

**TOWARDS A FRAMEWORK FOR
LARGE BUSINESS TAX
COMPLIANCE**

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

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

Series Editor:
Tina Murphy

Towards a framework for large business tax compliance

John Braithwaite and Andrew Wirth

Summary

This was an ideas paper prepared in 1998-99 to stimulate what became an ongoing process of reinventing large business compliance policy in the Australian Taxation Office (Tax Office). Some of the ideas in the paper are becoming influential in shaping developments in Australia, others have had no influence. Both kinds of ideas deserve recording, however, for the consideration of tax authorities in other times and places.

1. One way of conceiving the Tax Office's compliance objective in dealing with the large business market could be 'compliance with the purposes of tax law, while working to increase the certainty with which those purposes can be applied in practice'. Another could be 'reducing risks to the revenue while upholding the requirements of tax law and increasing the certainty of that law'.

2. The Australian Taxation Office Compliance Model (ATO Compliance Model) elements seem appropriate to large business tax policy. These are:

- (a) understanding taxpayer behaviour
- (b) building community partnerships
- (c) increased flexibility in Tax Office operations to encourage and support compliance, and
- (d) more and escalating regulatory options to enforce compliance.

3. The content of a large business compliance pyramid would be rather different from a cash economy pyramid. Moreover, making the pyramid work is more difficult in market segments where there are significant grey areas in the law which taxpayers are likely to seek to play with.

4. Even so, education (particularly towards best practice corporate compliance systems), informal recognition and partnerships towards reducing the costs of compliance can improve compliance among some large corporates.

5. To be effective, fieldworkers must be given more confidence to ask for management backing to escalate up a compliance pyramid. Training in tailor-made design of their own compliance pyramids that their own supervisors will support in an agreed context is one path to that confidence-building.

6. Before escalating to assertive use of Tax Office powers, segment leaders should normally invite the chief executive officer (CEO) or chief financial officer to a meeting to head the relationship back down the pyramid to a cooperative one.

7. More generally, genuine attempts should be made to circumvent adversarial stalemates by widening the circle involved in dispute resolution, progressively moving up the corporate hierarchy until an executive is reached who prefers cooperation. Responsive dispute resolution techniques of the sort used by restorative justice consultancies like Transformative Justice Australia may be useful here.

8. Tax compliance is impossible without a commitment to continuous improvement of the law. The Tax Office's key role is bottom-up pre-emption of and responsiveness to loopholes that are opened up in the law. Fieldworkers need to be rewarded in performance reviews when they show leadership by sharing an emerging compliance problem and following through to see it remedied by a Commissioner's ruling, a judicial decision or an improvement in the law.

9. The good repair of the law cannot be achieved without the joint commitment of the Tax Office, the parliament and the courts. One way for this to be achieved is for the Tax Office to be open with the Australian people about the depth of the problem and its commitment to confront it. By putting up its hand in this honest way, the public debate may force the hands of the other institutions. When all the key institutions jointly commit to purposive and firm tax law that delivers a fairer tax system, the business community and the general community will get behind the reform in a way that can deliver the kind of surge in voluntary compliance that occurred after 1985.

10. The Tax Office no longer has a 'procedure manual' culture; Tax Office culture is a storybook rather than a rulebook. Storytelling can be more deeply and productively institutionalised through best practice workshops that focus more on success stories than on

models (even compliance models!). Stories of diagnostic fieldworkers identifying systemic problems in their casework and following them through to law clarification (as in point 8) are an example of the kind of success story that must be valued.

11. While Tax Office staff are world leaders of risk identification, analysis and assessment, risk leveraging and evaluation of the leveraging still has a long way to go. Both qualitative single-case risk leveraging and quantitative multi-case strategies are needed. Regression-based, detective-based and trust-based risk leveraging can be arrayed in a risk leveraging matrix.

12. Qualitative monitoring and review of single-case risk leveraging initiatives are critical and should be recorded in case files.

13. Quantitative monitoring and review needs to be focused by reducing the number of performance indicators to those that matter most and consistently following through on them. In particular, they should be more focused on measuring the effectiveness of risk treatments rather than on measuring global levels of untreated risk.

14. To this end, each Tax Office large business segment could be asked to nominate its best cross-case risk leveraging strategy each year. An experimental methods consultant can be used to monitor which strategies produce the most cost-effective increase in revenue while maintaining compliance with the *Taxpayers' Charter*. The segments that are found to leverage risk in the biggest ways would get increased budgetary support for their strategy. This would also be a key plank in a strategy for evidence-based risk leveraging. Such a science of evidence-based risk leveraging is the greatest hope for more effective tax administration in the long term.

15. Partnerships with the business community need to be deepened over time. In motivating the engagement of business with such partnerships, from smaller ways such as test piloting new compliance initiatives, to larger ones such as projects to rethink corporate tax law, a longer-term vision for a fair and collegial tax regime must be projected out of the current cynicism. While we do not believe tax administration is ready for this yet, once partnerships start to build stronger and fairer compliance, at some time in the future the idea of a compliance-tax-rate-spiral might be developed – a formal commitment to link falling tax rates to the attainment of compliance benchmarks.

16. The Tax Office should continue to monitor business reactions to the professionalism of its officers. From a compliance perspective, monitoring of the perceived procedural justice of encounters with the Tax Office is especially critical.

17. Flexibility in Tax Office operations is not simply about moves to a storytelling culture about innovative ways of achieving compliance and pyramidal ways of thinking about compliance strategy. It is about pluralising audit, shifting from transfer pricing audits to Advance Pricing Arrangements, industry watching briefs, negotiated audit protocols, pre-filing agreements, innovative educational ideas and adaptive service – many-sided flexibility.

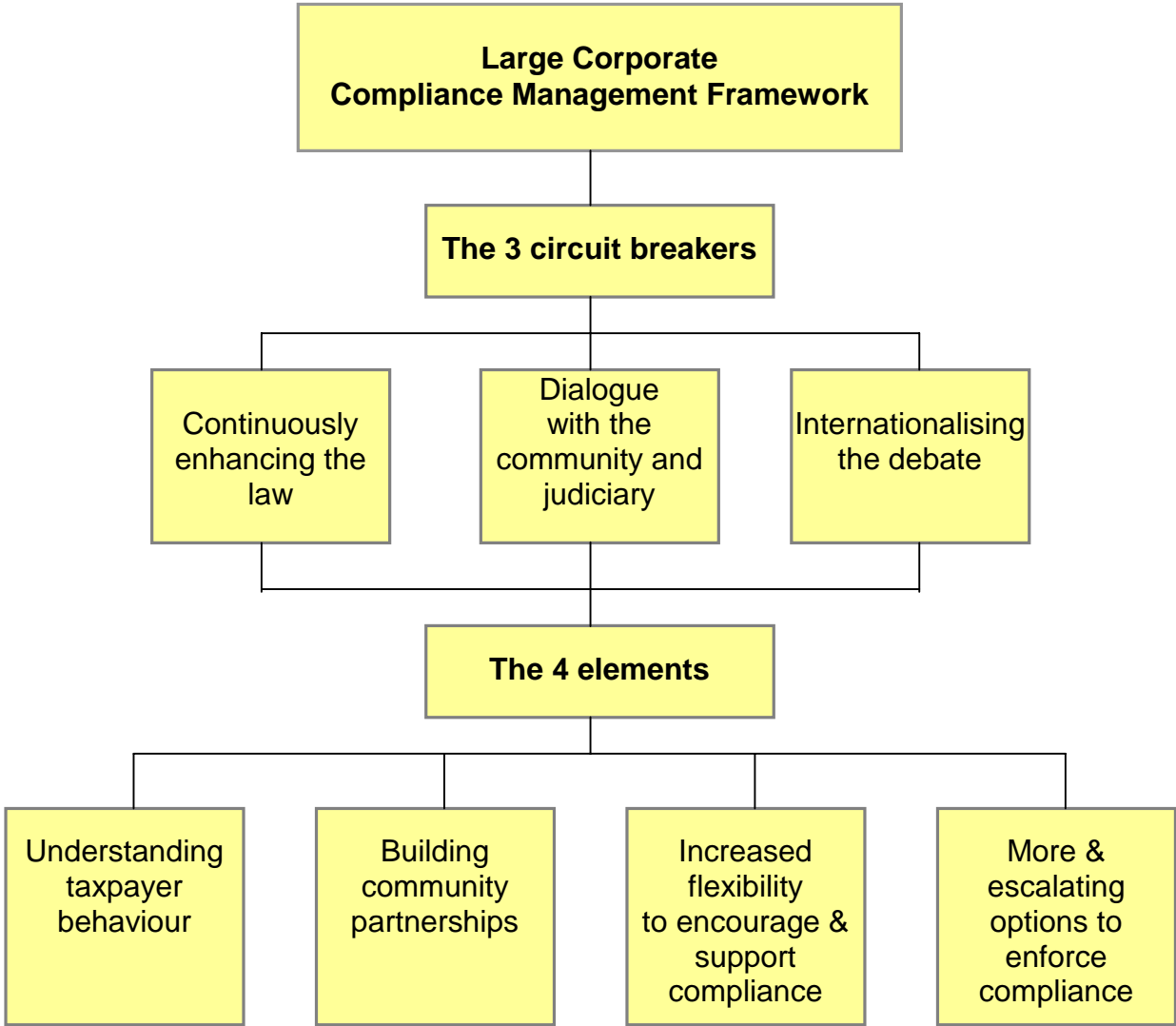


Figure 1: The Compliance Management Framework: A bird’s eye view

PART I: SETTING THE SCENE – BREAKING THE CIRCUITS

1.1 Aims of this discussion paper

In April 1998 the Cash Economy Task Force (1998) produced an influential report entitled *Improving tax compliance in the cash economy*. Our brief was to assess the relevance of this report, during late 1998 and early 1999, to the tax compliance of the large business market segment. At the time there was doubt whether the cash economy compliance model would be relevant to large business. Looking back, while many of the specific ideas in this discussion paper were not taken up, the thrust of its optimism that the Compliance Model could be sensibly adapted to large business compliance was.

Improving tax compliance in the cash economy proposed a new Compliance Model with four elements: understanding taxpayer behaviour; building community partnerships; increased flexibility in Tax Office operations to encourage and support compliance; and more and escalating regulatory options to enforce compliance. The purpose of this discussion paper is to open up some issues for consideration about applying the model to the Tax Office's compliance work on large business. Our preliminary examination reveals, however, that the four elements of the model mentioned above all do have relevance to large business, though a different kind of relevance than in the case of, say, the cash economy. This paper is structured around considering each of these elements in turn. The spirit of the paper is to identify a number of policy ideas that might give meaningful content to the model in the large business context.

1.2 What is compliance?

‘Compliance means that taxpayers are meeting their obligations in accordance with the Income Tax Assessment Act, regulations and court decisions.’ This is the definition adopted by the Tax Office measuring levels of compliance project team, and by the 1995 report to the compliance improvement committee on ‘Staff perceptions of the compliance behaviour of the top 100 companies audited under the large case program’. The latter report went on to show that in the large corporate domain, Tax Office staff adopted a more purposive view of compliance than the somewhat literalist view in the above definition. That is, Tax Office staff

working on the large case program were looking for compliance with the spirit of the law or the policy purpose intended by the parliament. Doreen McBarnet's (1992) British work shows that large corporations tend to be literalists because their modus operandi is to choose, depending on their interests, among five options:

1. Comply with the intention of the law
2. Compromise. Negotiate how a particular law works under particular circumstances and make a deal on how it will be applied.
3. Comply with the letter of the law in such a way that the declared objectives of the law may not be met (which she calls compliance in form).
4. Transform the legal rules, through lateral thinking, into positive routes for tax avoidance.
5. Break or ignore the law and hope you are not caught. This could include the preparation of secondary accounts to cover your tracks (Williams, 1995, p. 7).

McBarnet finds that large corporations tend to pursue a strategy of compliance in form to achieve two things: 'if successful, it allows taxpayers to escape tax. But at the same time, whether it is successful in that first goal or not, it allows them to escape any risk of stigma or penalty.'

In light of the above, a Tax Office compliance objective could be:

Compliance with the purposes of tax law, while working to increase the certainty with which those purposes can be applied in practice.

An alternative objective would focus on 'dollar-based information...as potentially ambiguous risk management data rather than unambiguous taxpayer compliance data' (Wickerson, 1993, p. 7). Such an objective might be:

Reducing risks to the revenue while upholding the requirements of tax law and increasing the certainty of that law.

1.3 The ATO Compliance Model

This paper will argue that the ATO Compliance Model provides a valuable framework for large business compliance work. However, it must be adapted in appropriate ways. In particular, the concepts and enforcement strategies through which one escalates in a large corporate compliance pyramid will be found to be quite different from those in a cash economy compliance pyramid. For example, at the peak of the ATO Compliance Model's enforcement pyramid, the Tax Office confronts disengagers from the tax system using a prosecutorial strategy. Many individual taxpayers and small businesses do opt out of the tax system altogether. Even some larger businesses that we call organised crime (but that in reality is rather disorganised) do this. They do not play the game – sometimes because they are so cynical or disenchanted about it, sometimes to evade it in a calculative way. But some large businesses, on the other hand, are quintessential game-players. At the peak of the large business enforcement challenge are the most entrepreneurial of the players of the tax planning game. Disengagement is not a major source of non-compliance here.

There is no problem with adapting the ATO Compliance Model to this reality of large corporate compliance. The idea of a compliance pyramid is that all compliance staff will discover a content for it that is relevant to the context in which they work. It is not a recipe book but a model to guide strategic thinking. The deeper question about the model for the compliance of large businesses is that it tends to assume that the majority of taxpayers want to comply and as we move up to more and more serious tax evasion, there are fewer and fewer taxpayers in this category. The best evidence we have on individual taxpayers suggests that this assumption is fairly accurate. For example, United States audit evidence has been used to conclude that about two-thirds of individual taxpayers intend to pay the right tax (some of them inadvertently cheat), but only a third of individual taxpayers actually set out to cheat in a significant way, and then to varying degrees (Andreoni, Erard & Feinstein, 1998, p. 820).

With large corporations in Australia, we believe it is clear that many more than two-thirds of taxpayers intend to comply with the letter of the law, or at least to have a 'reasonably arguable position' that they have done so most of the time. However, it seems equally clear that there are many who do not intend to comply with what the Tax Office regards as the policy purposes of the parliament's tax laws. The evidence for this is that more than half of

them pay no tax, some for many years, which is certainly not parliament’s intention.¹ Australia is not greatly different from other advanced economies in this respect. Indeed, we will argue that Australia is ahead of most in its response to it. Certainly Australia collects more than the Organization for Economic Cooperation and Development (OECD) average in company tax as a proportion of all tax revenue and as a proportion of gross domestic product (GDP). It is one of the few countries in the late 1990s that saw corporate tax revenues increase at a faster rate than the increase in company profits. To a considerable extent, this problem requires an international solution.

The fact compliance policy must confront squarely, however, is that while the pattern of individual compliance is broadly pyramidal, the pattern of large corporate compliance is oval-shaped, with most taxpayers playing for the grey.

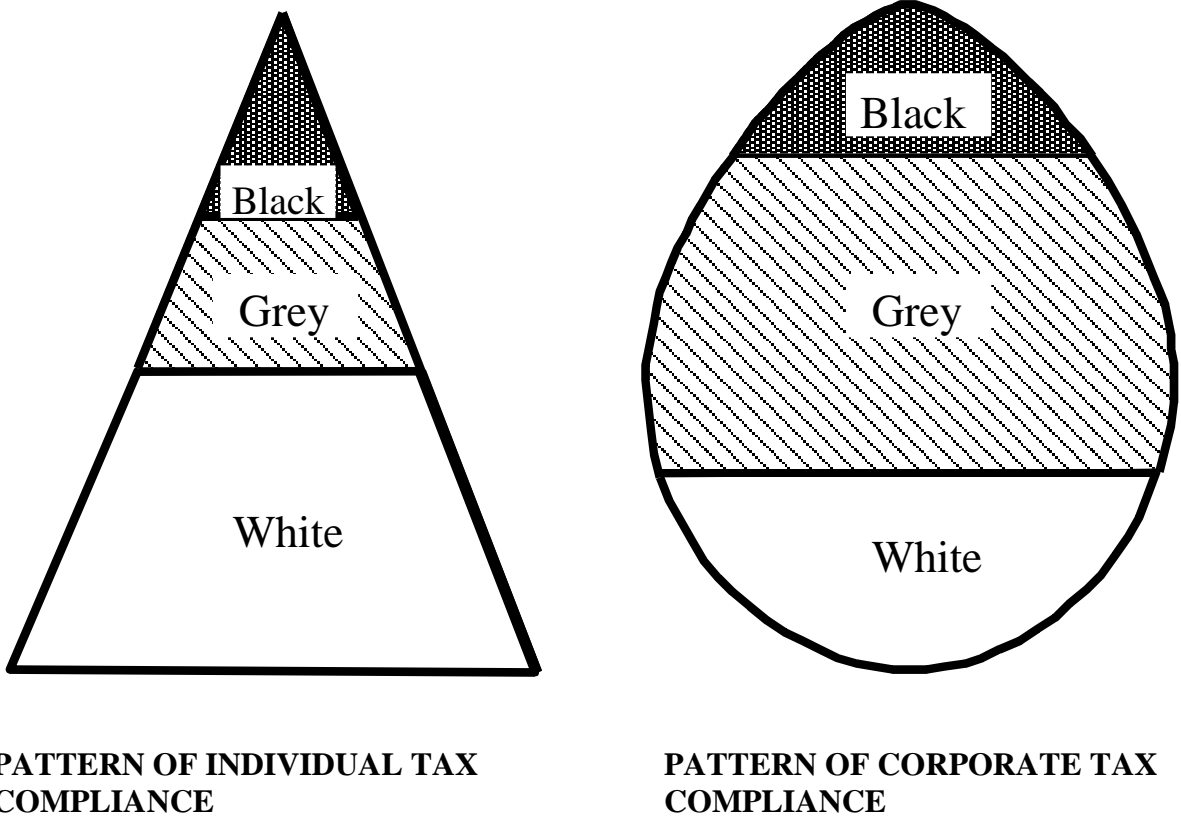


Figure 2: Patterns of individual and corporate tax compliance

¹ In a 29 May 1998 presentation to the NSW Annual State Seminar of the Taxation Institute of Australia, Large Business and International (LB&I) reported that almost 60% of its companies were non-taxpayers. Consolidation would doubtless reduce this proportion substantially because one large corporate group might include a number of entities that pay no tax and others that pay large amounts.

Large corporate compliance strategy might be conceived as pushing the large grey bulge in the middle of the oval downwards into the white zone – so that the oval becomes a pyramid. It is hard to make compliance strategies work when the oval represents the shape of compliance behaviour. As the shape of corporate compliance behaviour becomes more pyramidal, the compliance policies discussed in this paper will progressively become more effective. The task is more daunting than for the rest of the Tax Office because the reality of the challenge is majority non-compliance with the policy purposes of the law (at least as they are conceived by many Tax Office staff members). Law reform is the first of three key circuit breakers to move that grey bulge down into the white. Two further circuit breakers are proposed in this paper: one is for the compliance debate to take a more democratic turn, the other is for it to take a more international turn. Once those three circuits are broken, the paper seeks to show that there are a number of more specific policy options for improving compliance.

1.4 Tax compliance in a democracy

The Australian people increasingly believe that large corporations and high wealth individuals do not pay the share of tax that the law says they should. A June 1998 community survey of 1000 Australians found that only 32% believe ‘Tax laws are effective in making sure large companies pay their share of tax’, declining to 27% for ‘very wealthy people’. Only 20% believed ‘The Tax Office does a good job of stopping tax avoidance by large companies’, falling to 15% believing ‘The Tax Office does a good job stopping tax avoidance by very wealthy people’ (see also Wirth, 1998).

Such perceptions are a major risk to voluntary compliance by individual taxpayers. The reason is that there is evidence that individuals are more willing to pay their taxes honestly when they perceive most others to be honest; this evidence suggests that the direction of causality here is that when citizens perceive most others to be cheating, they are more likely to cheat themselves (Levi, 1988; Sholz, 1998; see also Cowell, 1990).

Perceptions are past the point of trying to pretend to the Australian people that all large corporations are paying a share of the tax burden commensurate with the share of pay as you earn (PAYE) taxpayers. The better way to manage this risk to the revenue is to be open with the Australian people about the depth of the problem. This means explaining to them that it is

not that companies are cheating in large numbers. It is that some large corporations are aggressively planning their way around Australian law and moving profits and losses around the globe to limit tax liability.

The purpose of this paper is to open up some ideas on how Australia might show some international leadership on large business compliance strategy and how it is on the way to doing this already. When the Tax Office gets international recognition for being at the cutting edge of the compliance management of large corporations and high wealth individuals, it will bring the Australian people with it. It will also bring the Australian people with it when it gets the international recognition for being more open with its people than other countries about the depth of a problem it is determined to confront.

1.5 The judiciary in a democracy and tax compliance

Equally importantly, a full and frank public debate about the nature of the problem is the way to begin to bring the Australian judiciary to an understanding of their central importance to solving the problem. The behaviour of the judiciary in the aftermath of tax reform is ultimately the most critical risk in the new Tax Office environment. History teaches us that when judges are literalist in the way they interpret tax law, legal entrepreneurs will open up more and more loopholes in the law. Yet because judges are properly independent of the executive government, it is not appropriate for the Tax Office to ‘tackle’ the judiciary when they fail to interpret tax law in the more purposive way that New Zealand judges seem to do under the influence of their Acts Interpretation Act.

So another path is needed. Most Australian judges believe in the sovereignty of parliament or the sovereignty of the Australian people or both. A tax compliance debate that engages the parliament with the desire of its people, openly expressed, that the law be interpreted to require large corporations to pay the share of tax the law intends is the best way to seek to move judges who believe in a sovereign parliament responding to a sovereign people. The judges understand that the kind of literalist approach of the Barwick High Court to tax adjudication can survive while tax law remains arcane to the people; equally, they understand that judicial repute suffers in the democracy when this approach is later discredited in the eyes of the people and their parliament. In the long run, cases like the recent Packer saga, where Australia’s richest person was accused of paying virtually no tax, are corrosive of

respect of the people for the law and the courts. The more open the public debate on tax law, the more clear it will be to the judiciary why this is so, and the more pointedly will they grasp the necessity and propriety of them being more purposive and less literalist readers of tax law.

Margaret Levi's (1988) analysis of the 1983–85 tax reform debate is that it did engage the Australian people in a way that did increase their preparedness to comply with the tax laws. Part of this accomplishment was that they did see the Barwick era of judicial interpretation in tax matters, of which they came to disapprove, come to an end.

Former Chief Justice, Sir Anthony Mason, in commenting on the ideas in this paper, agreed that public criticism of the judiciary on tax matters might not be productive. He suggested a conference where senior tax scholars, tax practitioners and judges engaged in an exchange that might lead to a special issue of a major law journal on the judicial interpretation of tax law. In less ambitious ways, the Tax Office has already experimented with this approach to improved dialogue with the judiciary.

PART II: THE COMPLIANCE FRAMEWORK

2.1 Understanding taxpayer behaviour

Perhaps this first element of the compliance framework should be conceived more broadly as 'understanding the tax system'. In managing large corporate tax compliance, the behavioural model of the tax system in Figure 3 has been influential. Yet the ATO Compliance Model does take a broad view of what understanding taxpayer behaviour means that is consistent with the behavioural model of the tax system. It means understanding individual and business behaviour in the context of an industry, macroeconomic and sociological environment. This is what is referred to as BISEP in the ATO Compliance Model. The key addition for the large corporate sector is that we must understand compliance in an international environment. We need to understand, for example, that the taxpaying behaviour of a Japanese transnational corporation in Japan is different from its taxpaying behaviour in other countries.

Tax system – behavioural model

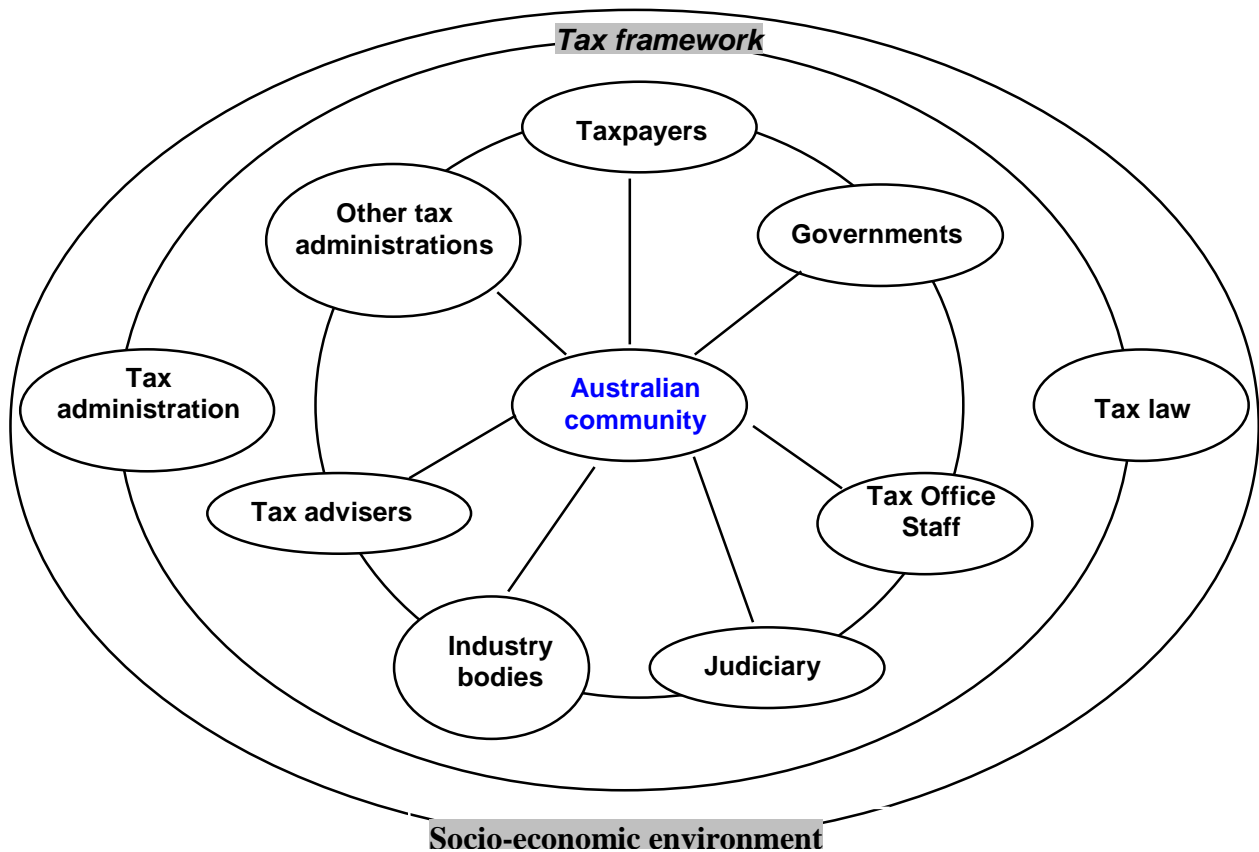


Figure 3: The Tax Office tax system behavioural model

The Tax Office approach to understanding taxpayer behaviour is risk management of a tax system. The Tax Office is a national and international leader in the analysis of risk, particularly at a strategic level. The shift of the Tax Office from an operations manual culture to a risk management culture has been profound. With an organisation of 19 000 staff, such large culture changes are difficult to pull off.

Australian Standard 4360 identifies the stages in risk management in Figure 4.

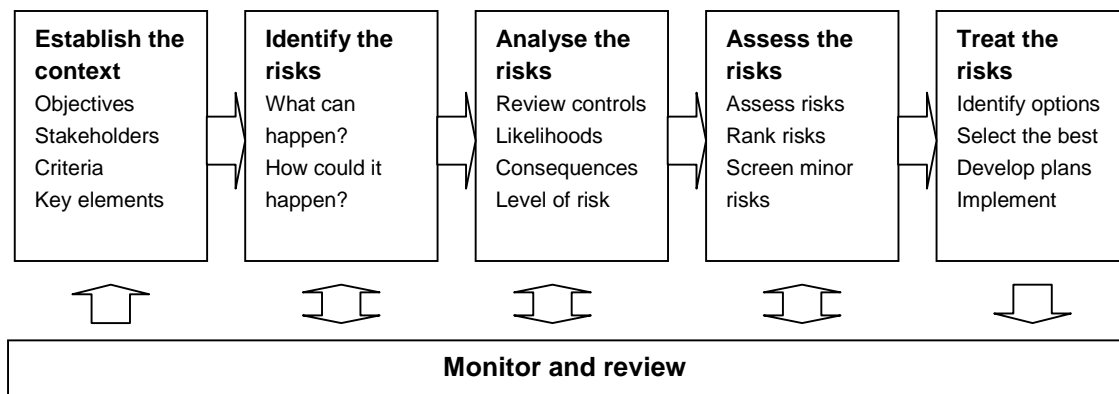


Figure 4: Stages of risk management (from Grey & Cooper, 1998)

Generally the Tax Office has done a very good job of the first four stages of this process, particularly at a strategic and organisational level, is only beginning to do a good job on the fifth stage (treat the risk) and is still doing a poor job on the final stage (monitor and review). In establishing the context, identifying the risks, and analysing the risks, the Tax Office has the advantage of being one of the most knowledge-rich organisations in the country. It takes research seriously. While there are gaps in this knowledge which need to be filled, the bigger challenge is to find existing knowledge and synthesise its implications. The Tax Office is so knowledge-rich that the greater need is for knowledge coaches to help people find the knowledge required to solve a particular problem. The Tax Office is taking up the challenge to develop the hard and soft networks for knowledge coaches to draw on in the mentoring they need to do. The Strategic Intelligence Network (Walker & Martin, 1998) is another important development here. Given that the Tax Office is rolling with these appropriate management responses to improve the wiring that allows messages to flow through the first four stages of risk analysis, we will have nothing further to say on the promising work going on here.

Straight to the deep problem. This is that while Tax Office staff are increasingly on top of risk analysis and assessment, mostly they do not operate by searching and seizing opportunities to leverage those risks. Ask in a large business industry segment in the Tax Office whether they have assessed and ranked risks and they will pull out a document that shows where they have done that. This is genuinely impressive. But ask fieldwork or management staff to tell you the best stories of how they have leveraged each of those risks and only some will enthuse with their triumphs.

Risk leveraging is a creative activity. It requires creative staff. It is a bad idea to provide a formula for how to do it because advisers will soon learn that formula. Continuous reinvention of risk leveraging is what will keep them guessing and therefore complying. A culture of continuous reinvention of risk leveraging seems to us to require taking storytelling more seriously within the Tax Office. The Tax Office has decisively moved away from being a business run according to a procedures manual. At the level of informal staff interaction, Tax Office culture is no longer a rulebook, it is a storybook.

Some staff see Tax Office management culture, in contrast, as a thicket of models. The challenge is to value stories that make sense of models, and models that provide a conceptual scheme for generating better stories. One staff response to the roll-out of the ATO Compliance Model was: ‘Oh no, not another model. Now a compliance model to add to risk assessment, chunking of our work to prime areas, health of the system analysis and planning, strategic direction, performance management, business systems models, accountability and governance, and on and on’. Our suggestion is that the approach to moving the Tax Office risk management model beyond risk assessment to risk leveraging is to create a framework for storytelling about compliance successes. Some leading corporations, such as 3-M, have come to the conclusion that an excess of abstraction is their problem, and have taken the remedy so far as to write their strategic plan in storytelling fashion (Shaw, Brown & Bromiley, 1998).

2.1.1 Tax Office culture as a storybook

Stories are central to human intelligence and memory. Cognitive scientist William Calvin describes how we gradually acquire the ability to formulate plans through the stories we hear in childhood. From stories, a child learns to ‘imagine a course of action, imagine its effects on others, and decide whether or not to do it’...Cognitive scientists have established that lists, in contrast, are remarkably hard to remember... (Shaw, Brown & Bromiley, 1998).

There are two interconnected staff morale rationales for considering a storytelling culture. One is that staff grapple with many models that are often presented to them abstractly rather than as stories. The second is that there is the feeling that those who are playing an aggressive

game are winning. Hence a framework for storytelling *with stories of success* that bring to life models, such as the Tax Office risk management model, is needed. A suggestion is therefore that parts of the Tax Office that are not already doing so conduct regular informal workshops which give staff a platform to share their latest success stories. This means a different kind of best practice workshop than sometimes happened in the past – less oriented to concepts and models of best practice and more to stories of best practice (from which an understanding of models flows). Each Tax Office large business segment would then select its best success stories and the ones that supply lessons of more general applicability for best practice workshops. A consequence of such a culture change would be that ‘heroes’ of risk leveraging success stories would be noticed in a way that would percolate into their performance reviews.

Our analysis, in summary, is that the abstractness of Tax Office risk assessment might be a roadblock to the contextual staff creativity that moves into risk leveraging. In the next stage of the development of a compliance framework, one suggestion would be for a document more dotted with success stories than this one. Perhaps that is an imprudent suggestion given the difficulty in rendering large business stories anonymous. Perhaps it would be more appropriately cautious about confidentiality to sustain storytelling only as an oral tradition for those staff dealing with large business tax compliance. But at the least our recommendation would be that it be a more deeply institutionalised oral tradition – a proliferation of storytelling best practice workshops that illuminate broad strategic issues.

A move to institutionalising Tax Office culture more as a storybook than a rulebook or a model-book is not to downplay the importance of rules and models. Internal rules and models will be more sensible when they connect with a more bottom-up process of reflection on accumulations of success stories. Risk leveraging occurs at two levels. One is at the level of clinical analysis of cases of single corporations – for example, diagnosing patterns of imbalance among corporate PAYE receipts and wages paid, goods and services tax receipts and income tax to inform a risk leveraging prognosis to heal the sick taxpayer. The second level is cross-case leveraging through more quantitative analysis of strategies.

The risk leveraging skill at the first level is the skill of the clinician who heals one patient. That is the level most informed by storytelling. The second level requires the skill of the medical researcher who finds generic therapies that will be valuable for curing many patients.

That is the level most informed by number crunching. The Tax Office is doing exciting work to enhance its large corporate number crunching capabilities. We now turn to how this opens up new horizons for risk leveraging.

2.1.2 Regression-based risk leveraging

Multiple regression is a statistical technique the Tax Office analyst uses to put a number of variables into an equation to predict tax collections. It can capture the complexity of a world in which there are many drivers of tax behaviour that can be combined into an integrated model. Such models are being developed by the Tax Office. Among other things, these models enable us to ask the following kind of question. Given what we know about the income of this company, the proportion of its activities based outside Australia, the industry sector it is in, movements in its stock price, the various ratings it has received by ratings agencies, and certain other pieces of known information, is it paying less company tax than the model predicts or more? Those that are paying a great deal less tax than the model predicts can then be approached to seek explanation and possibly be audited.

This is literally a strategy for leveraging up the regression line. To picture how regression-based risk leveraging would work, imagine the world is less complicated than it is.² Imagine that a single-variable measure of risk gives a good prediction of tax paid. Figure 5a shows that as the measure of risk goes down, tax goes up. Each dot represents a company and the five black squares represent the companies furthest below the regression line. Figure 5b shows what happens when we audit those five companies, bringing them above the old regression line instead of below it.³ The new regression line has a new set of five companies that are furthest below the line. In Figure 5c these are targeted for audits that move them above the line. By Figure 5c the regression line has changed to the point where for all levels of the risk measure, expected tax receipts are well up. As we iterate to 5d, 5e, 5f and so on, we move the regression line further and further upwards. With multiple linear regression, this is happening in a multidimensional space that it is hard for the human brain to imagine. But the principle is the same as in Figure 5.

² The real world may be complex in a way that makes any regression-based risk leveraging too simple. Data mining techniques that do not depend on linearity assumption of regression models may be needed.

³ This is another simplification. There may be a good reason why the outlier is below the regression line that is not captured by the model. That is, not all audits will bring the outlier above the regression line. Enquiries might also indicate valid explanation for the position of the company and these explanations help to build the Tax Office's understanding of business and the market place and avoid misinterpretations.

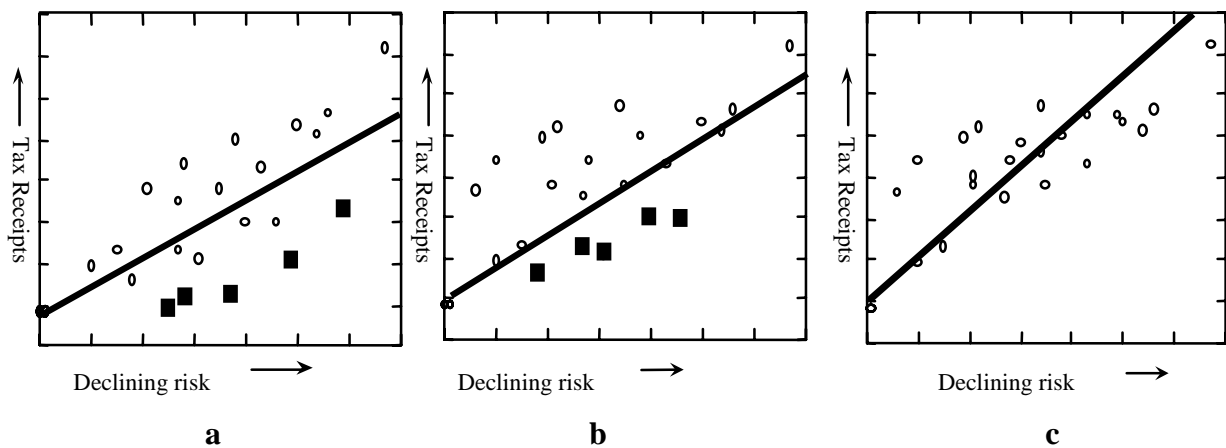


Figure 5: Regression of risk on tax receipts

Regression-based risk leveraging can be used not only to detect individual taxpayers that are below the regression line, but also whole industries that are below the line (when industry is taken out of the model itself). This means the intelligence tool can be used to identify industries with a culture of non-compliance where what is needed is to work with the key industry associations to co-design an industry culture change strategy.

2.1.3 Detective-based risk leveraging

Watching an industry or other group of taxpayers can be done to diagnose risk with the techniques of the detective, akin to the clinical skills of the doctor discussed earlier. The officer scans the horizon for information on industry developments that might have tax implications. A new subsidiary is opened in the Bahamas. Three industry leaders have a secret meeting in which they agree not to compete on tax planning; they will all pay around 10% so that they have enough for their franking credits. A new CEO with a reputation for aggressive tax planning is appointed to a formerly conservative company. Detection of these developments leads to real-time enquiries that prevent tax losses before they occur. Experience proves that the Tax Office asking the right question at the right time based on a strategic piece of intelligence is often quite sufficient to replace traditional audit-based retrospective deterrence with interrogation-based prospective deterrence. Tax strategy reviews and the analysis of strategic intelligence must also become central to detective-based risk leveraging.

2.1.4 Trust-based risk leveraging

Building trust is and should be a fundamental value of the Tax Office; it has a key role in making Australia a more decent society in this regard. Tax Office staff, for example key client managers, who build a relationship of trust with a particular client are able to draw on that trust to leverage compliance. Once there is trust, that trust is a resource that has benefits to both sides (Ayres & Braithwaite, 1992, Chapter 2). Those benefits imply a cost to breach of trust. Good Tax Office staff learn how to use their relationships to make judgments as to when they can rely on that trust to leverage risk (just ask that it be done), when it is best to ‘trust but verify’, and where it is best to withhold trust. We should never forget that cooperative relationships are the best source of evidence of what is going on in the business world. Even the best detectives are trusted by a lot of criminals. More importantly, however, the evidence from the research program of the Australian National University research group on business regulatory compliance is that when regulators treat regulatees as trustworthy, they actually behave in a more trustworthy fashion (Braithwaite & Levi, 1998). More specifically, treating business as trustworthy does increase their subsequent compliance with the law (Braithwaite & Makkai, 1994).

2.1.5 A leveraging matrix

It would be a mistake to see the regression-based, detective-based and trust-based risk leveraging approaches as only about the targeting of taxpayers. If regression analyses show that all 30 clients of a particular adviser are way below the regression line, it may be more efficient to target enforcement against one adviser than against 30 taxpayers. The same point applies with detective-based and trust-based analyses of intelligence. So there may be virtue in considering a strategic intelligence matrix of the form illustrated in Table 1.

Table 1: Illustrative matrix of regression-based, detective-based and trust-based leveraging of the risks posed by an imaginary taxpayer, agent and adviser to that taxpayer

	Taxpayer	Agent	Adviser
Regression	Below line	Average	90% of clients below line
Detective	No intelligence	No intelligence	Rumoured to be promoting a dubious new scheme
Trust	Trust but verify	Trustworthy	Breach of trust with Tax Office in past

An intelligence assessment of this table quickly leads to the conclusion that this taxpayer is not a good target for audit or some other form of monitoring. Nor is the taxpayer’s agent who submits their return. However, the adviser this taxpayer uses is a prime target for risk leveraging, one reason being that our presently honest taxpayer may be at risk of being tempted by the adviser’s dubious new tax planning scheme. For certain kinds of compliance strategies (for example, a letter to request that a certain matter has been checked), the trustworthy agent may be the better target precisely because they have a stronger interest than does the taxpayer in maintaining their reputation with the Tax Office as trustworthy. There is a growing literature on when it is better to target gatekeepers and when it is better to target principals (Braithwaite, 1997; Kraakman, 1984). Our main point here is that the ‘understanding taxpayer behaviour’ element of the ATO Compliance Model should be conceived broadly to include an understanding of the behaviour of gatekeepers to taxpayers.

2.1.6 Monitoring and review

When a single taxpayer, agent or adviser is the target of risk leveraging, monitoring and review are normally clinical. Did the medicine cure the patient? Was more tax assessed? Were new tax compliance policies put in place? Was a relationship of trust built with the Tax Office? At the single-case level, monitoring and review of risk leveraging is mostly qualitative, part of the storytelling culture.

More programmatic risk leveraging initiatives that target many taxpayers require more quantitative evaluation. Qualitative evaluation – for example, building trust with an industry association – still remains an important part of it, nevertheless.

Often, organisations like the Tax Office grapple with plans that have multiple outcomes. Most of these have a large number of performance indicators associated with them in the plan. Sifting down to critical success factors has been limited. If you alight upon a particular performance indicator, you are likely to find that the answer to the question of who is ensuring that the data required for the performance indicator are actually collected is ‘no one’. If you ask where the numbers exist on another one, you are likely to be told that no doubt some part of the office has found it useful to collect this one and would have it, but no one has collected it together nationally. Now there is actually nothing wrong with that. There should be all manner of statistical collections which are strategic at industry or segment level but not at a national or strategic level. There is a danger in an ethos of ‘If it can be measured easily, measure it’. ‘If it makes you look good to report it, report it. But just because the performance indicator is written down in an operational plan, that does not mean there is any heavy obligation to report it.’

When the Tax Office is under attack, if there are many performance indicators it is possible to get someone to dredge through the list of indicators and come up with something that looks good. Ultimately, this would be short-sighted. This reduces long-run effectiveness at redistributing resources to risk leveraging initiatives which bring more tax through the door (from those which bring in less tax) if it reports only good performance indicators on the latter initiatives. The business line loses its capacity to shift resources between segments so as to improve compliance, and top management loses its capacity to make sound decisions about shifting resources between business lines. Moreover, there is a risk that parliamentary committees, the Prime Minister’s office, the Australian National Audit Office or the media will demand this year’s bad results on last year’s arbitrarily selected performance indicator. A classic illustration is reporting growth in tax collections during periods of high economic growth, with the base year for calculating percentage increases in the collections being the year of the last recession. This creates a vulnerability for a tax authority at times like the present when the economy contracts sharply and the tax collection curve turns down.

While it can be a mistake to take too narrow a view of what performance indicators count, there is a difficult balance to get right here. Let us summarise the risks of having a clutter of performance indicators of unclear justification.

1. *If you measure everything, you measure nothing. If you have a hundred objectives, you have none.* You have a culture of excuses; every time one indicator goes off the rails you can switch to one that looks better.
2. *You have no consistent basis for allocating resources to where they will do you most good.* Comparative judgments of value for money are better delivered by careful, comparable measurement of a few indicators than by sloppy non-comparable measurement of many.
3. *The more measurable drives out the more important.* Counting the number of audits is simple. In the Tax Office full audits of large corporates are now quite rare because real-time pre-audit checks are more likely to be effective. So why would one count audits as a performance indicator?
4. *Some performance indicators are not necessarily risk-related.* A simple example is number of complaints – which could be a negative indicator of a large number of customer relations problems or a positive indicator of making customers aware of the *Taxpayers' Charter*.
5. *Some performance indicators are related to risk but in problematic ways.* 'Increased detection of tax planning arrangements' is obviously related to a critical risk. But would negative results reflect failure in detection strategy or success of compliance strategy in shutting down an explosion of new tax planning arrangements (that indeed may have occurred with mass marketed schemes since 1998)?
6. *The risk management loop is not closed because risks are treated without the treatment being monitored.* In an organisation with too many performance indicators, a culture of not worrying about following through on them develops. This is fatal for risk management. It means that risk treatment is not followed through to see if it works. Poor risk treatment practice persists. Many Tax Office performance indicators focus on the

measurement of risks in ways that are not connected to risk treatment. The worry is that risks may be measured to be getting worse and this will be blamed on defective risk treatment. The reality may be that the risk treatment is working brilliantly against the odds of stronger currents in the economy that will increase the risk whatever the Tax Office does.

7. *Becoming a hostage to fortune rather than to its own risk management.* Globalisation is causing all manner of risks to burgeon in ways beyond the control of the Tax Office. In such an environment the best performance indicators relate to the efficacy of risk treatments that good management can improve over time, rather than to the level of risk in an environment that is hostile.
8. *Measuring everything is costly.* The direct cost of keeping more performance indicators than you need is that a lot of people spend time entering numbers into a computer. The indirect cost is that the thicket of knowledge becomes so dense that sometimes staff cannot find the plants for the weeds.

2.1.7 Learning from medicine

It was not until 1914 that in the average encounter between a doctor and a patient the patient was more likely to come away better off than worse off. Unfortunately with law enforcement, we have probably not yet reached 1914. If we put more police into a neighbourhood, we are just as likely to increase the crime rate as to reduce it. The reason is that, like doctors with leeches, police do a lot of things that make crime worse (as well as a lot that makes it better).

Law enforcement needs to learn two things from medicine here. One big step medicine took towards making us healthier early this century was a research investment in randomised controlled trials of its risk leveraging strategies. If it believed a particular therapy or a particular pill would outperform existing therapies, it would randomly assign a large group of patients to the new treatment versus the old. In effect, this meant tossing a coin to decide whether patients got the currently popular therapy or the new one. With a large enough sample, the miracle of randomisation delivered two groups that were exactly comparable in every way other than the treatment. If fewer patients died under the new therapy, then we could be fairly sure that the therapy was the reason. This was the big advance over the old

science that allowed quacks to delude themselves into believing that when patients got better after being treated with leeches that it was the leeches that cured them. Or when they died that the leeches had not been applied early and often enough.

As more and more therapeutic advances increased our life expectancy, medicine's new problem was of *too much* knowledge. Most doctors were not up to date with what science was finding. So began a new evidence-based medicine movement to get the results of science through to doctors in a digestible form. A science of diffusing science through soft networks of revered peers. The nation that ventures into an evidence-based tax administration comparable to evidence-based medicine is likely to become the cutting edge. Evidence-based tax administration will be much cheaper than evidence-based medicine and much less fraught with ethical dilemmas.

2.1.8 Toward evidence-based tax administration

Imagine the Tax Office comes up with an idea for a new auditing product which it believes will improve compliance at lower cost. Some people think they are wrong, others that they are right. A new evidence-based Commissioner sees that there are some good arguments on both sides. Moreover, they both have equally good arguments as to why their approach would be procedurally fairer and cheaper for taxpayers, so there are no ethical arguments against experimentation. There are resources available for 200 audits across the market segments where this kind of audit is relevant. So the Commissioner requires that a risk analysis select the 200 most suitable targets for audit. The computer then uses a random number generator to assign 100 of these cases to the new audit product and 100 to the old audit.

Where there are one or two extremely large or atypical corporations, these might be excluded from the experiment on grounds that if both ended up in the same group, this would skew the results. Or the randomisation can block on them, so that it is guaranteed that one will go into the experimental group and the other into the control group. Absent such extraordinary lumpiness, the laws of probability prove that randomly assigning 200 companies or 200 individuals is almost certain to produce two groups with almost identical breakdowns on average income, age, sex, in fact, anything we can measure and check (and everything that we cannot measure and check). The only reason for a difference in tax paid by the two groups is that one gets the old style audit rather than the new style audit. There is no need for

complicated multiple regression analysis. You just count how much money comes through the door from the new audit group compared to the old audit group. There is no need to worry whether the reason the new audit process generates more money this year than the old audit process did last year was that company profits were up this year. The experimental group and the control group are identical in the profit circumstances they confront.

An even better research design will require a risk assessment to identify the 300 best targets for auditing. Then the computer will assign 100 to the new audit, 100 to the old audit, 100 to no audit. It might be that even though the new audit brings in more tax than the old audit, over a three-year follow-up, neither group outperforms the ‘no audit’ group. The reason might be that the ‘no audit’ group are afraid of an audit in years two and three, while the audit groups believe they get a free kick for those two years.

Under both research designs it is possible to test which is the cheaper process to run without having to contend with doubters who say the new process was cheaper only because it was tried out on less complicated audits. Randomisation will have assured that on average the new and old groups are of equal complication.

In few areas of problem-solving could randomised controlled trials be more viable than in tax administration.⁴ It has been necessary to the advancement of medicine to randomly assign sick patients to a placebo (an inert pill) or to no treatment when they might have been helped. While many of us are alive today because this was done, it raised awful ethical dilemmas. There is no such ethical dilemma in randomly assigning a high-risk taxpayer to miss out on an audit. There would be in a world where the community regarded it as just that all high-risk taxpayers should be audited. The world of tax is not such a world – the supply of compliance work is always less than the need for it; a high-risk company that is randomly assigned to no audit this year can always be purposively assigned to audit next year or the year after or both. However high their risk, we cannot afford to audit them every year.

⁴ Such trials might be more viable and less troubled by ethical dilemmas as in the case of medical trials, but these approaches can still pose a number of challenges. See Weiss and Rein (1969) and the review in Wirth (1994).

Many other kinds of compliance initiatives have the same character as audit in these regards. Consider, for example, an interesting initiative of simply writing to companies in the manufacturing sector that have paid no tax for three years to say that the Tax Office is concerned about this situation and requests them to write and indicate whether they think their circumstances will change such that they will be paying some tax next year. The hypothesis is that the fear they are being monitored in some special way will cause them to pay more tax in the next year. One hundred companies could be randomly assigned to no letter and no audits; 100 companies to the letter and X audits for those who fail to reply with an indication that they expect to pay tax next year; 100 to no letter and X audits; 100 to the letter and no audits. This design would enable an assessment of whether the (practically costless) strategy of getting the computer to send 100 letters increases tax receipts even without backing them up with audits for those who ignore them. Or whether this would work only when coupled with a commitment to do something if tax did not come in.

A major advantage that tax has in enabling randomised controlled trials compared with medicine is that it has the entire population of taxpayers on the computer, so randomisation with high external validity can be done at low cost. Most people who do not have experience of randomisation doubt that with corporations you would get an experimental group and a control group that would be identical on relevant characteristics. A needed confidence-building measure is to ask the doubters to name the variables on which the experimental group might end up different from the control group. The data would be collected to show that the two groups had the same value on average for these measures.

2.1.9 Evidence-based risk leveraging

The strongest criticism we have made of the Tax Office in this paper is that the loop is not being closed on the outstanding risk analysis, assessment and (increasingly) treatment it is doing. Radical surgery is needed in the Tax Office's approach to monitoring and review – fewer performance indicators that are more focused on specific risk treatments.

To move towards this focus, we recommend that each of the Tax Office's large business segments be asked to nominate one cross-case risk leveraging initiative each year that can be experimentally evaluated, with all research designs being approved by an experimental method consultant. The Commissioner might commit to increasing in the next year the budgets of two or three segments to fund the continuation of those initiatives which

accomplish the most cost-effective increase in revenue while complying with the *Taxpayers' Charter*. Bearing in mind the evaluation results, other segments would decide in light of their own budgetary priorities whether to continue their initiatives in subsequent years.

After five years, thirty-five randomised trials of compliance strategies would have been tested. Combined with the qualitative insights from the systematic building of single-case success stories nurtured by a storytelling culture, the Tax Office would show other tax authorities the path to evidence-based risk leveraging. No nation may be better placed than Australia to take this large step because Australia is so advanced on the path to market-segmented risk assessment and has such a knowledge-rich, if knowledge-chaotic, tax administration.

2.2 Building community partnerships

Building community partnerships is the second element of the ATO Compliance Model. Indeed, this model itself was the product of a community partnership, with active and constructive participation by the Australian Council of Social Services, the Queensland Chamber of Commerce and Industry, the Master Builders' Association, the Australian Retailers' Association, Ernst and Young, Johnson Partners and other state and Commonwealth government agencies.

Tax Office industry segments mostly do nurture constructive relationships with their key industry associations. Among the forums where Tax Office large business staff work with industry to co-design more mutually satisfactory tax administration are the Ralph Review of Business Taxation, the National Tax Liaison Group and the Corporate Consultative Committee.

In the next section on increasing the flexibility of Tax Office operations we consider the idea of not only co-designing compliance strategies with industry in the way this is already being done, but also using externals as 'test pilots' of the new designs when they are first put into the field. Partnership with the judiciary is out of the question from a separation of powers perspective. However, as argued in the early part of this paper, there is a need for a richer dialogue among community-Tax Office-parliament, carried forward at public conferences and in the media, to which the judiciary is exposed and chooses to respond as it sees appropriate.

At the level of individual taxpayers, the final section will consider options for rewarding ethical behaviour on the part of taxpayers. Valuing taxpayers who do the right thing as an alternative to negative sanctions has attractions in terms of building community partnerships. While we conclude there may be some limited things the Tax Office can do in this regard with large business, it is difficult to take this too far.

One idea for a new paradigm of community partnership would we suspect be premature until some of the other strategies in this paper were given more time to work. This is the idea of the government negotiating with the business community a *compliance-tax-rate-spiral*. The reason it may be a bad idea at this time is that there are too many corporations presently paying no tax who therefore have no interest in trading off higher compliance for lower company tax rates. However, floating the possibility of a *compliance-tax-rate-spiral* as something that might work in future could encourage public-regarding business taxpayers to see that in the long run there is much that Australian business could gain from a more cooperative compliance culture.

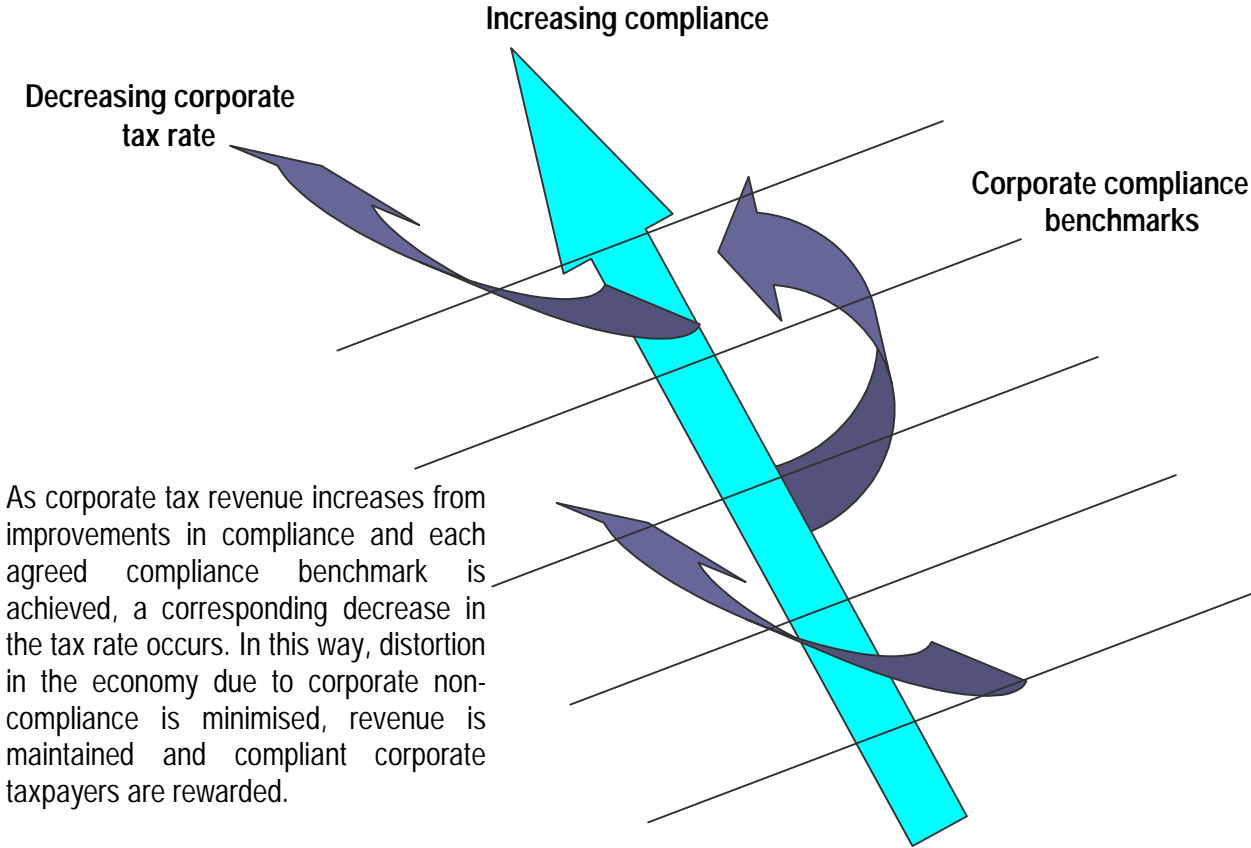


Figure 6: Compliance-tax-rate-spiral

So how would a *compliance-tax-rate-spiral* work? The Tax Office would set, say, five quantitative corporate compliance benchmarks. They would be benchmarks that involved an estimate of the extra dollars brought in by improved compliance. As each benchmark was met, the government's promise would be to reduce company tax rates by 2%. If all five corporate compliance benchmarks were surpassed, the company tax rate would fall by 10%. The compliance benchmarks would be set so that the aggregate increase in revenue from increased tax and increased penalties on non-compliers at each benchmark would be calibrated at the cost of a 2% tax cut. It would be highly desirable to incorporate tax penalties into the formula because this would give community-minded businesses an incentive to lend political support to higher penalties for non-compliers (that would be returned to compliers in lower tax rates). Business partnerships might be built on reversing the existing reality where non-compliers do not pay and compliers make up for it with a mechanism where non-compliers pay monies that are channelled directly to compliers.

While the government would generate no extra revenue by giving back all the gains from higher compliance and higher penalties in lower tax rates, it would generate a little extra revenue as the compliance rate moved up between benchmarks. Both business and the Tax Office would benefit from lower tax administration costs as the system moved to a more cooperative, less combative, compliance regime. But most importantly, business and government would both benefit from the higher income that a low-tax, low-litigation, high-compliance compact would bring.

The idea for the moment would be to do no more than introduce this into the debate. Not something that seems plausible, but something that signals the kind of world that might one day be possible if only we can learn how to forge a more meaningful business-community-government partnership towards a decent tax system.

Why call this a *compliance-tax-rate-spiral*? We assume two things. First, once the difficult challenge of achieving the first compliance benchmark had been met and the first tax cut delivered, momentum towards achieving the second benchmark would be easier. A virtuous circle that would feed upon itself. Once cooperative businesses had tasted the benefits of an initial 2% tax cut, they might even lobby for higher tax penalties (all of which would be returned to them) to deliver more quickly the next 2% cut. Increased compliance would not depend upon industry associations compelling their members to improve their compliance. It

would depend on (a) changing the nature of the social bargain between business and government (Levi, 1988) so that business actually wanted to comply with the law; (b) changing business culture so that business leaders disapproved of their business colleagues who did not comply with the law (as free riders on the rest of the business community and obstructers of national economic growth); and (c) business leaders politically supporting higher tax penalties and other measures to enforce the law against the grey economy (such as providing intelligence on dubious tax planning schemes to the Tax Office).

There is also an economic analysis of why the idea advanced here is a *compliance-tax-rate-spiral*. There is empirical evidence that as tax rates fall, compliance becomes economically rational for more individual taxpayers and voluntary compliance increases (Alm, Bahl & Murray, 1993; Alm, Jackson & McKee, 1992; Andreoni, Erard & Feinstein, 1998, pp. 838–9; but see Baldry, 1987; Clotfelter, 1983, Feinstein, 1991; Friedland, Maital & Rutenberg, 1978, Joulfaian & Rider, 1996; Williams, 1995, p. 4). Hence the virtuous circle is set up. A cut in the tax rate increases voluntary compliance and the increase in voluntary compliance moves the system down the path to the next 2% tax cut.

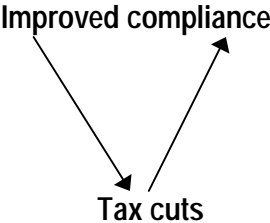


Figure 7: The compliance-tax-rate-spiral

Another way of building community partnerships could be to take forward those ideas in this paper that are worth further consideration by setting up a taskforce, something like the Cash Economy Task Force.

2.3 Increased flexibility in Tax Office operations to encourage and support compliance

The approach of the ATO Compliance Model values flexibility – showing that there are many ways of delivering on compliance and *Taxpayers' Charter* objectives. Institutionalising a storytelling culture is one way of fostering flexibility. Success stories which grab people's interest will be stories of innovation – of more flexible response than has been attempted in the past. Industry watching briefs and the development of a business intelligence capability are the eyes and ears for seizing opportunities to more flexibly respond to compliance challenges. The key client managers initiative is a most important way of showing major customers that whatever the problem, the Tax Office can solve it without giving people the bureaucratic runaround.

A growing source of flexibility in the Tax Office's approach to compliance is to take problems to international forums. The Advance Pricing Arrangement (APA) is one approach to locking in higher tax receipts from transnational corporations that has been enabled by leadership Australia has shown at the OECD towards settling an international framework where APAs can be negotiated (Killaly, 1996). APAs are negotiated arrangements between the Tax Office and corporations on a transfer pricing methodology which result in an appropriate allocation of income and expenses between related parties that are selling goods or services between different countries. Negotiating APAs is painstaking work, but because they lock in higher returns than audits do and because they shift the rules of the game to more cooperative ones with business, the investment is well justified. We are therefore inclined to support a performance indicator of increasing the number of APAs agreed per annum.

On the other hand, the Tax Office needs to monitor the cost of keeping APAs up to date in the face of company-specific, product-specific and time-specific changes which make the parameters of the APA obsolete. In addition, there was a worry that only 'squeaky clean' companies will ask for APAs, hence skewing Tax Office activity to areas of low risk. Initially, companies were reluctant to enter into APA negotiations because they feared this may have revealed tax liabilities going back over many years. However, since then APAs have become widely used. The kind of flexibility of Tax Office response that could be examined is for the Tax Office to consider granting an amnesty on tax liabilities going back more than two years as part of the incentive for entering into negotiations. International tax

competition can cause compliance problems which can be addressed only through international cooperation via forums such as the OECD and multilateral APAs. Similarly with tax havens, e-commerce and a variety of other questions.

The real power to increase flexibility does not lie with senior managers so much as with fieldworkers who are daily at the coalface. Fieldworkers must be the key risk identifiers. Their performance reviews should give high priority to evidence of identifying wider risks in the course of their fieldwork, documenting them and following through to ensure the risks are analysed and treated. In the view of some, this follow-through is not their job. Their job is to report the risks they identify to their immediate boss so that management can take care of it. This is neither our view nor that of senior Tax Office management involved in large business compliance work. The Tax Office needs more leadership from below. Fieldworkers can often report risks to segment managers who can be too busy to follow through on them. It is often more efficient for the fieldworker with the direct experience of the risk to chase it up through the Tax Counsel Network or up to the significant issues process in national office or the peak technical forum, to participate in the discussion there on what can be done to treat it and then to offer to be a test pilot for the treatment – to report back whether the treatment is working with the initial kind of risk they identified. Better still, the fieldworker might recruit one of the clients they work with to be an external test pilot as well, and also participate in the discussion in national office concerning the problem they have decided to own.

If tax professionals at all levels of the Tax Office from fieldworkers up are encouraged to be leaders, to own risks with a commitment to follow through all the stages of risk management, then loop-closing will improve. Most critically, the law reform loop will respond faster, and fieldworker morale will improve compared to a situation where they sit on their hands and grumble about management dropping the ball. What follows is that the Tax Office storytelling culture needs to be about stories of junior employees being rewarded in performance reviews for following risks right through to treatment and evaluation. In no area is this more important than law improvement.

2.3.1 Flexible adjustment of tax law

In the midst of the wave of tax law reform currently being experienced in Australia, we must remember that it is naive to believe that we can ever reform tax law and get it right in a way that will remain right for long. Nothing is more important to improving corporate tax compliance than law reform. But the reality is that as soon as the new law is in place, there will be legal entrepreneurs who will be at work opening up loopholes in it, and globalisation will over time deliver changes that will make it progressively obsolete. So law reform is not the task of an historic moment, but a continuous process.

The ship of tax reform needs to be continually rebuilt at sea as legal entrepreneurs open up one leak after another. Every decade or so the accumulation of extra pieces added to the ship to plug these holes will start to weigh it down with an excessive burden of complexity. The ship then has to be taken into dock and rebuilt from the ground up in a more simplified way. The most crucial health of the system assessment must involve a sophisticated group looking periodically at the ship to assess whether the overall pattern of its complexity justifies such a systemic legal refit. Plugging holes at sea and periodic simplifications of the whole structure are both recurrently necessary because an accumulation of new rules to plug old loopholes can be a resource for opening up new loopholes. Complexity favours the legal entrepreneurs. The objective is to give the judges only as much detail as they need to apply the policy purposes of the law with as much certainty as is possible for the contrived uniqueness of the circumstances with which they are continually presented.

The job of fieldworkers is to be the antennae that detect those risky new contrivances as early as possible. A good auditor has the ability to see that an issue that has come up in an audit will be a risk to the revenue in many other cases unless the law is clarified or improved. Provision exists for auditors to identify risks on case files that are available for computer analysis to group problems that are looking for common solutions. The culture change needed is one where writing down the risk is just the beginning of a process for the fieldworker of following the risk through to ensure there is a Commissioner's ruling, private binding ruling, litigation to clarify the case law, an actual change in the law, or a principled decision to let the risk sit there until the next comprehensive reform of the law. At every stage the fieldworker has a role as a reality tester for the lawyers, as an antenna to detect that latest manoeuvre of the other side and as a test pilot for the proposed legal remedy.

Tax law will become more certain and effective when fieldworkers are engaged with the daunting challenge of continuous improvement of a living law rather than the narrow challenge of enforcing a static law. It will become even more certain and effective if fieldworkers engage the public-regarding side of the large business at the coalface, where the problem in the law breaks out, to help repair the law in the public interest. Law reform in the past has been too top-down and insufficiently continuous. Also, as we argued at the beginning of the paper, it has not engaged the people of Australia in public discussion and understanding often enough. The Tax Office needs to persuade the people of Australia that more equitable and certain enforcement of the tax law is something they can reasonably demand of their institutions – parliament, judiciary and Tax Office. By articulating forcefully to the Australian people that the Tax Office does not want to be let off the hook for tax integrity, it makes it harder for the parliament and judiciary to be allowed off the hook (which to a significant extent they have been in the past).

We doubt that any amount of synoptic brilliance in re-configuring tax law at one point of history can deliver Australia a high-integrity tax system. Rather, what is required is for us to be more pre-emptive through a continuous improvement process of simplification-clarification-resimplification-clarification. This iterates endlessly. Commitment to excellence in the pre-emptiveness and responsiveness required for continuous improvement of tax law is the key. Australia can have a high-integrity tax system, but only if the Tax Office, the parliament and the judiciary jointly end the buck-passing. Our submission is that the Tax Office publicly put up its hand and force the hands of the other institutions.

2.3.2 Flexible dispute resolution

Improved disputing can improve compliance considerably. The reason is the now substantial evidence that when people and companies believe they have experienced fair procedures, they are more likely to comply with the law (Lind & Tyler, 1988; Makkai & Braithwaite, 1996; Tyler, 1990, 1998; Tyler & Dawes, 1993). The large corporate volume of the ATO Professionalism Survey does show procedural fairness to be a concern of large corporates with Tax Office staff (Donovan Research, 1998).

Adversariness arises often in tax fieldwork. Procrastination as an alternative to resolving disputes commonly uses delaying tactics such as manipulating the administrative privilege of

accountants, freedom of information requests, administrative law hearings, holding back on assistance with providing requested records, providing only parts of the information requested, and failing to attend meetings. Good Tax Office practice is to refuse to tolerate failure by either party to resolve disputes. Otherwise the agency hands victory to the people who practise 'Defer, Delay, Defeat'. Headbutting or delay that is obstructing resolution can be dealt with by widening the circle involved in the dispute. Some large businesses are alert to this option themselves as they regularly go over the head of fieldworkers to the segment leader and above. Experience demonstrates it to be a good option for the large business fieldworker as well (and so does theory, Braithwaite, 1997). If a matter is important enough, segment leaders can write to the CEO saying, in effect, 'we need you to supply this information in a timely fashion so we can settle this matter. We can use our powers to compel you to do so and stand ready to go to court to enforce this. But this is not the way we like to do business. Can we meet and exchange the information we need to get this dispute over with?' The insurance and superannuation segment of the Tax Office is one that already follows this sound practice, as others also undoubtedly do. At lower levels, an auditor having difficulty with a tax manager can ask for a meeting with the tax manager and his boss together, and then with the boss's boss if that meeting does not accomplish reconciliation.

The rationale for this path to flexible dispute resolution is that large businesses are full of many adversarial people and many cooperative people. The trick is to move up the organisation through various layers of adversarial managers until you reach a cooperative manager who insists that the matter be settled rather than take up more of everyone's time. Actually, the grounds for optimism that this works are even stronger than this. Even the most adversarial of executives have a cooperative, socially responsible self as well as a combative self. The gifted Tax Office staff member has the ability to treat clients with a respect that persuades even the most combative of them to put forward their socially responsible self. If she has a bad day where she fails to pull this off, she knows how to retreat, widen the circle for another day on which she hopes to catch the new player when his socially responsible self is to the fore. Moving up the organisation until you find a more senior cooperative person who will instruct the junior obstructionist to cooperate can be time-consuming. But it is less time-consuming than escalating prematurely to setting up an arbitration or litigation, or leaving the problem to fester. The restorative justice consultancy Transformative Justice Australia is one organisation well equipped to train staff in these techniques.

2.4 More and escalating regulatory options to enforce compliance

The Tax Office has in recent years made considerable movement down this path recommended by the ATO Compliance Model. Following the external evaluation of the Large Case Program⁵ by Pappas, Carter, Evans and Koop (1992), the Tax Office moved from full audit as a more or less standard single compliance product to a suite of audit products: roll-over audits, pre-lodgment audits, last year lodged audits, specific issues audits, loss tracking audits, new legislation/ruling reviews and record retention audits. Industry watching briefs and tax strategy reviews (which are risk assessments rather than audits) also became important fieldwork tools. The suite of products provides greater choice and flexibility to better target risk treatments; and taxpayers, subject to enforcement, can experience varying types of fieldwork contact, making them more careful in their tax affairs. Even if they have a full audit in one year, they cannot rule out some special purpose audit in the next year.

2.4.1 Reward as a compliance option

The ATO Compliance Model is of a compliance pyramid, with cooperative and educative compliance options at the base of the pyramid escalating to progressively more enforcement-oriented and punitive options as we move up the pyramid. The philosophy is to consider cooperative strategies first and escalate up through each layer of the pyramid only as each lower level of the pyramid fails to deliver compliance. This raises the question of why not try reward at the base of the compliance pyramid. The ATO 2030 Project examined this question and considered the idea of a ‘3 Star’ approach to recognising and rewarding good corporate compliance.

Some Tax Office staff and corporates considered it improper to reward large business for what was seen as meeting their legal obligations. We are sympathetic to this concern, especially in light of experience with other areas of regulation where financial incentives to meet legal obligations have engendered some perverse incentives to deliver the form but not the substance of what is intended to be rewarded. We do think, however, that the Tax Office can make a special effort to give a service ‘beyond the call of duty’ to clients that have exemplary compliance and cooperation in making the tax system work. For example, they

⁵ The Large Case Program focused ATO audit activity on the largest corporate taxpayers and was conducted during the latter half of the 1980s and early 1990s.

could be given extra quick turnaround of advisings. Indeed, it might only be as particularly trustworthy taxpayers that they could be given this – mutual trust enables an advisings process to be transacted more time-efficiently. The time-efficiency can be achieved by increasing Tax Office preparedness to accept the corporate’s tax analysis and relying on verifying selected key components of that analysis. The service of the key client manager could also be viewed in this light. Indeed, in light of the desirability of rewarding greater compliance with better service where this is a principled thing to do, key client managers could be allocated to the largest 100 corporate *taxpayers* in the country, measured by amount of tax paid over the past five years, rather than to the largest 100 corporations in *income*.

The Canadian Audit Protocols (Revenue Canada, 1996) are not just about a move to real-time and better coordinated audits; they are also about building cooperative relationships. Negotiated protocols offer the potential to reduce compliance costs for business and increase compliance effectiveness for the Tax Office. For example, scheduling visits by different areas of the Tax Office so that disruption to business is minimised, holding concurrent audits, assisting business with knowing in advance the form in which financial records might be kept to avoid double-handling. The key idea is that a tax administrator and participating large businesses can jointly produce a written framework that establishes guidelines and standards for building and maintaining a relationship for managing compliance.

While financial rewards that are identified as rewards for compliance can be dangerous in the signal they give, this is not true of the informal rewards of praise and giving credit where credit is due. Moreover, most people underestimate how important these are to assisting business regulatory compliance. In Makkai and Braithwaite’s (1993) study of Australian nursing home regulation, the use of informal praise by government inspectors was associated with improved compliance over the next two years, after controlling for other causes of compliance. An activity that could be underestimated in its value is a letter from the Commissioner to a large corporation that has moved from an obstructionist to a cooperative approach to compliance. Such a letter could thank the relevant executives of the corporation for the cooperation they afforded to Tax Office staff in doing their job and for the reasonableness they displayed in assuring that agreement could be reached on a just tax assessment. On all manner of smaller things, thank-you letters by more junior Tax Office staff and face-to-face expressions of appreciation are important compliance activities.

Large businesses which have exemplary corporate compliance systems and governance processes especially merit positive recognition, both verbally and/or in writing. In a storytelling regulatory culture, success stories should not be restricted to good things Tax Office staff members do; they should include stories of best practice large business behaviour, such as corporate compliance systems and governance processes put in place by corporates. This can be institutionalised by nurturing tax compliance professionalism in the way the Australian Competition and Consumer Commission has done with trade practices professionalism (through establishing the Australian Compliance Professionals Association) and consumer affairs (through initiating the Society of Consumer Affairs Professionals in Business).

A third approach to granting recognition to compliance following time-efficient verification and positive recognition would be more indirect. Its up-front and principal rationale would be in the ‘understanding taxpayer behaviour’ element of the compliance framework. This approach would be to conduct a study of why so many large businesses are honest, when the rewards of defying the spirit of the law can be large and the perceived risks of playing for the grey so small. Large businesses would be divided into nine groups according to whether their tax integrity was high, medium or low and whether their tax competence was high, medium or low. Only one of the nine groups would be included in the study and advised why they had been included. These would be the high-integrity, high-tax competence corporations. To be in the high-competence group, corporations would have to be assessed to have tax managers of formidable technical competence and recognised authority who assure that the company exploits all legitimate means of reducing tax but not by means of doubtful legitimacy or artifice. To be in the high-tax integrity group, the company would have to have an exemplary tax compliance system, be honest in its tax affairs, cooperative rather than obstructionist, and prompt in meeting its obligation to pay the tax required by law. We hypothesise that being included in a study of high-competence, high-integrity corporate taxpayers would be viewed as an unambiguously good thing. The main reason for the study is to understand what drives some corporations to operate cooperatively and to comply. It also provides informal positive recognition for their efforts. These highly competent public-regarding companies could be of special assistance as co-designers of tax reform and compliance policies.

Informal recognition in the form of expedited service (for example, advisings), and praise and recognition as a public-regarding corporate citizen (as by involvement in the co-design of Tax Office policies), are therefore possible at the base of a compliance pyramid. They can be combined with educative measures, the most important of which is advice and encouragement to establish credible corporate compliance systems. Accreditation is one path to nurturing tax compliance professionalism (or risk self-assessment). But there are others – such as sponsoring the establishment of a tax specialisation with the Australian Compliance Professionals Association.

2.4.2 Moving up the pyramid

The first step up a large business compliance pyramid might be a tax strategy review that checked directors' minutes, working papers, accounting and tax manuals, audit files, financial planning files, budgets/forecasts, and the like. This is a small step up the pyramid for a large corporation. It is hardly an enforcement step at all, merely a risk assessment exercise. Nevertheless, it is a good first step to take when perhaps all that is required is a signal that the Tax Office is reviewing the affairs of the business.

The second step might be real-time enquiries to clarify a concern. The third a special purpose audit or other low-intensity cooperative audit. The fourth a full cooperative audit. When escalated cooperative audits meet with repeated obstructionism, escalation to what we call 'assertive use of Tax Office powers' should be deployed with little hesitation. This means use of section 263 and 264 powers to demand documents and answers to questions, and surprise visits to premises to demand access to documents where this is necessary. Escalation from cooperative audit to assertive use of Tax Office powers should not normally occur until there has been opportunity for the Tax Office segment leader and the CEO to discuss cooperative dispute resolution options.

When both obstructionism and reasonable suspicion of serious non-compliance exists, a litigation taskforce might be put on the case. The litigation taskforce would be multidisciplinary, including a lawyer who would liaise with the Director of Public Prosecutions. The obligation of the head of the litigation taskforce would be to ensure that the necessary evidence was collected to pursue prosecution and other penalties. This is not to say that maximum legal action would be pursued; rather, the objective would be to make it clear

that this was inevitable unless the taxpayer moved the relationship down the pyramid to the more cooperative behaviour of resolving problems. There has been a view that the evidence rarely exists to warrant higher penalties or for prosecution to be successfully pursued. Doubts exist about this assumption. Rather, an alternative view is that a large corporation which has escalated this far up the pyramid will be vulnerable somewhere in its complex of activities to false and misleading statements having been made, among other vulnerabilities. In part, this view on tough enforcement may itself stem from a perceived lack of support from Tax Office managers, the Tax Office itself, and even the Director of Public Prosecutions. The use of a litigation taskforce can help crystallise this support and more tangibly signal to the staff and the taxpayer involved that swift and sharp enforcement will be taken.

The next rung in the compliance pyramid will be assessments/penalties that trigger litigation by the taxpayer and/or prosecution by the Director of Public Prosecutions.

The final rung of the compliance pyramid could be referral to the National Crime Authority (NCA). This occurs rarely at the moment, a situation that should continue. The NCA's superior powers and criminal enforcement capabilities should not be employed even on the most hardened criminals, but only on uncooperative hardened criminals who are believed to be major tax evaders.

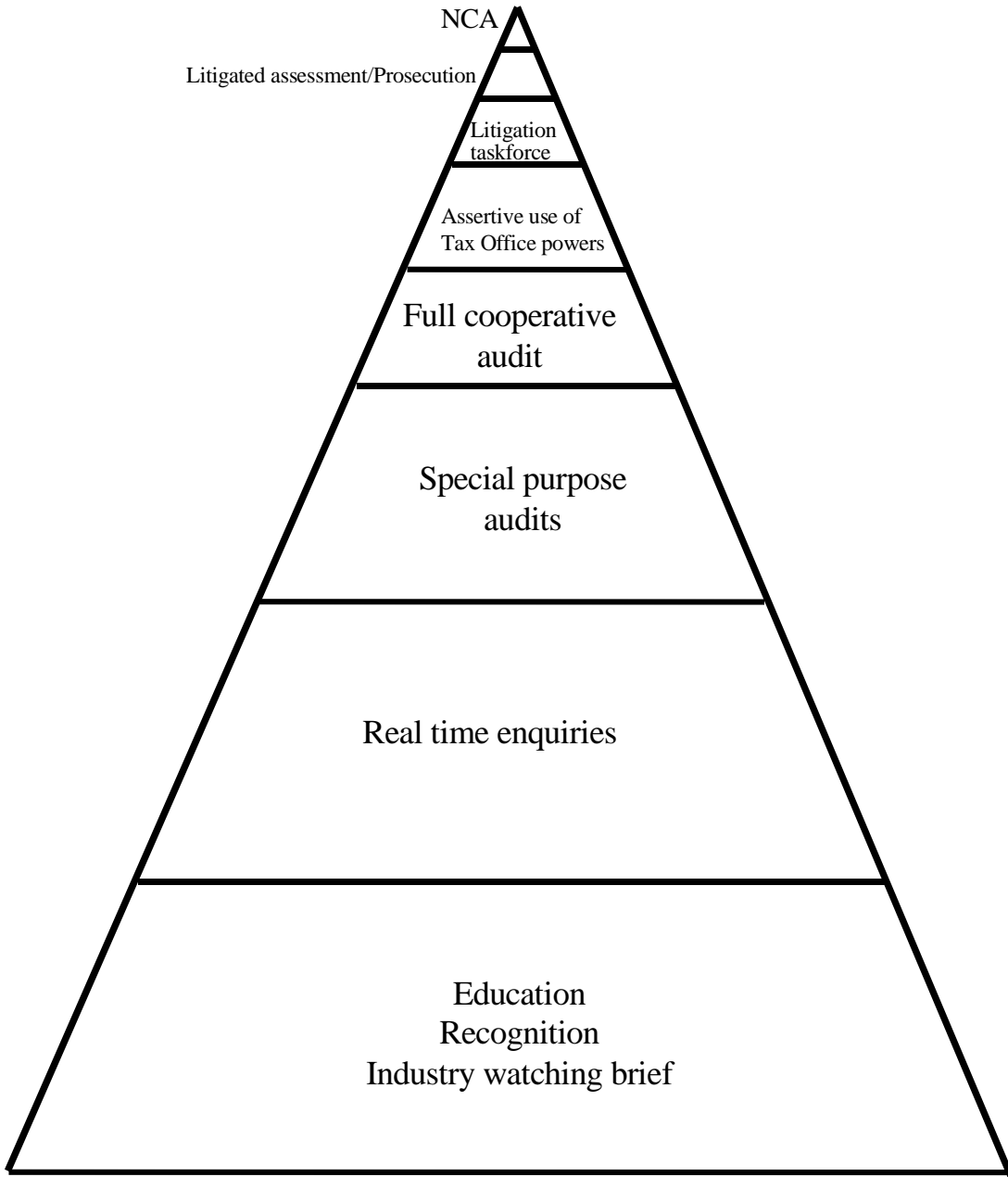


Figure 8: One illustration of a large business compliance pyramid

The pyramid in Figure 8 is an illustrative pyramid which may be useful in navigating the compliance options available in large business compliance at this point in time. No compliance pyramid can be effective without changing over time, with context, and in response to research findings from evidence-based risk leveraging. Nor should this compliance pyramid, or any other, be prescriptive. They are no more than a guide to compliance decisions that should never be allowed to trump contextual wisdom. It should never be a criticism of an officer that they are not following the Tax Office pyramid. It should be cause for praise when the idea of the pyramid is used flexibly to display an utterly original array of innovative risk leveraging strategies through which the Tax Office might escalate in dealing with a tough case. Rather than slavish implementation of ‘the model’, we should want success stories of innovation in pyramidal thinking about leveraging compliance.

By thinking pyramidally about the enforcement options available to you, you engender confidence and motivate cooperative compliance through showing a willingness to escalate up the pyramid. A regulator who believes that her pyramid is credible, and who is willing to escalate up it if necessary, rarely actually finds it necessary to escalate far up the pyramid. Confidence about the authority of the pyramid of enforcement capabilities projects an image of invincibility to the corporation that is the subject of tough enforcement. This rarely fails to engender cooperative compliance at low levels of the pyramid, enabling de-escalation to even lower levels. The effective regulator is cooperative and trusting at first, tough if that trust is abused, tougher and tougher if it is still abused, but forgiving if trust and cooperation is finally restored (Ayres & Braithwaite, 1992, Chapter 2). It does not matter that escalation at lower levels of the pyramid has very little bite with large corporations; at that level you are *signalling* escalation rather than cutting deeply into the corporate’s interest. The crunch is whether you are willing to escalate until you do reach something that bites.

For the pyramid to work, fieldworkers must be confident that they will get senior management backing if they escalate. They have that confidence because they do not escalate or threaten escalation of a particular type unless they get backing at a level that can support that level of escalation. Fieldworkers would not escalate to an enforcement option and would not initiate assertive use of Tax Office powers without getting the backing of their leaders in advance. Fieldworkers, however, should not assume their leader’s support when they want to escalate to assertive use of Tax Office powers and beyond. They must be able to count on their backing when the fieldworker and leader agree in advance on the circumstances of the

escalation. Once a litigation taskforce is established, control passes out of the fieldworker's hands into the hands of the head of the taskforce (usually a lawyer). Assurance that at some point the lawyers take over as a matter of policy adds to the confidence and authority of the fieldworker who can say: 'Look, unless we can sort this out, the conflict will escalate to the point where Tax Office policy requires that it be taken over by a litigation taskforce'. Near the peak of the pyramid, no promises of escalation would be made without the backing of the Commissioner.

Of course, many of the strategies in Figure 8 will be deployed for risk management reasons rather than out of any desire to give a signal that the behaviour of the taxpayer is causing their case to be taken more seriously. Sometimes when escalation up the pyramid is occurring, the circumstances will warrant a jump up several rungs of the pyramid. The pyramid represents a preference for resolving matters at lower levels, not a rule to do so. Starting at the base of a pyramid and moving up progressively is a presumption that can be overridden by compelling evidence (for example, of criminal behaviour or aggressive tax planning) that this is a case that should go straight to the peak of the pyramid. But we should be extremely reluctant to do that.

It is a challenge to educate people that there is no single or correct pyramid, but that there is virtue in having the professionalism that comes from having thought through the range of responses through which you would escalate when faced with non-cooperation. For example, one way to meet the challenge could be to build various compliance pyramids that deal with access to information. A workshop would get a group of fieldworkers who confront a similar group of clients with similar access difficulties to co-design their own pyramid of escalated response to denial of access. In the course of the workshop, they would be shown the compliance pyramids designed by other access workshops. Seeing their differences would give them both ideas and assurance that they could design their own. Indeed, there would not have to be agreement at the workshop. Different participants could go away with different pyramids that suited their contexts. The objective would be that each participant would develop a pyramid that she thinks would work for her and that she could get her supervisor to back her on. Such strategic conversations about navigating the compliance environment are at the heart of the Tax Office's strategic management system.

2.4.4 Many compliance building blocks

The pyramid is just a small part of the story we have attempted to tell about how large business compliance work might be improved. Enforcement is hardly an appropriate compliance response with a law the taxpayer does not understand. A law clarification response is needed. In a 1999 presentation, Jim Killaly, Deputy Commissioner of Large Business & International, used the following picture of ‘Compliance Building Blocks’ (see figure 9 below). It would be hard for us to provide a better summary of the variety of activities needed for the compliance framework we have been attempting to develop in this paper.

COMPLIANCE BUILDING BLOCKS

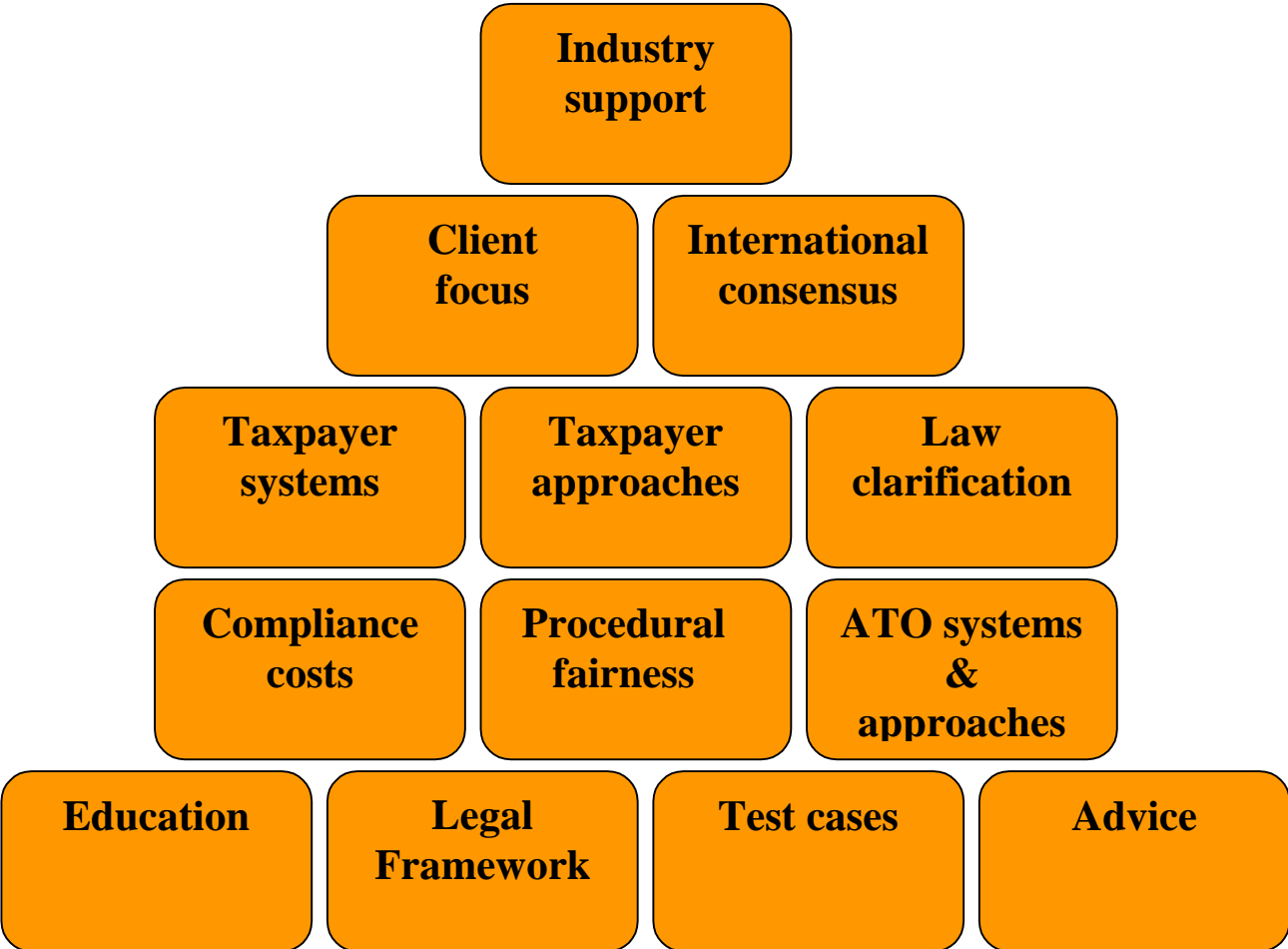


Figure 9: Compliance Building Blocks. From a presentation by Jim Killaly.

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