliance Model was designed using the concept of responsive regulation—a concept developed by scholars working in other fields of regulation. This paper aims to provide the reader with a background to understanding the theoretical concepts underlying the Model, and also discusses how and why the Tax Office came to develop the model. Using interview data collected from senior Tax Office executives, this paper will also present some success stories the Tax Office has had with the Model in changing taxpayer attitudes and behaviours.

Moving towards a more effective model of regulatory enforcement in the Australian Taxation Office

Kristina Murphy

Introduction

In 1998 a pyramidal model of responsive regulation was introduced into the Australian Tax Office (Tax Office) as a means to improving its management of taxpayer compliance (Cash Economy Task Force Report, 1998). In developing this model, the Tax Office incorporated regulatory theory that had been developed by regulatory scholars working in other fields of regulation (such as mining regulation, and environmental regulation; see Ayres & Braithwaite, 1992), as well as psychological theories that had been developed in the study of nursing home regulation (Braithwaite, 1995; Braithwaite, Braithwaite, Gibson & Makkai, 1994). Five years on, the ATO Compliance Model is being used routinely by Tax Office staff to help them develop more effective compliance strategies.

Since being introduced into the Tax Office in 1998, several other tax authorities around the world are beginning to recognise the value of the ATO Compliance Model. For example, the OECD has expressed interest in the model and both the United Kingdom and New Zealand have since taken the ATO Compliance Model and developed similar models that suit their local contexts (Hamilton, 2003; New Zealand Inland Revenue, 2001; UK Inland Revenue, 2001). The Pennsylvania State Revenue Department in the United States has also recently expressed interest in the Model and has begun conducting research, in collaboration with the University of Pennsylvania, to test the effectiveness of some of the principles outlined in the Model.

The aim of the present paper will be to first provide the reader with some background information about the regulatory principles that underpin the ATO Compliance Model (these principles also underlie the UK and New Zealand Models). It will then move on to discuss why and how the Tax Office came to develop their model, and it will also discuss some of the success stories that the Tax Office has had with the Compliance Model in improving attitudes and compliance among taxpayers.

An overview of regulatory theory

A debate in the regulatory literature has been between those who think that individuals and firms will comply with rules and regulations only when confronted with harsh sanctions and penalties, and those who believe that gentle persuasion and cooperation works in securing compliance with the law (see Ayres & Braithwaite, 1992). These two alternate approaches to regulation have been termed the ‘deterrence’ and ‘accommodative’ models of regulation. As will be discussed in later sections, a responsive model of regulation combines the best of both approaches into a single enforcement pyramid.

For those advocating a purely deterrence view, individuals and firms are seen to be ‘rational actors’ who are motivated entirely by profit seeking. They 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 (for a discussion see Kagan & Scholz, 1984). Advocates of this view therefore believe that harsh sanctions and penalties should be used to ensure compliance. Throughout the 1970s the majority of regulatory agencies around the world adopted such a deterrence model of regulatory enforcement. Regulatory officers were more likely to respond to detected shortcomings by immediately issuing notices of violation and issuing fines and as a result were seen to be harsh and insensitive (Kagan, 1989).

The deterrence model of enforcement has been criticised on a number of dimensions. One criticism has been that it 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 has currently been observed. Take, for example, the issue of tax compliance in Australia. The tax system in Australia is based largely on self-assessment and voluntary compliance by taxpayers. The probability of receiving an audit from the Tax Office is low. The chance of being caught avoiding tax is also, on the balance of probabilities, unlikely, and if a taxpayer is caught, the culpability penalties are relatively minor when compared to the potential for economic gain. Yet the majority of Australian taxpayers still comply with their obligations and pay their taxes with good will

(Braithwaite, 2003). This is much like the situation in countries such as the United Kingdom or the United States. Smith and Kinsey, for example, showed that the majority of American taxpayers were compliant even when the possibility of detection and punishment for non-compliance was obviously slim (Smith & Kinsey, 1987). Findings such as these are not unique to the field of tax compliance. For example, in a study of environmental compliance in the United Kingdom, researchers also found that the majority of regulated entities complied with regulatory requirements even though less than one percent of violators were prosecuted and fines were minimal (Hawkins, 1984).

In the 1980s, therefore, many researchers began to question the value of deterrence in regulating behaviour. Regulatory scholars began to focus their attention on researching compliance rather than deterrence and began to realise the importance of persuasion and cooperation as a regulatory tool for gaining compliance. Many regulatory agencies followed suit by adopting accommodative models of regulation (Grabosky & Braithwaite, 1986). Regulatory agencies advocating the accommodative model of regulatory enforcement tend to view business firms and individuals not as 'rational actors' but as 'social actors' who are ordinarily inclined to comply with the law, partly because of belief in the rule of law, and partly as a matter of long-term self-interest (Kagan & Scholz, 1984). Regulatory agencies adopting the accommodative model tend to be more oriented toward seeking results through cooperation rather than by coercion, and prefer to see themselves as consultants rather than as strict law enforcers. These agencies are more likely to give second chances, they give advice about how to comply, and may agree to ignore one violation in return for a correction to another violation.

The pros and cons of punishment and persuasion

Both the deterrence and accommodative approaches to regulatory enforcement have their advantages. It should be noted, however, that each approach also has major disadvantages if regulators choose to adopt one exclusively over the other. For example, it has been shown that the problem of a mostly punitive policy is that it fosters resistance to regulation and may produce a culture that facilitates the sharing of knowledge about methods of legal resistance and counterattack (Bardach & Kagan, 1982). Kagan and Scholz (1984) further

suggested that unreasonable behaviour by regulators can also generate resistance to compliance. Unreasonableness may involve disrespect for citizens, or arbitrary refusal to take their concerns into account in the enforcement process. For example, when a taxpayer with good compliance records inadvertently violates tax laws because the rules are complex or ambiguous, they are likely to regard punishment by the tax authority as unreasonable and unfair. If regulators adopt a purely punitive method of regulating, whereby they assume that individuals are solely self-interested and motivated by money, this may be perceived as unreasonable and will dissipate the will of well-intentioned individuals to comply, leading to potential resistance to the law (for a case study demonstrating this effect in the Australian taxation context see Appendix). In addition to the negative psychological effect of deterrence, punishment is often very time consuming and therefore very expensive.

Arguments usually put in favour of adopting an accommodative (or responsive) approach, are that it involves an efficient use of resources. In other words, persuasion is relatively inexpensive because persuasion will elicit a more cooperative 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 decisions as to how best to act to secure compliance (Black, 2001). If persuasion works, both sides avoid expensive enforcement and litigation procedures and more resources will be left to expand regulatory coverage. In this situation, society also gains the benefits of improved compliance at low cost to the economy.

While research on the effectiveness of the accommodative approach is only in its infancy, there is growing evidence to suggest that cooperation with regulated entities increases compliance. For example, support for a regulatory enforcement model based on cooperation and trust comes from examining the Tax Office's recent approach with 42 000 taxpayers who were accused of being involved in tax avoidance schemes (Murphy, in press; see also Appendix). After realising that their traditional deterrence approach for dealing with non-compliant taxpayers was not working (that is, more than 50% of taxpayers refused to pay back their taxes), the Tax Office decided to take on a more cooperative approach by first acknowledging that tax scheme 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 scheme related debts were abolished. After four years of active resistance, this strategy resulted in the Tax Office receiving a flood of settlement acceptances, with 87% of scheme investors finally agreeing to settle their debts with the Tax Office (Commissioner of Taxation, 2003).

In another study of compliance with Australian nursing home care standards, Braithwaite and Makkai (1994) also found that an accommodative regulatory strategy in the first instance was more effective in gaining voluntary compliance. In this study, 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 and the compliance score given at the second inspection was of interest. Braithwaite and Makkai found that if inspectors were initially seen to be treating nursing home managers with trust and cooperation, compliance was more likely to improve in the two years following the initial inspection. Scholz (1991) also found that the Occupational Safety and Health Administration in the United States could increase the effectiveness of their regulatory enforcement by administering less stringent sanctions and penalties (for similar findings see Feld & Frey, 2002; Fisse & Braithwaite, 1993; Frey, 1997).

It is acknowledged, however, that adopting a *purely* accommodative model of regulation, which basically views all individuals as good and honest, would be naïve. This regulatory style fails to recognise that there are individuals who are not so honest and who will take advantage of being presumed to be so. For example, one study conducted in Canada found that the same companies continued to violate health and safety regulations, despite being given lenient treatment (Brown, 1994). It was found that repeat violations accounted for 31% of the approximately 200 000 violations recorded between 1984 and 1986. Yet, regulators seldom imposed penalties on employers with repeat violations. In another study,

Harrison (1995; cited in Shapiro & Rabinowitz, 1997) compared compliance rates between pulp and paper industries in Canada and the United States and found lower compliance rates in Canada. Harrison attributed this finding to the fact that Canadian enforcers tend to be more lenient than their American neighbours when addressing non-compliance.

When considering all of these findings together, a regulatory enforcement strategy based solely on accommodation or a regulatory enforcement strategy based solely on deterrence is not the answer. The following section describes a new approach to regulation. This approach allows regulators to ‘speak softly, while carrying very big sticks’ (Ayres & Braithwaite, 1992, p. 40); that is, to be legalistic in some cases but accommodative and helpful in others. In other words it is an approach that seeks to establish a synergy between deterrence and accommodation.

Moving forward: Responsive regulation

In his book *To Punish or Persuade: Enforcement of coal mine safety*, John Braithwaite argued that sound regulatory enforcement could not be developed unless regulators understood the fact that sometimes those being regulated were motivated solely by making money and sometimes they were motivated by a sense of social responsibility (Braithwaite, 1985; see also Kagan & Scholz, 1984). In other words, it is possible that a firm may be a responsible citizen and social actor today but a rational actor calculating costs and benefits next month. Braithwaite therefore rejected a regulatory strategy based totally on persuasion or a regulatory strategy based totally on punishment. Following on from this argument, in his 1992 book with Ian Ayres, John Braithwaite stated that the time had come to escape what he described as ‘a long history of barren disputation’ between those advocating accommodative and those advocating deterrent models of regulatory enforcement (see Ayres & Braithwaite, 1992, Chapter 2). He proposed a convergence of the two approaches. This new theoretical approach to regulation is known most widely as *responsive regulation*, and it is now being recognised that regulatory agencies that do best at achieving their goals are those that strike some sort of sophisticated and dynamic balance between the deterrence and accommodative models of regulation.

The basic contention of Ayres and Braithwaite's theory of responsive regulation is not whether to punish or persuade, but *when* to punish and *when* to persuade. Ayres and Braithwaite clearly envisaged the possibility of stylistic choices within an agency, as staff encounter differing motivations among industries and individuals. Ayres and Braithwaite further suggested that regulatory officers should be prepared to shift from strict regulators to educators and back again according to their analysis of a particular case (see also Black, 2001; Kagan & Scholz, 1984). They also suggested that this flexibility in regulatory style could be adopted through the use of an enforcement pyramid of regulation.

The regulatory pyramid

One version of regulatory responsiveness involves the use of a hierarchy of graduated responses to non-compliance. John Braithwaite (1985) was the first to argue that compliance is most likely when an agency displays an explicit enforcement pyramid. According to Braithwaite, 'defection from cooperation is likely to be a less attractive proposition for business when it faces a regulator with an enforcement pyramid than when confronted with a regulator having only one deterrence option' (Ayres & Braithwaite, 1992, p. 36).

As can be seen in Figure 1, an enforcement pyramid consists of a number of layers, each layer representing a different enforcement activity a regulator could use to gain compliance from a regulated firm. As one escalates up the pyramid in Figure 1, the regulatory strategy changes from persuasion at the bottom through sanctions of increasing severity to licence revocation at the top. Ayres and Braithwaite (1992) suggest that a pyramid such as this should be used in conjunction with a 'tit for tat' strategy (see also Scholz, 1984a; 1984b). If the firm or individual being regulated is being cooperative, the regulator should respond in turn by being cooperative. If the regulated firm or individual is being uncooperative, the regulator should escalate up the pyramid through a range of compliance options that eventually lead to harsh sanctions. Thus, an enforcement pyramid such as this subjects regulatees to escalating forms of regulatory intervention if they continually refuse to respond to regulatory demands. Clear communication in advance that a regulator is willing to escalate their enforcement strategies up the pyramid in response to uncooperativeness

also gives incentives to those being regulated to comply with their demands. It is also important that regulators follow through with this enforcement action if it has been threatened, otherwise they may risk undermining the integrity of the system.

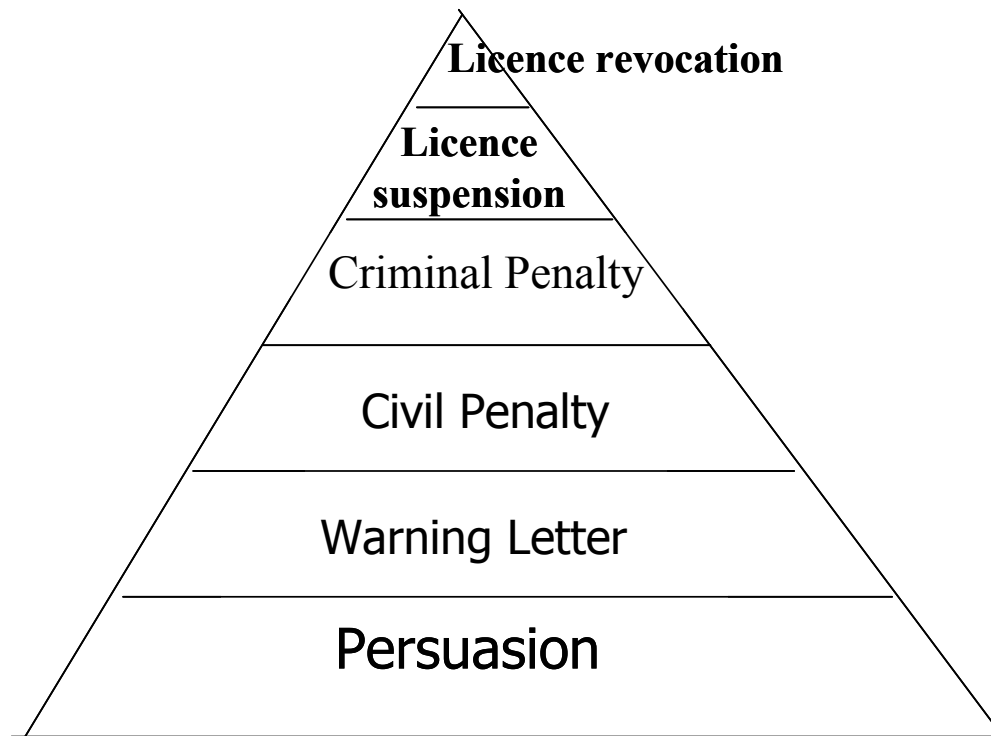


Figure 1: Ayres and Braithwaite's enforcement pyramid (source: Ayres & Braithwaite, 1992, p. 35)

One might ask, however, where the starting point should be. Should a regulator always start at the bottom of the pyramid, or should they start somewhere in the middle? Ayres and Braithwaite (1992) argue that because of the disadvantages of a punishment approach (that is, expense, counterproductive, unworkable in the long term), regulators should always start their enforcement strategies softly by using cooperation and persuasion, and should only respond with sanctions and penalties when the regulated firm or individual continues to be non-compliant. The advantage of using a pyramid such as this is that its use is therefore not dependent on a correct diagnosis of the motives of the firm or individual being regulated. One does not have to predict in advance whether the individual or firm is motivated by money or morals. All one needs to do is look for cooperation in correcting the problem at hand.

Experienced tax auditors sometimes have a problem with the use of a cooperative first encounter. They argue that their case selection methods and their experience give them a reasonably arguable position that some tax mischief has occurred and that they should enter the regulatory encounter ready to sanction. The proponents of an enforcement pyramid would counter argue that a cooperative first step will allow the delinquent taxpayer the opportunity to change their behaviour and adopt a compliant position. If this does not occur, then a swift escalation to sanctions is required to ensure that both parties understand the serious consequences of non-compliance. The costs of a cooperative first step to both parties are low, it only takes minutes at the commencement of each interaction, and the potential gains are high for each party.

So why should cooperation and persuasion be the strategy of first choice? Ayres and Braithwaite argue that when punishment rather than dialogue is in the foreground of a regulatory encounter, it is basic to human psychology that people will find this humiliating. Citizen response is likely to be weakened respect for compliance with the law. By keeping punishment in the background instead of the foreground of the encounter, the regulator is more likely to keep an individual's law-abiding self to the fore.

According to Ayres and Braithwaite, persuasion should be the strategy of first choice because preserving the perception of fairness is important to nurturing voluntary compliance (see also Murphy, 2002, 2003a, 2003b, in press; Tyler, 1990). While not having the space here to discuss this issue in detail, social theories that understand compliance from the perspective of institutional legitimacy and procedural fairness suggest that individuals and firms will regard tough enforcement action as more procedurally fair when persuasion has been tried first (Braithwaite & Braithwaite, 2001; Lind & Tyler, 1988). Research has also found that people are most likely to challenge a situation collectively when they believe that the procedures are unfair and that they personally suffered because of the injustice (Murphy, 2002, 2003b, in press; Tyler & Smith, 1998).

This is not to say that there is no place for punishment. While Ayres and Braithwaite argue that persuasion should be the strategy of first choice, they also suggest that if a regulated firm or individual continues to be non-compliant, the regulatory authority should increase

the severity of the regulatory response accordingly. In fact, ‘regulators should always retain the capacity to apply tough sanctions, because a strategy based entirely on persuasion and self-regulation will be exploited when actors are motivated by economic rationality’ (Sparrow, 2000, p. 40). Part of the key to successful regulation is the need for regulators to maintain their reputation for toughness so that they will not be perceived as ‘toothless tigers’. If regulatory agencies fail to punish rule breakers, others will start to question their own compliance. In her examination of tax enforcement, for example, Levi (1988) stresses that active prosecution of violators is crucial because perceptions of ‘exploitation’ will encourage non-compliance in other taxpayers. The key to maintaining compliant behaviour in any area of policing, therefore, is for regulators to remain able and willing to devote resources to maintain their reputation for toughness. But again, regulators should not lose sight that this portrayal of toughness should also be balanced with a respectful and cooperative approach in the first instance.

Finally, Ayres and Braithwaite (1992) argue that the greater the heights of tough enforcement to which an agency can escalate (at the apex of the enforcement pyramid), the more effective the agency will be at securing compliance and the less likely that it will have to resort to tough enforcement. ‘Regulatory agencies will be able to speak more softly when they are perceived as carrying big sticks’ (p. 6).

For example, consider the enforcement pyramid presented in Figure 2a. Here, it can be seen that the heights to which the regulatory agency can escalate its enforcement strategies are rather limited. There are not enough options for dealing with different types of non-compliers. In this situation, a regulator may have someone who has continuously violated regulations receiving the same sanction as someone who may have inadvertently violated a law for the first time. In the case of the pyramid in Figure 2b, however, the heights to which the regulatory agency can escalate its enforcement strategies are quite varied. In the case of the first time offender, a slap on the wrist might be considered more appropriate than revoking their operating license. In the case of the repeat offender, however, previous attempts to bring them into compliance have obviously failed and it would seem prudent in this situation—once the facts of their case have been determined—to take more serious action against them (because after all, they have been given several chances before).

Thus, the advantage of having a range of sanctions is that the regulator can pick and choose between a strategy they think is most appropriate given the circumstance. In addition, in the case of the enforcement pyramid in Figure 2b, the more punitive the sanction at the apex of the pyramid, the more likely an individual or firm will think the regulator is someone who should be listened to and cooperated with.

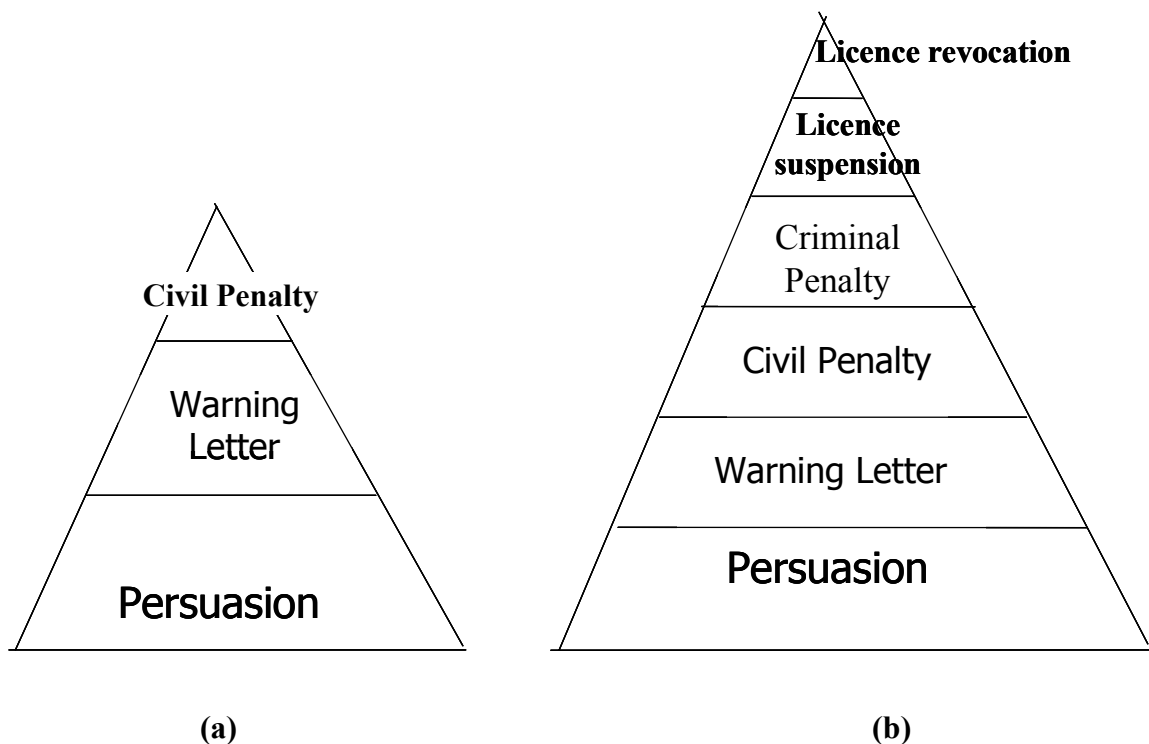


Figure 2. Regulatory enforcement pyramids that (a) provide regulators with a limited range of regulatory responses and (b) provide regulators with a range of regulatory responses to choose from (taken and adapted from Ayres & Braithwaite, 1992, p. 41).

Summary

So in summary, responsive regulation is a mix between the accommodative and deterrence models of enforcement. It has been suggested that one way to use responsive regulation effectively is to use an enforcement pyramid whereby the regulator can start with persuasion and escalate up the pyramid, skipping levels if necessary, if cooperation is not forthcoming. Finally, the advantage of using an enforcement pyramid such as this is that it

offers regulators a range of sanctions to choose from; it allows them to match the persuasive or sanctioning strategy to the level of observed non-compliance.

Bringing responsive regulation to life: The ATO Compliance Model

The advantages of adopting a model of responsive regulation have been increasingly recognised by many regulatory authorities. For example, in the late 1990s, the Tax Office realised that it should do more than just collect revenue. They recognised that a tax authority should also concern itself with building community confidence and partnerships to ensure the long-term sustainability of the tax system. A move away from the old style of command and control regulation was seen to be one way that this could be achieved. A pyramidal model of responsive regulation was therefore introduced into the Tax Office as a means to improving its long-term management of the tax system. Since this time, and after in-depth discussions with the Tax Office, a number of other tax administrations around the world have either introduced or are considering introducing similar models. The following sections will outline the moves made by the Tax Office to introduce its Compliance Model of regulation and will discuss some of the success stories that have been achieved as a direct result of the Compliance Model being utilised.

Reasons why the Compliance Model was introduced

As discussed in detail by Job and Honaker (2003), the Tax Office was facing a serious legitimacy crisis during the 1990s. Constant media reports about poor Tax Office practices, bully-boy tactics and accusations of excessive and unfair use of power were rife (Gumley & Wyatt, 1996). There were claims that the Tax Office was ‘out of touch’ and ‘lacked understanding’ (Anonymous, 1997a, 1997b, 1997c) and that poor use of penalties ‘threatened the integrity of the tax system’ (Chamberlain, 1996). Criticism and demands for change therefore came from community and government alike.

In response to political questioning and regulatory policy debate, the Tax Office adopted several measures intended to make it more open and sensitive to the concerns of taxpayers. These measures included the introduction of the *Taxpayers’ Charter*—a document that sets

principles and standards for the way the Tax Office conducts its dealings with taxpayers—and perhaps more importantly the move away from the long-established style of command-and-control enforcement to a program of responsive regulation (Hobson, 2003; Job & Honaker, 2003; Shover, Job & Carroll, 2003). This took the form of the *ATO Compliance Model*, which was publicly released for use in the Tax Office in 1998.

Prior to the introduction of the Compliance Model, the Tax Office was quick to escalate their enforcement strategies as soon as problems arose. Little or no consideration was given to a taxpayer's individual circumstances, and no thought was given to achieving future compliance. In an area such as taxation, the behaviour that is being regulated is continuous and fundamental to the long-term health of the community. In such a regulatory context, field officers must display patience and tolerance rather than legal authority, for the goal is not to punish but to secure long-term voluntary compliance (Hawkins, 1984; Black, 2001). The overarching aim of the ATO Compliance Model, therefore, was to create an environment that promoted compliance and provided a situation where long-term voluntary compliance and the systemic integrity of the tax system could be achieved.

As can be seen from the following section, communication with taxpayers plays a significant role in the ATO Compliance Model. Through adoption of the model, the Tax Office has acknowledged that they must communicate with taxpayers that they will be cooperative first. If there is no taxpayer cooperation in return the Tax Office will then communicate that it has the power and has the potential to use a range of punishments if compliance is not forthcoming. Hence, because of its hierarchical approach to compliance management, the ATO Compliance Model suggests that instead of the former routine of applying enforcement strategies and penalties, that enforcement should begin primarily through understanding, education and service delivery and progress to stronger methods (for example, audits or penalties) if and when resistance to compliance obligations is met.

The ATO Compliance Model

The ATO Compliance Model is depicted graphically in Figure 3 below. The work of Ian Ayres and John Braithwaite (1992) on strategies of regulation, and the work of Valerie

Braithwaite (1995; see also Braithwaite et al., 1994) on motivational postures, strongly influenced the design of the model.

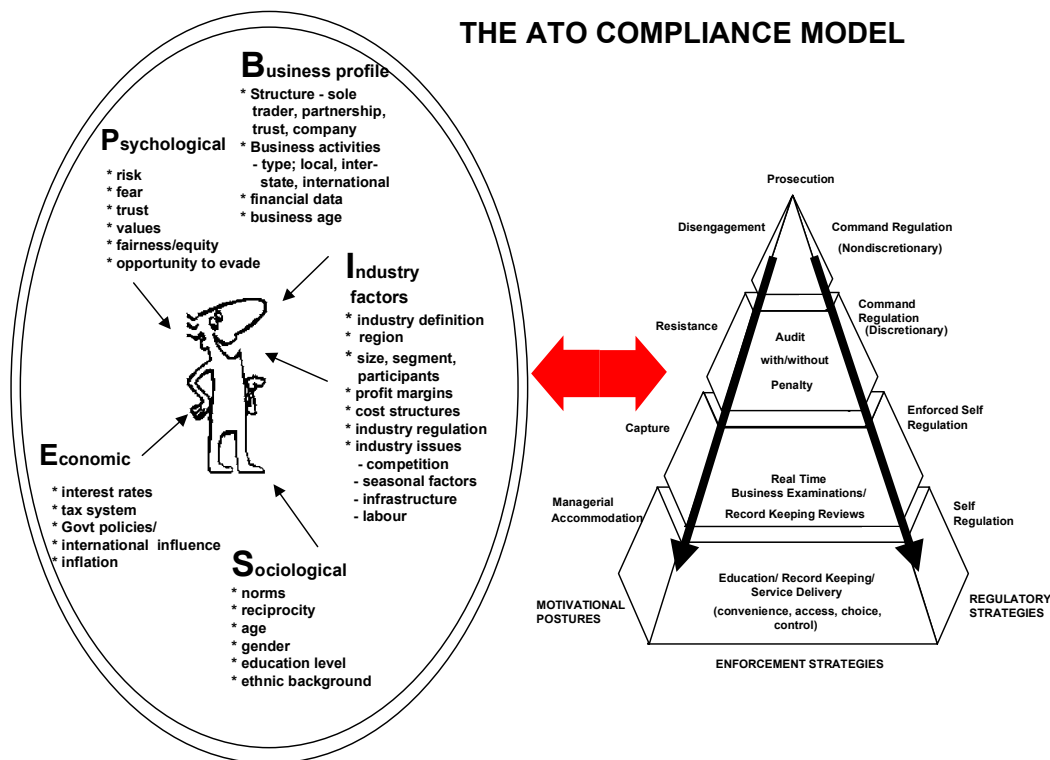


Figure 3: The ATO Compliance Model (source: Cash Economy Task Force Report, 1998).

As can be seen in Figure 3, there are three parts to the ATO Compliance Model: (a) understanding the whole of the environment in which the regulatory act occurs at the far left of the model (that is, the BISEP factors), (b) the attitude of the taxpayer to their taxation obligations on the left hand side of the pyramid, and (c) the range of available regulatory strategies on the right hand side of the pyramid. There is also an additional part to the Model that cannot be depicted graphically. This part involves matching the taxpayer's attitude to compliance to the appropriate enforcement strategy that should be used by the regulator (that is, how to manage the compliance).

The BISEP component of the model (that is, *B*usiness, *I*ndustry, *S*ocial, *E*conomic and *P*sychological factors) enables the Tax Office to understand the environment in which the regulatory act occurs. It allows the Tax Office to understand why a person may or may not be complying and it highlights that many different factors may be impacting upon their attitudes (such as trust or ethnic background). Hence, the first step in applying the Compliance Model is to determine which factors influence a taxpayer's attitude to compliance.

The concepts presented on the left side of the pyramid were initially developed in the 1990s by Dr Valerie Braithwaite as part of her research into the Australian nursing home industry. The left side of the pyramid looks at different attitudes and behaviours of the taxpayer (that is, their motivational postures). A good understanding of a taxpayer's BISEP factors allows the regulator to understand why a person has a certain attitude towards paying tax. As can be seen in Figure 3, there are four attitudes to compliance (for a fifth attitude, gameplaying, see below) that a taxpayer could adopt: commitment, capture, resistance, and disengagement. These postures represent the ways in which an individual could position themselves in relation to a regulatory authority, and they are predispositions to compliant or non-compliant conduct (Braithwaite, 1995). Taxpayers who adopt a committed or captured posture are generally compliant, while those who are resistant or disengaged are generally more likely to be non-compliant (Braithwaite, 2003). One very important aspect to understand about the left side of the enforcement pyramid, however, is that attitudes and behaviours can change; they are dynamic not static. A taxpayers' posture towards the Tax Office and paying tax can change on a daily, weekly or monthly basis. They can change in relation to different topics and they can change in response to the person they are dealing with.

The attitude of commitment represents taxpayers who are ready, willing, and able to comply with their tax obligations. They are committed to meeting their obligations and they consider there is a moral or ethical obligation to comply with the law. They usually regulate their own compliance. It has been found that approximately 92% of the Australian taxpaying population endorses a committed posture towards the tax system (Braithwaite, 2003). The second attitude of capture represents those taxpayers who may not be happy

with the Tax Office or tax system, but they acknowledge that paying tax is a part of life and accept their role as taxpayers. Further, captured taxpayers often require additional assistance in meeting their obligations as they may not have the skills or knowledge to get things right (73% of Australian taxpayers have been found to endorse a captured posture; Braithwaite, 2003). Most people say they want to meet their tax obligations because they want to, or because they have to. It is obviously in the interests of the tax regulator to ensure that most taxpayers remain committed, or at least captured by the system. The 73% of captured taxpayers need to interact with a fair and respectful tax system that treats them with integrity. These results also indicate that almost all Australian taxpayers will respond positively to cooperative and respectful treatment from the tax regulator.

The attitude of resistance represents those taxpayers who actively resist the self-regulatory system. They are likely to view the Tax Office with antagonism because they feel the Tax Office is actively pursuing people to 'catch them out' rather than to help them, and they are likely to believe that people should take a stand against the Tax Office. Here, this may involve trying to avoid meeting their compliance obligations. Fifty-five per cent of taxpayers were found to endorse a posture of resistance (Braithwaite, 2003). This means that they have concerns about the system and will avoid their obligations if given an opportunity to do so. Stronger sanctions need to be emphasised with this group if they reject initial respectful and cooperative overtures by the tax regulator. This group might participate in the cash economy as an act of political defiance if they have the opportunity to do so. They may also engage in other acts of creative compliance (McBarnet, 2003; McBarnet & Whelan, 1999), such as underestimating income or overstating deductions because they have concerns about the integrity of the system. They therefore need to understand the increased risks and costs of their potential forays into non-compliant territory.

The fourth attitude of disengagement represents those taxpayers who do not care that they are not doing the right thing by the Tax Office and they believe the Tax Office cannot do anything to them if they choose not to pay their taxes. In other words, these taxpayers no longer want to participate in the system (about 7% of taxpayers report being disengaged from the system; Braithwaite, 2003). Disengaged taxpayers still deserve a respectful and

cooperative first step. However, their responses to the regulator, and probably their history, will indicate a very rapid escalation to the top of an enforcement pyramid. The worst cases of disengagement are not usually regulated by a single agency in Australia. These hardcore transgressors generally require the cooperation of multiple regulatory agencies to join forces to incapacitate them (Ayres & Braithwaite, 1992).

In her book *Taxing Democracy*, Valerie Braithwaite (2003) describes what she sees as a fifth attitude to compliance in the area of tax. Although not physically depicted on the ATO Compliance Model, this fifth attitude represents taxpayers who are game-players. These taxpayers enjoy the game of finding the grey areas of tax law and the challenge of minimising their tax (about 13% of taxpayers). They do not necessarily think they are doing the wrong thing by the Tax Office, and they often believe they are fulfilling their obligations under the law (Murphy, 2003a, 2003b; Murphy & Byng, 2002a). This group of taxpayer are unique as they can sit anywhere along the left side of the compliance pyramid. Regulatory strategies for this newly identified group require further research.

It is indeed possible for these postures to be held simultaneously, depending on the context (thus, the explanation for the overlap in taxpayers endorsing a particular posture; 92% committed, 73% captured, 55% resistant, 7% disengaged, 13% game-players). For example, a taxpayer may be genuinely committed to the tax system while at the same time being resistant to it. Those who resist most vocally, who challenge Tax Office decisions and who are openly critical of the institution, are not necessarily more non-compliant as a group than taxpayers who choose other ways of engaging with the system. Instead, they might just be exercising their democratic right to protest against a particular decision or rule they feel to be unjust. In such a situation, resisters may be able to provide valuable feedback for tax administrations about the operations of their tax system (for a more detailed discussion of this see Braithwaite, 2003). These factors therefore need to be considered when deciding upon an appropriate enforcement strategy.

The right hand side of the ATO Compliance Model represents the different strategies of regulation that can be used when dealing with taxpayers. The concepts presented here were inspired by the work of Ayres and Braithwaite (1992). At the base of the pyramid, the

activities are persuasive and focused on self-regulation. In other words, responsibility is given to the taxpayer to regulate their personal tax compliance behaviour. For self-regulation to occur, the tax authority needs to make things simple for the taxpayer (for example, educate them, make information easily accessible). According to the Tax Office, its preferred approach is to develop and apply strategies that encourage self-regulation, or voluntary compliance, emphasising cooperation and the building of relationships. At the next level, sanctions increase and self-regulation may need to be enforced. Here, taxpayers may need assistance to comply. Strategies the Tax Office can use to gain compliance here would include sending out reminder letters, conducting real time reviews, or providing information. Small fines could be required to persuade people to comply.

Further up the right hand side of the pyramid, the style of engagement becomes progressively more punitive and has more of a command and control quality. At the command regulation with discretion level, the Tax Office would advise taxpayers of top-end sanctions they may face if they continue to resist the Tax Office's attempts at encouraging compliance. Strategies that may be used here would be to conduct audits, to impose penalties, or to initiate enforceable undertakings¹. At this level of enforcement, there would still be discretion in the actions that the Tax Office undertook against a taxpayer.

Finally, the command regulation with no discretion level is where strong enforcement action, usually involving the courts, would be the only option left to the tax authority. Examples here could include large fines or prosecuting taxpayers in the courts for continued non-compliance. In extreme cases, forms of incapacitation such as deregistration or bankruptcy are considered.

The arrows in the Compliance Model represent the desirability of the Tax Office to apply strategies that encourage a downward movement of taxpayers from resistance to the preferred level of self-regulation (Cash Economy Task Force Report, 1998). The beauty of

¹ An enforceable undertaking is an undertaking given to a regulator that is enforceable in a court. They are generally accepted by the regulator as an alternative to civil or administrative action where there has been a contravention of the legislation they administer.

the model, however, is that it also allows the Tax Office to move to stronger enforcement methods if and when resistance is met. The added advantage of an enforcement pyramid such as this is that sanctioning options can be *tailored* to a particular industry or individual (to see how the ATO Compliance Model has been tailored for the purposes of enforcing tax compliance among large businesses see J. Braithwaite, 2003).

When the Tax Office commences a regulatory conversation, their understanding of the taxpayers' environment and attitude to compliance leads to a dialogue on the appropriate mix of persuasion and sanctions required to maintain an acceptable state of compliance (Black, 2002). When required, a sticks and carrots approach that allows for 'a short period of 'stick' followed by a longer 'carrot' period of reintegration' can be initiated to manage the compliance of a taxpayer (Ayres & Braithwaite, 1992, p. 43). If successful this managed position will cause a behavioural change and improved attitudes towards future compliance.

Stories of success with the ATO Compliance Model

Has the ATO Compliance Model been successful and has it been a good policy decision to introduce a model of responsive regulation into such a large regulatory organisation? Two and a half years after the Compliance Model was introduced into the Tax Office's everyday compliance strategies, researchers from the Centre for Tax System Integrity at The Australian National University (ANU) conducted a series of in-depth interviews with 25 senior tax officers from within the Tax Office. The main objectives of the interviews were to gain information about how the Compliance Model was being accepted into the organisation, and to gain information about some of the success stories that the Tax Office had achieved when using the Compliance Model (Hobson, 2003). While a formal evaluation of the Model's effectiveness has still to be conducted, anecdotal evidence from these interviews indicate that the Model has proved to be successful in affecting taxpayer attitudes and behaviour. This section documents just a few of the success stories that were raised in the interviews.

Case Study 1: Small family operated business

‘This husband and wife business in Brisbane had quite a significant tax debt and the field officer went out, had a look at their records and realised that they were just not conducting themselves in the correct manner – not in a business like manner. Their records were a bit dishevelled. It seemed that they had not claimed tax deductions that they were entitled to, partly because they hadn’t assembled their records in an orderly fashion. Then it was a situation where they had quite a bit of work but they weren’t getting paid. They didn’t have a system of collecting their debts. And so it was a situation where this couple were bordering on bankruptcy. In fact, that would have been the next step by the Tax Office—put them out of business. Instead, we worked through their situation, realised that, in fact, [they] were entitled to some tax deductions they hadn’t claimed. And so we were able to reduce the bill quite significantly. And for the balance of the bill we negotiated an arrangement where they paid by instalments. And then, after a period of about 12 months or so, they had satisfied their tax debt and they’re [now] operating quite profitably and quite happily. If we’d gone in with the old approach, it would have been just simply to issue the summons, go to bankruptcy, put these people out of business. But instead, we looked at the reasons behind the debt and behind the situation that they were in. [The field officer] went out there not from the point of view of collecting the money and finalising the case, which is the traditional approach, but with a view to providing some assistance to see how we could resolve this issue.’

Case Study 2: Building and construction industry

‘We visited businesses and talked to them and we were just there, doing some examinations of their current records and things like giving them advice, and where there was a problem we gave them the opportunity to fix the problem and we revisited in three months. And that had sort of never been done before. We then looked at all the people we visited, before they lodged their return, and just saw what their return did from last year to this year, to see if there was any increase in income declared. And you know, it showed that there was. The people we had visited, their income actually went up more than the industry average, and more than they put in last year, and things like that. So there seemed to be some power in the visit approach rather than auditing.’

Case Study 3: Restaurant and café industry

‘I sat down with a group of executives in the industry association to basically find out what the reasons behind non-compliance were, with the BISEP exploration. I found out that one of the reasons was that they don’t really know their obligations and how to fulfil their obligations. So as a result of that conversation, understanding the drivers for non-compliance [and] in many cases not knowing how to fulfil their record keeping requirement, we came around and developed a booklet specifically written for the restaurant industry, showing them how to keep their records. Now, having done that, and then understanding it, and understanding the BISEP and coming up with products that were to address those concerns of the industry, we have heard back from both the industry as well as the accounting and tax agent groups, who say it’s really been helping the taxpayer in that particular industry to comply.’

Case Study 4: Filing behaviour

‘There was a project that was run where the letters that were sent to taxpayers, instead of saying, ‘You haven’t lodged your return this year, where is it? Get it in by this date or you’re in trouble’, they said along the lines of, ‘Well, we’ve noticed that you normally lodge your return on time, but we haven’t got yours this year, what’s happened to it?’ That seems like a fairly subtle change in approach, but it was actually very surprising the extent to which that change, the response to the letters. Not only did we get better lodgment outcomes, when people rang up they were nice. They didn’t ring up and abuse you for sending them a nasty letter, they rang up and they were nice, and they said, ‘Thanks for the letter, and you know, my return will be in by this time’. That’s just a small example, but that approach in lodgment is far broader now and it’s embedded in their practices.’

These case studies provide just some examples that were raised by senior managers within the Tax Office in their interviews with ANU researchers. They show that the principles underlying responsive regulation can be introduced and implemented effectively into a large regulatory organisation such as the Tax Office, and they show that the move away from a regulatory approach that relies on threat and legal coercion can still be effective in gaining voluntary compliance.

Conclusion

The ATO Compliance Model has now been in operation within the Tax Office since 1998. The present paper has provided both an overview of the principles and concepts underlying the model, has provided a detailed description of how the model was constructed by the Tax Office for use in the area of taxation administration, and has discussed a number of success stories that have been achieved as a result of the Model's use. While it is unclear at this stage whether the Tax Office has had overwhelming success with the Model in bringing about *long-term* compliance among those they regulate, the case studies discussed above, along with findings presented in other papers (Hobson, 2003; Job & Honaker, 2003; Shover et al., 2003), appear to be encouraging. From these reports, therefore, it appears that the Tax Office has made a good policy decision by introducing a style of regulation that is responsive to the needs of both taxpayers and tax officials. As one Tax Office executive said in his interview, 'I just think that it's a good tool for us to use really'.

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Appendix

Throughout the 1990s tens of thousands of Australian taxpayers ‘invested’ in mass-marketed tax effective schemes. Their investments provided them with combined tax deductions exceeding four billion Australian dollars. The Tax Office maintained that investments in these arrangements were largely funded through tax deductions and little private capital was at risk. The Tax Office therefore came to the conclusion in 1998 that taxpayers who invested in these schemes did so for the ‘dominant purpose’ of obtaining a tax benefit, and, as a result, the anti-avoidance provisions of Part IVA of the *Australian Income Tax Assessment Act 1936* applied. The Tax Office moved to disallow scheme related tax deductions claimed up to six years earlier and issued amended assessments to approximately 42 000 investors. Scheme investors were told that they had to immediately pay back taxes with interest and appropriate penalties (that is, within two weeks) or they would run the risk of facing the full extent of the law.

The majority of investors, however, claimed that the schemes they invested in had been sold to them, in many cases by their accountants or financial planners, as a way of legally minimising tax. Many investors believed that they had done nothing wrong by investing in these schemes and resented being penalised and thought of as ‘tax cheats’. The majority therefore actively resisted the Tax Office’s demands that they pay back tax. Some four years after amended assessments had first been issued more than 50% of scheme investors had still refused to enter into settlement arrangements with the Tax Office to pay back their taxes. Further, a number of fighting funds and lobbying groups were set up to represent scheme investors’ interests. These fighting funds offered investors the opportunity to fight the Tax Office’s view of the law in court (for more on this case study see Murphy, in press, 2002, 2003a, 2003b; Murphy & Byng, 2002a, 2002b).

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