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Restorative Justice and Responsive Regulation, (2002),
Oxford University Press, New York

Information Feudalism (with P Drahos), (2002), Earthscan, London

Shame Management Through Reintegration (with E Ahmed, N Harris
and V Braithwaite), (2001), Cambridge University Press, Melbourne

Regulation, Crime, Freedom (2000), Aldershot, Dartmouth

Global Business Regulation (with P Drahos), (2000),
Cambridge University Press, Melbourne

Corporations, Crime and Accountability (with B Fisse), (1993),
Cambridge University Press, Melbourne

Responsive Regulation: Transcending the Deregulation Debate
(with I Ayres), (1992), Oxford University Press, New York

Not Just Desserts: A Republican Theory of Criminal Justice
(with P Pettit), (1990), Oxford University Press, Oxford

Crime, Shame and Reintegration (1989), Cambridge University Press, Melbourne

Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies
(with P Grabosky), (1986), Oxford University Press, Melbourne

Occupational Health and Safety Enforcement in Australia (with P Grabosky), (1985),
Australian Institute of Criminology, Canberra

Corporate Crime in the Pharmaceutical Industry (1984),
Routledge & Kegan Paul, London and Boston;
Japanese edition, Sanichi Shobo, 1992

The Impact of Publicity on Corporate Offenders (with B Fisse), (1983),
State University of New York Press, Albany

Prisons, Education and Work, (1980), UQP, Queensland and
Australian Institute of Criminology, Canberra

Praise for *Markets in Vice, Markets in Virtue*

"This outstanding book draws on a wide range of interviews to offer a compelling depiction of the growth of the tax shelter industry in both Australia and the United States, and of the ways it might effectively be combatted by sophisticated regulators. It should be required reading for anybody interested in the tax shelter problem and, more broadly, the problem of how contemporary competition is creating markets in vice and how they may be turned into markets in virtue."

Professor Reuven Avi-Yonah, University of Michigan

"With characteristic style and ebullience, John Braithwaite cuts through the complexities of tax avoidance, and drawing on extensive practical knowledge offers four key strategies for flipping 'markets in vice' into 'markets in virtue'. This highly readable book will be of interest both to tax specialists and to those concerned about the effectiveness of regulation, but who never thought that tax could be interesting. In Braithwaite's hands, it is."

Dr Julia Black, London School of Economics

"Written in John Braithwaite's engagingly direct style, this book casts a bright light on some of the arcane practices that underlie one of the most crucial issues of the 21st century: whether tax systems can continue to provide funding for public services in ways that can be accepted as fair and just. Its penetrating analyses and practical proposals should be read not only by tax advisers and officials but by every concerned citizen."

Professor Sol Picciotto, Lancaster University Law School

"Professor John Braithwaite, probably Australia's most internationally renowned social scientist, has written an original, sparkling, readable analysis that opens our eyes to aggressive tax avoidance behaviour in the United States and Australia, and the only partly successful regulatory attempts to deal with it."

Professor Allan Fels AO, The Australia and New Zealand School of Government

**MARKETS IN VICE
MARKETS IN VIRTUE**

MARKETS IN VICE MARKETS IN VIRTUE

John Braithwaite

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Preface

Ultimately this is a book about competition policy, globalisation and how national regulatory polices can respond to some of the problems these create. Its aim is to make a contribution to regulatory theory by thinking inductively about a considerable amount of data from a specific arena of regulation. Vice is an exciting topic. The book opens with a consideration of some vices that fascinate people – paedophilia, pornography, drugs, corruption, problem gambling – then it quickly settles in to develop the theory of markets in bads juxtaposed with markets in goods on the non-titillating topic of tax avoidance.

“Sixty-four percent of women attorneys think that tax lawyers make undesirable dates”, quipped Daniel Dolan. This captures something of why many would think the substantive focus of this book dull. It comes from the collection of tax quotes at <www.tax.org/quotes/> used here and there in this book. My experience in working with a lot of tax lawyers and their colleagues in accounting, was that they were actually engaging people who were having a large impact on the world for good or ill. In New York I found myself repeatedly intimidated by the wit and intellectual agility of those I was interviewing. I had not realised that among New York tax advisers there could be so many who spoke like Woody Allen, with comparable pace and panache, and not incomparable dabbling in vice and virtue. The global virtuosity of their vice and virtue makes them much more instructive in their sophistication than say pornographers.

Some of my sharp tax advisers seemed impatient as I slowly asked questions in my Australian drawl. Yet in both New York and Australia, the elite tax advisers and the busy government officials I interviewed were universally generous with their time. I mostly asked for one-hour appointments and routinely left their office after two or more hours of enjoyable and enlightening conversation. It is to these 105 anonymous informants who gave so generously of their time in these interviews that I owe my greatest debt of gratitude.

Secondly, I want to thank the Australian Taxation Office and the Internal Revenue Service for their institutional support for the research, and the senior tax officials I spoke to from the UK, New Zealand, Japan, Germany, the European Commission, the OECD and Canada whose thinking also shaped the ideas herein. While this particular project was not funded by the ATO but by the Australian Research Council, the Australian National University and New York University, many of the other Centre for Tax System Integrity studies cited and relied upon in this research were funded by the ATO. The support from Commissioner Carmody and all of his most senior staff has been tremendous during this program of work. None of the references to *named* individuals or corporations were a result of information supplied by tax officials or from my interviews, but came from publicly available documents.

Thirdly, I owe an enormous debt to *all* my colleagues from the Centre for Tax System Integrity at the Australian National University, but especially to Tina

Murphy, Linda Gosnell, Rob Williams, Bevan Murphy, Andrew Stout, Andrew Wirth, Alice Dobes, Greg Rawlings, Stephen Mugford and Valerie Braithwaite. They gave me the largest doses of assistance with this particular project. Margaret Farmer from Federation Press and Dedi Felman from Oxford University Press both provided counsel and editing unusually wise in the final stages of this project. I also want to pay a tribute to the New York University Law School, home for my New York fieldwork. NYU was an unusually engaging community of scholars with the most outstanding group of tax lawyers to be found at any of the world's law schools, and, as I found after September 11, a place of profound compassion. One regret about this book is that there was no opportunity for our admired American colleague, Leslie Whittington, to comment on its conclusions. She perished along with her husband and her two little girls while they were travelling to join the Centre for Tax System Integrity for a year on one of the planes hijacked on September 11. A collection of works from all members of the Centre, *Taxing Democracy* (edited by Valerie Braithwaite), was published in 2003 in her memory.

I am grateful to publishers of the following articles, from which some sections have been reproduced herein:

- J Braithwaite, 2003, "Large Business and the Compliance Model" In Valerie Braithwaite (ed), *Taxing Democracy: Understanding Tax Avoidance and Evasion*, Aldershot: Ashgate, 177-202.
- J Braithwaite, Y Pittelkow, and R Williams, 2003, "Tax Compliance by the Very Wealthy: Red Flags of Risk" in Valerie Braithwaite (ed) *Taxing Democracy: Understanding Tax Avoidance and Evasion*, Aldershot: Ashgate, 205-228.
- J Braithwaite, 2003, "Making Tax Law More Certain: A Theory" *Australian Business Law Journal* 31(2): 72-80.
- J Braithwaite, 2003, "Meta Risk Management and Responsive Regulation of Tax System Integrity" *Law and Policy* 25(1): 1-16.

When discussing Australian data in this book, references to dollars are to Australian dollars (79 cents US at the time of writing) and when referring to US interviews a dollar of course means a US dollar.

It is common to end prefaces with fawning admiration for one's spouse. In this case, I reverse the convention by lodging a complaint. Valerie Braithwaite normally says she finds it unnecessary to read my books because she has already discussed them over our evening glass of wine and during bedtime chats. I have dedicated this book to her in the hope she might read it for a change! Also for her leadership in things that matter.

John Braithwaite
Canberra
February 2005

To Val
with love

Part I

**COMPETITION POLICY,
EFFICIENT VICE
AND TAX SYSTEM INTEGRITY**

Competition policy and efficient vice

Efficient markets

Laws that attack monopoly have a long history, and even existed in the Roman empire (Braithwaite and Drahos, 2000: 185) but the story of a modern competition policy, executed with vigour, begins in the 1880s in North America when Canada and at least ten American states passed antitrust laws. Very little of the rest of the world was affected by this until quite late in the 20th century. Most of the competition authorities in the world have been created since 1990. There were barely 20 in the 1980s; today there are more than 90.¹ More importantly, the vigour with which competition has been enforced and monopoly attacked has grown decisively in all the developed economies. Part of this has been professional deregulation at the behest of a globalising competition policy for the professions underwritten by the World Trade Organisation's General Agreement on Trade in Services. These global and national policy shifts have effected important change. Cartels still exist, monopolies still dominate markets, but mostly price competition is more vigorous than in previous centuries. The result is that management cannot afford to be complacent. If managers are not aggressive at creating a demand for what they sell, more aggressive managers in competing firms put them out of business. This requires progressively more efficient production of the goods people want.

Yet this book is about how competition drives the more efficient production of *bads* as well as goods. Consider the expanding problem of obesity: competition policy has made us fatter. The marketing of fattening foods is a field where we can see competition among progressively more sophisticated advertising agencies to market and package these goods more seductively, creating some of the world's most successful brands – like Coke and McDonalds. Part of this, unfortunately, is based on pitching advertising at children and at adults by emotional appeals to identity rather than to reason. So a young man who eats hamburgers and drinks Coke is projected as the kind of person who is surrounded by slim, beautiful women and who has a lot of fun. The appeal of the ad lies in its image of what sort of male it is possible to be, as opposed to a pitch about the nutritional value, taste or price of the product. Beer advertisements that portray male beer drinkers surrounded by women in skimpy bikinis likewise tend to communicate nothing about the taste or price of the beer; they associate the brand with a feeling of sexual titillation and an identity of sexual attractiveness. A market in the vice of overeating is created in this way. In response, a

¹ Thanks to Professor Eleanor Fox of New York University in helping me with various sources to reach these figures.

market in virtue is also spawned. Alongside the ads for fast foods on our television screens, we see advertisements for diet programs and fitness clubs. Fitness clubs have greatly improved the quality of their service; personal trainers assess and advise us, equipment gets better and better, locations more convenient, access to magazines and audio-visual programs of our choosing is made available as we exercise. So competition policy has delivered both more efficient markets in fat production and in fat reduction.

Competition-induced supply

Robert MacCoun and Peter Reuter (2001) have written perhaps the best book ever on drug policy. After surveying the evidence on many different experiments in drug policy around the world, their most important conclusion is that legalisation of illicit drugs does not have much effect in worsening drug abuse as a social problem, at least not on its own. Legalisation is mostly associated with sharp increases in drug abuse only when the market moves on to aggressive commercialisation. So allowing people to grow their own pot of marijuana on their back landing and smoke it privately does little if anything to increase marijuana use. But the existence of networks of coffee shop retail outlets and street pushers linked to substantial commercial producers does a lot to expand the market. We see this in the history of mass addiction. For centuries Indians were eating opium without it becoming a drug of mass addiction. It became a mass addiction in China when the British East India Company decided to market it there and invest in a more efficient and appealing system for drug delivery than opium eating – opium smoking in a pipe – as well as a network of opium dens for marketing it. Tobacco similarly had been a subject of ritual use by indigenous Americans for many centuries without causing mass addiction. Nor was there mass addiction in the first few centuries of European use of tobacco. It was competition between British and American tobacco multinationals in the late 19th century that delivered the breakthrough of a more appealing delivery system for this drug – the compact cigarette – and more sophisticated marketing pitched at teenage men and women to insinuate the message that smoking was sophisticated and conducive to sex appeal.

We see the same commercialisation dynamic with (what starts as) the comparatively harmless, episodic activity of gambling – for example, on infrequent race days in a local town. But over time, racing clubs become commercialised and the gambling services that grow around them are networked through mass communications. No longer do we have to wait for the local spring racing carnival to have a bet. We can wager on races that occur in some town, somewhere else, almost every day of the week and tune in to an electronic call of the race provided by a commercial broadcaster of the event. In all large Australian cities and in some US cities it is now also possible to visit casinos at all hours – all year round – or we can gamble on the Internet. The marketing appeal of the casino far exceeds that of the poker school of old in the back room of a pub. The surroundings are comparatively sumptuous, the staff attractive and charming, with quality food and entertainment on site. And the television marketing of the product is inveigling. In the year Australia's second casino opened in 1979, total

expenditure on casinos was \$10 million. By 1986, the majority of Australia's casinos had been built and \$158 million was being spent in them. By 2002 this had increased to \$2543 million, a real percentage increase in 23 years of 6630 per cent. In the same period, real spending on electronic gaming machines also increased 566 per cent. While this was not as big a relative jump as for casinos, the absolute dollar increase is much greater as a result of the wider commercialisation of pub and club gambling: \$8916 million in 2002. By 2002, Australians were losing an average of more than \$600 per person to these machines, but only an average of \$172 a year in casinos.² The more aggressive competition in gambling services in Australia today between race clubs, casinos, gambling in licensed social clubs and bars, sports betting and Internet gambling provides a more appealing range of ways to have a flutter and is driving up the sales in all of these sectors. But this also creates a larger pool of problem gamblers who can, as a result of their problem, fail to feed their children properly and drive their families into bankruptcy and violence. A more virulent market in vice has also been spawned.

This is the supply side story of markets in vice. We will see from the study of the market for tax avoidance in this book that there is an important demand side induced by competition as well.

Competition-induced demand

It is easy to discern competition-induced demand in the case of tax. Managers come under competitive pressure when their company is paying a legally appropriate amount of tax to apply "aggressive management techniques" to that liability. The market demands managers who reject the view that paying tax is normative; it rewards managers who construe a tax liability as a problem that aggressive management can eliminate.

The way in which competition-induced demand emerges is less obvious in the case of gambling (which is one reason why tax is better chosen as an illuminating case study of markets in vice and virtue) but it is there, as the following analysis shows.

Competition has turned sport into a business. It is a competitor in the entertainment industry. Investors in sporting franchises want spectators through the turnstiles, but more importantly, they want viewers watching their sport on the box in preference to other sports and other television programs. So what will happen when aggressive managers of one football code lead it to become the global first mover in offering interactive on-screen gambling services as matches unfold? Let us imagine it is soccer that does this globally. If on-screen gambling is allowed by Australian broadcasting regulators to be beamed into Australian television sets, Australian sports fans who like to gamble will watch more European soccer and less Australian Rules football, less rugby. Gamblers will like being able to bet on who will win as they watch the game, with the odds changing as the game progresses. Sounds like fun to the gambler who reckons he or she knows the sporting team and their chances. So by being a first mover into

2 My thanks to David Marshall and Jan McMillen for assistance with these figures which are sourced from the Australian Gambling Statistics maintained by the Tasmanian Gambling Commission.

the supply of better-packaged sports betting, soccer profits at the expense of rugby and other sports. This might be accomplished even if Australian broadcasting regulators ban on-screen sports betting. If soccer managers are a bit more aggressive in the competitive struggle, they can get around the ban by beaming it in through the Internet – which is beyond the control of Australian regulators. So Australian media corporations, in their competition with the Internet, may be inclined to support the aggressive managers of soccer in their bid to broadcast sports betting. Soccer, rugby, Australian Rules and Australian media organisations are predicted to become competitive businesses that demand the services of sports betting firms to hook up to their sport. Sports betting not only spreads because betting firms market the appeal and improve the delivery systems for betting; it also spreads because sports demand it in their competition with other sports and other entertainment providers. Sports businesses in a thoroughly marketised economy that fail to identify, demand and deliver things that many fans will like, will fall behind in the competition.

Efficient vice

The problem of increasingly effective competition harnessing modern management techniques to the more efficient production of bads is a general one. The problem can also be illustrated with many other vices – such as paedophilia and its mass marketing by competing commercial exploiters of this vice through the Internet, sex shops and sex tourism agencies. Indeed, it can be illustrated with a more competitive and more globally networked market in bodies of various ages and in body parts, not only for sexual exploitation, but for illegal immigration, for medical, cosmetic and other uses as well. Again, the competition-induced demand side is not as clear as the supply side in something like prostitution, as compared to tax. But the demand side does exist; it is often said that companies that refuse to bring in prostitutes for favoured clients in some places miss out on contracts. In a ruthlessly competitive market, on the supply side there is the offering of bribes, on the demand side the extortion of bribes. Here there may also be a tipping point where in certain markets of the world, advantage has been so often sought by the supply of bribes that the demand for bribes can no longer be stopped.

We will see that the mechanisms whereby competition induces demand for vice are much more refined and complex when it comes to markets for tax shelters. The firm may not only demand a bidding war as to which tax shelter promoter can come up with the best and cheapest shelter to eliminate a tax liability; it may also demand the cheapest insurance premium against the shelter being disallowed. Not only is vice demanded; insurance is also demanded against vice being punished (this is explained in Part III). Another kind of “insurance” documented in this book is driven by the demand for letters from respected lawyers declaring their opinion that the shelter is legal. While we will conclude that aggressive tax planning is more supply driven by promoters of shelters than demand driven, we will find that supply-driven tax shelters pass a tipping point beyond which an aggressive tax planning contagion creates a

demand-driven market. A herding phenomenon transforms a supply-driven market into a demand-driven problem.

It would be a delicious irony if competition policy enforcement ever became a large enough risk for firms that competition among global insurers offered worldwide insurance against fines by national competition agencies!³ What could a national competition law do to prevent a global insurer making a payout for its fine to a global corporation through an account in a tax haven? The global corporation could then reduce its tax liability because the fine will reduce its profits in the nation where the fine is imposed; but it does not report for tax purposes the counterbalancing insurance payout in its worldwide income. The fine imposed by a competition policy that has induced more aggressive use of tax havens would then increase the worldwide profits of the corporation it fines!

The biggest reason why paedophilia is less interesting as a market in vice than the selling of tax advice is that with paedophilia we have simply a market in vice and none of the complex tension between the market in virtue and vice that will be revealed in what competition policy has done to tax. In this sense, tax policy is more analogous to complex policy domains like health. Michael Porter, of the Harvard Business School, sees a paradox in the fact that the United States has the most aggressively competitive healthcare system in the world, but a system that delivers less cost-efficiency and poorer health outcomes than less competitive systems (Porter and Teisberg, 2004). How, Porter and Teisberg muse, could it be that in a competitive market it takes 17 years on average for the results of clinical trials to become standard clinical practice? Surely the market would drive out of business providers who failed to adopt the improved practice?

The paradox arises because at the micro level US healthcare organisations seek to compete less in curing the comparatively sick, and more in creaming the comparatively healthy. They seek to compete less in cost reduction than in being clever at cost shifting – shifting costs from payer to patient, from health insurer to hospital, from hospital to doctor, from insured to uninsured, and so on. So insurer payments to hospitals of a fixed amount per admission for a given ailment fosters competition in the provision of cheaper treatments rather than more effective or innovative ones. If the treatment fails, the hospital gets another admission and another payout. Porter and Teisberg's diagnosis of the US health system is that competition occurs at too macro a level – at the level of insurers, networks and hospital groups. To improve quality and safety at reduced cost, competition needs to occur at a more micro level – disease-by-disease, patient-by-patient. Porter and Teisberg (2004: 4) cite the accomplishments of the Texas Heart Institute in achieving surgical costs one-third to one-half lower than other providers despite taking on the most difficult cases. They achieve this by specialising in a disease in which they both “learn to do it right the first time” and learn to innovate. The Texas Heart Institute competes in a market in the virtue of being best at addressing a particular set of problems.

Yet sadly, the aggressive competition that most American health providers experience translates into the vice of cutting corners on quality and passing costs onto another – someone who may be a less efficient bearer of those costs or someone who goes sick because they cannot afford them. Through the lens of this

3 I do not suggest that competition enforcement is a big enough risk to make such insurance worthwhile. In fact, I am almost sure it is not.

book, therefore, the challenge of the high mortality and morbidity the US health system delivers compared to other nations is not one of making competition more vibrant; it is the challenge of flipping competition in vice to competition in virtue.

Regulating one man's vice, another woman's virtue

The examples of the sex trade and the payment of bribes in countries where every business pays them beg the question: what is vice and what is virtue? Liberal economic theory argues that effectively competitive markets are good precisely because they allow the preferences of individual citizens to drive the price mechanism. The state or the church do not tell us what is good for us; such choice is the essence of being a free citizen of a liberal society. It nevertheless remains the case that all of us have views, albeit conflicting, about what is good or evil. Mostly these normative judgments reflect our views about the obligations we owe others. It is therefore analytic that, to the extent that competitive markets succeed in delivering the more efficient satisfaction of freely chosen preferences, they will more efficiently produce bads as well as goods – however bad and good are defined.

A paradox of a more effectively liberal economy is that it forces us to make more judgments about vices we wish the state to regulate. Because a perfectly competitive market economy more efficiently produces vice, indeed innovation into vices yet to be invented (such as designer drugs), it creates a greater demand from citizens for state regulation.

In the 1980s it was standard to speak of Western economies as entering an era of privatisation and deregulation. In retrospect it is clear that what happened in that decade, and has continued since, was privatisation and regulatory growth. When the Thatcher Government in Britain radically shifted the provision of nursing home beds from the public sector to the private nursing home industry (Day and Klein, 1987), resources began to flow into 200 little nursing home inspectorates in district health authorities around the country. Just as well, because the evidence from both the US and Australia is compelling that while abuse and neglect is common in government and charitable nursing homes, it is much more so in private nursing homes (Jenkins and Braithwaite, 1993). Empirically, this market in vice was found to be mediated by top-down pressure on managers to achieve financial goals by cutting corners on quality of care; this pressure was much greater in privately owned homes.

Education also began to become more marketised under Prime Minister Thatcher. Regulatory tools such as league tables on the teaching performance of schools monitored by The Office for Standards in Education (Ofsted) and comparable approaches to the performance of universities were established, so consumers would have data on which were the best schools and universities.

The policy called the New Public Management in Britain was called Reinventing Government in the United States (Osborne and Gaebler, 1992). The watchword of the Clinton Administration became that government should be “reinvented” to do less rowing and more steering. The night-watchman state of classical liberal theory and the Keynesian welfare state became phenomena of the past. Jacinta Jordana and David Levi-Faur (2004) see the night-watchman state (in

which most steering and rowing was done in civil society) as the dominant model in the 19th century until the New Deal in the 20th century. The welfare state (in which the state did so much of both the steering and rowing) then became the dominant model from 1945 to the 1970s. The regulatory state in which civil society does most of the rowing, with the state concentrating on steering emerged as the contemporary model by 1980 (Majone, 1994; Loughlin and Scott, 1997; Parker, 2002). For example, Mrs Thatcher privatised public functions such as telecommunications and then created a new regulator – the Office of Telecommunications (OfTel). The supply of water was partially marketised, and regulated by the Office of Water Supply (Ofwat). Fortunately, when rail was privatised, the new regulator was not called Oftracks!

In Australia, when the Keating Labor Government moved privatisation into the heartland of the Keynesian welfare state by privatising the Commonwealth Employment Service's job-placement service for the unemployed, it created an Employment Service Regulatory Authority. However, when John Howard's new conservative government believed its own rhetoric on privatisation and deregulation, and decided in 1996 it could continue the privatisation without the new regulatory agency, it soon found itself embroiled in fraud scandals involving private providers of job placement services. In many other areas the Howard Government fell into line with other Western nations in building a bigger regulatory state. It partially deregulated nursing home inspection, and then substantially re-regulated it. Just as the pages of regulatory laws and the budgets and staffing and regulatory bureaucracies increased under both the Reagan and Thatcher Administrations (see, for example, Tramontozzi & Chilton 1989; Ayres and Braithwaite, 1992: Ch 1), so they also increased two decades later under John Howard's conservative Australian government.⁴

Jordana and Levi-Faur (2004) show that the tendency for state regulation to increase with the growth of privatisation is global, and that as privatisation spreads, new regulatory agencies spread even faster. As a case in point, they show how the growth in the number of regulatory agencies moved from the West to take off in Latin America in the 1990s. There is a central question of social theory here: have we seen a transition from "nation state" to "market state" (Bobbitt, 2002) and from "liberal" to "welfare" to "regulatory capitalism" (Levi Faur, forthcoming).

The conclusion so far is that because the more aggressive production of goods that results from effective competition policy also leads to more aggressive production of things citizens view as bads, the rise of more vibrant (or virulent!) markets is historically associated with the growth of state regulation. It is also suggested that the simultaneous rise of both phenomena can be defended normatively.

4 In 2002, the Commonwealth Attorney-General's Department estimated there were 1800 Commonwealth Acts in force. 170 of these were promulgated in 2001, 148 in 2002. But more tellingly, the number of rules per Act, and the complexity and length of Acts are increasing. For the 1990s, the number of pages of law per Act was twice the number for the 1980s and three times the quantity for the 1970s (Argy, S, *Mechanisms for Improving the Quality of Regulations: Australia in an International Context* (Canberra: Productivity Commission, July 2003)). Tax law is probably the most extreme example, which has grown 27-fold in its pages of law since 1970 according to Michael Inglis ("Why we Urgently Need a Proper, Working Systemic Model for the Australian Federal Tax System", Paper to Centre for Tax System Integrity, Canberra, 2004).

I confess to being, on balance, comfortable with both the growth of more competitive economies and the growth of the new regulatory state. That is, I agree with liberals that adults are mostly better able than a nanny state to judge what is best for them. So, a more liberal economy that expands choice mostly expands goods rather than bads. This is especially true because citizens generally internalise the needs of others into their preferences, especially the needs of children.

It would be folly to abandon the values of competition policy merely because it also promotes the efficient production of vice. Equally, it is folly to be a libertarian who does not come to terms with the fact that with the more efficient production of goods comes more efficient production of social evils that might require regulation. So it is a sensible normative inclination to support both more competitive markets through competition policy and more rigorous regulation of the excess and exploitation this engenders.

However, in regulating new bads we must be prudent not to destroy the creative process for new goods. Consider the globalisation of a more aggressive market for military goods and services. This includes a troubling market in weapons of mass destruction and components to produce them, not only out of the old Soviet empire – as we are learning at the time of writing from the revelations about Dr Abdul Qadeer Khan's Pakistan trading network for nuclear technology and know-how. This is a market in a new vice of late modernity that, if unregulated, would end us. One is also tempted to respond in an unequivocally disapproving fashion to the privatisation of infantry through the use of multinational mercenary corporations. But perhaps we should allow ourselves a little moral uncertainty about where evil resides.

When a major war breaks out, militaries from various states are likely to be installed by the UN to fracture the monopoly of violence in the war-torn state or region. Often UN peace operations are dealing with the private armies of warlords who are controlling most of the war-torn nation or region, rather than official state commanders-in-chief. However, we have also seen situations where external states have been reluctant to commit their troops to highly dangerous UN peace operations – such as in Rwanda and Sierra Leone where Western interests were not at stake. For example, in Sierra Leone, when military intervention was needed in the 1990s to protect citizens whose limbs were being hacked off by warlord armies, it was only a Western mercenary multinational which was willing to risk its troops – for an ample fee.

In some economies a debate is beginning about cutting defence expenditure to increase international competitiveness and to drive down national debt, while increasing the will to greatly expand that debt in a time of crisis by large loans to hire mercenaries. The final element of that debate is about the need to regulate the professional standards of mercenary armies to assure compliance with the Geneva Conventions. In 2002 the British Home Office issued a Green Paper on the licensing of "private military companies"; *The Economist* (16 February, 2002, p 53) quipped that the regulator might be named Ofkill.

I am not advocating the installation of mercenary armies by the UN in places like Rwanda and Sierra Leone, and certainly not as military intelligence interrogators in Baghdad prisons. Neither am I advocating that my country wipe out its national debt by eliminating most of its defence budget and instead hire

mercenaries should it come under attack. I simply advocate leaving our minds open to the possibility that genocides could sometimes be prevented and poverty reduced by shifting the world's resources out of defence budgets and allowing competitive private markets in the efficient and timely delivery of infantry services to exist. My point is simply that we should never view what is vice and what is virtue as unproblematic, that we should be open to the possibility that what stands as a vice in a familiar context might emerge as a virtue in the new circumstances that events and dynamic markets constantly create.

The limits of competition policy in respect of vice

The Australian Competition and Consumer Commission (ACCC) acts as an enforcer of national competition and an enforcer of consumer protection. The Commission makes competition decisions based on what it judges to be the ultimate interests of Australian consumers, rather than just in terms of what would maximise competition.⁵ This model – the simultaneous consideration of both consumer protection and competition at the time of deciding whether a monopoly or oligopoly should be attacked by a competition authority – is a good one. Yet the model is still a limited institutional solution to the problem that markets in virtue also lead to markets in vice. The vice often relates not to the victimisation of consumers, but to the victimisation of workers, for example, or children who are sex workers within paedophilia markets. In other cases the vice is environmental destruction or even the destruction of our sense of virtue itself.

This chapter started with an analysis of the rather stark vice of gluttony. When my children were young, one of the games my wife Valerie and I played with them when travelling in Europe was guessing which vices and virtues were represented in the sculptures and paintings in the cathedrals and museums. We were all best at identifying gluttony. The one we persistently had most trouble with was hope. For citizens of the 21st century, hope hardly seems a virtue at all. Worldly-wise scepticism seems a more plausible candidate than hope as a late modern virtue. Medieval legends of hope are perfect for parody, as in *Monty Python and the Holy Grail* (Cartwright, 2004). Peter Drahos's (2004) work gives a clue as to why hope has been lost as a modern virtue: it has been commercially corrupted and become the stock-in-trade of political candidates and their spin doctors ("Merchants of Hope") in the market for our votes, and also of multinational corporations in the market for our money. Manipulated hope does not lead to mature hope in a community. Rather, virulent markets in the vices of manipulative, wishful and wilful hope destroy what Tori McGeer (2004) calls responsive hope (virtuous hope).

5 For ten years to 1995 I served as a part-time Commissioner with Australia's national anti-trust and consumer protection agency, what is today called the Australian Competition and Consumer Commission (ACCC). A number of us from the consumer movement and the ACCC formed a foundation – the Foundation for Effective Markets and Governance – in part to promote this model of driving antitrust and consumer protection institutionally in Asia and the Pacific. Like many on the Commission and in the Australian consumer movement, we shared the view that this model is a worthy one.

The virtue that will be the focus of this book is not quite as nuanced as responsive hope. Instead the focus is on tax system integrity, which is under threat from competition policy. We will see that part of what is under threat is the ethics of professions like law and accounting. Here we must revisit the qualification about the limitations of reinstitutionalising competition policy. During the 1990s, the ACCC was required to issue decisions about striking down professional monopolies of many different kinds. One of the arguments professions like law would at times advance successfully was that the integrity of a legal system that protects citizens from procedural abuse would be best protected by maintaining a monopoly of lawyers over a certain type of practice – as lawyers were required to undertake training in professional ethics and could be struck off if they failed to honour ethical standards. In deciding whether to yield to such arguments, the ACCC was required to balance the public benefits from maintaining such standards against the anti-competitive nature of the professional monopoly. Institutionalising a deliberative process where all stakeholders – professions, consumers, government, business purchasers of legal services – can comment on the competition law remedies available does seem to have value as one check that more competitive markets in legal services do not also induce more aggressive markets in professional vice. But the conclusion remains that reinstitutionalising competition policy in this way alongside consumer protection against market vice can only grapple with some of the problems of markets in vice.

Developing a regulatory theory for flipping markets from vice to virtue

For the reader who can accept that the problem of markets in vice induced by more effective competition in a capitalist economy is a general one, the rest of the book then seeks to:

1. Develop a greater understanding of how markets in the vice of tax avoidance and evasion have developed from the centre (New York) to the periphery (remote Kalgoorlie); show how tax competition is transforming taxation from an institution that redistributes wealth from rich to poor as it pays for public amenity, to one that redistributes wealth from the poor and the middle class to the very rich; and advance the best integrated strategy we can manage for confronting the specific vice of aggressive tax planning (Readers may care to jump ahead to Figure 13 (p 140) to see the final model of how markets in this particular kind of vice are driven nationally and globally and how contagions of aggressive tax planning can be thrown into reverse.); and
2. Show that regulatory interventions that flip markets in vice to markets in virtue are possible; analyse why Australian tax administration has accomplished this more effectively than recent US regulatory policy; and advance understanding of how markets in vice emerge and how to flip markets in vice into markets in virtue.

In short, the tax-shelter problem is used as an example to illustrate how competition in a globally networked economy creates massive problems of markets in vice.

One point of a detailed analysis of the growth of one kind of market in vice is that it shows where the opening theoretical account in this chapter is rather too simple. In the next chapter, we will see it is not true that sharpened competition has constantly driven down ethical standards among tax professionals. Rather, aggressive tax planning has been a cyclical phenomenon, where markets in vice get out of hand until a variety of public and private interventions flip the balance back toward markets in virtue. Moreover, it turns out that Australian cycles of aggressive tax planning are very different from US cycles.

Another respect in which the analysis so far turns out to be too simple in the tax arena is that it is excessively preoccupied with the supply side of markets. Subsequent chapters will conclude that while aggressive tax planning is more supply than demand driven, there is always an economic interest in demanding tax planning. We will see that aggressive tax planning and its control can only be understood by grasping the recursive relationship between its demand and supply.

For example, we will see that most Australian taxpayers use a professional tax preparer. Most demand the services of an “honest, low fuss” tax preparer rather than a legal game-player. In other words, virtue is more in demand than vice. Reciprocally, “honest, low fuss” tax preparers supply virtue. They advise against aggressive tax planning and act as compliance agents of the state in a variety of ways. It follows that a promising strategy for tax system integrity is to drive more clients into the hands of such “honest, low fuss” preparers. This can be accomplished (as discussed in Chapter 5) by switching targeting of audits from taxpayers with the greatest risk profile to clients of tax preparers whose portfolio of clients as a group have the worst compliance record. This motivates taxpayers to move their business to honest preparers and motivates preparers to rein in dishonest taxpayers.

The most interesting aspect of this research is the insight into the cyclical growth of markets in vice and strategies that flip markets in vice into markets in virtue. However, this book also aims to develop a well-rounded understanding of the problems of aggressive tax planning in Australia and the US. While markets in vice and virtue is the major theme of the book, there are major parts of the story of the rise and fall of aggressive tax planning that are remote from this theme. Penalties and the administration of enforcement are important in various ways independent of this theme, for example. Other issues are fundamental to the control of aggressive tax planning but in ways that make flipping of markets in vice into markets in virtue only a small part of control effectiveness. For example, I will argue for a tax law that privileges principles over rules in terrain where concepts are complex. While one reason for the superiority of principle-based tax law is that it fosters markets in virtue and cramps markets in vice, this is only part of the story. Chapter 10 argues for principle-based law for a wider fabric of reasons. The book therefore has two aims – first to advance the best integrated strategy we can manage for confronting the specific vice of aggressive tax planning, and second to advance the more general project of understanding how markets in vice emerge and how to flip markets in vice into markets in virtue.

The story begins in the next chapter, Chapter 2, which conceives of the beginning of the 21st century as a turning point in shifting Western tax systems

from being institutions that redistributed wealth from the rich to the poor to the reverse. The trajectory leading to this point started some decades ago, and Chapters 3–5 in Part II show that in the past two decades Australian tax administration has fought against this tide, outperforming other developed economies in its success in collecting tax from the big end of town. For example, in comparison with the US, for the past decade and a half corporate tax collections rose sharply in Australia and fell sharply in the US. This part describes specific programs like the Transfer Pricing Record Review and Improvement Project and the High Wealth Individual Taskforce that have substantially increased corporate tax collections. It will also be shown that over the last twenty years the Australian Tax Office (ATO) has made an important shift to being a strategically tough enforcer against the big end of town. On this, trends in the two countries are also reversed. But, it will be argued that tougher enforcement by the ATO has been less significant than its shift to a pyramidal, responsive strategy, overall, accompanied by a huge retraining investment in The Compliance Model. There has been no such shift of IRS enforcement strategy to become more responsive, nor is there evidence of the considerable shift from risk management to meta risk management in the IRS that there has been in the ATO (see Chapter 5). In Malcolm Sparrow's (2000) terms, in comparison to the ATO, the IRS is a "process improvement" rather than a "problem solving" organisation that organises itself laterally for responsiveness.

For all that, we will discover in Part III of the book that there are a number of important ways that IRS regulatory strategy is more sophisticated than the ATO's. Overall, while I do argue that the sophistication of the regulatory strategy shifts that have occurred at the ATO are a reason for its comparative success in struggling against the fiscal and moral termites that have been eating away at the integrity of Western tax systems, the more fundamental fact I will show is that the termites are more voracious in New York than Sydney. In this Part of the book, I will conclude that New York is a generation ahead of Sydney, Kalgoorlie and Peoria in the sophistication of aggressive tax planning. I attribute this to the more aggressive competition in the New York market for financial advice. This sets up the conclusion in Part IV that while increasingly aggressive competition in financial markets increases competition in vice, "smart regulation" (Gunningham and Grabosky, 1998) can flip markets in vice to markets in virtue, so the more aggressive competition for financial advice can ratchet up tax virtue.

Part IV is an extended analysis of the learnings from the first three Parts of the book on what works in controlling aggressive tax planning. While the empirical research of the Centre for Tax System Integrity does give us some insights we have not had before, genuinely evidence-based tax administration is still a long way off. As a result, what is advanced in Part IV is really only an incipient theory of what might work, grounded inductively in the Centre for Tax System Integrity's empirical research during the last seven years. Chapter 10 draws on the ideas of many of the New York informants, though Australians like Michael D'Ascenzo will be able to see where I have drawn on their ideas as well. These policy ideas on how to reform tax law are then put together in a way that perhaps none of them will recognise as their own, or want to own! Chapter 11 then picks up the meta risk management learnings from Chapter 5, which presents encouraging empirical evidence of the effectiveness of meta risk management strategies

like the Australian Transfer Pricing Record Review and Improvement Project. Chapter 11 takes this approach a radical step further by drawing on the natural systems ideas of some of the ATO's most innovative thinkers who worked together on the Corporate Consolidations Project. Chapter 12 pulls together conclusions on how to improve enforcement strategy in a way that is heavily influenced by ideas of Michael O'Neil from the ATO.

Chapter 13 re-conceives the transformation of aggressive tax planning contagions into reverse contagions as a political project of flipping markets in vice into markets in virtue. I found a lot of virtue and forlorn longing for a more virtuous past even in the most aggressive corners of tax planning in New York, Sydney and Melbourne. A characteristic of my scholarship on corporate crime for decades has been to look at what others see as glasses half full of vice and view them half full of virtue. Enforcement to combat vice is actually not more important than strategies of professional self-regulation, restorative justice and constructive forms of social movement politics for tax justice that are oriented to pouring more virtue into the glass. Because many front-line Australian business regulators are more open to seeing in a balanced way the half-full, half-empty glass than some US regulators, I suspect they are more effective than many US agencies in a variety of domains, not just tax compliance. With tax, I propose that there has been an especially delicious paradox of greater effectiveness on the Australian side. For most of the past decade Australia has had a conservative government that has put in place tax policies intended to benefit the rich – lower corporate tax rates, a shift toward heavier reliance on more regressive indirect taxes, and a variety of other less far-reaching regressive measures. Yet in Chapter 2 and in Part II we will see that ATO officials put in place a variety of administrative measures that made multinational corporations, large Australian corporations and high-wealth individuals pay more tax than they had been paying under the structurally more egalitarian policies of the Labor governments of the 1980s and early 90s. In an era when so many structural factors converged to dislodge Australia from the place it once held among the most egalitarian societies in the world, imaginative tax administration has played an important role in preventing it from slipping further down the ranking of nations in terms of inequality of wealth. With imaginative tax administration for tax system integrity, however, I sadly do believe the glass is still more empty than full in Australia. It only looks better in comparison with other nations with glasses even more empty of regulatory imagination. The 21st century is shaping up as a bad century for tax, unless we become more open to radically different approaches to the revenue.

So Chapter 14 summarises nine of the simpler strategies that might tackle aggressive tax planning with genuine effectiveness and integrity. It also draws on the most interesting aspect of this research – the insight provided into the cyclical growth of markets in vice and strategies that flip markets in vice into markets in virtue. This opens the door to an exploration of generic countermeasures with examples of how these might be deployed to flip markets in vices other than tax to markets in virtue.

Tax systems in crisis

Pothinius: Is it possible that Caesar, the conqueror of the world, has time to occupy himself with such a trifle as our taxes?

Caesar: My friend, taxes are the chief business of a conqueror of the world.

George Bernard Shaw (*Caesar and Cleopatra*)

This book attempts an empirical examination of how aggressive tax planning has been marketed in the United States and Australia during the past 30 years. My interest is also in going beyond the specificities of tax shelter marketing in these two nations at the turn of the century to learn something of the globalisation of the market for tax shelters. These markets are national, but they are just as importantly global and local (with New York very different from Peoria, Sydney from Kalgoorlie and indeed Melbourne). They are “glocal” as the globalisation theorists like to say.

The story of post-1970 aggressive tax planning told in this book is one of the most important parts of the bigger story of why the super-rich are paying a lower (and declining) effective rate of income tax than the middle class, and why the situation is much worse than captured by the official figures.

What is aggressive tax planning?

What Australians refer to as the market for aggressive tax planning, Americans refer to as the market for tax shelters. The Australian usage is more communicative of what is actually involved. Aggressive tax planning can mean engineering transactions that generate tax losses, excluding income from taxation, deferring recognition of income into a later year, or converting income into a different, lower-taxed form. Contrivance is used to “shelter” income, wealth or capital gain from being taxed. Most aggressive tax planning involves the asymmetric treatment of losses and profits across two or more taxable entities. Funds are shuffled between entities so that the losses will be held where they generate a maximum tax loss and the profits flow to where they are untaxed (or less taxed). Because aggressive tax planning is characterised by innovation in finding new ways of getting around the intended effects of tax laws, a legal or statutory definition with too much specificity risks capturing known tax shelters without netting newly emerging tax products.

This book employs a broad definition of aggressive tax planning as a *scheme or arrangement put in place with the dominant purpose of avoiding tax*. In terms of Australian law, this conceives of any tax planning that the courts find to be in breach of Pt IVA of the *Income Tax Assessment Act 1936* (Cth), Australia’s general

anti-avoidance provision, as aggressive tax planning. US law does not have a general anti-avoidance provision, though it has some anti-abuse rules that apply to specific types of transactions in ways that also fit the broad definition above. While there is a core area of abuse that both legal systems will uncontroversially subsume as aggressive tax planning, this core is surrounded by a large penumbra of uncertainty. It is this very ambiguity that makes aggressive tax planning a rewarding research topic for contemplating vice and virtue. The point of this research project is not to resolve the ambiguity, but to explore its implications empirically. Many of the Australian interviewees rejected the aggressive tax planning label as a descriptor of their activities. They felt things were labelled aggressive “for political purposes” or “to get public support for what the ATO [Australian Taxation Office] is doing”.

When the US Treasury initiated a discussion in 1999 of the need for a general anti-avoidance rule principle, or in US terminology, a general anti-abuse rule (GAAR), to confront the corporate tax shelter problem, the conception of a shelter was broadly similar to the Australian conception of aggressive tax planning. A shelter involved attempting to “obtain a tax benefit in a tax avoidance transaction” where a “tax avoidance transaction” is any transaction (i) “in which reasonably anticipated pre-tax profit ... is insignificant relative to the reasonably expected net tax benefits”, or (ii) “that inappropriately eliminates or significantly reduces tax on economic income” (Kleinbard, 1999: 232). Point (i) on its own is a narrower definition than the Australian conception, but point (ii) is considerably broader. A more light-hearted definition of a shelter as “a deal done by very smart people that, absent tax considerations, would be very stupid” has been attributed to Professor Michael Graetz (Department of the Treasury, 1999: v). Professor Calvin Johnson has given this thought more precision: “a tax shelter is an investment that is worth more after-tax than before-tax” (quoted in Johnston, 2003: 220).

The definition of aggressive tax planning as a *scheme or arrangement put in place with the dominant purpose of avoiding tax* subsumes the core concerns of both the Australian and US attempts to grapple with the ambiguities.

The cyclical nature of aggressive tax planning

The history of aggressive tax planning in the US and Australia manifests an almost perfect cyclical harmonisation. Both the US and the Australian Treasuries fought off a major wave of tax schemes targeted at individual taxpayers of above average wealth from the mid-1970s and early 1980s and both suffered another boom in tax schemes between 1995 and 2000. On the surface it appears that Australia and the US are locked into the same twenty-year cycle of aggressive tax planning crises that get out of hand for a few years then dampen down till two decades after the last crisis began – following a credible response from the tax authority and the courts.

A neglected topic in white-collar crime research generally is its cyclical nature. Both Australia and the US had a “greed is good” boom in stock market fraud during the same period in advance of the 1987 crash (the Bonds and Skases in Australia, the Levines and Milkins in the US). In both countries, corporate crime enforcement was greatly strengthened in the late 1980s and early 1990s. But

in the long boom that followed until the crash of September 11 in 2001, greed became once again good in both nations.

The fact that the Big Five accounting firm, Arthur Anderson, was a common player in the collapse of Enron in the US, and the collapse of HIH in Australia (and other major corporate failures in both nations), must cause us to consider the possibility that globalisation is delivering a harmonisation of white-collar crime cycles between nations.

This book concludes that cycles of aggressive tax planning are supply driven by the promotion of questionable schemes by global organisations like Arthur Andersen. At the same time, this book concludes that the US and Australia do not have the harmonised aggressive tax planning cycles that seem apparent on the surface. Rather the suggestion is that the US is at present one cycle ahead of the Australian cycle. Australia can therefore look to the tax avoidance crisis the US faced at the very end of the 20th century to see some important features of its own future problems.

The Centre for Tax System Integrity at the Australian National University has done some limited fieldwork on the UK – another market for aggressive tax planning which also seems to be behind US developments in the increasing aggression of tax shelter marketing. However, the UK was more like the US in the 1990s in that its main tax problem related to large corporates and high-wealth individuals rather than to retail shelters for reasonably well-off middle-class people, as in Australia. That is, in the UK, like the US, the leading innovators in the supply of tax shelter opportunities are not particularly interested in the middle-class market; they supply to extremely wealthy individuals and affluent corporations. Since 2000 it has become increasingly clear that Australia is on the same trajectory as the US and UK in this respect.

The larger crisis

"A great century for tax"

Oxford Professor Christopher Hood said in 2000 that the 20th century had been "a great century for tax collection by Western governments". In previous centuries, both the US and Australia had seen bloody tax revolts. For the US this led to revolution. In Australia, the Eureka Stockade in 1852 was the closest thing Australia ever had to a revolution – gold miners took to arms to resist the collection of inequitable gold taxes which fell as heavily on those who found little gold as it did on those who made a million. No such resistance occurred in the 20th century in these and most other Western democracies.

At the beginning of the 20th century, few Western economies were organised well enough to be able to collect income tax or company tax. It was at the customs barrier that the economies of a century ago were well enough organised to demand a tax payment. In 1901–1902, the first year of Australia's existence as a nation, 77 per cent of Australian tax revenue came from customs and excise duties (Smith, 1993: 42). Land taxes, taxes paid on transfer of land and taxes paid on estates at the time of death progressively became somewhat more important. Australia did not establish a national income tax and company tax until 1915 (a few years after the first US company tax), though in the decade before this there had been some minor collections of income taxes by State

governments. The Labor Australian Federal Government at this time invented the progressive income tax with continuously rising marginal rates (Smith, 1993: 45). While the government did not proclaim a redistributive intent, the tax also shifted the burden from the poor to the rich by imposing higher rates on property income than on earned income. Workers with annual incomes under £156 paid no tax at all. As with the early State government income taxes, only highly paid workers paid income tax. Between the two World Wars collections from new sales taxes and other indirect taxes grew.

Surprisingly, Steinmo's (1993) data shows that for much of the 20th century, the US tax system was more redistributive than the Swedish and British systems and possibly even, it might be added, the Australian system. This was particularly so during Franklin Roosevelt's long presidency. In the mid-1930s, less than the wealthiest 5 per cent of the US population paid any income tax (Steinmo, 1993: 24). During the 1930s, top marginal income tax rates in the US reached 81 per cent and were generally higher than in Sweden, the UK and Australia. During World War II they rose to 94 per cent and were still at 90 per cent under the Eisenhower Administration. Later, in the 1950s, the top Australian rate of 85 per cent finally exceeded that in the US.

Income tax, company tax and sales tax steadily increased the proportion of Gross Domestic Product (GDP) that went to government during the 20th century. This was a general phenomenon throughout the Western world. It is what Christopher Hood meant by the 20th century being a good century for tax. Collectability was assisted by the corporatisation of the Western world (see Braithwaite and Drahos, 2000: Ch 9). Financial institutions also became more concentrated and computerised, making withholding on interest and dividends feasible. As retailing organisations became larger companies, as opposed to family-owned corner stores, the collection of indirect tax became more cost-effective. When most of the Australian (and to a lesser extent American) working class was a rural working class, itinerantly shearing sheep for graziers, cutting cane or picking cotton, collecting taxes was difficult and costly. But as the working class became progressively more urban – in the employ of large city-based corporations – income tax collections from workers became a goldmine, especially after the innovation of Pay As You Earn Tax (PAYE) in all Western economies mid-century (withholding of tax from pay packets by employers, which started in Australia in 1944).

From progressive to regressive taxation

Over time, taxation became less redistributive. Workers paid a higher proportion of their income in sales taxes and other indirect taxes than did the wealthy. Where income tax was progressive, sales taxes were regressive. So as indirect taxes grew, the tax system became less redistributive. The income tax also became less progressive. At the beginning of the 20th century only the wealthy paid it, as they were the only ones who were not itinerant and who had enough income to make collection cost-efficient. And as workers became wealthier and less itinerant, eventually almost all of them were caught in the income tax net, and as they got wealthier, they were also caught in the bracket creep of a progressive tax system – inflation brought more and more of the workforce under the higher tax brackets originally targeted at the wealthy.

The latest erosion of the redistributive tax system in the US has been a shift away from audits for the wealthy in favour of audits of the poor. In 2001, for the first time, low-income taxpayers (earning less than US\$25,000) were subject to a higher audit risk than high-income taxpayers earning more than US\$100,000. The number of audits of those earning over \$100,000 dropped from 74,566 in 1992 to 29,086 in 2001 – despite a huge increase in the number earning this amount in the course of the boom decade. The Heritage Foundation, which has led the lobbying for lower taxes on the rich, defends this accomplishment of the Bush Administration because of its belief in high rates of fraud on the part of the poor (Johnston, 2003: 135).

Admittedly, it remains the case that most income tax in the US is paid by the rich. In 2001, 41 per cent of income tax was paid by the wealthiest 5 per cent of the US population (McIntyre, 2002: 2) who earned 33 per cent of the nation's income. With the 41 per cent number falling and the 33 per cent number rising under the George W Bush Administration, there is now only limited progression left in the income tax to counter the extreme regression of other taxes such as those on sales, excise and payrolls (Johnston, 2003: 11). In the aftermath of the Reagan Administration in the late 1980s and early 1990s, the US tax system had become so regressive that the poor paid out more in tax than they got back from the sum of social insurance pensions and other public transfer payments (Goodin et al, 1999: 169-72).

At the same time, some Fortune 500 corporations were simultaneously paying no tax and drawing billion dollar corporate welfare cheques in the form of tax rebates. For example, Microsoft paid \$3 billion in US tax between 1996 and 2000 and received \$12 billion in tax breaks. In the first two years of the new millennium, Microsoft's effective tax rate was 1.8 per cent (see <www.ctj.org/html/corp0402.htm>). Energy giant Enron paid no income taxes at all in four of the last five years of its existence; IBM had an effective rate of 3.4 per cent for the five years to 2002. Even General Electric, America's most profitable corporation over this period, had an effective tax rate of only 11.5 per cent thanks in part to its creative lease-backs in the electric power plant market that it dominates globally (build it, sell it, then lease it back to create deductions in high-tax jurisdictions and record profits where taxes are low). Colgate-Palmolive, which paid Merrill Lynch and other advisers \$25 million in transaction costs for just one shelter that saved it \$94 million in taxes (Department of the Treasury, Washington DC, 1999: 23), managed a negative income tax rate of 1.3 per cent for the five years to 2002 thanks to corporate welfare payments. CSX Corporation paid no federal income tax at all in three of the four years before its CEO, John W Snow, became George W Bush's Treasury Secretary.

Lower corporate tax

International corporate tax competition started when the Thatcher Government in the UK cut the corporate rate from 52 per cent to 35 per cent in 1984. The US followed suit in 1986 with a cut from 46 per cent to 34 per cent. Another round of cuts raged between 1996 and 2003 when the average rate of corporate tax in the 30 richest countries fell from 37.5 per cent to 30.8 per cent (*Financial Times*, 2 May 2003, p 1). In May 2003 PricewaterhouseCoopers tax partner John Whitney warned, "I believe that corporate tax is in near terminal decline. Over the next 10

years governments may have to deal with a lot less corporate revenue ...". Capital gains tax is used to capture some of the corporate wealth that is passed on to build individual wealth. As the US capital gains tax rates were almost halved between 1987 and 2003 (Johnston, 2003: 40) Australia resisted this trend and introduced a modest capital gains tax that accounted for a growing proportion of its revenue.

Most OECD countries in the latter part of the 20th century also saw the proportion of total revenue collected from company tax fall sharply due to global tax planning by large corporations (Steinmo, 1993: 20). Australia was actually an exception to this trend from the 1990s to the time of writing (2004), as we will discuss in later chapters. But the US was part of the international trend to lower company tax collections fuelled by international tax competition, though the US fall in the percentage of tax collected from corporations has not been as steep as for some other countries such as Sweden (Steinmo, 1993: 175). Nations competed to retain the capital of their corporations and wealthiest individuals by bidding down both top marginal income tax rates and company tax rates very sharply in the 1980s (Steinmo, 1993: 30). By 1995 Germany was collecting only 2.8 per cent of its total tax collections from corporate income tax. Even after it recovered to 4.4 per cent for the rest of the decade (Genser, 2001: 5), by 2001 corporate income tax had again fallen to only 1.7 per cent of tax collected. This is so low as to raise the question whether the substantial transaction costs in collecting corporate taxes justify such miserly returns, especially when full dividend imputation in Germany in the 1990s meant that shareholders would have to pay some of this tax (the tax on their dividends) if company tax were abolished. These transaction costs include not only the very expensive business for the government of collecting complex corporate taxes, but also the compliance costs for business which, even in Australia, a comparatively successful country in collecting corporate tax, have been estimated to be as high as 28 per cent by the Ralph Report (Johnson and Pender, 2002).

Tax breaks and "loophole madness"

The late 20th century also saw a growing political imperative of "loophole madness", whereby governments granted tax breaks to more and more private interests. The value of tax expenditures or tax breaks in the US increased particularly precipitately during the Reagan years – from 25 per cent of federal revenues in 1973 to 32 per cent in 1979, and to 55 per cent in 1986 (Steinmo, 1993: 143).¹ This phenomenon, in both Australia and the US, also created the loophole-ridden tax laws that were a major part of what enabled the late-century explosion of aggressive tax planning. The opinion polls at the end of the 20th century in both the US (Steinmo, 1993: 158) and Australia consistently showed that ordinary citizens felt that large corporations and wealthy individuals should pay more tax and both middle- and low-income families should pay less. It would appear that the imperatives of the global competition for capital and for political campaign contributions outweigh the democratic imperative to respond to the wishes of the

1 During the Reagan years the top marginal personal income tax rates fell spectacularly – the top federal income tax rate was 70 per cent when Reagan became President in 1981; it was 28 per cent when he left office in 1989 (Avi-Yonah, 2002: 1391).

people on this matter and that, by offering concessions, the corporate tax system has essentially become a way for political parties to raise campaign funds.

Mobile wealth

Meanwhile, the rich were getting cleverer at making their wealth more mobile as they approached old age, and as a result, governments collected less and less revenue from death duties. These duties were finally abolished in Australia in the 1970s. The rich also got better and better tax advice on how to make other taxable assets harder to track down through the use of multiple family trusts and other tax shelters. By the end of the century, they began to make extensive use of offshore tax havens and international arbitrage.

A century that started with workers having itinerant wealth ended with the wealthy having the mobile wealth. Even wealthy corporations started to reincorporate their US operations as “runaway headquarters” in tax havens like Bermuda to avoid paying US tax – just as they have moved intellectual property such as patents, copyright and the title to the company’s logo to such havens.

Tax systems transformed

Yes, the 20th century was a good century for tax – a growing proportion of GDP was collected (OECD, 2001: 35-39, 86-87).² But it was a century where taxation was inverted from being a pre-eminent tool for the redistribution of wealth from rich to poor, to, by the turn of the century, becoming a tool for redistribution from the poor and the middle class to the very rich.

In the large middle of the US tax system, a great amount of redistribution still goes on – from the upper middle class and moderately wealthy people down to those less well off. It is the very richest individuals and wealthy corporations that pay the lowest effective tax rates. Effective income tax rates on individuals still continue to rise slowly in the US until adjusted gross income hits \$2 million, beyond which it falls (Sullivan, 2004). This situation historically has got worse and will become worse still with the Bush Administration tax changes that are still to have all their effects. In the Clinton years, when the federal income tax burden on Americans overall rose by 18 per cent, it fell by 16 per cent for the richest 400 taxpayers (Johnston, 2003: 16). However, the situation is actually much more regressive than the official figures indicate – we know that very wealthy people receive a lot of income in the form of gifts and inheritance that are grossly undervalued for tax purposes (Johnston, 2003: 86-90, 165-66), they receive a lot of income covertly off-shore, and they receive vast income in deferred, often non-taxable benefits. Former General Electric (GE) CEO Jack Welch’s recent divorce litigation revealed the multitude of untaxed or minimally taxed deferred benefits he was receiving from GE. To look at just one example, Welch used a company jet arguably worth \$3.5 million a year. If Welch flew to Paris, the cost to GE would be more than \$100,000 each way if it had to charter a plane, but by using a company plane, Welch would be out of pocket just \$486 each way in

2 And it is simply not true that the Reagan and Thatcher revolutions ushered in an era of smaller government – the Bush and Howard governments in the US and Australia at the time of writing are the biggest spenders these nations have yet seen.

federal tax liabilities given the way Congress required the IRS to value the personal use of company planes (Johnston, 2003: 62). Johnston (2003: 57) reports that in 2003 two hedge fund managers each had more than \$2 billion in untaxed deferral accounts offshore, and another two hedge fund managers had such accounts with more than \$1 billion. One of these managers was just 35 years old, with the prospect of decades of untaxed compound interest on his funds. "Deferral, the tax lawyers say, is 90 per cent of tax planning. Delay a tax for 30 years and its cost in today's money is almost nothing. Inflation and investing the unpaid tax should cover the whole bill" (Johnston, 2003: 117).

Fiscal termites

Former IMF tax policy chief Vito Tanzi (2000) has argued that while the 20th century has been a good century for tax, the 21st century may not be. Tanzi says the late 1990s showed the risk of fiscal crisis in response to eight "fiscal termites":

1. Electronic commerce and transactions (using cyberspace to buy where there is no tax);
2. Electronic money (cutting out the financial reporting of intermediaries that allowed the efficient 20th century growth of VAT and sales tax);
3. Intra-company trade (multinationals avoiding tax by internal sales at high prices into high-tax countries, low prices into low-tax countries);
4. Off-shore financial centres and tax havens (with deposits which Tanzi estimates to exceed US\$5 trillion);
5. Derivatives and hedge funds (about a trillion dollars flow through hedge funds each year; we will see they have a central role in aggressive tax planning);
6. Inability to tax financial capital (the increasing impossibility of imposing high taxes on mobile financial capital that moves in response to tax rates);
7. Growing foreign activities that lead, for example, to tax-free non-resident accounts and foreign shopping, and
8. Foreign shopping (a spin-off from increased travel by wealthy individuals).

Subsidiaries in the top 11 tax havens accounted for 23 per cent of foreign profits of US companies in 1988, 38 per cent in 1999 and 46 per cent in 2001 (Sullivan, 2004). This area of the US aggressive tax planning problem has not improved since the end of the 1990s shelter boom. In contrast, for Australia, funds flowing in from OECD-identified tax havens fell between the peak of the aggressive tax planning boom in 1997–98 to half that level in 1999–2000, and stayed around that reduced level until 2003. Funds flowing out from Australia to tax havens fell by more than a quarter between 1997–98 and 2002–03 (Australian Taxation Office, 2004: 4). We will see in Chapter 5 that during this period Australia put in place some quite effective measures against corporate profit shifting including shifting profits into tax havens.

Much of the reason for the 20th century being a good century for tax was attributable to the efficacy of withholding taxes. The US abolished withholding tax on interest paid to foreigners in 1984, and Reuven Avi-Yonah (2000a, 2000b) has shown that this was a disaster for equality of wealth. He argues that

capital-importing countries generally have been subsequently unable to impose such withholding taxes “for fear of driving mobile capital elsewhere or increasing the cost of capital for domestic borrowers, including the government itself. The result is that individuals can generally earn investment income free of host-country taxation in any of the world’s major economies” (Avi-Yonah, 2000a: 1). Furthermore, in the absence of withholding taxes, home countries of the foreign investors also mostly find it impossible to collect the tax, at least where investors exploit foreign accounts where they are protected by bank secrecy laws.

Thus, cross-border investment income can largely be earned free of either host- or home-country taxation ... For example, consider a wealthy Mexican who wishes to earn tax-free interest income by investing in the bonds of an American corporation. For a nominal fee, he sets up a Cayman Islands corporation to hold the bonds. The interest payments are then made to that corporation without any US tax withheld under the so-called “portfolio interest exemption”. The individual does not report the income to the Mexican tax authorities, and they have no way of knowing that the Cayman Islands corporation is effectively an “incorporated pocketbook” of the Mexican resident. Notwithstanding the US-Mexico tax treaty, the IRS has no way of knowing that the recipient of the interest payments is a Mexican resident and therefore cannot report this to the Mexican authorities. As a result, the income is earned completely free of tax (the Caymans, of course, impose no income taxes of their own). Nor is such tax evasion limited to residents of developing countries. When the IRS recently managed to persuade one tax haven banker to talk, it discovered that most of the accounts were owned by Americans who wished to hide their income from the IRS. (Avi-Yonah, 2000a: 2)

In recent years we have even seen the phenomenon of Big Five accounting firms such as PricewaterhouseCoopers and Arthur Andersen moving the corporate headquarters of their consulting arms to tax havens (Bermuda and Luxembourg). Another threat to that mainstay of 20th century administrative accomplishment in tax collection – withholding at source – comes from derivatives. “[F]or a derivative that consists of several contracts, for tax purposes each contract is treated as if standing on its own, leading to incentives to use the most tax efficient combinations of contract components. Second, withholding taxes only apply to positive cash flow whereas an increasing number of derivatives envisage both positive and negative cash flows” (Tanzi, 2000: 13). Derivatives can be engineered in a variety of ways by fertile minds to outflank withholding.

Together, these fiscal termites pose a risk of the 21st century being as bad for tax as the 20th century was good.

Moral termites

Fiscal termites in turn introduce moral termites into the tax system. For example, the Australian Prime Minister announced in 2002 that the amiable, wealthy, non-tax paying, tennis player, Pat Rafter, was Australian of the Year. The fact that he didn’t pay tax (or even officially reside) in his own country was probably overlooked as most international tennis stars have a tax haven as a place of residence. Michael Jordan, America’s most popular sporting star of the 1990s (and surprisingly also Australia’s according to some surveys), was, like Rafter, a citizen of Bermuda and no one criticised him for that, it was said. The moral termite here is

that our greatest heroes, our most respected and successful citizens, communicate through their actions the message that avoiding tax is normal and acceptable. This is the moral termite that follows in the path of the fiscal termite. Such practices also result in a second kind of moral termite that eats at the integrity of the tax system: the perceptions of those who believe Pat Rafter is a wealthy cheat, ripping off the support sport-crazed Australian taxpayers give to the development of our elite athletes. The Centre for Tax System Integrity is working on this second moral termite particularly through the research of Michael Wenzel (Wenzel, 2003; Wenzel, forthcoming; Wenzel, 2002; see also Kinsey and Grasmick, 1993; Porcano, 1988; Levi, 1988) on the negative effect of perceived distributive injustice on voluntary tax compliance. People who see themselves as poorer are less willing to pay tax voluntarily when people they perceive to be richer are believed to cheat.

Tax compliance was successfully constituted in the 20th century as an obligation of citizenship, that did indeed motivate large proportions of the population to economically irrational levels of voluntary compliance, particularly in the Anglo-Saxon countries and Northern Europe, although less so in Southern Europe, and considerably less so in Eastern Europe and in the poor economies of the South. The termites are gnawing at these citizenship foundations of the welfare state. Pat Rafter embodies the emerging citizenship in societies like the US and Australia where voluntary compliance is considerably lower among those younger taxpayers who entered the workforce during the past two decades (Ahmed and Braithwaite, 2004; Tittle, 1980; Wenzel, 2002).

In addition, because every one of Tanzi's eight fiscal termites are more easily exploited by the rich than by the poor,³ they will continue the transformation of the tax system from its pre-1970s Keynesian dispensation as an institution that redistributed wealth from rich to poor into more decisively the reverse. Avi-Yonah (2000a: 1) sums up well how developed nations responded to capital becoming more mobile and subject to greater tax competition: "first ... shifting the tax burden from (mobile) capital to (less mobile) labor [structurally increasing inequality of wealth], and second, when further increased taxation of labor became politically and economically difficult, by cutting the social safety net [increasing inequality again]". Avi-Yonah (2000b: 1577) also points out there is evidence that as economies become more open, taxes on capital go down while taxes on labour go up.

Not so simple choices

Facing these realities of globalisation, it could be presumed that each nation has to choose between attracting capital and securing growth on a small-government, low-taxation-of-capital, weak-safety-net trajectory, or having a bigger-government, lower-growth trajectory where the gulf between rich and poor is not allowed to widen. But the choice is not that simple. When we allow the gulf between the rich and the poor to widen, this also substantially reduces subsequent growth,

3 Avi-Yonah (2002: 1393) explains that tax havens are more useful to the rich than the poor "because income from capital is easier to shift than labor income, and the rich earn more income from capital. There are no solid recent estimates of how much tax evasion of this sort is engaged in by US residents. But in other developed countries, such as Germany, tax evasion by capital owners is estimated to be rampant (about fifty per cent of interest income by German residents is estimated not to be reported)".

especially in the long run (Agion et al, 1999; Alesina and Rodrik, 1992; Persson and Tabellini, 1994; Repetti, 2001: 832–840). Increasingly, the economic evidence suggests that the reason inequality dampens subsequent growth is that it causes an underinvestment in education by the poor. When a large fraction of the population under-invests in education, compared to the investment being made by the economies with which one competes, productivity growth falters (Agion et al, 1999; Perotti, 1993; Galor and Zeira, 1993). This is the most plausible account of why “the relatively egalitarian states of East Asia have grown three times faster than the highly unequal economies of Latin America” (Mack, 2002). The poorest people of East Asia see more point in investing in the educational development of their children than Latin America’s poor. Andrew Mack also points to World Bank research that greater income inequality increases risks of criminal violence and also armed violence between warlords in various nations: civil war and unsafe streets reduce economic growth dramatically. Finally, Mack points out “increasing inequality and social exclusion increase the risks of a backlash against the very market reforms that represent the best long-term hope of escaping the scourge of poverty” (Mack, 2002: C2). Empirically, it is politically easier to do the constant economic restructuring needed to succeed in the contemporary world in nations where safety nets mean the poor do not fall into a deep hole when they lose their jobs (Leibfried and Rieger, 1995).

Policy options

The policy options considered in this book are examples of the alternative paths to making a crude choice for or against the low taxation of wealth and a weak safety net for the poor. Part IV examines a variety of ways that national tax authorities can learn together how to combat the aggressive tax planning that exploits derivatives and tax havens. Strategic, evidence-based tax administration can be advanced internationally in a way that sustains the capability to fund a credible safety net for the poor and that shifts some of the tax burden from labour to capital and wealthy individuals. Both US and Australian tax administrations have some valuable lessons for the rest of the world on how we might begin to do this. It follows from the analysis in this chapter that these are measures that can advance both economic growth and economic equality for the nations that introduce such administrative measures. Moreover, all nations can share in greater growth, greater equality (and therefore better prospects of peace) when international cooperation works to secure them globally.

Avi-Yonah (2004) sees the fundamental justification for corporate taxation historically and normatively as the regulation of large corporations – being able to steer them and prevent them from exercising unbridled power. For example, tax breaks are the primary instrument used to induce companies to invest in Research and Development. Avi-Yonah argues that requiring companies that report higher book income to pay more tax (a reform discussed in Chapter 10) has merit because it could put a brake on corporations such as Enron and WorldCom who have previously declared spuriously high book incomes yet still paid no tax. A change in corporate tax administration could be a policy lever to prevent such extreme abuses of corporate power.

In this way, there is a macro-social and macroeconomic “virtue” that effective tax administration can enable, and an environment that it can create

where pro-competition microeconomic policies can be pursued. But first, we must understand some differences between the US and Australia in the way the corporate tax gap has widened.

Obviously, this study presumes that it is appropriate and right that citizens be taxed. While taxation is a price we pay for civilisation, a democracy must decide how much of it is desired in the trade-off with private consumption. This leads to the second implicit theme that once a democracy has voted and settled on tax laws, breaking those laws is a vice. Finally, for the reasons argued in the last paragraph, it is assumed that a tax system that redistributes wealth from the rich to the poor is better than one that does the reverse. There are of course those who reject all of these assumptions. They believe that taxation is theft, that it unjustly punishes the enterprise of the wealthy, that there is virtue in beating the tax system by making no contribution to it. There are places in the world where the libertarian dream of a society where no one has to pay taxes, where state bureaucrats do not interfere in markets or control gun ownership, where there is no welfare, is realised. The greatest concentration of these is in Africa – in states like Liberia, Rwanda and Somalia.

A widening US corporate tax gap in the past decade, a narrowing Australian gap

American informants in this study believed that the shelter boom targeted at large corporations⁴ that started in the mid-1990s drove a widening gap between book and taxable income; that is, between the income declared in the company accounts to the stock exchange (book income) and taxable income. This tax gap has always been wider for corporate tax than for individual income: Slemrod (1985: 236) found the tax gap to be about 6 per cent for wage and salary earners; about 14 per cent for interest and dividend income; and 53 per cent for income derived from partnerships and small business. Even with the record profits at the height of a decade-long boom in 2000, corporate income taxes contributed only 10 per cent of total US tax receipts, up from the all time low of 6 per cent in the 1983 recession, but down on the mid-90s and way down on the 35 per cent of US total receipts that was coming from corporate income taxes at the end of World War II (Yin, 2000: 3–23). In more egalitarian societies such as New Zealand, it was even the case until the 1930s that corporate tax was a source of more revenue than personal taxes (Caragata, 1998: 200). The US Treasury has shown that the corporate tax gap got wider every year in the mid-1990s. In fact by 1996 the *gap* between taxable and book corporate income was greater than both the *total* taxable income and the total book income of 1992. In these four years the size of the gap increased four-fold from \$31 billion to \$143 billion. The gap widened further each year until the end of the 1990s. Figure 1 summarises the US picture of corporate tax collections as a percentage of GDP from mid-century. During World War II corporate taxes averaged 5.6 per cent of GDP, 4.5 per cent under

4 In the US in 1997, 9017 of the 4.71 million corporations had \$250 million or more in assets. This group of less than half a per cent of the corporations paid 78 per cent of the corporate tax collected (Yin, 2001: 228). In Australia, the skew is similar but not so extreme: 75 per cent of company tax collections are from “large” companies with total income over A\$10 million (Wickerson, Reddon and Khan, 2001: 265).

the Truman and Eisenhower Administrations, 3.7 per cent under Kennedy and Johnson, 2.7 per cent under Nixon and Ford, 2.4 per cent under Carter, 1.6 per cent under Reagan and George Bush, 2.1 per cent under Clinton (under whom it initially lifted sharply but then started to fall again). The first two years of George W Bush show a further sharp fall to below 1.5 per cent.

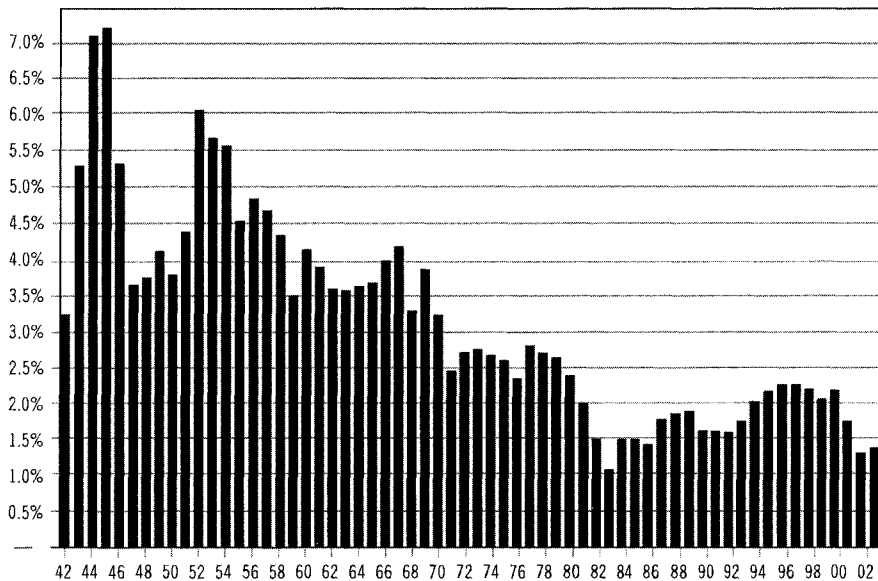


Figure 1: US corporate income taxes as a percentage of GDP, Fiscal 1942 to Fiscal 2003 (www.ctj.org/html/corp0302.htm)

Over this period, the opposite was happening in Australia. Figure 2 (p 30) shows that throughout the 1990s company tax collections grew faster than the economy, and increasingly so.⁵ While final figures are not available at the time of writing, Australian corporate tax collections continued to rise faster than the economy through 2004, though this may simply reflect a record profit share of national income in 2004 (*The Australian*, 4 March, 2004, p 23) and audit collections from large business were up by over 90 per cent for 2004 compared to 2003 <www.ato.gov.au/sp200404.htm>.⁶ Figure 2 shows that during the decade to 2003, corporate tax collections grew to 300 per cent at the three the rate of GDP growth. There has

⁵ The 2001 increase in corporate collections is actually inflated artificially by tax system changes that pushed 2001 rebates into 2002. Half the 2001 gains over 2000 were therefore lost in 2002. In 2002 company tax rates were also cut from 34 per cent to 30 per cent and GDP growth fell post September 11.

⁶ Imputation of dividends is sometimes credited with high corporate tax collections in Australia compared to countries that do not have dividend imputation. Many Australian companies like to pay some tax so that their shareholders can deduct this for their dividend income on their personal income tax returns. But this does not explain the large growth in corporate tax revenue in Australia during the past two decades when Australia has continuously had imputation of dividends. It is not the imputation regime that has changed during this period, but something else that is responsible for growth in collections.

been a particularly steep increase in corporate tax collections in Australia since 1999. Yet even in 1999, according to the most recent comparative figures of 30 OECD countries, only Luxemburg (a tax haven) was higher than Australia in corporate tax collections as a percentage of GDP (OECD, 1999: 69). Australian corporate tax at 4.9 per cent is more than twice the US percentage (2.4 per cent) in 1999 and two years later it was more than three times the US percentage. The Australian company tax rate then was 30 per cent and the US rate 35 per cent. Therefore the difference is not about tax rates but about effectiveness in collecting those rates. For every year since 1986, corporate profits as a percentage of GDP were higher in the US than in Australia, so the bigger tax share from corporations cannot be explained by a bigger profit share from corporations.⁷ Overall both Australia and the US are low tax nations, ranking 26th and 27th respectively among the 30 OECD members on total tax revenue as a percentage of GDP in 1999 (OECD, 2001: 84). The key difference between them is that while US corporate tax collections were low and falling in the 1990s, Australian corporate tax collections were comparatively high and rising. Of course, the word “comparatively” is a significant qualification as corporate tax as a proportion of tax collections had fallen worldwide during the century, although not consistently – for long periods in many countries corporate tax as a percentage of GDP was rather stable. But for the biggest economies – the US, Japan, Germany and the UK – it fell in the 1990s (OECD, 2001: 69) and the rest of Europe on average fell less steeply, with effective average corporate tax rates falling 10–15 per cent in eight EU economies between 1980 and 1996 (Genser, 2001: 20).

In the longer sweep of history, as nations develop, the share of corporate profits in GDP increases, though there are also periods when it decreases. This is particularly true of the 20th century when economies became increasingly corporatised (Braithwaite and Drahos, 2000: Ch 9), a process that continued into the 1990s with the privatisation of traditionally state-owned enterprises such as telecommunications and energy producers. Yet as corporate profits rose as a percentage of GDP, corporate tax payments as a percentage of GDP fell.

That Australia should be so far ahead of the rest of the OECD in corporate tax revenue as a proportion of GDP is hardly cause for celebration; it simply highlights the “fiscal termites” elsewhere. As in other successful economies, the profit share of total factor incomes has been steadily rising in Australia for the past two decades and the wages share steadily falling (Pusey, 2003: 201), so we should expect an increase in corporate tax revenue as a proportion of GDP. We need to explain why Australia has had a sharp rather than a steady increase, but more importantly why so many other societies like the US have had a decrease.

7 Between 1986 and 1991 the gap between Australian and US corporate profits as a percentage of GDP widened. It narrowed between 1991 and 1994, widened again between 1994 and 1997 and then narrowed again from 1998. But *every* year the US corporate profit share of GDP was higher than the Australian share. Source: Bureau of Economic Analysis, National Income and Product Accounts Tables, Table 1.14: Corporate profits and Table 1.1: Gross Domestic Product <<http://www.bea.doc.gov/>>. Australian Bureau of Statistics, 5676.0 Business Indicators Australia, Table 9: Company profits before income tax, and 5204.0 Australian System of National Accounts, Table 8: Gross domestic product account current prices <<http://www.abs.gov.au/>>.

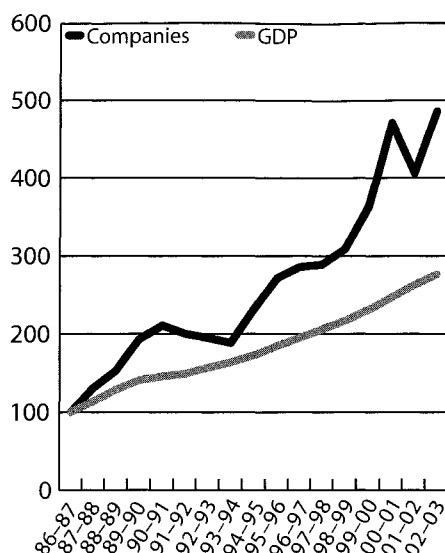


Figure 2: Growth in Australian company tax collection compared to GDP growth 1986–2004⁸

To put Australian “success” in perspective, corporate tax paid in Australia in recent years as a percentage of earnings before interest and tax has hovered around 10 per cent for all companies and 8 per cent for large companies and as a percentage of total profit/loss between 17 per cent and 20 per cent for all companies, 14 per cent and 16 per cent for large companies (Wickerson, Reddan and Khan, 2001: 284–5). The rise in corporate tax revenue as a percentage of GDP and as a percentage of all tax collections in the 1990s followed an 18-year period between 1967–68 and 1985–86 when there was a general downward trend (Wickerson, Reddon and Khan, 2001: 265).

In a presentation on the 29 May 1998 to the NSW Annual State Seminar of the Taxation Institute of Australia, the Large Business and International Business line of the ATO reported that “almost 60 per cent” of companies that fell under that description paid no tax. Consolidation of companies under a corporate banner is reducing this proportion substantially – one large corporate group might include a number of entities that hold no profits and pay no tax and others that pay large amounts. By 2004, less than 40 per cent of large Australian corporates were not paying company tax. Similarly, in the US, between 1996 and 2000 more than 60 per cent of all corporations paid no tax, about 40 per cent of corporations with at least \$250 million in assets or \$50 million in gross receipts paid no tax, and 80 per cent had a tax liability of less than 5 per cent of their total income (General Accounting Office, 2004: 6, 17). Compared to individual workers, clearly both Australia’s and America’s wealthiest corporations do not pay their fair share of tax and the wealthy can greatly reduce their contribution by legally classifying themselves as a company instead of as an individual.

⁸ Thanks for assistance from Lyn Pysden of the Australian Taxation Office with this data.

From the early 1930s to the end of the 1960s, Australia's distribution of wealth became more equal. Since then, inequality between men and women has significantly narrowed but the gap between rich women and poor women, rich men and poor men has widened markedly (Higman, 2002: 43, 297, fn 52). If Australia and the US are to return to the positions of world leadership in egalitarianism that they enjoyed under the Keynesian policies of Robert Menzies and Franklin Roosevelt, they might not do it in a Keynesian way, but part of what they must do is work together transnationally to recover some of the lost virtues of that era's taxation philosophies.

The fieldwork reported in this book suggests that one explanation for the low and falling corporate tax collections in the US compared to the comparatively high and rising collections in Australia is that the Australian corporate tax base is yet to come under the level of attack from corporate shelter promotion that the US has experienced from the mid-1990s. Secondly, Australia has put in place some sophisticated strategic corporate and high-wealth individual compliance policies in areas critical to revenue collection during the 1990s that appear to have been successful. In addition, the High Court has moved to a more principle-based approach that has put some brakes on "creative compliance" (McBarnet and Whelan, 1999) though it could hardly be said that this is true of the approach of most Federal Court judges to tax cases.

What kind of future?

The corporatisation of the world during the 20th century enabled huge improvements in the efficiency with which individual and corporate income tax and indirect taxes could be collected. This in turn enabled progressive growth in the size of the state throughout the century. It also enabled tax to be used during most of the 20th century as a very important tool in the redistribution of wealth. On both these fronts, growth in the efficiency of tax collection during the 20th century was indispensable to the creation of the welfare state and to the military capabilities of Washington as the new Rome.

For the reasons discussed above, after this "great century for tax" we now seem embarked on a potentially disastrous century for tax. The "fiscal termites" previously mentioned threaten to hollow out the state and redistribute wealth from the poor to the very rich. Welfare for the poor is being driven down by burgeoning corporate welfare, delivered through the tax system. Fiscal termites breed moral termites. Public opinion has not been oblivious to these structural shifts – in an admittedly unsophisticated way, ordinary people have noticed them and resent them deeply. As a result, the problem of top-down tax avoidance driven by globalisation is compounded by bottom-up tax evasion – detectable growth in most societies in the size of the underground economy as ordinary people fight back, for example, by using cash transactions and barter to void tax (Schneider, 2002). Again, the Australian story is not quite so pessimistic, with Schneider's analyses carried out for the Centre for Tax System Integrity suggesting slower growth or even decline in the underground economy in Australia compared to other countries.

Threatened is collapse of the remarkable 20th century accomplishment of a high integrity tax system that is based on voluntary disclosure and observed in

countries like Australia and the US with a degree of honesty that far exceeds the level of compliance that would be economically rational (Andreoni, Erard and Feinstein, 1998).

The analysis of this book is that the underlying driver of this looming catastrophe is not rational evasion by ordinary people as much as rational avoidance by the rich, though we must not be too glib with this evasion/avoidance distinction because a general anti-avoidance law really makes avoidance illegal. Aggressive tax planning is conceived as both the most important fiscal termite and the mother of moral termites.

The political prognosis

A depressing feature of this turn-of-the-millennium flipping of the integrity of the tax system is that the response to it is so privatised. While most people are crudely but acutely aware of the existence of tax shelters that are available to the rich but not to them, their response is not political resistance so much as privatised cheating in smaller ways they can manage to get away with. No Boston tea party, no Eureka stockade, not even Fabian politics looms as a concerted political response to the new distributive realities of the tax system. Even the most politicised warriors of the left have been largely missing in action in contesting this structural shift. As Richard Rorty (1998: 77) has pointed out, the cultural left has redirected political concern from the materialist focus that dominated left politics for most of the 20th century to a preoccupation with issues of identity, difference, stigma and victimisation. Bernard Harcourt (2001: 245) and others (Honneth, 1995; Fraser, 1997: 14) have conceived this as a shift from a “politics of redistribution” to a “politics of recognition” that privileges cultural domination and acts of disrespect as priorities. A politics of recognition is a wholesome thing. Yet at moments when huge redistributive shifts are in play, it seems important to be old-fashioned enough to recognise their political importance and materialist enough to analyse their structural drivers. I hope this book will begin to illustrate how this might be accomplished in an analysis that embraces nuanced cultural analysis enabled by ethnographies of both Wall Street and the back streets of the periphery.

The inequities of emerging tax systems occasionally are incanted among the grievances of the anti-globalisation movement, but actually not very often. To the extent that social movement politics has had a presence in tax policy debates, it has been more that of the “tax revolt” – the refuseniks of Keynesian welfare, not Galbraithian refuseniks of corporate welfare. Intellectual property – the other big materialist shift in the contemporary world that is redistributing resources from the poor to the rich – has finally engaged left politics. But this happened only after global business had already won the war in the Trade Related Intellectual Property (TRIPS) agreement at the World Trade Organisation with the left firing barely a shot in opposition (Drahos with Braithwaite, 2002). And it happened only after the politics of recognition was mobilised in the form of an HIV-AIDS rights movement that could call up the feelings of disrespect, domination, victimisation and identity politics of AIDS sufferers in Africa – who were being denied affordable therapies as a result of TRIPS.

With tax, the political prognosis is much gloomier. A marriage of the politics of recognition to the politics of redistribution is harder to imagine. On the

other hand, popular resentment over the inequity of the tax system is much more profound than popular agitation over the injustice of the new world intellectual property order.

Formulating a transformative vision

This book does not provide the missing ingredient of a vision for how to restore the justice of the world's tax systems. It does, however, indicate some of the ingredients needed to formulate such a transformative vision.

One of those ingredients is a *global* imagination that reveals why termite-riddled redistribution from poor to rich is much more advanced in the US than Australia. Another is an obverse *national* policy imagination that does not see states as powerless to govern their tax systems in a global era (Weiss, 1998). For example, global e-commerce is a fiscal termite. Yet it also creates the possibility, for example, as electronic transfers of money become more universal, to opt to pay for *everything*, through banks and credit cards. Then an automatic electronic debit tax, greater for international and corporate transfers than for an individual's or intranational transfers, becomes an option. Just as responding to corporatisation via withholding taxes was the key to 20th century success in taxation, it is not impossible that a creative response to the digitalisation of global finance might make the 21st century a good one for tax after all. There is no credible vision of how to do this as yet, but it is true that every global technological threat to the regulatory capabilities of the state also mirrors a technological opportunity for the state.

This book identifies some imperfect, but partially effective micro-administration of tax compliance by the ATO, which meant that Australian tax receipts from wealthy corporations and individuals increased instead of decreased in recent decades, contrary to trends in the US and many other rich countries. In sum, escaping the collapse of the integrity of 21st century tax systems will require us to think globally and administer locally. It will require a marriage of a global social movement for tax justice with the conservative, arcane, technocratic competence of tax lawyers, accountants and IT visionaries. If global gay rights activists accustomed to Seattle-style politics can enter a political marriage with stuff-shirt intellectual property lawyers, there is the political possibility of creative liaison between ordinary folk who are fed up with corporate handouts and the brilliant and compassionate minds of many of the elite tax practitioners I interviewed. The same concern for social justice that motivates an admittedly modest smattering of smart tax practitioners to work for the government when they could be paid five times as much to work for the big end of town might also motivate some to lend their talents to such a global social movement for tax justice. I found some elite private practitioners to be disgusted by the avarice of some of their clients, particularly in New York. Partly, this book seeks to reveal their story and how their talents and their virtue might be mobilised to defend the integrity of our threatened tax regimes.

Put another way, one aspiration of this book is, in a field of extreme legal and financial-technical complexity, to work through how global social change requires both the clarifying vision for change that comes from social movement politics and the complexity-creating competence of epistemic communities who share a common technical language. The latter knowledge in this case is tax-

technical. Technical solutions without widespread political engagement will be arid. Social movement missiles unguided by technical competence will be political froth and bubble that miss their mark. Smart bombs are needed where NGOs supply the pyrotechnics and suits the smarts. In *Global Business Regulation*, Peter Drahos and I found that global regulatory change is much more likely when there is a creative synergy among the push for change (a) from citizen groups, (b) from within epistemic communities, and (c) from states that can be enrolled by reformers to take the lead in enacting change (Braithwaite and Drahos, 2000). In an area as technical as aggressive tax planning, egalitarian social movements cannot make progress without those epistemic-community and state liaisons. Equally, technocratic reformers concerned about tax system integrity are likely to continue to be routed by the political end-runs of wealthy tax avoiders unless deliberative spaces are opened up where democratic voices are heard and where the machinations of tax welfare lobbyists for the rich are rendered transparent.

Before we can explore how these technical-political linkages might flip markets in vice to markets in virtue in Parts IV and V of the book, we must first explore how the cyclical resurgences of aggressive tax planning happened first in recent Australian (Part II) and then in recent US (Part III) history. We will come to conceive of these upswings in aggressive tax planning as driven by an increasingly competitive and ruthless market in tax advice. This chapter has, I hope, been sufficient to provide a glimpse of the lost virtue – a tax system that was the pre-eminent instrument for redistributing wealth from the rich to the poor – that the Keynesian welfare state had considerable success in pursuing. Many readers, of course, will not view the pursuit of a more egalitarian society as virtuous. They, however, may still come to see some of the tax avoidance and evasion strategies to be described in the chapters that follow as hardly the most virtuous way of moving toward the less egalitarian society they favour.

Part II

AGGRESSIVE TAX PLANNING IN SYDNEY AND MELBOURNE

The Australian advice market

The only effective design for diminishing the income inequality inherent in capitalism is the progressive income tax.

John Kenneth Galbraith

A brief history of aggressive tax planning in Australia

The 1970s boom

In the 1970s, a variety of Australian aggressive tax planning schemes were developed and utilised with increasing momentum. For example, trading stock schemes flourished from 1974, when these succeeded before the High Court of Sir Garfield Barwick. The most notorious schemes were crude asset strips called “bottom of the harbour” schemes, in which a company claiming a large and dubious deduction would be bankrupted so there might be no tax recovery if the deduction were investigated. Some 7000 companies were sent to the bottom of the harbour between 1974 and 1981. In all, more than 30,000 taxpayers participated in the tax avoidance schemes of the 1970s (Grabosky and Braithwaite, 1986: 153).

Arguably, the Bottom of the Harbour scandal cost the Fraser government power and ushered in the most far-reaching institutional change in the Commonwealth criminal justice system Australia has seen, including the creation of the National Crime Authority (now “Commission”). It was an enormous challenge: “From the time that the first scheme of this type (bottom of the harbour) was detected until the first prosecution was launched, well over seven years had passed. The major institutions of Commonwealth law enforcement appeared to be incapable of coming to grips with a problem of this magnitude.” (Freiberg, 1988: 141). The watershed McCabe and Lafranchi report of 1981 initiated by the Victorian Corporate Affairs Office identified a number of principal reasons for the epidemic of corporate asset stripping frauds. One was Federal and High Court decisions unsympathetic to ATO enforcement that emboldened the promoters; another was payment of commissions to accountants and solicitors who referred vendors; a third was timidity and chain dragging by the ATO in taking action, and a fourth was “increased willingness of the community to participate in tax avoidance” (Freiberg, 1988: 137). Two decades later, the last three of these were major drivers of the 1990s boom in aggressive tax planning, when increased community demand for tax avoidance schemes was led by the supply of such schemes by promoters. In retrospect, the Bottom of the Harbour

boom was probably also first supply and commission driven and then became demand driven.

The McCabe and Lafranchi report had a dramatic impact. It listed 923 companies that were asset stripped and their office holders included the names of many of the most prominent members of the Victorian elite. The level of scandal and discomfort increased when the Costigan Royal Commission revealed links between this kind of white-collar crime and organised crime.

The 1980s

Margaret Levi (1988) has argued persuasively that by the mid-1980s the Hawke government had rebuilt public confidence in the tax system with law reform (which started with the Fraser government's general anti-avoidance legislation in 1981), increased investment in the tax office, unprecedented consultation with the Australian people (which included a tax summit) and some high profile prosecutions of purveyors of the late-1970s schemes. Levi believes voluntary compliance with Australian tax law improved during the 1980s as a result. While this seems plausible, it is hard to verify across the board. Devos (2002: 17) reports that non-compliance detected in audits fell from a high of 87 per cent in 1984–85 to a low of 59 per cent in 1990–91 after which it gradually began to increase again. What is clear is that aggressive tax planning became much less aggressive during the 1980s and into the 1990s. Practitioners interviewed said there was fear of the potential power of the new general anti-avoidance provision in Part IVA of the *Income Tax Assessment Act 1936* (Cth), a fear to which they became inured by the 1990s as a result of the general disuse of Part IVA.

The 1990s boom

ATO estimates of the growth in deductions claimed by investors in mass marketed aggressive tax planning schemes from 1987 to 1998 (Figure 3) show an increase from no such deductions in 1990 to deductions worth in excess of \$1.4 billion in 1998. The detected scheme participation represented in Figure 2 amounted to \$4.7 billion in scheme-related deductions identified by the ATO. Individual taxpayers accounted for 64 per cent of this, companies 27 per cent and trusts 8 per cent. These schemes include a wide variety of schemes in primary production, such as forestry, horticulture, tea tree oil, viticulture and livestock. The agricultural nature of so much aggressive tax planning is a distinctive aspect of the phenomenon in Australia. But film and franchise schemes are also popular, and these are standard fare of aggressive tax planning in Canada, the United Kingdom and New Zealand. Most of the mass marketed schemes involved round-robin financing and non-recourse loans (see Box 1) with the objective of delivering an inflated tax deduction for the investor. It should be noted that a number of the promoters and advisers interviewed argued that one effect of the late 1990s ATO crackdown is that non-recourse loans are no longer a widespread feature of mass marketed tax schemes.

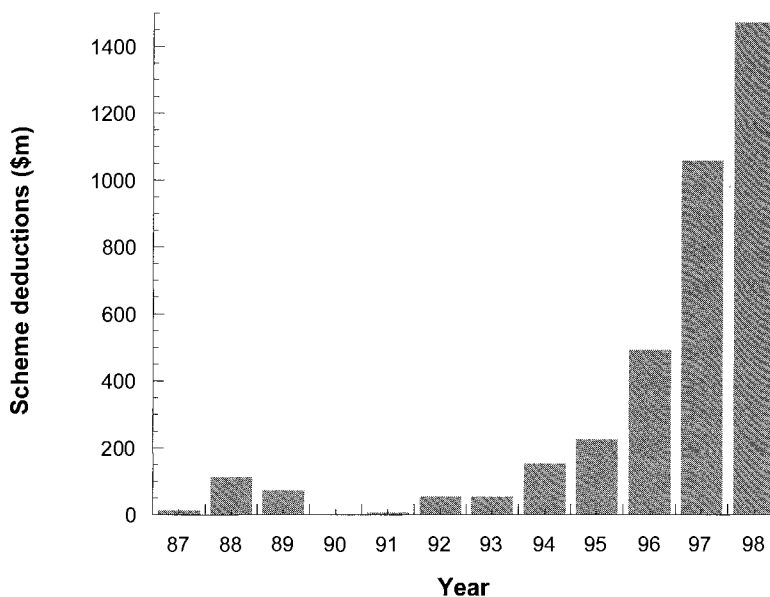


Figure 3: Growth in claimed scheme-related deductions from 1987–98

Source: Murphy, 2002.

Box 1: Round-robin with non-recourse loan

Philip paid an upfront fee of \$134 to participate in a franchise scheme. The promoter's finance company lent him \$30,000 by way of a non-recourse loan (that is, one which only had to be repaid from any future profits from the underlying franchise business) and \$10,000 by way of a personal loan.

Philip agreed to repay the personal loan when his tax refund was received. He did not have to undergo any credit checks or provide any security.

The entire \$40,000 was paid directly from the promoter's finance company to the promoter's management company and then immediately deposited back with the finance company. This is commonly referred to as a round-robin. Philip was advised to claim a deduction of \$40,000 as franchise management fees. However, the effect of the round-robin is that no funds (other than Philip's upfront fee of \$134) are available to the management company to provide any franchise management services.

Philip claimed the \$40,000 as a tax deduction, increasing his tax refund by \$19,400. He repaid the personal loan, leaving him with a net gain of \$9,400 despite the fact the franchise did not produce any income.

Philip's tax return was amended to disallow the claimed deduction of \$40,000. He was required to pay \$26,360, being the tax shortfall of \$19,400, penalty of \$1,940 and interest of \$5,000.

Source: Australian Taxation Office, 2001 Annual Report of the Commissioner for Taxation, p 48.

The growth curve for the mass marketed schemes in Figure 3 is a mirror image of the growth curve of the number of corporate asset strips of the 1970s with a lag of exactly 20 years (compare Figure 3 above to the year by year tabulation of 1970s assets strips in Freiberg, 1988: 140). Between 1987 and 1994, the ATO investigated probably not more than 14 mass marketed schemes, and it investigated another 14 between 1995 and 1997 (Murphy, 2002). In nine of the first 14 schemes investigated, deductions were disallowed. But during the late 1990s there were a large number of schemes on which the ATO appears to have vacillated in expressing a view. Alternatively, as one senior tax officer put it, the problem was less vacillation by the ATO, than ineffectiveness: one of the ATO expressing “the view to the promoter who did not pass it on”. In the opinion of many of the advisers interviewed, there was vacillation and this was “because they could not get their minds around them”. A barrister who provided opinions to the ATO on schemes agreed that “matters that are hard to understand just sit in the too hard basket”. There was, in the 1990s, a degree of ATO paralysis, perhaps the result of a lack of confidence in its own technical competence. One accountant explained that the ATO had been relaxed when he discovered a legal loophole in the mid-1990s, which he claims the ATO initially accepted as legitimate, a position it later reversed. He claimed that by the late 1990s, the ATO was panicking because use of the loophole in aggressive tax planning had become widespread: “The ATO doesn’t, didn’t, worry if tax planning is not widespread”. It is true that there was a pattern of the ATO moving slowly on schemes when they did not assess them to be costing a lot of revenue (see further Chapter 5), but another reason for this was that second-generation mass marketed mutations of boutique shelters were often less legally robust than their boutique forebears. Scheme inventors tended to blame financial planners for this:

When financial planners get hold of it, they don’t understand the technical detail and just get it wrong. And sometimes they don’t even care. The appearance that the scheme works is enough for them to go-for-broke making money from commissions while they can (mostly from clients with whom they have no ongoing relationships).

The opposite also occasionally happens – where the reverse engineering of a scheme by a second mover removes the bugs in the first mover promoter’s scheme.

From 2000

By 2001, the ATO had finalised its position on no fewer than 176 investment schemes with 56,000 known investments, though involving only around 42,000 taxpayers because of multiple investments. For these cases, the ATO had issued assessments totalling \$1.5 billion in tax, penalties and interest. A further 60 scheme audits were underway. In addition, by 2001, the ATO had finalised its position on 71 employee benefit schemes, assessing \$557 million in tax, penalties and interest. These schemes were marketed to a narrower range of people and were not marketed with a prospectus in the way most of the agricultural and film schemes were. The advisers interviewed were extremely critical of the delays on the part of the ATO in disseminating a consistent view on tax schemes to the marketplace, but generally agreed “They are better and quicker at it now than ten

years ago". As of 30 June 2001, there were 3011 cases on managed investment schemes and 57 on employee benefit schemes before the courts, a similar number to that which hit the courts 20 years earlier in consequence of the late-1970s wave. For both waves, however, the number of cases that went to trial was fewer than a couple of dozen. In both waves, when the Federal Court started to decide a few cases against taxpayers, thousands of others pulled back from a trial. The ATO strategy was to seek to settle most of these through a series of test cases for different types of schemes. In addition to the mass marketed and employee benefit schemes, there were a variety of other more boutique schemes that were more narrowly marketed.

Part of the ATO response to the take-off of aggressive tax planning was to introduce product rulings in 1998. The idea was to give investors a path to certainty as to acceptable and unacceptable tax products. In the year ending 30 June 2001, there were 146 applications for product rulings, mostly for agricultural, franchise and film investments. At first advisers thought it would be extremely difficult to get product rulings, so interviewees said there was some surprise when so many were issued. While it is argued that the aggressive tax planning boom of the late 1990s came to an end by 2001 as a result of a firm enforcement response by the ATO (see further Chapter 5), this does not mean that the use of tax-effective agricultural and film schemes has come to an end. Rather, the post-2000 generation of tax-effective investments are constrained by the product ruling process to have more economic substance, to involve loans that are repayable (as opposed to non-recourse loans), and to involve substantial plantings or filming. Tax is still lost, but the degree of freedom for creating deductions is reduced and more investment goes into real job-generating economic activity. This is good for the economy and often consistent with what tax breaks are designed to accomplish. More of the tax planning is legal and fewer of the arrangements are artificial scams. Some of those interviewed would be rather cynical of this interpretation, believing "there is not a lot of logic in what is allowed through [the rulings system] and what not". Some reported they still had a degree of freedom obtained by a kind of opinion shopping between different ATO offices, known by national firms to have approaches of greater or lesser sympathy to different types of tax effective investments. One barrister argued that some product rulings had "brought in blatant shelters and caused a lot of non-commercially viable investment". The legitimacy of the rulings systems has been dealt a severe blow by the prosecution of Nick Petroulias, a senior tax official, on charges based on allegations that he took payments of one-third of the profits from the promotion of certain schemes in return for pressuring his employees to give favourable rulings on schemes that he had actually assisted in devising and promoting. Committal proceedings and appeals against them have been raging since 2000 and at the time of writing, the trial is yet to commence.

The interviewees generally agreed that by 2001 there were fewer mass marketed products available that were not approved by the ATO, perhaps even, in the words of one senior accountant, fewer "than at any time in recent decades". Murphy and Byng (2002) report research from the Agribusiness Research Group that shows investment in rural tax schemes fell from \$1.2 billion in 1998-99 to \$330 million in 2001-2.

However, in the 2001 federal election campaign, the ATO came under attack for inconsistent enforcement, especially in the remote marginal seat of Kalgoorlie, Western Australia, where high-income miners had been heavily targeted by promoters. Investors in a variety of schemes complained that they knew people who had been investing for years in these schemes without the tax office moving against them, and that this had led them to believe that the ATO accepted the schemes as legitimate. Consequently, they felt it unjust that the ATO now moved against those with investments in those schemes.

The interviews

The arguments and conclusions expressed in this book are based on interviews conducted in 2001 and 2002 of people who I was advised were well-placed insiders on the nature of the aggressive tax planning market. One was a judge, one a journalist, eleven were partners in accounting firms, nine were partners in law firms, five were barristers, one was the CEO of a finance company, and one a promoter who was neither an accountant nor a lawyer. Ten of those interviewed clearly fitted the ATO's definition of the promoter of an aggressive tax planning arrangement and some of the others might arguably fit within the definition. The interviewees were located by asking prominent promoters identified in media stories to provide, in confidence, the names of colleagues and competitors. Just over half the advisers approached agreed to be interviewed. Only the journalist among the foregoing was female. There is little doubt that the aggressive end of the tax planning market in Australia is overwhelmingly a male activity. Twenty-two ATO officers with involvement in aggressive tax planning policy and enforcement were also interviewed. In addition to these 51 interviews, a considerable number of ATO staff involved in the High Wealth Individuals Taskforce and 27 advisers of high-wealth individuals were interviewed in 1999 for a previous, related project (Braithwaite, 2003). Passages in quotation marks in this book are quotations from the interviews unless it is clearly indicated as a quote from a published work. Respondents were assured that their comments would be treated anonymously. In addition to the 78 people who were approached for the Australian fieldwork and granted interviews, 16 were approached who declined to be interviewed.

The advice market

The key players in the advice market are those who develop tax planning ideas. Often these are lawyers in small firms, but they may be in large law firms, accounting firms, finance houses, or may even be academics. Very often their schemes are first marketed as boutique schemes to just a small circle of clients. In some cases, word gets out and mutations of the scheme appear, progressively adapted to be suitable for mass marketing. In many other cases, mass market variants do not result; schemes remain boutique products crafted to meet the needs of a narrow client base.

Client mix

Among the tax advisers interviewed, were some whose market was mainly boutique products for large corporations, others whose market was mainly small- and medium-sized businesses, and others catering mainly to high-wealth individuals. It is also common for advisers to have a mix of the foregoing types of clients, for example, a number of small- and medium-sized business clients and one or two high-wealth individuals. Then there are those involved in mass marketed schemes aimed at individuals whose income is well above average, such as doctors, barristers, airline pilots, with high-income Queensland and Western Australian miners at the bottom of this spectrum of the market. These are similar targets to those of the late-1970s boom, during which, it was said, doctors were particularly highly favoured targets. None of the interviewees pitched products at low- or average-income earners. While all of the interviews were with advisers in Sydney and Melbourne, many had clients throughout Australia.

Promotion paths

Six of the promoters interviewed did most, even all, of their promoting only to accountants, financial planners and lawyers. In some cases their promotion was to quite a limited circle; one had a "two-tier" marketing arrangement where he had "a dozen accountants" to whom he gave ideas, "then *they* market to their clients." He also had some limited relationships with some lawyers and financial planners.

In the late 1990s, the dominant path for Sydney and Melbourne promotion of tax schemes – both mass marketed and employee benefit schemes – was probably from a promoter, often with training in tax law, to financial planners and accountants, with these financial advisers being paid commissions for putting their clients into schemes. Some promoters were generalists, putting people into whatever was hot at any point of time, but always having a bias toward products where they were early movers in cornering a market and/or where the fees they could charge were highest. This is normally the same thing because promoter returns fall when competing promoters move in on any kind of scheme. Monopoly profits tend to be large but short lived: "The better the idea, the shorter the shelf life" (Melbourne High Wealth Individual Adviser). But there were other promotion paths. There were agribusiness and retirement village investments promoted by business people with a genuine desire to grow trees or build retirement villages of perhaps marginal viability. These business people received advice from lawyers who persuaded them to promote their investments as tax-effective schemes; their example dragged even less economically viable agribusiness and retirement village investments into the scheme marketplace. There were schemes that started out as boutique products for a select group of clients later being mass marketed by major accounting firms and investment banks.

As in the US market, the (then) Big Five accounting firms and some major investment banks became increasingly proactive in promoting products in the late 1990s, though not as proactive as in the US. Major law firms were overwhelmingly reactive, even more so than in the US ("when we work with tax products, it's their product – the bank's, the accountant's – it's not our product"). Different Big Five accounting firms were involved in active promotion of "R and D" syndication,

film schemes and superannuation schemes. Finance houses of varying degrees of substance were also promoters, though often their substance was not great; the so-called finance houses were just vehicles for a single promoter. At least two of these companies are empty shells today.

In Kalgoorlie, promotion seems to have been less mediated by accountants, though as in the dominant Sydney-Melbourne path of promoter to accountant, promotion was still commission driven. In Kalgoorlie some promoters seem to have had a direct sales force. One of the 29 Goldfields investors interviewed by Kristina Murphy and her colleagues said they became involved with aggressive tax planning after they received a pamphlet in their letterbox; they contacted the “financial adviser” named on the pamphlet. But in most cases, the initial contact was face-to-face. Eleven other investors initially got the idea from a friend or family member, eight from their accountant or financial adviser, and nine from a door-to-door salesman promoting the product (in some cases this salesman was a financial planner) (Murphy, 2002: 12). Schemes were sold shrewdly by promoters who cold-called, canvassed, offered “spotters fees”, utilised networks, made friends and positioned these schemes as something with a limited supply that only a fool would turn down – or “mate, you’d be the only one who misses out” as one interviewee reported – all to great success (Hobson, 2002: 16).

One Sydney promoter, while mainly oriented to commission marketing to accountants and financial planners, also used the Internet extensively for promotion. This promoter was keen to say that he was not a promoter but someone who gave advice to lawyers and accountants on schemes; yet at other points in the interview he lapsed into describing himself as a promoter. At one point he said: “Let’s assume I’m a promoter; I don’t think I am”. One suburban accountant interviewed was invited to a seminar by this promoter; 80-90 accountants attended. It may be that in light of this presentation of a professional self we need to be cautious about accepting that the dominant form of promotion was promoter to commissioned accountant. That is, some promoters making this claim may have been doing a lot of direct marketing as well, distributing prospectuses by direct mail marketing, through the Internet, financial planning seminars, and by techniques such as telephone-marketing followed by a house-call from a financial adviser for cases that fit targeted investor profiles. Or they may have had ownership links to “finance houses” that were doing this direct marketing to investors.

Finance houses of various kinds are important players in the aggressive tax planning market. These include stockbroking firms that are increasingly more diversified financial advice houses and investment banks (often called merchant banks in Australia). Franking credit trading, film investments, financial arrangements designed to exploit tax concessions for intellectual property and financial products such as linked bonds are included among the forms of aggressive tax planning in which these houses specialise. At least two large insurance companies were involved in running seminars on employee share plan schemes.

Advice mentalities

A major divide is between tax advisers who thrive on commissions from scheme promoters and those who depend on long-term relationships with wealthy individual and corporate clients and who see a commission mentality as a threat to those relationships. The latter kinds of advisers are more likely to offer advice

of the following sort when a client comes to them minded to participate in a scheme: "You form the view if you would get into this investment as a commercial investment. If the answer is yes, then we will help you get a tax advantage with it." A conservative advice mentality like this tends to be the obverse of a commission mentality. Another elite conservative adviser had the opinion that Macquarie Bank equity linked bonds "would survive attack. But don't do it was my advice to clients because they will be attacked. You will have the expense of fighting the ATO and no one can guarantee the result". This unusually well informed adviser felt that it would help those who wanted to take this kind of conservative stance for the ATO to announce not only what it is attacking and what it accepts (through rulings) but also what it is considering attacking. Since this 2001 interview the ATO has more or less decided to follow this advice, reaching a similar conclusion to that made by the IRS in the US at the end of its late 1990s wave of aggressive tax planning. The 2001 Annual Report of the Commissioner for Taxation said:

Early publication has the advantage of putting people on notice that we may disagree with claimed tax benefits. On the other hand, expressing concerns before we have full details and are able to come to a concluded view runs the risk of commercial damage to what may prove to be a legitimate product. We have now concluded that the public interest requires early publication of our concerns. (2001: 56).

To this end, in 2001, the ATO introduced the Taxpayer Alert system, which alerts taxpayers to schemes it has under investigation on the ATO website. This approach is what tax advisers – from the more reputable to the more aggressive end of the market – want. As one of the most prominent scheme promoters put it, what advisers want the ATO to say is: "Here's what we definitely don't like ... Here's what we're not sure about ... Here's what we'll live with ...". There are concerns, however. Bersten and Rumble (2002), while supportive of Taxpayer Alerts, warn that once issued, a Public Ruling on the matter should be issued on a tight time-frame and that there should be a more transparent public ruling process that exposes the Commissioner's legal judgements to the discipline of contestation.

Neither the now Big Four nor other major accounting firms in the Sydney and Melbourne market charge fees based on the percentage of tax paid, or if they do it is rare.¹ However, it is said that there are promoters from smaller firms who do this in the Sydney, Melbourne and Brisbane markets. This is also quite rare in the British tax advice market, but very common in the New York market (see Part III).

A number of promoters interviewed market mostly to accountants and financial advisers, relying on them to put their clients into schemes. Commissions seem central to motivating this relationship. "Some accountants and financial advisers don't take a commission. Some ask you to pay it to the client. But most do take commissions. And many are driven by the amount of commission in deciding what to advise unfortunately."

1 At least they do not seem to have been doing this with company tax or income tax during the 1990s or today, though apparently in the past contingency fees were a feature of chasing down some sales tax rebates in Australia.

At the extreme of the “commission mentality” end of the market, there are promoters “who have made so many millions from their schemes in a short space of time that they do not care what happens to their clients. Their attitude is that they can retire for a few years on their investments, or permanently”. One promoter interviewed alleged that a colleague had made \$12 million in nine months on one type of scheme. Some of the leading promoters made mass marketing fortunes in their 20s and 30s; they are brash young men hardly ready for retirement and contrast sharply with the grey-haired “suits” who are the dominant figures of tax planning advice to large corporations in Australia. Young aggressive promoters can lie low during the lull after an aggressive tax planning boom and wait for the next upswing in the shelter cycle. Other “cowboys” still “can’t get jobs” (Sydney Promoter) and some others “are still doing it but very quietly”. One of the mass marketed afforestation companies used to deliver tax benefits, Australasian Plantation Timber Ltd, went into receivership in July 2001. One accountant summarised the diversity of promoters aptly when he said: “Promoters vary from Macquarie Bank to leftovers of the white shoe brigade [shady developers from the Bjelke-Peterson era in Queensland]”.

Another feature of the advice market for aggressive tax planning is that a large proportion of the advisers, perhaps half, have experience working for the ATO.

Product development

In the words of one accounting firm partner: “A boutique product means you devise something and take it to selected investors. As distinguished from where the investor comes to you with a question about how best to structure what he wants to do commercially.” Many mass marketed schemes start with an idea for a big client originating in an answer to the latter kind of question that then becomes a boutique product for a number of selected big clients. Then later still it becomes a scheme mass marketed on a commission basis to smaller clients.

A common trajectory reported by a partner of a major national accounting firm was for an “adviser to a wealthy client to look at the ball from different angles and see an opportunity for one client. Then he applies it to a few more clients. Then it gets mass marketed but more likely by a financial planner picking it up than a practicing accountant”.

The 1990s provide examples of schemes that worked as boutique products but that did not work in the mutated forms in which they were mass marketed. Sometimes this unfairly put heat on the original boutique scheme, thereby increasing the attractiveness in the post-2000 tax shelter market for designers of boutique shelters to keep their cards close to their (and their client’s) chests.

The 1990s also provide examples of mass marketed schemes that did not work being remade into shelters that did work. Many of these have since been the subject of a successful application for a product ruling. The bank of public rulings, including product rulings, has become a resource for those designing boutique shelters, providing guidance as to what might work and what might be the subject of *private* binding rulings. As one accounting firm partner put it: “in structuring arrangements, you read existing rulings, looking for nuances of acceptability” intended by the ATO to be read into the ruling. One promoter who does not use product rulings said: “Rulings encourage aggressive tax planning.

They set out line-by-line what you have to do to avoid tax". Hence, while the aggressive tax planning boom of the late 1990s has come to an end, it has, as does each cycle, left a residue of learning in the tax planning industry that can permanently erode the revenue. The wash-up of a tax planning boom is like a Balkans or Middle-Eastern peace settlement where some pieces of territory are won and others taken away. The settlement is only temporary – lasting until there is another opportunity for both sides to contract the territory previously won by the other. This metaphor suggests that court cases that bed down the new settlement at the end of a shelter boom are of great importance to the distributive justice of a tax system that will emerge from the next shelter boom.

At the end of the 1990s boom, says a partner in an accounting firm, conservative accounting firms would "tic-tac with the ATO if an investment does not fit the ruling in all respects. We say to the ATO: 'Does it fit the ruling?'" This partner also said: "We are happy to rely on a barrister's opinion on a specific transaction for a specific client but not on any idea that we put a number of clients onto. Then we want the safe harbour of a ruling." One accountant captured the conservatism prevailing in this area post 2000: "You go to the ATO for a ruling when you know what the answer is." This conservatism attracts a certain kind of client who is prepared to enter post-2000 tax-effective investments but who would have been too risk averse to enter the late 1990s mass marketed schemes. Product rulings legitimate tax planning and therefore attract people to it. This point was made repeatedly by both aggressive and conservative advisers: "People do think the ATO endorses an investment if there is a product ruling." One interviewee said, in 2001, that he was still writing to all Melbourne barristers each year with an agricultural tax effective investment idea or prospectus for them.

There were instances in the 1990s of what the interviewees widely agreed to be supply-driven tax planning, for example, Arthur Andersen's promotion of employee benefit trusts and Macquarie Bank's promotion of financial products. However, even in this supply-driven market sector there were those who pointed out that people would go to Macquarie demanding one of their products after they had heard of it (that is demand- as opposed to supply-driven aggressive tax planning).

Reputational competition

In a way also reflected in the New York interviews, there was reputational competition among aggressive tax planners. Interviewee X would say that he was cautious with his client's money, only putting them into schemes that worked and were vouched to work by QCs (senior barristers) of the highest standing. But Y, X would say, was engaged in a different version of the same scheme that was highly dubious, that did not get the detail right. In turn, interviewee Y would say he was cautious, only using products that worked, while X played fast and loose. And whenever X had actually got his clients into trouble, Y would draw great satisfaction from this, and vice versa. On the other hand, the reputational competition was not so great that limited forms of cooperation were impossible. Informants described meetings of half-a-dozen leading promoters to, among other things, discuss tactics in dealing with the ATO.

The ideas people

Most aggressive tax planning ideas are not new in any fundamental way: "There's not a lot of original thinking in this industry" (Melbourne Barrister). They are variations on old themes of creating artificial losses to write off against gains, deferring taxable gains, shifting gains to a jurisdiction or to a form where they will be taxed at a lower rate, and so on. The innovation is in finding a new loophole, a new financial product that creates its own loophole by virtue of being a new phenomenon for the law, or a new form of arbitrage. One promoter said that in the Australian market in the 1990s there was about "one idea each year" that had a genuinely new element to it, another put it at about seven or eight in the last ten years. These ideas are then picked up and promoted, usually by a very similar group of people. So most promoters commercialise or market ideas rather than develop them.

One promoter argued that law reform to quarantine losses, for example, preventing an investor from deducting losses on a film or agricultural investment from his or her salary, would have prevented most of the 1990s schemes, demonstrates the scale to which schemes are but variants of a few themes. (Similar reforms were introduced in the US in 1986 and seemed to be effective, see further Chapter 6.)

Some of the best ideas are highly contextual and do not originate with outside tax advisers: "You have a company restructuring that is done for commercial reasons. Then they stumble onto a tax opportunity that maybe the tax manager or the CEO sees. Or their accountant sees it. Then they come to me [a barrister] for an opinion that will help them make it work." This can even happen at the level of reorganisation of a family business. In situations where there is a big tax opportunity that needs to be properly sculpted, hundreds of thousands of dollars can be spent on tax advice. In the New York market this can be tens of millions of dollars. Similarly, a restructuring company will often obtain independent legal advice on whether an Option A or an Option B will produce a better tax result with a corporate restructure. This can stimulate the creativity of the lawyer to come up with an Option C: "But I would not see Option C until I had been involved in a discussion with them around A and B first." Hence, many of the best tax planning ideas are not the creation of a solitary genius, but are the outcome of people bouncing off one another in a creative dialogue.

Tax lawyers can also get ideas for shelters that will work for risk averse clients when considering less-legitimate schemes, for example "when they brief us from the shonky end of the market when the shit hits the fan, when they need our expertise and reputation to help them out of trouble".

The small number of genuine ideas people in tax planning are shy of glory for their creations: "Our business is based on generating ideas for our clients that we always get a QC's opinion on. But we can't afford to be seen as an ideas factory. I never take credit for our ideas when the Business Review Weekly calls."

Some ideas come in idiosyncratic ways. The inventor of one of the important late-1990s schemes, a university tax lecturer, said the idea came to him as he was explaining a concept to students on the blackboard. One promoter who used this lawyer's ideas described him as "Mr Academic" even after he had gone into private legal practice, and as a brilliant man "excited by the challenge" of tax planning ideas. Brilliant designer he might have been, but he was not seen as a

competent promoter. While the designer was “Mr Academic”, this promoter described himself as “Mr Commercial”. Informants told other less precise stories of students in university tax law lectures identifying loopholes as a result of the learning process. In one of these cases, the loopholes may well have been apparent to the tax professor, but it was the student who had the interest and the marketing flair to use it in a way the professor did not have “the commercial wit to do”. Another inventor of one of the leading tax loophole discoveries of the 1990s got the idea while reading an article on tax law. As in most areas of innovation, the academy is an important engine room of ideas, but poor at commercialising them.

One prominent tax scheme inventor said that the key to success is “a culture, an attitude in the firm: If there is a tax problem, then there is a solution. It’s just a matter of finding it. Without going over the line. We’ll squeeze it but we won’t go over the line”. While the scheme inventors interviewed seem to have this kind of culture infused with optimism about what their craft can accomplish, tax officialdom seems infused with pessimism, especially in the middle ranks and among those who do the fieldwork. Rob Williams (2001) found similarly in his interviews with ATO officials concerned with aggressive tax planning, though ATO comments on a draft of this chapter probably rightly point out that by 2003 wins in the courts by the ATO on mass marketed and employee benefit schemes had created greater optimism within the agency.

Another tax scheme inventor said his firm applied de Bono principles to tax – “thinking outside the square”. Some of the ideas people interviewed found routine tax work dull. They derived enormous job satisfaction from the creative part of the work. In this sense, the motivations at the ideas end of aggressive tax planning has something in common with juvenile vandalism, arson and illicit drug use – a quest for excitement in an otherwise dull life.

A crucial kind of ideas person that was not interviewed is the “rocket scientist” within an investment bank who comes up with new ideas, especially ideas for financial product shelters. They were described by some of their colleagues as academic types, “Einsteins” in a world of “suits”. But unfortunately their self-perceived motivations cannot be explored in the absence of interviews with them.

The investors

During the 1990s there was a steady demand for corporate and high-wealth individual aggressive tax planning in the context of corporate restructurings, international arbitrage in global operations and other complex transactions and structures. This continues today. Much, perhaps most, of this investment in aggressive tax planning arises from the investor presenting to the adviser with a structural or transactional problem and the professional adviser seeing a tax planning opportunity that arises through it. But wealthy corporations were not the main investors in the 1990s boom in aggressive tax planning in Australia in the way they were in the 1990s US shelter boom. The main investors in the 1990s boom in aggressive tax planning in Australia were individuals earning more than average incomes.

In Kristina Murphy's (2003a) interviews with 29 individual Kalgoorlie investors in mass marketed schemes attacked by the ATO, 25 of them had sought third party advice from solicitors or accountants on the legality of the schemes that were promoted to them and some also said they had sought advice from the ATO itself or the Australian Securities and Investment Commission.² Murphy reports a deep sense of procedural injustice driven by the perception that it is not fair for an ordinary person to face tax proceedings and bankruptcy in circumstances where they had invested on the basis of a prospectus with a QC's opinion saying that it is legal and after they had taken the step of obtaining an independent professional adviser's opinion that was also supportive of its legality. This resentment is given particularly sharp focus by the perception that the ATO did not have a public presence advising against the schemes until late in the 1990s (see also Williams, 2001). And the perception that the ATO, by accepting the tax returns of Kalgoorlie acquaintances and paying refunds on scheme investments year after year, led ordinary people to think that the ATO had approved the schemes and vindicated the advice in the prospectus and of their own accountant or lawyer. A survey of the general population of Australian taxpayers by Wenzel, Ahmed and Murphy (2002) found that two-thirds of Australians erroneously said "yes" to the following item: "Assume you submit a tax return where you have claimed a deduction. You then receive a refund from the Tax Office for this deduction. Does this signal to you that the Tax Office has approved your deduction?" After all this, Murphy (2003a) found that some investors felt the ATO "treated them as cheats" in ATO public announcements, in the letters and encounters they had with the ATO. This explains why so many investors (an estimated 22% of Goldfields Region investors (Cartwright et al, 2003: Table 4)) sent good money after bad paying into fighting funds, some of which were sponsored by the very promoters and advisers who had so poorly advised them.

Kristina Murphy (2002), Sophie Cartwright and her co-authors (2003) Kersty Hobson (2002) and Rob Williams (2003) have made important contributions in helping us to see the risk to the revenue of these people being disengaged from their obligations to pay their fair share of tax for the rest of their lives, and also the risk of their family and friends being similarly disengaged because of what they see as the injustice the government has inflicted on their loved one. In many cases, the effect on these investors' lives has been devastating, which is why investor reaction has been extreme and why they have attracted sympathetic political concern, including that of the Prime Minister. There have been significant numbers of bankruptcies of scheme investors, of marriage breakdowns and suicide attempts (Cartwright et al, 2003). A large tax debt was even seen by police as the "final straw" in a murder-suicide that eliminated a New South Wales family of four (Daily Telegraph, 20 March, 2002, p 2). A restorative justice approach to investors in mass marketed schemes may be one path to re-engaging such investors with their obligations to the integrity of the tax system (see Chapters 13 and 14).

Some promoters interviewed had an interesting spin on the distributive injustice, as well as the procedural injustice, in play here:

2 Murphy (2003b, 2004) subsequently reported similar results from a survey of 2301 scheme investors who responded to a mailed survey.

The ATO is not worried if Lend Lease and the big boys put wealthy clients into schemes. It's Mums and Dads getting into it that worries them. I suppose you can't blame them in one way. Mums and Dads are the source of most revenue – mass marketed schemes to them are a bigger risk to the revenue and there is not the commercial investment that is important to Australia's future that there is at the big end of town. But it's hardly fair.

A personal experience of the author illustrates how promoters can play up such unfairness. When a financial planner cold-called, I said I was interested in hearing about tax-effective investments and he came to my house to present the investments he had on offer. Part of his structured presentation used a flip-board. One of the first graphics was of press clippings reporting a court case in which it was reportedly revealed that Australia's richest man, Kerry Packer, had paid only \$3 in income tax. "Is that fair?" he asked. "Compare it to how much tax you pay. Is it right that people like you pay so much when people like Mr Packer pay so little?" That this is a common way of thinking is borne out by what one of the fighting funds for the Kalgoorlie scheme participants has on its website:

The sad thing is too, like this is affecting the average backbone of Australia. We're not talking about Kerry Packers and stuff here, they don't pay any bloody tax and the average Australian pays the tax and they're the backbone of this country and that's who it's affecting (Hobson, 2002: 23).

The battlers outback see themselves in juxtaposition to the big city rich in Hobson's research. Hobson (2002: 23) found remarkably that in a majority of the interviews with Goldfields region scheme investors there was reference to the "emblematic case of Kerry Packer". This juxtaposition of the differences in the way investors versus advisers see aggressive tax planning leads us in to one of the big policy questions that animated this research. Is aggressive tax planning more driven by demand from investors or supply driven by the promotion of advisers? This issue is developed in the next section.

Supply or demand driven?

Supply and demand

My informants were more or less equally divided according to whether they believed that the aggressive tax planning market of the late 1990s was more demand driven or more supply driven. By 2001 there was general agreement that there was more demand than supply for mass marketed schemes. Many clients would say to firms formerly involved in aggressive tax planning, "What's around?" But mostly, in the words of one promoter, by 2001 what they were being told was "Be careful". Another said the exact words he uses back to clients demanding tax schemes are: "At the moment the Tax Office is rampant". Demand was said often to be mediated by suburban or provincial accountants. They would call the downtown Sydney or Melbourne promoter with the plea: "We'll lose our clients, Frank, unless we put them into something." The problem is that such clients "hear about a scheme in the bar". But bars are full of bravado, so "What they hear is half wrong", or is about something people were getting away with in the 1990s but not now.

The impact of rulings on supply and demand

The Melbourne tax planner consensus was that as of 2001 you would respond to this kind of demand by “only put[ting] a client in if there is a product ruling”; tax products are “unmarketable without a ruling”. There were three Melbourne interviewees who did not adopt this as a hard and fast rule. And the Sydney promoters did not agree with this Melbourne consensus at all. Some Melbourne advisers took this as one kind of evidence that the advice market is “more aggressive in Sydney” though some said it was more aggressive still in Western Australia. One Melbourne law firm senior partner regarded it as “ridiculous” for Sydney and Western Australian advisers to believe that a QC’s ruling was enough to give clients assurance in a scheme.

The Sydney promoters interviewed argued against this view on the following lines. First, you cannot trust the Commissioner on rulings in any case: “The Commissioner has a history of going back on rulings”. An implicit part of this view was that if you were from the “Sydney-disreputable” end of the advice market, as opposed to the “Melbourne-reputable end, the Mark Liebler end of the profession”, there was more reason for distrust that your rulings would stick. Unwinding rulings given by Nick Petroulias has worsened this perception, not only among the promoters who had deals with Petroulias that are now being attacked. The second part of this Sydney promoter case against rulings is that with a ruling you have to explain how your facts fit the ruling, whereas with a QC’s opinion you get it on the particular case. Thirdly, there is speed. The Commissioner might take a year or more to give a ruling, whereas “if your cheque book is big enough, a QC can give you a written opinion in three weeks”. Fourthly, because QCs are more in touch with “commercial reality” and generally more technically competent, they are less likely to make mistakes that would not impress the courts than are the ATO. Fifthly, “Why let the ATO know what you are doing?” Or, “If you ask for a ruling you stick your head up to get it kicked. Then they disseminate it so your competitors get into it. Then they can reverse it.” One Sydney promoter even said that their professional indemnity insurance is available to give clients assurance, a fragile claim when there do not seem to have been any successful claims on such insurance in respect of this cycle of mass marketed schemes.

Putting these reasons of varying persuasiveness aside, what is really going on in the strategising of promoters who were big players in the 1990s boom is that they are moving to the marketing of more boutique shelter products that in the words of one Melbourne promoter pass two tests: “In the new environment, tax planning ideas must be: (1) something that does not proliferate, that avoids the heat of becoming widespread; (2) something that does not show up in a tax return”.³ Keep the client base rich and small and keep it secret, especially from the ATO (which means no rulings). Keep it in-house. No seminars, no

3 An example given by this promoter was a claim based on a dubious small business exemption. Capital gains are treated more favourably for small businesses (under \$5 million). Self-assessment means there is no declaration that what the business is doing is claiming a small business exemption. So the ATO has to pick this up. This promoter claimed that either abolishing self-assessment or requiring the business to apply for a small business exemption so the ATO could check that it met the test of being a small business would increase the revenue substantially.

cold-calling, no prospectuses stamped “product ruling”. This is what the new boutique market means. It sits alongside a market for legal tax-effective investments with product rulings. Post-2000 this boutique market in secret tax shelters may be bigger in Sydney; the product ruling advice market in ATO-approved tax shelters (many of which, however, are still investments of doubtful or marginal commercial substance) may be more predominant in Melbourne.

From supply- to demand-driven schemes

One lawyer who advised on tax schemes said I was “absolutely spot on” when I offered the following summary after a long interview:

So a mass marketed scheme wave starts on the supply side when promoters run seminars after coming up with an idea for minimising tax. Confidentiality agreements leak; some clients and accountants are good at drawing out as much information as can be gleaned short of signing a confidentiality agreement. Clients then go to their own accountants and ask about the idea. These accountants get advice from their lawyers about how to make the idea work. Then those lawyers might relay that advice to other accountants they work with. Then their clients start talking about the idea at the pub and it spreads like a bushfire. By then, what started as supply driven has become demand driven.

There is no doubt that the evidence is that there is a lot of pent-up demand out there waiting for the right supply side impetus. Braithwaite, Reinhart, Mearns & Graham (2001) found that approximately 22 per cent of Australian taxpayers considered several different ways of minimising their tax each year.

During the supply-driven phase, only those with a taste for risk respond initially to marketing by promoters. The risk averse herd does not follow them until they see these risk takers get away with it one after the other. Then when those with a moderate taste for risk follow the high risk takers and also get away with it there can quickly be a stampede of investors with exaggerated perceptions that “everyone is doing it”. If the stampede into the market for the scheme is big enough, this perception almost becomes a self-fulfilling prophecy. Sometimes the first movers have an extremely high taste for risk because of some kind of short-term desperation: “Come 30 June [end of the tax year] some people get irrational. They are desperate for a tax product because they say ‘I have a big tax liability and I don’t have the cash to pay it.’” Such people can be the pioneering risk-takers who are followed by the progressively more risk-averse. So you get a sequence of need followed by greed followed by contagion (“everyone is doing it; why be a mug?”). Because promoters work particular networks (eg, airline pilots of one of Australia’s major airlines but not the other) this contagion can get out of hand much more quickly in one locale than others. In the case of the 1990s boom, this was in Western Australia, which accounted for more than 40 per cent of all the subscriptions to mass marketed schemes. People in the West received professional advice to jump into more unsophisticated schemes than those promoted on the East coast. One lawyer suggested that people got “more carried away” in the West because the risk-taking mentality of mining communities then gets compounded as more people jump in on advice from “a local accountant who might say its okay without really understanding the legal issues, but just noting

that clients of other accountants are getting away with it en masse". Provincial accountants no less than miners themselves take too seriously an opinion of a QC from the city when "you can always get someone to sign an opinion saying it is okay. Promoters came to me and when I said no they just shopped around until they got the opinion they wanted" (Melbourne Barrister).

Kristina Murphy (2002: 13) points out that "Tax agents tend to be more adventurous than their clients in thinking a particular minimisation strategy will be upheld by a subsequent legal challenge (Hansen, Crosser & Laufer, 1992)". One reason can be that agents were getting rich on commissions from scheme promoters; they get the commission and under self-assessment the taxpayer bears the risk if their return is not right. One promoter referred to Mum and Dad scheme investors as "bunnies" and that is indeed the way they feel. Investors follow the herd into shelters because promoters structure incentives for other advisers (through opinion shopping and commissions) to increase the propensity for risk taking. Reverse contagion occurs when investors learn that their advisers have been less risk averse than they themselves choose to be. For this reverse contagion to happen, investors need to see advisers called to account by the ATO through public pronouncements that advisers are giving erroneous advice on the legality of schemes. Reverse contagion occurs when potential investors find out about actual people who have been burnt or see a television current affairs exposé with people who have been burnt.

From the interviews with both advisers and tax officials, there is, in summary, a perception of aggressive tax planning being more or less equally supply and demand driven. Kristina Murphy's questionnaire data, from 2301 investors in alleged aggressive tax planning schemes, suggests this perception is wrong. Sixty-nine per cent of her respondents asserted that the idea to invest in tax schemes came from a financial adviser (the supply side), 34 per cent claimed it had come from a tax agent (note some are claiming both kinds of supply-driven aggression) and only 16 per cent said they had directly approached a tax expert to put the idea into practice (the demand side) (Murphy and Byng, 2002). From a policy perspective, these data make it prudent to assume that mass marketed tax planning is more supply than demand driven. Moreover, the fact that even the tax professionals I interviewed mostly felt the 1990s boom started out as a more supply-driven phenomenon and then later became more demand driven means that preventive policy must be focussed on the supply side. This means policy options like a shift in deterrence emphasis from investor penalties to promoter penalties, an idea that will be considered in Part IV.

The boutique products market is never as supply driven as the mass schemes market. Boutique products are crafted in response to demand articulated by wealthier clients with the capacity to pay for something more expensive than the mass marketed product. Put another way, the boutique market is stuck at the need stage of the need-greed-contagion sequence in the histories of mass marketed products outlined above.

International supply of tax planning opportunities

Looking to the future, there are structural changes afoot in the advice industry that may make aggressive tax planning more supply driven in future, including on the boutique side of the market. One is strategic plans of the largest

accounting firms in Australia that mandate an X per cent growth in their tax business where X is driven to ever higher levels by expectations passed down from the US where we will see, in Part III, that tax shelter advice has been the boom sector for major accounting firms.

Tax havens and concealed transactions

A number of informants said that tax havens were becoming more important. Tax havens are mostly used as a secret zero-tax link in an international avoidance chain that is perfectly legal. But use of off-shore havens for hard-to-detect evasion is also quite common as reported by advisers who insisted that they did not assist clients with such illegal use of havens themselves but who said they were aware of it happening, including on the part of their own clients. Such clients used "reputable advisers" for their public persona in dealings with the ATO and less reputable ones to assist them in laundering money. One promoter named two Big Five accounting firms who would not put you into off-shore tax havens but who would "put you in touch with advisers who will", including in one case a branch of their firm in another (Asian) country. Non-professional family networks, especially mediated by international ethnic diasporas, also deploy "informal value transfer" (Passas, 1999). A common view in the interviews was that so long as you conceal the path of the money offshore, "which is not hard to do, though not without cost", "there is nothing the ATO can do". Mandated disclosure of large fees to tax advisers was one step that was suggested as useful with this problem. But then, one lawyer said: "They will pay commission offshore." Even so, there might still be a deterrent effect because "it is still fraud if you fail to disclose" and the fee might be picked up in a joint audit.

One new development that I was told about in my interviews was purchasing, via the Internet, financial products that do not have a source in any nation, making it hard for any nation to tax the activity, as there is no jurisdiction within which transactions occur; they occur in cyberspace.

Multinational operations and investments

An interesting indicator of change in the tax planning market was one law firm interviewee who had been a promoter of mass marketed schemes and had moved out of that completely. His new focus was on linking his (small) law firm to a network of similar firms in the US, UK, New Zealand and like economies. Interviews were conducted at two middle-sized metropolitan Australian accounting firms, which also operated in a similar strategy of international networking. The idea was that these firms would network knowledge about the best opportunities for their clients in different countries. In our discussion of the New York advice market in Part III we will see how the major accounting firms' global operations allow them to share knowledge in-house about international arbitrage opportunities. Arbitrage means seizing opportunities that arise from mismatches in tax rules between different jurisdictions. What this Australian informant was describing was the approach of a network of small law firms to the same objective. The clients of this Australian law firm were corporations and wealthy individuals, clients a cut above his former mass market clients but a cut below those of the Big Four in their international arbitrage advice. The lawyer said his firm did not put

clients into tax havens: "There are enough opportunities in New Zealand, Australia, the US, the UK and such places to wipe out tax liability without going to tax havens." He saw national approaches to tax law enforcement as piecemeal; what he was offering to clients was playing one nation's laws off against another's. For a long time in the corporate compliance literature there has been recognition of the fact that while state regulators only achieve coherence in their law enforcement at the national level, multinational corporations can achieve global coherence. They pit their global organisational system against the global non-system of tax enforcement. This is true on both the investor side with multinationals and on the advice side with the (now) Big Four and global investment banks.

What I discovered in this interview, reinforced less directly in some others, was a shift away from mass marketed schemes into boutique tax planning based on a new networking model that enables small law or accounting firms to be able to think world-systemically while tax offices continue to think nationally. There has long been recognition of this phenomenon at the level of major accounting firm advice to multinationals. Now we see it at the level of small law/accounting firm advice to wealthy individuals and smaller national or local corporations. In this new model, international coherence in tax planning is accomplished by a network of a finite set of international professional linkages instead of by a global set of operations by both the investing and the advising firms. It is misleading perhaps to call what I discovered here global networking because serious linkages did not extend beyond half a dozen countries. But then nor is most multinational Big Four tax shelter planning fully global. The largest global players mostly ignore sophisticated tax planning opportunities in African economies as not worth the cost of expensive boutique arbitrage.

This law firm adviser rejected the label aggressive tax planning as properly applying to what he now does compared to its appropriate application to what he did in his mass marketing days: "Its not aggressive. Its just a different way of thinking." Indeed it is! The niche market this firm grabs is of people who are exceptionally wealthy from their real estate business, for example, who are respectable and do not want to be caught up in tax havens, who "want to see their funds invested off-shore with Deutschebank, Rothschild, etcetera". But they are interested in schemes that can deliver them a total tax wipe-out by putting them into offshore superannuation, among other things.

There was an important difference in the way Australian large corporate tax advisers viewed what they were doing compared to the New York advisers I interviewed. The Sydney and Melbourne lawyers were subservient in a way compared to the "grab the bull by the horns" attitude of New York advisers, at least with respect to their servicing of foreign multinationals: "Australia just has to fit into their global and regional strategy", as one of these subservient Australian advisers put it. Australian international companies can be more aggressive on the demand side. But as one law firm partner put it, it's not so much a matter of searching for shelters as: "X is happening. How do we do it? This is our bread and butter."

Is international tax planning supply or demand driven?

As we make the move into international tax planning, the distinction between demand- and supply-driven tax planning becomes less clear-cut. There is a demand for total tax wipe-outs from wealthy people who would rather pay staggering fees to tax advisers than even larger tax liabilities to the state. But in important ways this demand is being stoked by a creative new supply of international tax arbitrage opportunities. Its implicit message is that you might have to risk being seen as a cheat to accomplish a total tax wipe-out domestically. But if you are willing to pay our steep professional fees, we can tap a supply of international arbitrage opportunities that can give you a total tax wipe-out without any risk of Australian courts finding you in breach of Australian law.

Rationalisations

Tax professionals involved with putting people into mass marketed schemes report that their clients are much less inclined to blame them if anything goes wrong than they are to blame the tax office. Williams's (2003) study of 2029 investors in mass marketed schemes likewise found them persistently blaming of the tax office for their predicament and more rarely censorious of their advisers. This seems to provide many of them with a sense of vindication – that what they were doing must have been reasonable if even their clients think so after they have gotten in hot water as a result of it. "Everyone dislikes the tax man", one promoter said, however, in pointing out that when you have more access to talk with the taxpayer on a regular basis than does the tax office, it is not so difficult to cop less of the blame. The bottom line, then, is that promoters of supply-driven aggressive tax planning can get away with the tax office being blamed rather than them personally being blamed for things that go wrong with most of their clients most of the time.

"Blaming the tax man" is also important for promoters in rationalising to themselves their involvement in aggressive tax planning. It was almost standard for tax planners to vindicate their own professionalism by demonising the lack of professionalism and politicisation of the Commissioner in particular, but also of the ATO in general: "The Commissioner has the view that the public should pay as much tax as possible. The public resent this view and they are right."

In those cases where this rationalisation package broke down because clients clearly blamed their advisers rather than (or as much as) the tax office, it was common for advisers to position these particular clients as irrational, naïve, unreasonable people who were distinguished from the reasonable majority of clients who blamed the tax office. An employee share plans promoter whose clients had settled with a tax penalty called a meeting with his clients. One of these clients said in driving home with his accountant: "Can't you contact Mr Kennett [the then Premier of Victoria]". This client is positioned as someone from another planet because he thinks the State Premier could help on a federal tax matter. Another client said he would "knock his accountant's block off" if he had to pay a penalty. This one is positioned as even violently irrational. Some clients blame advisers not because they got the law wrong but because they got caught when they could have placed their money with someone else who was clever

enough to protect them from getting caught. Then advisers explain that most clients are not like this at all; they maintain solidarity with their advisers.

Some adviser rationalisations turn a grain of truth into a rock of misrepresentation: "In the short term each dollar you [the investor] give me as promoter goes into my tax. So the Commissioner is not losing money so long as this is the case." This is hardly the case. If a hundred dollars of tax is avoided by the scheme and \$80 of this goes into the pocket of the investor and \$20 into the pocket of the promoter, the Commissioner will get back less than \$10 of the \$100 owed.

David Matza (1964) argued that law-breakers do not so much reject the moral legitimacy of the law as "drift" between law-supportive and law-neutralising identities, between virtue and vice in the terms of this book. Sykes and Matza (1957) suggested five techniques of neutralisation that make drift possible: (1) denial of victim, for example, "we weren't hurting anyone"; (2) denial of injury, for example, "they can afford it"; (3) condemnation of the condemners, for example, "they're crooks themselves"; (4) denial of responsibility, for example, "I was drunk; I didn't understand it was against the law"; (5) appeal to higher loyalties, for example, "I had to stick by my mates; I had to do best by my client". To varying degrees, all these techniques of neutralisation apply to the thinking of promoters. But "condemnation of the condemners" is clearly the most important. In unpublished results from Williams's (2003) study of 2029 investors in mass marketed schemes, he found the same techniques of neutralisation in play on their side. It is likely investors learnt many of their rationalising scripts from their advisers. The dominant themes were the same as in my interviews with advisers – ATO "retrospectivity", the ATO changing its position ("shifting the goal posts"), ATO tardiness in reacting – giving the impression the scheme was okay.

The one technique of neutralisation that Williams found to be present among investors that is not present in the same way among advisers is the "appeal to higher loyalties". Williams found investors who saw their schemes investments in terms of building Australia: "apart from the financial benefits I went into [the scheme] because it was an opportunity to do a little toward securing my children's future. I was pleased to be investing in an industry that provided jobs in rural areas; I am disappointed that I will now be financing unemployment benefits in this area through my taxes!" Another investor said: "The primary producing investments I was involved in were done for the following reasons. I was investing in Australia! Creating employment for Australians! Creating income for my later years, that would be keeping intellectual capital in Australia. Encouraging research and development. To provide for my family." Advisers who put investors into such agricultural and R and D schemes did not rationalise their behaviour in terms of building the Australian economy. But there certainly was the technique of neutralisation of "appeal to higher loyalties" in terms of their loyalty to their clients and their families.

One tax scheme inventor captured succinctly a widespread view among promoters: "There is neither logic nor morality in tax law, just a bunch of rules." One common view was "[Yes,] when there is mass hysteria, the ATO needs to do something." But the nature of the mass hysteria is often that tax products that do actually work (by this the interviewee means the product he is involved with) get taken to the extreme "and then the Commissioner throws the net over the lot"

(including their scheme). There is a new variation on the “condemnation of the condemners” technique of neutralisation here – being a victim of the illegality of others; the view that it is not that my client and I are perpetrators of illegality; we are victims of illegality.

Flipping a tax advice market in vice to a market in virtue seems quite a challenge when advisers believe that virtue resides in their conduct and vice on the side of the ATO. On the other hand, flipping is more possible in a world of drift between different readings of vice and virtue than in one of more fixed conceptions of right and wrong.

Enforcement challenges

This chapter considers the evidence from the interviews on the nature of enforcement challenges confronted by the ATO. The first challenge is that of intelligence, knowing what schemes are out there and how they work. It is found that the most important forms of intelligence gathering are rather informal, dependent on cultivating relationships. Then we will consider how enforcement strategy was buffeted by strategic cases until the ATO took greater charge of setting the agenda of strategic cases. What was an enforcement challenge could be flipped into an enforcement resource with a sufficiently strategic approach. The capacity to do this is one of a number of dimensions of ATO competence in compliance management. Perceptions of ATO technical incompetence were a recurrent theme in the interviews. Overturning this challenge is one we return to in Part IV. The challenge of whether investors and advisers perceive there to be serious risks from enforcement also turns out to be more of a resource than a challenge so long as there is a moderate degree of credibility to the enforcement practice. The Australian data suggest Australian investors have unrealistically high expectations of enforcement action being taken against them and tax professionals are mostly quite sensitive to the reputation risks from putting clients into aggressive tax planning schemes.

Intelligence gathering

One enforcement challenge is the inherent dynamism of aggressive tax planning. For example, an aggressive tax planning scheme can be well down the ATO's list of enforcement priorities and then, partly as a result of the ATO's inaction, there can be a stampede into the scheme. Similarly, there can be a mutation of a scheme that has greater mass appeal than the original. Such dynamism makes timely intelligence imperative.

Intelligence gathering might be formal, such as a rule requiring shelter disclosure – an approach taken by the US (see Chapter 8) – or informal, such as having a cup of coffee with a promoter, with the added benefit of letting the promoter know that they are being watched.

One intelligence gathering strategy suggested by two practitioners was simply to ask taxpayers who had participated in schemes in the past whether they were getting into or had been approached about any new ones. This would have the effect of being an investor-targeted “shot-across-the-bows” akin to the strategy of “having a cup of coffee” with promoters. Most intelligence effort in Australia has been directed at gathering information from tax professionals rather than taxpayers. For example, there have been efforts to get practitioners to pass on to the ATO promotional literature sent to them on doubtful tax schemes.

Generally, practitioners have not responded favourably to such requests and some resent even being asked for their voluntary cooperation in assuring the integrity of the tax system in this way. Practitioners perceive danger in collaborating with the ATO and take cautionary tales seriously. One interesting tale of informal intelligence gathering that went wrong for the informant was an accountant from a major firm who said as an aside to an ATO officer, "This guy [their client] is squeaky clean. You should be going after so and so instead [a former client who did not pay his bill]". The latter lodged a Freedom of Information request with the ATO for a document that named the accounting firm informant as the source of the tip-off and at the time of interview, was threatening to sue the accounting firm.

Allegedly, Nick Petroulias, during his period as head of Strategic Intelligence and Analysis of the ATO in the late 1990s, organised rulings for promoters on very favourable terms in return for assistance with his intelligence work. According to one promoter, Petroulias hit them with s 264 of the *Income Tax Assessment Act 1936* (Cth) (mandating disclosure – generally of client lists) and then said, "I'll be your friend if you play by my rules". Most of the promoters interviewed had been approached by Petroulias with this kind of proposition, as had many other advisers interviewed. One promoter claimed that the offer was for quicker rulings that held for longer periods for advisers who shared intelligence. Some others suspected they were more favourable rulings than others got – in terms of tax arrangements that were acceptable to the ATO. One promoter believed Petroulias was a "double agent", certainly getting some useful intelligence for the ATO but also betraying the revenue to certain favoured advisers. Some informants believe bribes were paid to Petroulias for some favours and others decisively disbelieve this. The latter allegations are at present being tested in the courts. When I interviewed Petroulias in 1998 he claimed to be giving promoters a guaranteed period of making hay with a boutique product so he could use the intelligence to ensure it remained a boutique product and did not become a mass marketed product. Effectively the deal was if you were clever enough to open up a loophole, the ATO would protect your windfall for a finite period (though some promoters said this could be six years!) and the ATO would close the loophole sooner rather than later for everyone else.

Most advisers interviewed thought the Petroulias intelligence strategy was a good one in principle, but believed that in practice it was done with insufficient integrity and accountability. One promoter went as far as to say that the Commissioner's 1999 crackdown with announcements that various schemes would be attacked was "all totally the result of Petroulias's work". It was "ironic", he said, that this had been so effective in causing mass marketed schemes to "dry up". "It was a great injustice to Nick because it worked. He found out what was going on." Beyond the controversial strategy of "pay the shelter" when intelligence is provided, Petroulias did a lot of other more informal intelligence gathering that seemed unexceptionable: "Petroulias says, 'We're likely to go after X; I hope you're not in that.' Then I say: 'Did you hear so and so [a competitor] has a new version of the Y scheme.' "

One promoter suggested that a better path would be a "promoter liaison committee", arguing that the committee structure would provide a natural accountability to other professionals that one-on-one meetings with Petroulias

failed to deliver. Others were cynical that advisers would be open in such a context on the basis that anyone with a really good idea for exploiting a loophole would keep it to themselves: "They draft legislation with holes in it, then we find and use the holes. It's against our interests to tell them about the holes." Generally, the interviewees thought people would be willing to mention gossip they had heard about what competitors were doing in order to put the ATO on to their competitor's scent rather than their own. But one-on-one informal relationships with promoters are probably the way to draw out this kind of gossip in any case; gossip is an intimate activity, not a committee activity. At the end of all of these considerations, most advisers think the ATO should do a better job of the natural gleaning of intelligence that will come from having cups of coffee with them, but that they should eschew a strategy of offering special deals to advisers who are particularly useful in the intelligence they provide. One promoter made what seems a clincher of an argument: "If you have \$10 million riding on a need to give Petroulias some intelligence, what do you do? Make it up."

Some advisers argued that what they regarded as the Australian propensity to replace the rule of law for taxation matters with a "rule of press release" leads to a reluctance of advisers to talk to the ATO about what they are doing. In the old days, one experienced lawyer said, you could go to the Commissioner, he could agree that your scheme works and you would get the benefit of the scheme until he managed to change the law. Today, the lawyer thought the more likely response would be a press release from the Commissioner saying he will attack it one way or another. The rulings system also encourages such reporting "when they know that they will get the answer they want" but not when this is in doubt and the investor is determined to go ahead. Relying heavily on any of these ways of encouraging the disclosure of shelters that jeopardise the revenue seems unlikely to succeed. Certainly they will not succeed as well as a system of shelter disclosure rules combined with informal participation by the ATO in networks of tax professionals. Such networking can pick up gossip about schemes that are not being disclosed and that can therefore be attacked, in the first instance for the offence of failing to disclose. As stated above, the shelter disclosure rule approach is a path the US has taken. It will be discussed further in Parts III and IV.

Strategic cases and enforcement strategy

Old hands consistently reported that at the time of the late 1970s explosion of aggressive tax planning, the case law was supportive of gaming tax law. They reported this to be much less true with the late 1990s wave of shelters. The case law became progressively more supportive of the Commissioner's attacks on aggressive tax planning during this period. Indeed top management of the ATO told me they saw the tax planning of the late 1990s as a great opportunity to secure decisions from the courts that would give Part IVA, the general anti-avoidance provision, more bite. One senior ATO informant saw a long period after the enactment of Part IVA when the ATO was rather afraid to test it lest the Gibbs or Mason High Courts (in the 1980s and early 1990s) neuter Part IVA in the way the Barwick High Court had the previous general anti-avoidance provision (s 260 of the *Income Tax Assessment Act 1936* (Cth)) in the 1970s. During the first decade of Part IVA's existence, the ATO was of the view that Part IVA was working as a "benign big

gun" that was sufficiently threatening despite the fact that the ATO had been timid in actually using it to initiate litigation. According to an ATO informant, after a number of years there emerged concern that practitioners might forget Part IVA's existence. Moreover, there were some aggressive practitioners who came to believe that Part IVA was a broken gun and that the ATO's fears that it might not be supported by the High Court were realistic. According to several informants this perception was instrumental in starting the contagion that became the late 1990s aggressive tax planning boom. The moment of truth had arrived for the ATO, which then had no choice but to put Part IVA to the test. When it did, it won some important victories. *Spotless*,¹ for example, was specifically mentioned by some promoters as dampening game playing. It may be that by waiting for the next wave of aggressive tax planning to begin to get out of hand before it thoroughly put Part IVA to the test, the ATO made a prudent strategic decision. A crisis that threatens the integrity of the tax system is perhaps the right environment for obtaining decisions on the scope of a general anti-avoidance provision favourable to the ATO. And in the climate of the 1990s boom in aggressive tax planning and its immediate aftermath, the ATO received some rather favourable decisions from the courts in respect of Part IVA that strengthened its arm.

Several QCs, when asked why the complexity of tax law seemed worse in Australia than perhaps any other nation, responded (as one put it): "The Tax Office and Treasury are not prepared to trust the courts and there is some reason for them to think they should not." In their view, the complexity of Australian tax law could be explained as fallout from a history of court interpretation in favour of taxpayers, particularly the literalist interpretation of the High Court during the 1970s when Sir Garfield Barwick was Chief Justice. Excusing the government for drafting complex law in response to these cases, another QC said, "The government can't ignore this history and should not do so because the history of Barwick cases is part of our law." He described this as a history of "failure breeding failure in tax law". But he was then quick to point out that the "rate of change" of tax case law is now so great that cases 20-years old (others said 10-years old) are of very limited relevance today in tax law.

Another accounting firm partner who had been a senior ATO officer saw the problem differently from the way he had seen it in his ATO days. He saw it as one of excessive distrust of business (as opposed to distrust of the courts). The ATO "paranoia" was to see large corporate transactions as tax driven when they were generally commercially driven with a tax advantage crafted into them. He saw the complexity of Australian law as driven by "exceptions rather than normal transactions". It would seem both these critics and both their perspectives are correct – that complexity has been driven by excessive ATO/Treasury distrust of the judiciary in the aftermath of the Barwick court and of normal business transactions. Chapter 10 proposes that the solution is to hand the judiciary a more principle-driven tax law that trusts them with enhanced discretion, that empowers parliament with a quick corrective form of response where that discretion is exercised in a way that threatens the revenue, and that trusts normal business transactions by specifying examples of normal transactions in the law that comply with the principles.

1 *FC of T v. Spotless Services Ltd* (1996) 186 CLR 404.

ATO competence in compliance management

Most practitioners interviewed were extremely critical of the ATO. Said one adviser, "With Bottom of the Harbour [asset stripping of the 1970s wave] the ATO sat on its hands. Here [the 1990s wave] the ATO was complicit in it by ill-conceived rulings." This adviser has many high-wealth individuals as clients, who he had advised not to touch the schemes that came under attack from the ATO from the late 1990s. He and advisers like him felt the ATO did the right thing in finally attacking such schemes and felt the ATO was too tardy in doing so. When the ATO did attack, they drew vindication from the fact that they had kept their clients out of trouble. The view among this type of adviser was: "They've got it right now. But they are trying to escape responsibility for the mistakes of the past." Yet even those who had put hundreds of clients into ill-fated schemes tended to think that the ATO had "got it right" after 1998 in cracking down on other schemes; the ATO had only got it wrong in respect of their scheme!

One promoter felt the ATO culture is about believing that "the community is out there to cheat them – a fraud squad mentality. Those who don't subscribe to that view leave the ATO." Later this promoter asked, "Why do they stay there?" Musing aloud, he thought, like others interviewed, that one reason might be a philosophical commitment to being on that side of the fence. But like other informants he viewed it as a puzzle, for not only were they paid so much less than in the private sector, but "it's also socially better to work for KPMG than to say you work for the tax office". Some practitioners feel that a minority of highly competent tax officers stay because of a philosophical commitment to their work, though sometimes they were believed to stay for more individual reasons like being a single parent and needing to leave work at 5pm. Second Commissioner and Chief Tax Counsel Michael D'Ascenzo was singled out in a number of interviews as the leading example of someone who could make a great deal of money ("\$800,000, probably four times what they pay him") in the private advice market. But the most recurrent comment was that "the incompetent ones can't leave". In particular, the less technically competent tax officers can succeed in the Tax Office, but not in the tax advice business. One partner of a major law firm even argued that "technically superior people are held down in the ATO". Other lawyers interviewed agreed that ATO promotion systems favoured management generalists over those who are technically excellent.

This perceived ATO technical incompetence was a recurrent theme in the interviews: "When the ATO loses what should be unlosable cases, it sends a message to the community", said one scheme promoter. The same promoter saw the ATO as "weak" and "lazy". In interviews in the tax office itself the same divide is apparent. There are those who see tax-technical competence as the skill a master practitioner of tax administration needs above all, and those who see compliance as a challenge that management generalists are best equipped to meet because litigation is only one compliance strategy and not the central one. The technical elite of the ATO are partially aligned with the private profession in gently ridiculing the technical incompetence of those who are not members of their club. And members of the club of elite administrators who are non-technical generalists sometimes gently admonish the technical elite and their acolytes as locked into a discredited old-guard audit mentality that would suggest that expensive

audits followed by expensive litigation are the most cost-effective way of improving compliance. Technical competence is considered further in Chapter 12.

How investors perceive enforcement risks

For enforcement to work, both taxpayers and tax professionals must see risks in breaking the law. Objectively, it seems a huge challenge for enough audits, enough prosecutions to be launched for these actors to perceive that they are at risk. It turns out, however, that perceptions of enforcement risks are more a resource than a challenge for the tax authority because the perceptions of such risks are often unrealistically high.

Murphy and Byng's (2002: 17) survey of 2301 investors in mass marketed schemes found that investors had surprisingly high perceptions of the risks of being detected and punished if they made an illegitimate \$5000 work deduction on their tax return. Perceived ATO deterrent threats were much higher among known scheme investors than among the general population of taxpayers. Whether or not these scheme investors were greater risk takers than most Australians before the event, after the event, once they had become known to the ATO as a tax scheme investor, they had highly exaggerated perceptions of the capability of the ATO to detect and punish tax illegality. No fewer than 42 per cent of the 2301 scheme investors thought there was a 100 per cent chance that the ATO would catch an illegitimate \$5000 work deduction and 61 per cent believed that it was 100 per cent certain that they would have to pay a fine as well as the tax owed and interest on that tax. Including these, 80 per cent saw the fine as 75 per cent certain or more. Only 42 per cent of the general population, compared to this 61 per cent of scheme investors, saw the fine as 100 per cent certain. Their experiences with the ATO also caused scheme investors to see "being taken to court" as slightly more likely to be a "large problem" than was the case for a random sample of taxpayers (Murphy and Byng, 2002: 18). Fear of being taken to court by the ATO is very high among the general population, but even higher among taxpayers who have in the past been detected as scheme investors. On these preliminary results, it seems that investors perceive enforcement risks as large and strategies of deterrence potentially powerful. Kristina Murphy will be undertaking a great deal of further research for the Centre for Tax System Integrity on perceptual deterrence and investment in tax planning schemes.

How professionals view their risks

Professional indemnity claims against accountants concerning tax advice are rare. The interviewees were asked about this risk factor but none spoke of professional liability claims in aggressive tax planning cases. The only professional liability claim described was a case involving outright fraud by advisers where the clients sued for good measure. Said one interviewee, "It's difficult to sue a tax adviser because in complex cases on the way up through the Federal Court and to the High Court there are going to be judges on both sides. So if judges can be wrong in the same way, where is the case?"

Promoters saw a written opinion from a respected barrister as protection against lawsuits: "They'd have to take all of us on". Such "offloading [of] risk"

creates a community of shared fate among a phalanx of professional risk takers that is hard for the individual client to take on. Conservative advisers do not think such opinions cover their professional liability at all. "You give your opinion on the law. Then you add a paragraph on what the Commissioner's attitude is likely to be." So the prudent adviser will say, "Here's what the rules say, here's the risk of Part IVA striking the shelter down and here's the risk that the Commissioner will attack it regardless of the reasonableness of these legal arguments. You as the investor must make your own commercial judgement." This is fine for sophisticated investors but a difficult game for an unsophisticated small investor. While promoters are not being sued by investors, at the time of writing, large numbers of investors are being sued by financiers for loans proffered to participate in the tax schemes of the 1990s.

For promoters who also sell finance to investors in their schemes, loan defaulting has been one risk that has adversely affected some promoters. With non-recourse loans mostly being driven out of the mass marketed scheme scene by ATO enforcement, the risk of investor default will loom larger for promoters in any future aggressive tax planning boom.

For reputable firms, as opposed to fly-by-night promoters, reputational risk resulting in loss of clients is the biggest risk in putting clients into aggressive positions. This is particularly so with corporate Australia. CEOs are concerned about their own reputations and will steer away from professional advisers who might tarnish it: "The CEOs want their Order of Australia. They want an honest image with the government and in the media for that."

The inventor of one of the most widely used employee benefit schemes said he made a mistake by going around the country speaking on the scheme at the behest of an investment bank that mass marketed it. The mistake, he said, was that the public nature of the promotional activity made him and his clients a target for ATO scrutiny, often unreasonably. The mass marketing also meant that he as the inventor of the scheme lost control of its integrity. He was also approached by a partner in a Big Five firm who said, "Tell me about this idea of yours." The inventor said, "I gave him everything (all the research) under a confidentiality agreement. This included opinions from [names of three QCs]." According to the inventor a group of solicitors and another Big Five firm put together a similar scheme, but in his view, they did not do their research properly. At a presentation given by the inventor on his idea, another promoter asked for the name of the QC who had given the opinion that the scheme worked. The inventor gave the name of one of the QCs to the promoter, who then went to the QC, "got the guts of it", and set up his own version "without getting the detail right". Such "bastardisation" is what creates avoidable heat from the ATO, according to this thrice-bitten-and-twice-shy scheme inventor.

Another product inventor told a similar story of the risks of associating with "cowboys" and the benefits of keeping lines of communication open to the ATO: "I will talk law with the ATO. It's in my interests to have a relationship with them to help them understand that I don't want cowboys to give me a bad name." He went on to explain how "cowboys" had taken his ideas and misused them, thereby putting heat on him. This heat included becoming a target for Nick Petroulias in the form of a demand for his client list, "when all I got was \$400 for one hour of legal advice that was then touted by a promoter".

One kind of heat is the auditing of their personal tax affairs. But promoters are variably at risk of this. One intriguing case was a promoter who openly claimed recurrent success in accomplishing a total tax wipe-out for some of his clients. Accomplishing this was a matter of professional pride; he would see himself as professionally negligent if he did not devise clever tax strategies that would get his clients out of paying all their taxes if that is what they said they wanted to accomplish and if they were willing to pay his (considerable) fees to accomplish it. However, he also said with pride, "I pay taxes". He said he did this because it is right to pay his fair share, even though he knew how he could structure his affairs to totally wipe out his tax liability. In sum, here we have a man whose identity as a leading-edge tax professional causes him to take pride in wiping out the tax liabilities of others. At the same time, his identity as a citizen, as an Australian who wants to pay his way, causes him to take pride in not doing that with his personal affairs. While it is common for promoters to be aggressive in avoiding their personal tax obligations, I suspect it is not uncommon for promoters to make the choice of this particular promoter. For some, the reason may have less to do with the politics/psychology of identity and more to do with being satisfied with a very high income that they do not want to jeopardise by making their personal affairs a target of ATO investigation.

Tax minimisation without an underlying commercial purpose can be a breach of the ethics codes of the major Australian professional accounting bodies. After the late 1970s wave of aggressive tax planning some accountants were thrown out of the Australian Society of Certified Practising Accountants under this provision. But the Society received no complaints from investors over the conduct of members during the 1990s boom. The Society is also thinking of introducing a new Financial Planners CPA designation, members of which would receive the benefits of a Society investment advice subscription that would weed out pure tax shelters devoid of investment substance. Complaints to the Tax Agents' Board by the ATO, of which there were 33 in 2002–3, seems to drive more of this professional regulation.

Australian innovation in regulating aggressive tax planning

There are important ways in which Australian regulation of aggressive tax planning is more innovative than US approaches, other ways in which it is less sophisticated and other respects still in which both Australian and US policies are less effective than they could be. Corporate tax collections in Australia have climbed substantially as a proportion of GDP over the past two decades even though tax rates have fallen. Referring to this, Australian Commissioner Michael Carmody, in evidence before the Senate Economic References Committee of 9 February 2000, said, “it is fair to conclude that this reflects, at least in some part, compliance improvement following from our strategies”. The ways in which this indeed might be fair relate to some shifts to a responsive regulatory strategy within a sophisticated web of controls that includes strategic use of Australia’s general anti-avoidance provision, the work of the ATO Promoters Taskforce, the High Wealth Individuals Taskforce and meta risk management strategies. Many of the elements described – especially responsive regulation, meta regulation and the work that targets promoters – can be conceived as strategies that flip markets in vice to markets in professional virtue, as discussed further in Part IV.

From “command and control” to “responsive regulation”

The introduction of income tax self-assessment in 1986 marked the beginning of a process toward what Ayres and Braithwaite (1992) call a “responsive regulatory strategy”; a process that gathered pace during the 1990s. Prior to 1986, the dominant strategy had been one of traditional “command and control”. Taxpayers lodged their returns; the ATO assessed them and decided how much tax was due. Audits were conducted to detect the provision of false information on returns, which, when detected, typically resulted in the imposition of modest penalties. The combination of low average penalties and very low probabilities of detection meant that effective deterrence was wildly implausible. By 1986, ATO assessment of returns “had degenerated to lip service in many ATO branches with assessors being asked to process 1000 individual returns in a standard seven hour, twenty-one minute day” (Dirkis and Payne-Mulcahy, 2002). In the same year, Grabosky and Braithwaite (1986) were highly critical of the lack of credibility of ATO enforcement. They concluded that the probability of detection in the few minutes devoted to an assessment and the minimal probability of an

audit were risible. The problem was not one of reluctance to resort to criminal prosecutions. In 1983, Grabosky and Braithwaite (1986: 162) found there were 102,345 prosecutions (the biggest categories being failure to lodge returns and sales tax breaches), making the ATO by far the most prosecutorial business regulatory agency in Australia. The sales tax prosecutions on their own accounted for more business prosecutions than any other of the 96 regulatory agencies in the study. But the average fine imposed in ATO criminal prosecutions was \$76! Braithwaite, Walker and Grabosky (1987) classified the ATO as a “token enforcer”, in their principal components and hierarchical clustering of 105 enforcement variables for 96 Australian business regulatory agencies. Grabosky and Braithwaite (1986) were critical of an ATO incapable of credible enforcement against promoters who were major criminals and others who were bleeding the revenue through what, at the time, seemed highly sophisticated avoidance schemes.

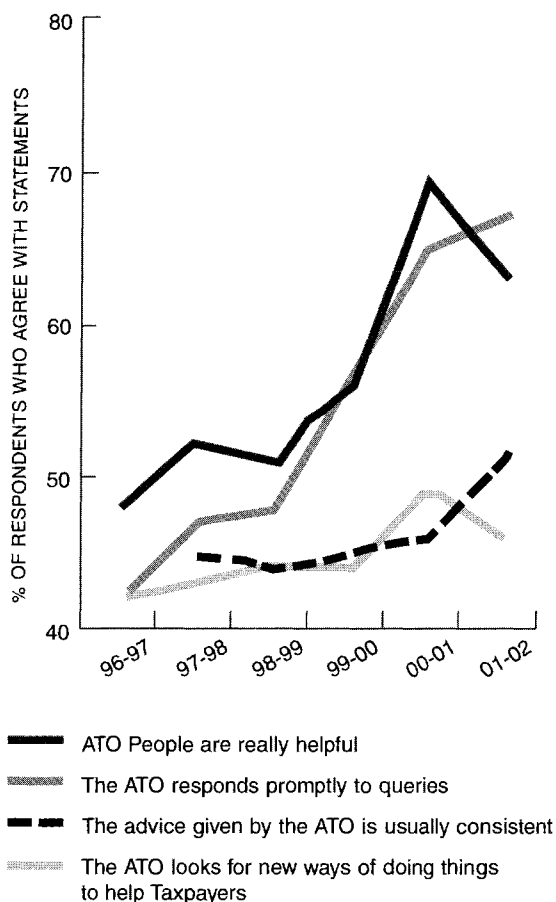
The transformation of tax enforcement policy in this period was politically painful for the then Commissioner, Trevor Boucher, who from the mid 1980s put more credible enforcement capability in place. Michael Carmody, his successor, built on these accomplishments in the 1990s (as discussed in Chapter 2). Both were much more forceful in attacking aggressive tax planning than Bill O’Reilly who had presided over the ATO until the early 1980s. There were more than 20 cases arising from the late-1970s schemes that were referred to the Director of Public Prosecutions and some promoters went to prison. Boucher suffered for turning tax enforcement around. Conservative leadership aspirant Bronwyn Bishop badgered Boucher in Senate hearings for allegedly hounding honest business people and ultimately, with the backing of the business community, drove him from office. Boucher was treated unjustly by the Australian people: first, in the early 1980s by critics such as myself for failing to tackle aggressive tax planning, then a decade later from the right for doing so. I apologise to him here for my minor role in this injustice: the results of this research are testimony to the fact that all along Boucher, Carmody and the new guard at the ATO were slowly, if imperfectly, transforming the organisation’s capability to confront the more complex risks to the revenue.

While Senator Bishop and business were successful in intimidating the Tax Office in the late 1980s once Bottom of the Harbour schemes had faded as a political issue, the ingredients of a more responsive strategy were already locked into place.

These were self-assessment, which passed to taxpayers the responsibility of establishing and stating their assessable income; a shift of resources from petty prosecutions to strengthen enforcement capability against aggressive tax planning at the big end of town; much heavier (though still inadequate) legal penalties; and enhanced investment in audits allowing for an increase from fewer than 30,000 audits a year throughout the 1970s to 125,479 in 1994–95 (Devos, 2002: 10). In the late 1990s, to emphasise that cooperative compliance was the approach with taxpayers who did not indulge in evasion or aggressive tax planning, a Taxpayers’ Charter was introduced to define a set of taxpayer rights to procedurally fair tax administration. By 2004, Commissioner Carmody was able to announce that in the past year, 81 people had been sentenced to prison terms for tax evasion. In 2003, a father and son were fined a record \$53 million for

tax evasion by their family business and in a separate court case ordered to repay \$9.2 million in evaded tax plus interest (Sydney Morning Herald, 28 June, 2003). Biennial surveys of 2000 citizens who have had contact with the ATO reveal improvements in confidence in the ATO during this period (see Figure 4).

Figure 4: Community perceptions of the ATO, 1996-2002



Note: since 2000-01, these results represent answers from respondents who had contact with the ATO, other than just submitting a tax return, in the previous year.

Source: Commissioner of Taxation, 2003: 60

The ATO Compliance Model

The key elements of responsive regulation (Ayres and Braithwaite, 1992) were already partially entrenched when the ATO decided to more deeply institutionalise responsive regulation in what became known as the ATO Compliance Model. These key elements were:

1. An enforcement pyramid;
2. Cooperative compliance with an investment in ensuring procedural justice at the base of this enforcement pyramid; and
3. A credible capacity to escalate up the pyramid to progressively more severe sanctions in the face of persistently aggressive non-compliance.

Many business regulatory agencies around the world moved in the direction of responsive regulation late in the 20th century. In tax administration, Australia, followed by New Zealand, were first movers to more systematically adopt this approach.

The ATO Compliance Model was an outcome of its Cash Economy Taskforce. Valerie Braithwaite was a leading member of the Taskforce from 1997 and persuaded the Commissioner to fund a Centre for Tax System Integrity in 1998 at the Australian National University to evaluate the rollout of the Compliance Model. This book is part of the work of that Centre. The Taskforce itself incorporated the responsive regulatory principle of “tripartism”, with NGO representation, notably that of the Australian Council of Social Service representing the poor, as well as representation from business and the accounting profession. This principle was also embedded as point (b) in the four-pronged model.

The four prongs of the ATO Compliance Model are:

- (a) Understanding taxpayer behaviour;
- (b) Building community partnerships;
- (c) Increased flexibility in ATO operations to encourage and support compliance; and
- (d) More and escalating regulatory options to enforce compliance.

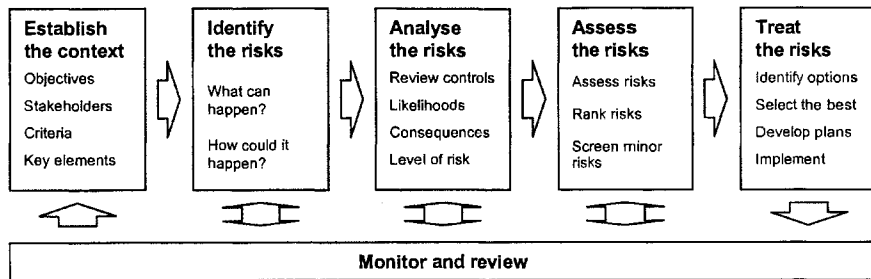
(a) Understanding taxpayer behaviour

The first prong of the ATO Compliance Model, understanding taxpayer behaviour, has been predominantly approached by the ATO under the rubric of risk management. The shift of the Tax Office from an “operations manual” culture to a “risk management” culture has been profound. Such large cultural changes are difficult to achieve in an organisation with 22,000 employees.

Australian Standard 4360 identifies the stages in risk management in the Figure 5, below.

The ATO generally has done a good job of the first four stages of this process – “Establish the context”, “Identify the risks”, “Analyse the risks”, “Assess the risks”), particularly at a strategic and organisational level. It 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 completing the stages “Establishing the context”, “Identifying the risks” and “Analysing the risks”, the

Figure 5: Stages of risk management



Source: Grey and Cooper, 1998

ATO has the advantage of being one of the most knowledge-rich organisations in Australia. This is because the ATO takes research seriously. The ATO is so knowledge rich that while there are gaps in its knowledge that need to be filled, the greater need is for knowledge coaches to help people find and synthesise the knowledge required to solve a particular problem. The ATO is taking up the challenge to develop the hard and soft networks necessary for knowledge coaches in their mentoring. These are promising and appropriate management responses to improve the wiring that allows information to flow through the first four stages of risk analysis.

The problem is that while ATO staff are increasingly on top of risk analysis and assessment, mostly they do not operate to treat those risks. If you ask an industry segment of the ATO whether they have assessed and ranked risks, they will pull out a document that shows where they have done that. But if you ask fieldwork or management staff to tell you how they have treated each of those risks, only some will enthuse with their triumphs. The Centre for Tax System Integrity has had only limited success (but see Wenzel and Taylor, 2004; Wenzel; 2002) in persuading the ATO to become more evidence based in its tax administration, for example, via randomised controlled trials of risk treatment where files are randomly assigned to one risk treatment versus another. Risk leveraging is a creative activity, requiring creative staff. It is a bad idea to provide a formula for how to do it because advisers soon learn that formula. Continuous reinvention of risk treatment would keep them guessing and therefore complying.

Creating a culture of continuous reinvention of risk treatment would require taking storytelling more seriously within the ATO. The ATO has already decisively moved away from being a business run according to a procedures manual. At the level of informal staff interaction, ATO culture is no longer a rule-book – it is more a storybook (see Shearing and Ericson, 1991). In contrast, some staff see ATO management culture 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 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.” Nonetheless, the suggested means for taking storytelling more seriously, in order

to move the ATO 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:

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 and Bromiley, 1998: 42)

There are two interconnected staff morale rationales for considering a storytelling culture. One is to address the issue that staff grapple with many models that are often presented to them abstractly rather than as stories. The second is to address the fact that there is the feeling that the aggressive tax planners are winning. Hence, a framework for telling stories of success that bring to life models, such as the ATO Risk Management Model, is needed. Few parts of the Tax Office conduct regular informal workshops that give staff a platform to share their latest success stories. "Heroes" of risk treatment success stories are mostly not noticed in a way that percolates into their performance reviews.

(b) Building community partnerships

Building community partnerships, the second element of the ATO Compliance Model, has been implemented by the ATO at the level of partnership with the accounting and legal professions and the business community. Partnerships with other elements of civil society have been less vigorously pursued. As a result, the tripartism of business, government and community required by responsive regulation is often effectively a bipartism of business and their professional advisers on one side and the ATO on the other. Yuri Grbich, for example, has attacked the ATO for responsiveness to "business clients" in its rulings in ways that have compromised the integrity of the tax system, left it vulnerable to "special pleading by interest groups" and indeed to "temptations to be corrupted" (2001: 12). For Grbich, "better understanding business" and "community partnerships" in the Compliance Model at times become "code for showing a more compliant attitude to the views of the regulated and putting less emphasis on protecting the revenue base" (2001: 23). He illustrates this argument with private rulings that have surrendered to what he believes to be aggressive tax planning. For Grbich, the point to be taken from the allegations of corruption against Nick Petroulias over rulings he granted is not whether impropriety is actually established, but "that this individual exercised such very large unchecked power" (2001: 23). He sees an ATO "putting a torch to the belly of strong, independent officers who stand up to aggressive tax planners, but which exacts much less accountability when they concede large chunks of tax" (2001: 12).

Too many private rulings are given away because this is the path of least resistance. The loyalty, commitment and sense of self-worth of under qualified officers (certainly their main fear of negative feedback) centres on "clients" rather than their "employer". The problem is not *insensitivity* to business but a

desperate and misguided desire to *please* those whom they are supposed to be regulating. They have an exaggerated respect for partners in leading law and accounting firms, who, after all, are only doing their job of giving the best spin on the rules for their clients. This indicates a failure to create, preserve and reinforce commitment to core organisation values. This insecurity is a symptom of a lack of adequate tax-technical expertise and a neglect of the corporate culture (Grbich, 2001: 24).

One remedy is, as will be discussed in Chapter 12, to invest in that underlying need to strengthen tax-technical expertise. Another is, as emphasised in the last section, reform of the storytelling culture of the organisation to one that makes heroes of those who do not shirk from taking on risks to the revenue. A third, as the Australian National Audit Office (2001) has also concluded, is improved accountability checks on the exercise of discretion to issue private rulings. But a missing ingredient (argued further in Chapter 14) is oversight of the whole process and selected controversial cases by an assertive social movement politics. Grbich's warning is well taken. In the absence of more serious investment in these four counterbalances, "community partnerships" is an element of the compliance model fraught with as much risk of industry capture and even corruption as it is with the benefit of a more efficient and cooperative culture of compliance.

(c) Increased flexibility in ATO operations to encourage and support compliance

Flexibility in delivering on compliance

"Increased flexibility in ATO operations to encourage and support compliance", means, in part, a capacity to provide input to government for flexible adjustment of tax law (considered in detail in Chapter 10). The Compliance Model illustrates this prong and the value of flexibility by showing that there are many ways of delivering on compliance and the objectives of the Taxpayers' Charter. Institutionalising a storytelling culture is one way of fostering flexibility. It is likely that the success stories that grab people's interest will be stories of innovation – of more flexible response than has been attempted in the past. The development of an intelligence capability is the eyes and ears for seizing opportunities to more flexibly respond to compliance challenges. The Key Client Manager initiative, which dedicated an officer to smoothing all interactions with the ATO by very large corporate taxpayers, is a most important way of showing major customers that whatever the problem, the ATO can solve it without giving people the bureaucratic run-around.

Taking problems to international forums

A growing source of flexibility in the ATO's approach to compliance is to take problems to international forums. Advance Pricing Agreements (APAs) are one approach to locking in higher tax receipts from transnational corporations. APAs are negotiated arrangements between the ATO 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. This approach has been enabled by Australian leadership at

the OECD towards settling an international framework for the negotiation of APAs (Killaly, 1996). Negotiating APAs is painstaking work, but because they lock in higher returns than audits and because they shift the rules of the game to more cooperative relationships with business, the investment is well justified (see further the discussion below in the section on meta risk management). On the other hand, the ATO needs to monitor the cost of keeping APAs up-to-date in the face of company, product and time-specific changes, which make the parameters of the APA obsolete.

Initially, there was concern that only “squeaky clean” companies would ask for APAs, hence skewing ATO activity to areas of low risk. And indeed, initially, companies were reluctant to enter into APA negotiations because they feared revealing tax liabilities going back over many years. However, since their introduction in the 1990s, APAs have become widely used.

Encouraging leadership at all levels

The real power to increase flexibility does not lie with senior managers so much as with fieldworkers. It is they who deal daily with the promoters and investors. Accordingly, fieldworkers must be the key risk identifiers. Their performance reviews should give higher priority to evidence of identifying wider risks in the course of their fieldwork, documenting them and following through to ensure that the risks are analysed and treated. In the view of some, this follow-through is not their job; rather their job is to report the risks they identify to their immediate boss so that management can take care of it. This common response indicates the ATO needs to encourage 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 the Significant Issues process in the ATO’s national office. In such circumstances, the fieldworker could participate in the discussion on what could be done to treat the risk and “test pilot” the treatment, eventually reporting back whether the treatment is working on the identified risk. Better still, the fieldworker might recruit one of their clients to be an external test pilot as well, and also participate in the discussion in national office concerning the problem the fieldworker has decided to own.

If tax professionals at all levels of the ATO are encouraged to be leaders, to own risks with a commitment to follow through all the stages of risk management, loophole-closing will improve. Most critically, law reform will respond faster, and fieldworker morale will improve from the current situation in which some sit on their hands and grumble about management dropping the ball. The ATO 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.

Flexible dispute resolution

More flexible dispute resolution can improve compliance considerably. There is now substantial evidence that when people and companies believe they have experienced fair procedures, they are more likely to comply with the law (Lind and Tyler, 1988; Tyler, 1990; Tyler and Blader, 2000; Tyler and Dawes, 1993; Tyler

and Huo, 2002). Tax fieldwork can be adversarial. Procrastination is a frequent alternative to the resolution of disputes and delaying tactics, such as manipulating the administrative privilege of accountants, making Freedom of Information requests, initiating administrative law hearings, holding back on assistance with providing requested records, providing only parts of the information requested, and failing to attend meetings, are common. Good ATO practice is to refuse to tolerate failure by either party to resolve disputes. Otherwise the agency hands victory to the people who practice “defer, delay, defeat” tactics. Head butting 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, 2002). 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 area of the ATO is one that already follows this 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 accomplishes no reconciliation.

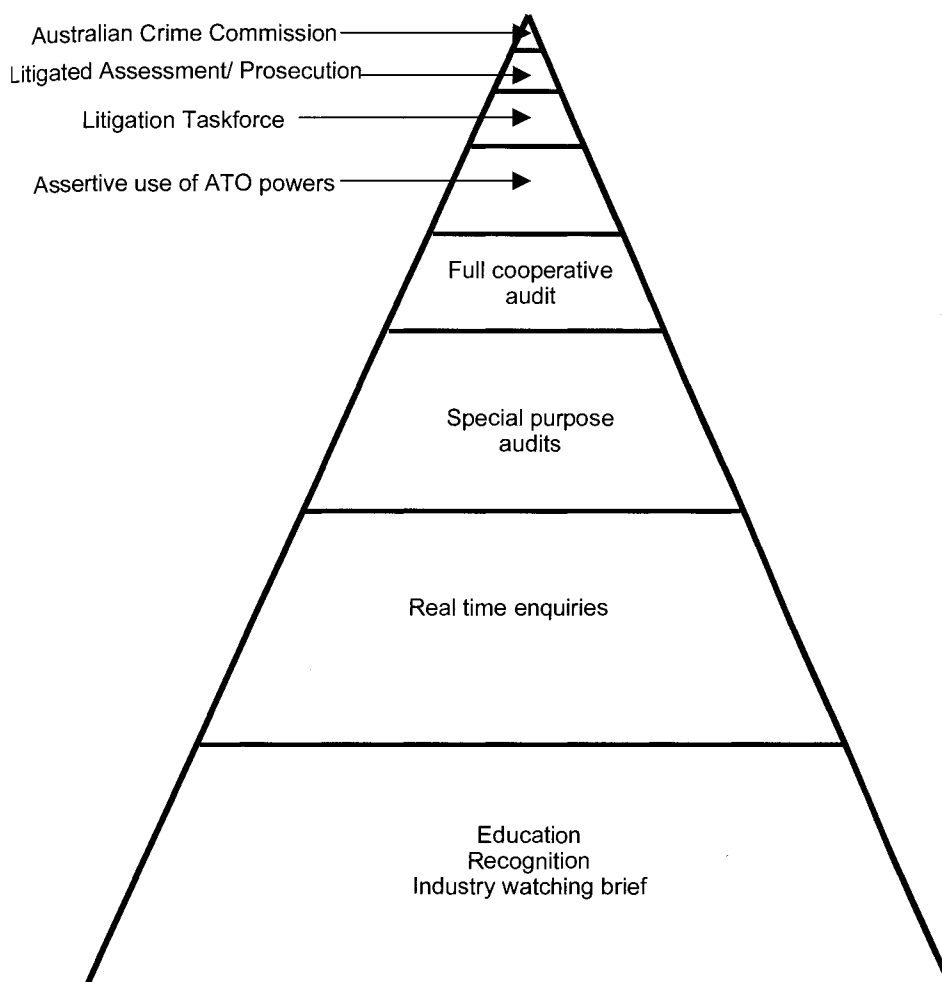
The rationale for this path to flexible dispute resolution is that businesses are full of many adversarial people and many cooperative people. The trick is to move up the organisation’s layers, past any adversarial managers, until reaching a cooperative manager who insists that the matter be settled rather than take up more of everyone’s time. Actually, the grounds for optimism that this approach 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 ATO officer has the ability to treat clients with a respect that persuades even the most combative 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 and 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 an organisation in order to 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 arbitration or litigation, or leaving the problem to fester. Slowly, only slowly, these restorative justice philosophies are beginning to percolate through the ATO in the rollout of the third prong of the Compliance Model.

(d) More and escalating regulatory options to enforce compliance

In recent years, the ATO has moved further to implement the recommendation of the ATO Compliance Model for more and escalating regulatory options to enforce compliance. Following the external evaluation of the Large Case

Program¹ by Pappas, Carter, Evans and Koop (1992), the ATO moved from full audit as a more or less standard single compliance product to a suite of audit products: roll-over audits, pre-lodgement 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 provide greater choice and flexibility to better target risk treatments; and taxpayers subject to enforcement can experience varying types of fieldwork contacts, 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. Figure 6 is one example of a large business enforcement pyramid using these kinds of products from Braithwaite and Wirth (2002).

Figure 6: One illustration of a large business compliance pyramid



¹ 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.

Many ATO staff still have only a limited understanding that responsive regulation means that there is no single, ATO-wide or segment-wide correct enforcement pyramid (see Hobson, 2003). Or that it means they, with their colleagues, must creatively design their own enforcement pyramids to deal with the particular compliance problems that are their responsibility; that they must secure the backing of their superiors to move up that pyramid when escalation is recommended and refine their pyramids when escalation and de-escalation fail. Pyramid design workshops sometimes happen in local areas of the ATO, but are hardly a routine part of organisational life.

The Promoters Taskforce

Chapter 4 showed that aggressive tax planning is significantly supply driven. The Promoters Taskforce is successor to the Tax Planners Project of the late 1990s, and is an ATO initiative to target promoters as drivers of aggressive tax planning. The Taskforce maintains a list of “high risk” promoters and develops a compliance plan for each one. It seeks to promote a whole of government approach to promoters, some of whom are also enforcement targets for other government agencies. An early key insight of the Tax Planners Project was that the professional advisers of investors in aggressive tax planning schemes were often found to have dubious personal tax affairs themselves. Though, as stated in Chapter 3, this is not true of them all by any means. The next insight is that there is opportunity to confront risk by attacking the tax returns of these advisers. That is, if you prick the balloon of their personal aggressive tax plan, their clients might meekly follow into compliance. On the other hand, fumbling the personal affairs of key promoters could leverage risk in the wrong direction. For example, a settlement on the personal tax of a promoter that is too generous or fails to grasp the full financial scope of the transactions might cascade to giveaway settlements to all his clients.

A third insight is that promoters may be ruthless, but they are also amenable to compromise and respond to warning shots at the base of an enforcement pyramid. The Promoters Taskforce targets not only the tax planners but also their associates, families, controlled entities and networks. This is relevant because a promoter who might play hardball with his own affairs might want to keep his mother out of conflict. Moreover, as one promoter said: “Even if you are going to win, it is sometimes not a good commercial proposition to fight the ATO. And in a tax case there is always uncertainty. It’s complex and a lot depends on whether all of the facts come out in the trial and who the judge is.” One accounting firm partner also made the point that there can be a payoff in a shot-across-the-bows of a promoter at the base of the pyramid: “Even saying ‘Can I come and have a cup of coffee’ to a promoter keeps pressure on them.” This practitioner was one of a number who were supportive of Petroulias’s intelligence-led enforcement strategy in principle, while disapproving of his practice: “Petroulias did a good thing by going to [two Big Five firms] to talk about their share schemes. It was a shot-across-their-bow. They knew they were being watched ... they bully you by threatening your client base. This causes a lot to fold and settle.”

On an enforcement pyramid directed at tax planners, the first step might be for the ATO to ask for lists of clients. Escalation up the pyramid to the next step might take the form of the ATO approaching people on such lists. "This makes clients very nervous", one promoter explained. In one case in 2001, the ATO made early contact with 300 investors involving deductions of \$45 million to advise them that the ATO took a dim view of the scheme before they lodged their tax return. While this is costly enforcement work, a lot of money is at stake. It is also cheaper than managing subsequent litigation and political fall-out of the kind that made the ATO an election issue in Kalgoorlie in 2001. Some promoters worried a lot about this tactic: "The ATO has enormous powers and they abuse them. They don't attack your firm; they attack your client base." Another adviser suggested that a move away from self-assessment with taxpayers who have been involved heavily in aggressive tax planning may have merit, "or a one-day meeting pre-lodgement to go through the return – no one wants that".

Audits are a next step up the regulatory pyramid. Most of my 2001 informants felt the risk of audit had diminished substantially since the mid 1990s, though some felt that there were plenty of audits at the big end of town and in some ways these were biting harder. Nevertheless, instances were described in which Big Five accounting firms were asked by major clients not to give written advice on whether a course of action might or might not be legal because the client was going to "risk it" in an environment in which they perceived "the tax audit program had fallen in a hole" and the prospects of detection were quite low. One suburban accountant said that clients would say they had been in business for 35 years and never seen the ATO and nor had any of their friends. None of this accountant's 400 clients had been audited since 1986, and only one or two of his clients had had a tax review of any type (short of audit) since then. His view was that "The lack of presence of the ATO assists schemes to take off". At the end of 2002, the ATO launched a substantial reinvestment in increased audit activity with much media fanfare, partly because it became aware of how widespread such perceptions were.

A next step up an enforcement pyramid might be to target the tax returns of tax planners themselves. In general, tax planners said they "do not want to be named" in any enforcement action, and such escalation concerns them. The publicity in recent years surrounding the tax affairs of barristers (discussed further in Chapter 13) had quite an effect on a number of advisers. These advisers were terrified at the prospect of anything like what happened to some of the bankrupt barristers overwhelming them. It affected clients as well. A suburban accountant said he put it to his small business clients at times: "The press is out there if you get caught ... clients don't want to see their name appear anywhere." He said the fear of adverse publicity steered a number of his clients away from the 1990s schemes.

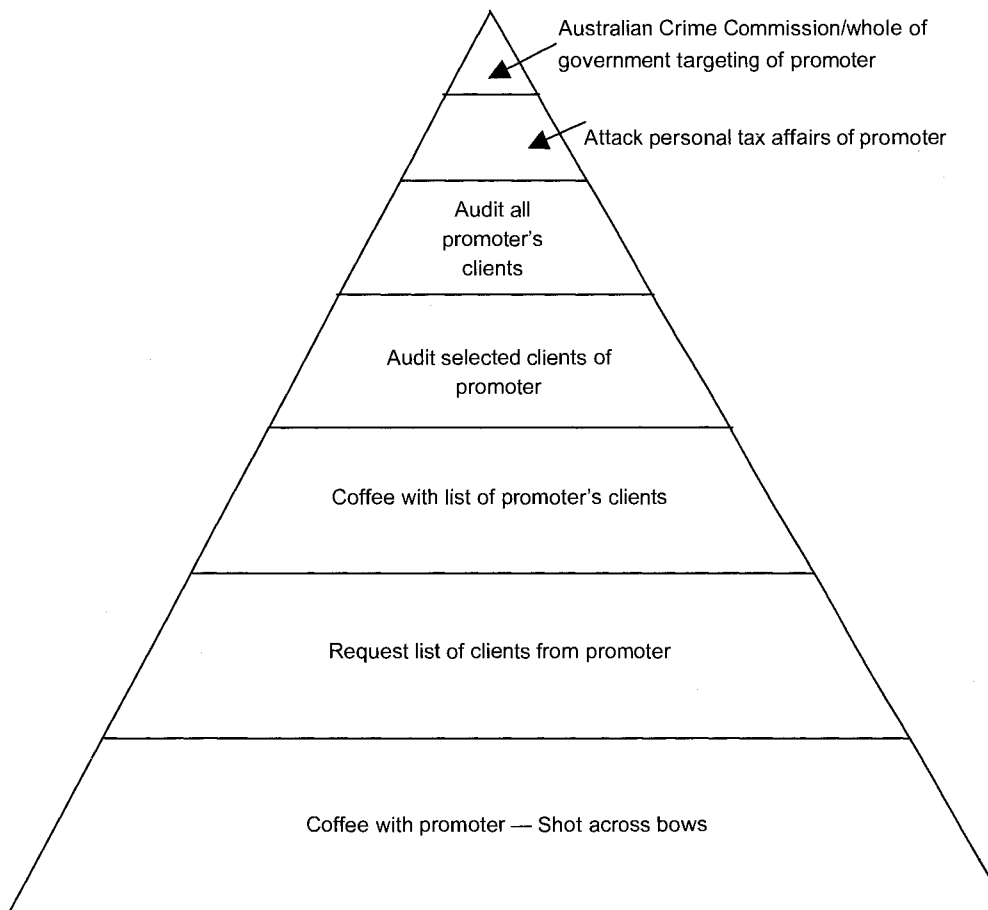
But there were exceptions. One informant said his notoriety in being named in the financial press as one of Australia's leading promoters, even in one case as the "number one promoter", had delivered new clients to his door. This promoter commented: "After that, I wouldn't go to [mentions his own name]. There'd be too much heat." But actually, he said, the negative publicity brought him new clients. There is a market niche for clients with a taste for risk; adverse publicity, up to a point, can help cultivate that niche. Of course, that is the point

of the responsiveness of the regulatory pyramid – when a strategy backfires or can be foreseen as likely to do so, then jump to the next level of the pyramid.

At the peak of the Promoters Taskforce enforcement pyramid is a joint investigation with the Australian Crime Commission, an option particularly likely in cases where international tax avoidance schemes raise wider issues of money laundering (see Figure 7). Other enforcement agencies might also be drawn into a whole of government attack on the affairs of a white-collar criminal who dabbles in a variety of forms of illegality.

The Promoters Taskforce is working on incorporating a variety of other options into its enforcement armoury such as promoter penalties (an intention to introduce them in 2005 was announced). The Promoters Taskforce is concerned with prevention as well as enforcement. For example, it is developing a co-regulatory approach to the registration of tax professionals, where endorsed professional bodies are first given an opportunity to educate and enforce ethical standards, but where the ATO steps in with public enforcement options – perhaps statutory injunctions, show-cause notices, enforceable undertakings and negative licensing – when professional self-regulation fails.

Figure 7: One way of viewing the evolving Promoters Taskforce Pyramid



Crafting specific enforcement pyramids for specific schemes

The Commissioner and his most senior people think responsively about how to attack specific schemes that pose a looming threat to the revenue. One lawyer involved with tax schemes said that a feature of the ATO's enforcement pyramid these days is its willingness to go to the High Court. His view was that it used to be "last call" for the ATO at the full Federal Court but that now the Commissioner had signalled a clear willingness to go to the High Court. This increases both costs and publicity in taking on the Commissioner, risks he said which did not deter a Kerry Packer (Australia's richest person) but did deter others: "Regardless of the merits, [small and medium business] clients don't thank you if you get them into a fight with the ATO. It's the fear of big brother."

Press releases

At the base of many enforcement pyramids to attack specific shelters is a press release. When ATO intelligence leads the Commissioner to the conclusion that a form of aggressive tax planning is not legal and an emerging threat to the revenue, the normal response is *not* to look for a case to test it in the courts but for the Commissioner to move more quickly by issuing a press release. The press release will announce an ATO view that the scheme is illegal, that the Commissioner intends to attack it in the courts if necessary and advise investors to be cautious about recommendations to enter the scheme. These announcements tend to be widely covered in the print media, especially in the financial press. A common observation in the practitioner interviews was that "Nine out of ten" taxpayers, and often all of them, will pull out of any tax shelter that the Commissioner says he disapproves of in a press release. A number of my informants felt the ATO under-utilised or was too slow to use this power: "The ATO sits on things it could kill off" (Adviser to High-Wealth Individuals). Other informants complained of the abuse of the enormous power the Commissioner holds in this respect. For example, several advisers felt Macquarie Bank Equity Linked Bonds were probably legal. One claimed "the Commissioner's own people told him they are legal". But in spite of this he claimed the Commissioner put out a press release denouncing the bonds. This may have protected the revenue by causing nine out of ten taxpayers to abandon the product, but it "made Australia look stupid to international investors". The stupidity at issue, this adviser alleged, was not having a reliable rule of law.

Other promoters felt that the Commissioner's approach to press releases used to be different. It had been that when a loophole was discovered that was causing an acute loss of revenue, the Commissioner would announce: "We're going to change the law". Since May 1999, one adviser alleged rather provocatively that there had been a change to press releases that in effect said: "This is not on. There will be legal changes. And by the way we're not going to accept existing returns with this arrangement." While this is an exaggerated account of a more subtle shift, a shift in this direction there has been; grounded in the Commissioner's belief that Part IVA (the general anti-avoidance provision) can be relied upon more than in the past to attack the arrangements that are the subject of such alleged announcements.

The introduction of taxpayer alerts in 2001 refined this pyramid by enabling the Commissioner to precipitate earlier movement out of a particular scheme by announcing his doubts about its legality, to be resolved by an investigation over the ensuing months. At the time of interview, most informants had not yet had any experience of taxpayer alerts to comment on, though there was a lot of in principle support for this earlier warning of risk.

Press releases are a valuable tool because aggressive tax planning creates an enforcement-swamping problem for the regulator. In the late-1990s boom the ATO had almost a hundred thousand moderately complex aggressive tax planning cases to deal with, about twice the number they had to deal with in the late-1970s boom. Full investigation and consistent enforcement in the courts is not an option a regulator can afford in such circumstances. An analogy is the enforcement-swamping problem of open-air drug markets in many of the world's largest cities. Ordinary citizens are often puzzled as to why the police don't just shut them down. The answer is that there are hundreds of drug trades each day in these locations and only a few police available to patrol a particular locale at any point in time; indeed at most points in time there will be only one or none. So a solitary police officer who arrests the first person she sees make a sale at an open air drug market then spends the next few hours back at the station – processing the arrest, filling out paperwork, notifying the offender's lawyer, and so on. Meanwhile everyone else at the drug market proceeds with their sales free of police harassment. Some police are of the view that they accomplish more by exercising discretion, turning a blind eye to normal trades in order to maintain a presence in the drug market so that they can warn off dealers from selling to children, calm any outbreaks of violence, protect ordinary citizens from harassment, and so on. But there is an alternative. It is for a police commissioner to make an announcement and distribute leaflets in the drug market stating that: "This market will be shut down from 9 am next Tuesday. Any person selling drugs after that time will be prosecuted." Then the enforcement-swamping problem becomes more tractable. A viable number of police must be deployed at 9 am Tuesday to arrest the first person to trade, and any subsequent traders until the market shuts down. Very often it is not necessary to arrest anyone because come 9 am no one is there volunteering to be the first to be arrested.

An announcement by a tax commissioner can have a similar effect. There are not the resources to litigate the tax affairs of every person who has entered a tax shelter. But there are the resources to attack the much smaller number who enter a particular shelter after a taxpayer alert or other announcement in respect of the shelter. Indeed, such an announcement can include an implied warning that if you are the first entrant to be detected after the announcement and have knowledge of the announcement, the book may be thrown at you. Again the ATO cannot afford to throw the book at the hundreds who would want to continue to enter the shelter after the announcement, but it can afford to do so with the first taxpayer it catches entering the shelter after the announcement. And because no one wants to be that first person, those hundreds may stay right away from the shelter. All those who entered the shelter prior to the announcement may be offered an only moderately onerous settlement. For them too, the Commissioner sometimes announces a date by which the settlement offer must be accepted.

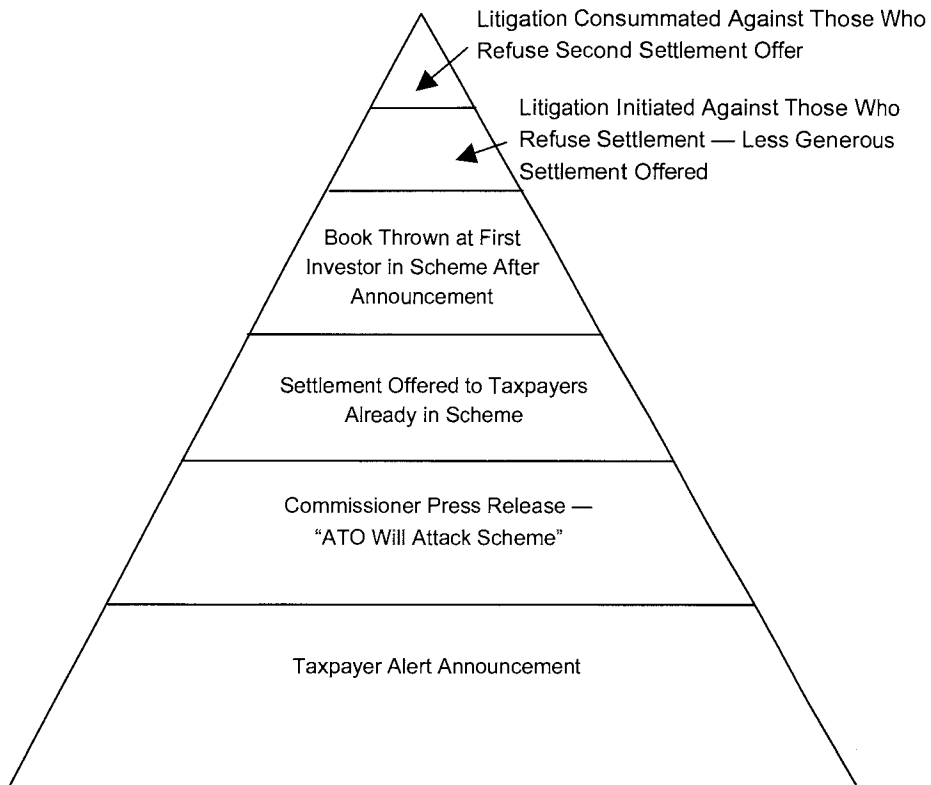


Figure 8: A specific-scheme pyramid crafted to cope with an enforcement-swamping problem

Then enforcement to the full extent of the law can be directed against those who do not settle (see the example of a pyramid for a specific scheme in Figure 8).

Settlements

At the time of writing, some 41,000 taxpayers had been offered settlements over their participation in late-1990s schemes, of whom 36,600 had accepted the settlement by the offer deadline. Like a well-pitched press release, a well-pitched settlement offer can solve an enforcement-swamping problem by clearing 90 per cent of cases.

Some advisers interviewed were critical of ATO settlements. One said: "Settlements where you surrender your rights are offending people". Even so, this promoter, like others, conceded this is what he would do if he were the Commissioner: "You settle 80-90 per cent, even if you lose 10 per cent in court, you still have the revenue from the settlements". These advisers reported that many of their clients felt that a taxpayer was "blackmailed" in circumstances where the ATO used its superior resources to drive for settlement with a taxpayer who did not have the resources to fight a legal battle. At the big end of town, settlements often do get results from a kind of blackmail: "Bank A settles

with the ATO because it is worried about the ATO finding out about something nearby that might come out in litigation. The ATO goes to bank B and says we forced A to settle and so we will to you."

The High Wealth Individuals Taskforce

The High Wealth Individuals Taskforce was established in 1996. The objective was to enhance compliance management strategy for high-wealth individuals. In the first year of operation, 180 high-wealth individuals received a questionnaire about the groups of entities they controlled or from which they received income. In subsequent years the questionnaire process was formalised by conversion of the questionnaire into an expanded tax return. This strategy has now been taken up by the Promoters Taskforce, which, in 2003, required 90 promoter-controlled entities to lodge early and expanded returns. In 1997 and 1998, 142 and 143 high-wealth individuals completed expanded returns for 2371 and 2599 associated companies, trusts, partnerships or individuals respectively. Most of these high-wealth individuals have had at least some of their entities audited by the Taskforce. By 2004, the Taskforce had targeted 700 high-wealth individuals and 17,000 entities associated with them.

All of these high-wealth individuals have eight-to-ten figure wealth and many of them pay no or little tax. One adviser interviewed advised a high-wealth individual who, the adviser asserted, had paid no tax since 1987. As far back as the 1993 financial year, 80 individuals each with a net worth of over \$30 million had been identified by the ATO as reporting taxable incomes of \$20,000 or less (Joint Committee of Public Accounts and Audit, 2001: 74). High-wealth individuals are clearly a special risk group who have an enlarged incentive to invest in aggressive tax planning advice.

The innovation of the Australian High Wealth Individuals Taskforce was to examine the affairs of high-wealth individuals holistically. Rather than assessing a high-wealth individual's personal return and the returns of the various companies and trusts in their control as separate returns, the ATO assessed the tax risk over the totality of entities controlled by the high-wealth individual (often numbering in the hundreds). The insight is that the high-wealth individual is the strategic decision maker for all of these entities and therefore it is a fruitful strategy to focus enforcement attention on that individual. Furthermore the objective has been to come up with risk-treatment strategies attuned to an holistic understanding of the sets of entities controlled by single high-wealth individuals. In this regard, the Taskforce has also provided advice to government on:

- Abolition of research and development (R and D) syndication arrangements;
- Deductions claimed for intellectual property schemes;
- Trust losses;
- Private company dividends disguised as loans;
- Misuse of charitable trusts;
- Franking credit trading and dividend streaming;
- Taxation of foreign source income; and
- Denial of artificially created capital losses.

In an analysis of the work of the Taskforce, Braithwaite (2003) concluded that this work has been a successful and internationally distinctive risk-leveraging strategy. One important basis for this conclusion was the way the tax paid by entities controlled by high-wealth individuals had increased substantially since the Taskforce was established compared to entities not controlled by high-wealth individuals. Expanded returns decreased the degree of freedom of high-wealth individuals for aggressive tax planning. Hence the biggest impact of the Taskforce was preventive rather than retrospectively collecting more revenue. The Auditor-General concluded the average tax paid by the high-wealth individuals targeted by the Taskforce increased by 36 per cent between 1995 and 1998 and tax paid by groups of entities associated with high-wealth individuals increased by nearly 49 per cent (Joint Committee of Public Accounts and Audit, 2001: 88). In its 2000 Annual Report, the ATO reported a \$927 million reduction in losses claimed by targeted high-wealth individuals between 1997 and 2000. Even though these preventive effects were the more important fiscally, the ATO's 2001 Annual Report indicated that new audits of 25 high-wealth individuals had resulted in a \$341 million increase in the tax payable, of which \$188 million was in dispute. Putting aside the work of the Taskforce on structural reform and indirect prevention, these direct audit results repaid many times over the budgetary investment of under \$10 million in this group.

Meta risk management

The term "meta risk management" means the risk management of risk management. Drawing together a number of longstanding themes in the regulation literature with more recent writing on neo-liberal governmentality, Peter Grabosky (1995) developed the theme of meta regulation, which he called "meta-monitoring". Essentially, this is government monitoring of others' self-monitoring. He further elaborated on these ideas with Neil Gunningham (1998) in *Smart Regulation: Designing Environmental Policy*. The most sustained development of this approach is in Christine Parker's (2002) *The Open Corporation: Self-Regulation and Corporate Citizenship*. The penultimate chapter of that book is entitled "Meta-Regulation: The Regulation of Self-Regulation". Parker jointly explores notions of meta regulation and meta evaluation – the evaluation of corporations' self-evaluations of their compliance systems. A somewhat different version of meta regulation, that of the monitoring of the activities of one part of the state by another, has been developed by Bronwen Morgan (2002). The ATO has begun to give these ideas more of a risk-management orientation and one specifically attuned to tax administration.

According to Ulrich Beck's (1992) influential book, *Risk Society: Towards a New Modernity*, societies have become more reflexive about risk. The ATO's Risk Management System (see Figure 5 above) can be seen as an example of Beck's risk modernity; it is tax administration reflexively remaking tax administration in a risk paradigm. Until the late 1990s, the ATO Risk Management System had been largely a rather conventional case of a regulatory organisation getting more analytic about the risks the organisation must confront. A further step toward a reflexive risk paradigm has been for the ATO to monitor and seek to remake the risk management systems of the organisations it regulates. This is a move from

the ATO developing its own internal Risk Management System to influencing the risk management systems of other important organisations in its risk environment.

One of the earliest shifts of this kind was in nuclear safety regulation after the near meltdown at Three Mile Island in 1979 (Rees, 1994). One cause of the accident was that nuclear power plant operators had become rule-following automatons rather than strategic thinkers about risk management systems. When something went wrong that was not covered by a rule, operators lacked the systemic wisdom, the risk analysis intelligence, to think systemically about what needed to be done. So nuclear regulation changed from a paradigm of government inspectors checking compliance with rules to a new paradigm of which an important part became regulatory scrutiny of risk management systems and reintegrative shaming within the nuclear professional community of companies that failed to improve those systems. Within a decade safety related automatic shutdowns of nuclear plants (known as SCRAMS) fell from an average of seven per unit per year to less than one per unit per year in the US and then in the next decade fell to 0.1 per unit per year (Braithwaite and Drahos, 2000: 302).

Another important shift of this type occurred following the 1988 Piper Alpha disaster, in which 165 workers lost their lives when a North Sea offshore oil rig overturned. Following the recommendations of Lord Cullen's Report on the disaster, regulation of offshore oil and gas production worldwide became based on the rig operator developing a "safety case" (a safety management system) that it submitted to the national regulator for analysis and approval (Cullen, 1990). Instead of government inspectors directly enforcing rules, they moved to a system of checking that the operator was both self-enforcing its safety management system and continuously improving it. Ulrich Beck (1992: 232) discusses this kind of feature of the "risk society" as "externally monitored self-coordination".

The most recent debate about this regulatory paradigm shift occurred after the Asian financial "meltdown" of 1997–98. The 20th-century approach to assuring that banks did not collapse was to insist that a bank maintained a certain ratio of loans to gold in its vaults, in order to ensure the bank had enough capital to withstand a run on the bank or non-repayment of loans. Over time the required capital ratios became more complex. For example, in the calculation of such ratios, the bonds of an OECD government counted for more than bonds in a private company. But in a crisis these capital adequacy ratios did not always make sense. For example, in the midst of the Asian meltdown, were General Electric or Microsoft bonds really less secure than bonds with the government of OECD member nation South Korea? Many experts began to believe it would be better to require banks to disclose to national and international regulators details of their risk management systems and their risk according to those systems. Moreover, experts suggested that regulators should test these systems by seeking proof that they could cope with major shocks. For example, the regulator might instruct: "Run your risk-management software and show me what will happen if there is a 40 per cent fall in the value of the yen at midnight tonight". While the complexity and volatility of financial risk in a world of derivatives and rapidly fluctuating currency markets would seem to make this regulatory paradigm shift vital, in practice regulators are finding it difficult to design a reflexive system

capable of evaluating the assessment of financial risk of both sophisticated global banks and banks with lesser risk-analysis capabilities. Nevertheless, there seems little doubt that this is the direction prudential regulation will move (Mayes, 2001).

Globalisation and the new financial engineering of purpose-built financial products render more complex and volatile risk to tax authorities (Tanzi, 2000). Yet it is also true that new information technologies make possible more sophisticated monitoring of such risks than have been possible in the past. It follows that a shift is needed in tax compliance strategy to risk analysis of the risk management systems of taxpayers and tax agents. One of the objectives of the Centre for Tax System Integrity has been to help Treasury policymakers and the ATO to understand how the ATO can move from an organisation with a comparatively sophisticated approach to shaping its own risk management system to an organisation which is also sophisticated in shaping the risk management systems of other organisations in the taxpaying environment. The following discussion focuses on just two aspects of ATO meta risk management – the Registered Software Project and the Transfer Pricing Record Review and Improvement Project.

The Registered Software Project

Business tax returns and many individual returns are based on computations undertaken by accounting software. Such software can be designed to minimise error, make anomalies visible and assure the correct computation of tax liability. The idea of the Registered Software Project is to develop specifications that software must meet to be registered by the ATO as approved for calculating tax obligations such as Goods and Services Tax, Capital Gains Tax, and other types of taxes. It is hoped that this will not only directly improve compliance and reduce the cost of compliance, but also reduce the cost of auditing compliance. When a software product is registered, ATO auditors only have to check inputs and outcomes from the program (assuming that the computer has got all other stages right between input and outcome, and assuming all transactions were input in the first instance).

The ATO has put these specifications on to a website <<http://www.ato.gov.au/rsf>>, together with a number of test scenarios that provide detailed financial data on real world tax situations. The website won first place in the Australian Interactive Multimedia Industry Association's Internet Best Practice Award for 2000. By early 2001, 170 software products were registered on the site. To get registration the software manufacturer must run the required test scenarios through their software. If they come up with the same answers as the ATO and otherwise meet the specifications, they certify themselves as meeting the registration requirements. They then post their self-certification to the ATO website. After a 24-hour delay that gives the ATO the opportunity to check or question the self-certification, the software product is registered as ATO-approved for this or that kind of tax, or for several on a matrix of approved taxes.

While the ATO occasionally check for false self-registrations, the scheme is largely self-enforcing. That is, competitors "dob in" (squeal on) software manufacturers who claim that their product meets the requirements when in fact it

does not. Effective sanctions are available to the ATO for non-compliance with the self-registration arrangements. Should the statement “approved” on the website be replaced with the statement “under review”, it would cost the software’s manufacturer business. The statement “approval suspended” or “approval revoked” in respect of a posting to the website could not only damage the confidence of accounting firms in that product, but also in the manufacturer.

The Registered Software Project satisfies the four key components of the ATO Compliance Model (Braithwaite and Braithwaite, 2000): understanding taxpayer behaviour; building community partnerships; increasing flexibility in Tax Office operations to encourage and support compliance; and more and escalating regulatory options to enforce compliance.

It satisfies the first component, understanding taxpayer behaviour, in that the registered software strategy is based on the understanding that most small business and all large business taxpayers use software to calculate their various tax liabilities, that over 90 per cent of businesses choose that software on the advice of their accountants or tax preparers, and that accountants and tax preparers desire some quality assurance for software products.

It satisfies the second component of building community partnerships in that the strategy was developed collaboratively with the Australian Information Industry Association and was initially floated by the Commissioner to a meeting with tax advisers, who responded warmly to the idea. Brainstorming meetings with software experts are under way to see if they can come up with ideas for designing specifications so that financial manipulations to avoid tax liabilities become more visible, and so that transactions are channelled so that business is forced into playing the accounting game with integrity. This is an example of regulation by architecture. It does not matter if the accountant wants to cheat; the architecture of the software prevents them from doing so. This paradigm of risk regulation builds on Shearing and Stenning’s (1987) classic study of Disney World; it does not matter if children want to do certain risky things, the bars and the architectural channelling of their movements control the risk.

It satisfies the third component of increasing flexibility in ATO operations to encourage and support compliance as this meta risk management approach is more flexible than ATO production of approved software. Self-registration with periodic checks is more flexible than the British approach of government accreditation of software products.

It satisfies the fourth component of more and escalating regulatory options to enforce compliance in that no software manufacturer is forced to participate in the registration scheme. So at the base of the regulatory pyramid is a free market of highly-informed accountants and advisers who know how to check the registration website and are likely to prefer registered rather than unregistered products. Then there is escalation to an “under review”, “approval suspended” and “approval revoked” entry on the website. Then there is the fear of private litigation against software manufacturers who misrepresent the facts about their registration. This risk is signalled by an ATO disclaimer on the website that the manufacturer who posts the registration to the website is responsible for the veracity of the claims made about the software. At the peak of the enforcement pyramid is prosecution under the criminal law of fraud.

In sum, accounting software is designed as a means of managing a business risk – specifically the risk of making erroneous financial calculations. The Registered Software Project sets up a means for a business to manage the further risk that the software it employs is not capable of correctly assessing the business's tax obligations in the form of self-enforced self-regulation to ensure its business software meets ATO standards. At a distance and at low cost, the Tax Office risk manages the risk management of accounting software. Hence the Registered Software Project is an example of meta risk management.

Transfer Pricing Record Review and Improvement Project

Transfer pricing

More than half of world trade is between subsidiaries of the same multinational enterprise group. This provides opportunities for shifting profits from one part of the group to another. Transfer pricing arises, for example, when a subsidiary of a multinational company in country A sells something to another in country B. If country A has high taxes and B has low taxes, then it is rational to sell goods at a low price from the company in country A to the subsidiary in country B. This means that less profit will be recorded in country A (which has high taxes) and more profit will be made in country B (which will tax it less). The global profitability of the multinational company will thereby be increased at the expense of country A. One study estimated that transfer pricing accounted for \$45 billion in US taxes avoided by multinational corporations (Godfrey, 2001a). Examples of artificially high transfer prices revealed by the research were \$5655 per toothbrush, \$5000 for a flashlight and \$2306 for a hypodermic syringe. Instances of under-priced goods were \$1.58 for a ton of soybeans, \$528 for a bulldozer and 82 cents for a prefabricated metal building.

The “arm’s length” principle

Australia, like most nations, seeks to combat this profit shifting by transfer pricing rules that enforce the principle of ‘arm’s length’ dealings. The arm’s length principle uses the behaviour of independent parties as a guide or benchmark to determine the allocation of income and expenses in international dealings between associated enterprises.

In 1997 and 1998, the ATO introduced Transfer Price Rulings TR97/20 and TR98/11, which tell taxpayers what they have to do to set arm’s length prices and what sort of methodologies and documentation they must have in place to assure the ATO that they are not shifting profits out of Australia. TR 98/11 also explains how the ATO will assess whether profits recorded by the Australian enterprise are “commercially realistic” or “less than commercially realistic”. A matrix (Figure 9) defines the risk of audit in terms of the intersection between the assessment of the quality of transfer pricing processes and documentation and the commercial realism of the taxpayer’s outcomes. TR 97/20 sets out a number of acceptable methodologies for setting or reviewing the international dealings with associated enterprises. This Ruling endorses all of the OECD methodologies, which are Comparable Uncontrolled Price Method, Resale Price Method, Cost

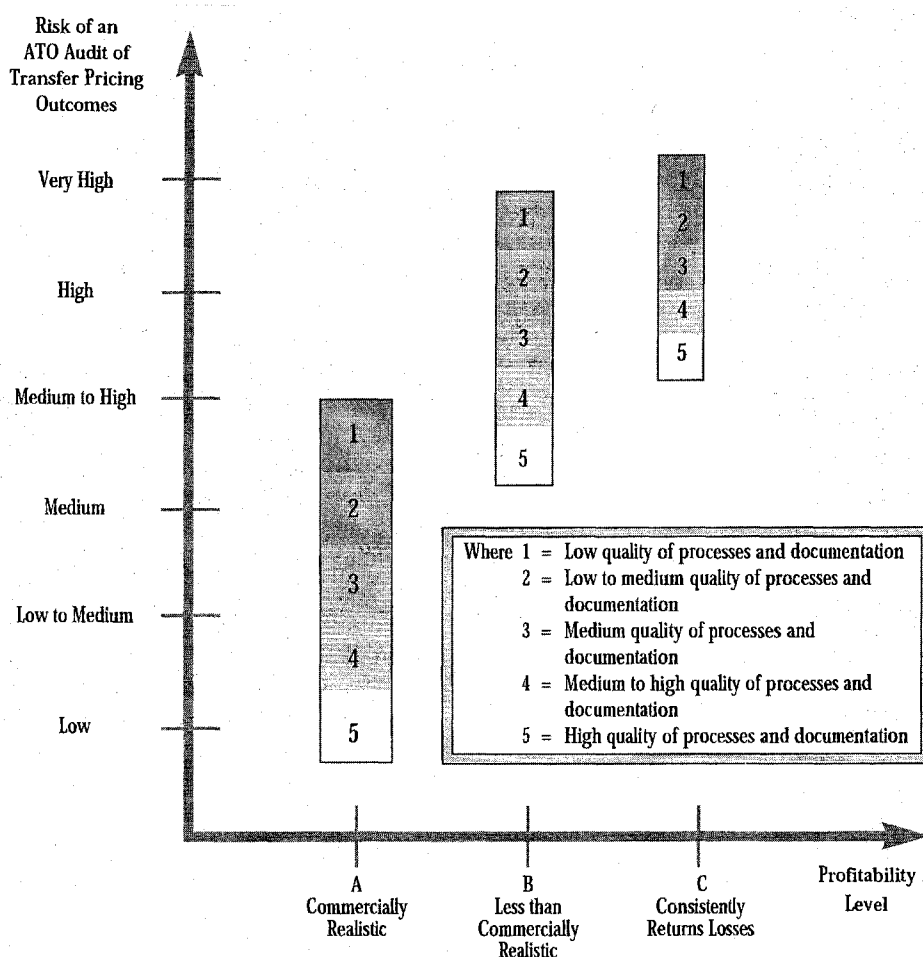


Figure 9: The risk of an ATO audit for transfer pricing as defined in TR 98/11

Plus Method, Profit Split Method and Transactional Net Margin Method. ATO analysts rate the quality of a taxpayer's processes and documentation from one to five on a number of criteria.

Meta risk management and meta meta risk management

This approach to profit shifting is meta risk management on the part of the ATO because the ATO is managing the risk to its operations that taxpayers do not use effective methodologies in their own management of the risk that they engage in illegal profit shifting. The Transfer Pricing Record Review and Improvement Project is the most striking element of this new meta risk management. The interesting thing about TR 98/11 is that it is unusually transparent about just how the ATO will assess the taxpayer's risk management (see Figure 9). This feature reinforces the reflexive quality of meta risk management. The ATO shows business that if corporations manage their risks of breaching the arm's length

principle in ways the ATO specifies or through some other persuasive methodology of their own, then they will be left alone: "We will risk manage you benignly if you manage your risk in the image of our standards of risk management". Conversely, the ATO leaves itself open to absorbing new risk management approaches from business into its risk management paradigms. In a virtuous circle, ATO risk management constitutes corporate risk management and corporate risk management constitutes ATO risk management.

In one respect TR98/11 involves meta meta management. Steps 1-3 in Chapter 5 of TR98/11 outline how a company might implement a process for setting or reviewing their international dealings with associated enterprises in accordance with the arm's length principle. Step 4 introduces a means by which the company might employ meta risk management, by strongly recommending that the company install a review process to ensure that adjustments are made when the environment changes. The third layer of risk management, the meta meta management, is embodied in ATO monitoring of compliance with the ruling as the ATO's means of managing its own risk associated with a company's internal risk management of its transfer pricing risk management.

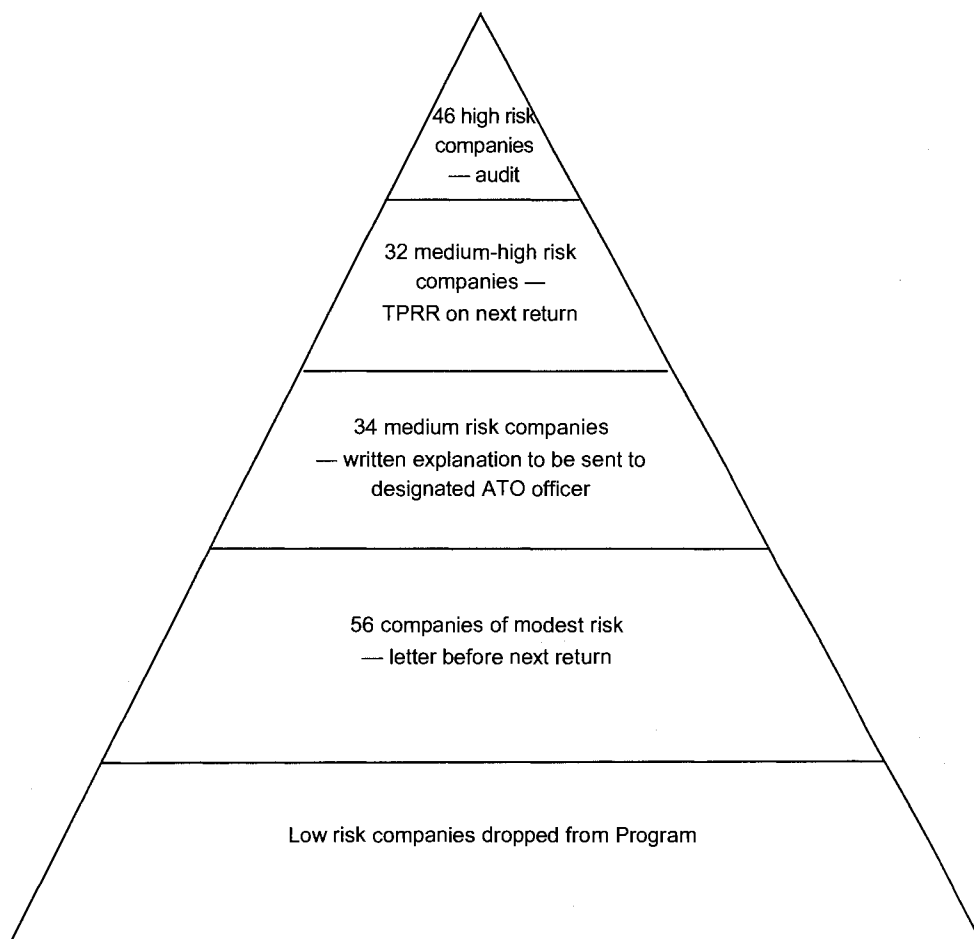
The project

Soon after the promulgation of TR 98/11, the ATO widely distributed three booklets on the new approach, sent letters to relevant companies, and conducted a number of public seminars and private seminars for the clients of major accounting firms. There were also consultation meetings with the transfer pricing partners of the Big Five accounting firms. At these seminars and meetings the Transfer Pricing Record Review and Improvement Project was foreshadowed.

One hundred and ninety companies, mostly with total income between \$50 million and \$500 million and at least \$30 million in international related party transactions, were selected for the Transfer Pricing Record Review and Improvement Project. A new audit product – the Transfer Pricing Record Review (TPRR) – was developed to be trialed on these companies in order to roll out the risk management approach revealed in TR 98/11. Program staff visited the selected companies to conduct the TPRR. At the end of the review, each of the companies received a letter advising them of whether their transfer pricing processes and documentation were assessed as of high, medium or low quality and whether their profits were commercially realistic or less than commercially realistic.

Depending on the risks assessed by the ATO, a hierarchy of risk management responses was deployed as revealed in Figure 10. At the base of this enforcement pyramid were cases assessed as such low risks that they did not require direct ongoing contact from the ATO. When they had finished in the program they simply received a letter advising them that their risk had been assessed as low.

Fifty-six cases at the next rung of the pyramid were also of sufficiently low risk as to warrant no more than a letter prior to the next year's return urging them to continue to observe arm's length pricing. Thirty-four companies with somewhat higher risk were asked to send their next tax return and a schedule of information, called Schedule 25A, as well as a "letter of explanation advising how your company's current transfer pricing practices and documentation comply



**Figure 10: Enforcement pyramid:
Transfer Pricing Record Review and Improvement Project**

with the arm's length principle". This material was to be sent to a named ATO officer (a signal of more focused scrutiny).

Thirty-two cases of still higher assessed risk were told that they clearly had a problem and would be subjected to another TPRR for their next return. This indeed happened in all cases. This was a signal of a last chance being given.

The 46 highest-risk cases from the 190 companies reviewed were sent a letter notifying them of intention to audit.

The Advance Pricing Agreement option

All companies at the top three rungs of the pyramid were given the option of negotiating an Advance Pricing Agreement (APA), with the effect of, in the terms of responsive regulation, de-escalation of their position on the regulatory pyramid. An APA is an arrangement negotiated between the company and the ATO

(and in some cases involving the company's associated enterprises in other countries and the relevant revenue administrations in those countries) on the methodologies that will be used to calculate transfer prices on the company's future international dealings with associated enterprises. It is a risk management arrangement on profit shifting tailored to the goods and services to be traded in the future by a particular company.

The benefit of an APA for the Tax Office is that it shifts the burden of the ATO's risk management in respect of a particular company from the ATO to that company. The benefit of the APA for the company is threefold. It receives certainty, freedom from ATO attention, and is relieved of the need to pay large fees (which can approach a million dollars) to accounting firms for transfer pricing work. Twelve of the companies identified for audit by the Project applied for APAs. This result achieved one of the objectives of the Project, which was to get more high-risk firms into APAs. Consistent with the meta risk management strategy, the resource investment in the Transfer Pricing Record Review and Improvement Project was quite modest. The idea was to get the firm to do most of the risk management work. Three to five days at the company's premises by two officers was all that was required for the initial review. The TPRRs of the 190 companies were completed in less than six months, which was significantly less time than invested in previous transfer pricing risk assessment products.

The results

The amount of tax paid in the year of the review increased by 32 per cent (from \$70 million in 1996 to \$91 million in 1997 – the year under examination in most cases) even though the income for these companies actually fell by 5 per cent in this year. This appears to be a return of \$21 million in extra tax on an investment of less than half a million dollars worth of ATO resources. Table 1 shows that the tax paid by companies in the program jumped much more sharply in the post-review year, 1998, to be 139 per cent higher in the post-intervention year than the pre-intervention year. Not surprisingly, there was some erosion of this effect in the three subsequent years. But even with this erosion, across the three latest years, these 190 companies had settled down to paying about double the tax they were paying before the program. The greatest benefit of the program, therefore, with some modest erosion over time, seems to have been received not in the year where returns were subject to direct ATO scrutiny, but in subsequent years when the firms had subjected themselves to intensified self-scrutiny through improved risk-assessment methodologies. The results of this program were assessed by the simple method of adding the net tax paid from all companies in the program. One of the problems with this method is that some firms went bankrupt during this six-year period. To show the effects of this, Table 1 also presents the average tax collected per surviving company, that is, with bankrupt companies dropped from the study. The pattern of the results is the same: average collections were up 30 per cent in the intervention year, and on average by 114 per cent in the four post-intervention years compared to the pre-intervention year.

This was also the pattern of results in the bottom section of Table 1, which relates to the second tranche of 74 companies that went into the Transfer Pricing Record Review and Improvement Project in 1999–2000. This second tranche of

Table 1: Total income and net tax of companies in the Transfer Pricing Record Review and Improvement Project for 1998–99 (1997 generally the return first reviewed) and 1999–2000 (1998 generally the return first reviewed)

	1996	1997	1998	1999	2000	2001
	\$mil	\$mil	\$mil	\$mil	\$mil	\$mil
1998–1999 TPRR n = 190	Pre-intervention	INTERVENTION ↓	Post-intervention	Post-intervention	Post-intervention	Post-intervention
Net tax all companies	70	91	167	125	129	157
Net tax per surviving company	3.7	4.8	8.8	6.7	7.1	9.1
Total income all companies	34,209	32,519	32,726	34,795	33,033	31,411
1999–2000 TPRR n = 74		Pre-intervention	INTERVENTION ↓	Post-intervention	Post-intervention	Post-intervention
Net tax all companies		630	740	968	913	974
Net tax per surviving company		13.1	15.4	20.2	19.8	21.6
Total income all companies		28,920	32,549	35,125	48,205	57,265

corporations were much larger on average and were harder to improve because they were already paying a higher proportion of their income in tax than the first tranche, perhaps because they had already been subjected to ATO monitoring in the past. Here the return subject to review was generally the return in 1998, so 1997 is the pre-intervention year in the bottom section of Table 1. Tax collected in the intervention year, 1998, was only 17 per cent higher than in the pre-intervention year, and only 51 per cent higher on average in the three post-intervention years. For net tax per surviving company, the second tranche improvement was 18 per cent in the intervention year and averaged 56 per cent for the three post-intervention years. The program had less impact on the larger corporations in the second tranche than on the smaller companies in the first tranche. It understates the reduction in the success of the program on the larger corporations in the second tranche to say that a doubling in tax collected from the

smaller companies in the first tranche is reduced to a 50 per cent increase. This is because some of the second tranche corporations acquired corporations that were not paying a lot of tax, a move that pushed up their revenues substantially in 2000 and 2001. This new element in the last two years of the second tranche makes the results hard to interpret for these years.

The results from the larger second tranche companies, while much less impressive in percentage improvement terms, are much more impressive in extra dollars collected for the effort invested. The increase in collections in the intervention year was \$21 million for the first tranche, \$110 million for the second. The first three post-intervention years returned an extra \$211 million for the 190 smaller companies, \$965 million for the 74 larger ones. Subsequently (for the three-and-a-half years to March 2002), the Commissioner claimed that the Transfer Pricing Record Review and Improvement Project resulted in more than \$2 billion in tax adjustments (a different measure from the total increase in net tax paid). However the success is measured, it seems huge: roughly of the order of a billion in extra tax for every million in expenditure by the tax office on the program.

The results for the second tranche of companies, as with the first, are consistent with the main effect of the program being more a meta risk leveraging effect in the post-intervention years than a direct monitoring effect for the intervention year. This can be seen as a natural meta risk management experiment with a natural replication that delivered the same pattern of results.

The patterns in the data are consistent and the effects consistently big. Unfortunately the effects are so big that the ATO is reluctant to randomly assign a group of targeted companies to non-intervention, as a control to compare with the effects of TPRR intervention on other companies. Such randomised controlled trials are what are needed now to advance evidence-based meta risk management.

Project objectives

The Transfer Pricing Record Review and Improvement Project had many aims in addition to the objective of increasing the amount of tax collected. The Project was part of a strategy to improve the level of compliance across all firms that trade internationally by promoting the application of the transfer pricing rulings TR 97/20 and TR 98/11. It was also part of a meta risk management strategy to reduce compliance costs. The project also had an intelligence function in showing that the quality of transfer pricing documentation was very poor and poorer than expected. In a second round of the project in 1999–2000, the quality of the documentation and processes assessed by the ATO had improved, with 35 per cent of companies assessed as having documentation of high or medium-high quality, compared to 16 per cent in the previous year. There was also a modest fall in the ATO-assessed audit risk rating. Overall the project successfully conveyed the message that the ATO was willing to get more serious about profit shifting than it had been in the past.

The Project measured against the ATO Compliance Model

The Transfer Pricing Record Review and Improvement Project satisfies the four key components of the ATO Compliance Model.

The Project satisfies the first component of understanding taxpayer behaviour. Under TR 98/11, Step 1 of the method for selecting an appropriate transfer pricing methodology is for the taxpayer to “[a]ccurately characterise the international dealings between the associated enterprises in the context of the taxpayer’s business and document that characterisation”. When the taxpayer does this well, the ATO will acquire a much enhanced understanding of taxpayer behaviour simply by reading this documentation. At the third rung of Figure 10, the requirement for a written explanation of the relationship between the company’s transfer pricing and the commercial realities of its business has also helped understanding of complex forms of taxpayer behaviour. This proffered understanding also changes the nature of any audit of the company. One senior ATO manager described the written explanation as a “thesis on the relationship between what’s really happening and the accounts. An audit then becomes more directed as a test of that thesis”.

The project satisfies the second component – building of community partnerships – as the Transfer Pricing Record Review and Improvement Project is a collaborative one with major accounting firms and corporate clients. It was seen, in the words of one ATO manager, as a move from “policing to partnership”. The objective of shifting resources from transfer pricing audits to APAs was seen as a shift from “the angst of audit to the better tone of APA negotiations”. Profit shifting enforcement in the past had been “crafted on a canvas of suspicion”. The remarkable transparency of the TR 98/11 approach was crafted to build trust. Meta risk management means a risk management partnership in this project. The Project succeeded in enrolling some of the major accounting firms to persuade their clients that the partnership offered in the project was superior to audit. In the words of one ATO officer, they saw their interest in, “sending the message that unless you employ us to get your methodology in order you’ll be audited eventually”. Wisdom in selecting targets is also important in this area. Selling the idea of an APA to a lead multinational from a particular country may bring other companies from that country to the negotiating table. Industry sectors are another example of a network that can be used in this way. When a leading corporate player from a particular industry sector signs an APA others in that sector may gain the confidence to do likewise.

The Project satisfies the third component of increasing flexibility in ATO operations to encourage and support compliance, as TR 97/20 endorses a number of different pricing methodologies that the company can choose. The APA is a highly flexible approach, tailoring compliance requirements to the activities of the specific company. In fact, it is an enforced self-regulation (Ayres and Braithwaite, 1992: Ch 4) strategy of meta regulation.

That the project satisfies the fourth component of the model, more and escalating regulatory options to enforce compliance, is demonstrated by Figure 10, which shows that a regulatory pyramid the ATO can escalate up and down is very much in play here. One criticism of APAs, is that they divert resources to cooperative corporations and away from corporations who use aggressive tax planning. While this might be a generally valid criticism of APAs, it is not a valid

criticism of the deployment of APAs in the context of the Transfer Pricing Record Review and Improvement Project. In this Project, all of the most aggressive companies who spurn the opportunity to negotiate an APA are subject to a transfer-pricing audit, a more intensive intervention than the APA. Hence there is fidelity to the principle of the Compliance Model that cooperation must be associated with movement down the enforcement pyramid and combative tax planning with movement up.

Conclusion: An expanded risk-leveraging toolbox

The ATO has made a considerable shift from the culture of checking returns to find breaches of the law accompanied by the pretence of consistent enforcement that led them to be identified as a “Token Enforcer” in Grabosky and Braithwaite’s (1986) study. This change has been to a culture of risk analysis, where the ATO scans its environment for the greatest risks and moves resources to where those risks can be managed. This is the shift from reactive law enforcement to proactive risk management (where law enforcement provides just some of the tools in a regulatory pyramid). Meta risk management is a further stage in this strategic change process. It is the move to the risk management of risk management. While proactive risk management can be more strategic than reactive enforcement, even more strategic leverage might be achieved by asking how the ATO can lever others to do fruitful risk management – enrolling others to be agents of virtue instead of enforcing virtue.

The approach of self-assessment captures the above basic intuition. Instead of using ATO staff time to check the arithmetic of taxpayers, the approach trusts taxpayers to do the arithmetic. However, the complete approach is not one of trust alone, but one of “trust and verify”, achieved by developing strategies for educating taxpayers how to check themselves and by educating agents to check their checking. In this way, ATO resources can be shifted from direct checking to meta monitoring (Grabosky, 1995), for example, by shifting enforcement resources to the clients of agents who are risk takers rather than risk checkers.

For any given risk to the revenue, being sensitised to the meta risk management option means asking the following questions:

1. Is there someone who has under their control better levers of that risk than the ATO?
2. Can the fact that the other party is successfully leveraging the risk be made transparent to the ATO?
3. Can the ATO work with them to persuade them to pull those levers?
4. Are there levers the ATO can pull to get the other party to pull their risk leveraging levers?
5. Can the ATO organise its levers into a pyramid that escalates up from trust and persuasion at the base of the pyramid?
6. Does ATO leveraging of the other party’s leveraging reduce risk at lower cost than direct monitoring and enforcement?

The other party can be the taxpayer themselves, as in self-assessment; they can be third parties like software manufacturers as in the Registered Software Project;

they can be tax agents or internal corporate compliance systems as in the Transfer Pricing Record Review and Improvement Project. Or they could be a parish priest who a persistent non-lodger nominates as their supporter in honouring their commitment to get their tax return lodged in future as part of a lodgement prosecution settlement. Meta risk management is about encouraging creativity in finding the best levers for the hardest cases and the most effectively automatic levers for the routine cases. This means creative self-enforcement where entrenched resistance to compliance is found, automatic self-enforcement where routine compliance can be expected (eg, where third party deductions at source are possible).

Often the answer to Question 6 above is that there is no cost-effective meta risk management strategy. Because regulators are only beginning to learn how to ask Questions 1 to 5, it is likely in some of these cases that there are meta risk management strategies to be discovered by those creative enough to craft them. Meta risk management is obviously a strategy so flexible that it is vulnerable to capture by the regulated industry if the regulator is not willing to invest in the monitoring aspect of meta risk management. Capture or corruption can enrol the regulator into a market in vice, as opposed to the intended strategy of enrolling the firm into a market in virtue. The evidence is pretty compelling that this has not happened with the Transfer Pricing Record Review and Improvement Project. The returns have been so great that the regulator has not been tempted to invest in trust without also investing in verification.

This chapter provides some examples of how the ATO has moved away from a Procedures Manual culture. The High Wealth Individuals and Promoters Taskforces and the Registered Software and Transfer Pricing Record Review and Improvement Projects are just some examples of creative initiatives within the framework of the ATO Compliance Model.

In addition to becoming more responsive, more focused on procedural fairness through the Taxpayers' Charter and more catalytic (meta risk management), the ATO has also become a more anticipatory organisation. That is, it is more oriented to prevention as opposed to cure. In the terms of Malcolm Sparrow's (2000: 136) invaluable book, *The Regulatory Craft*, the ATO, in a wide variety of ways that matter, is on a trajectory from being a "process improvement" to a "problem solving" organisation. A "problem solving organisation" deploys risk analysis to pick the most serious problems and fix them. Most regulatory organisations, Sparrow argues, are actually of the "process improvement" variety: they frame their objectives in terms of improving agency machinery or processes instead of setting problem reduction objectives. In Sparrow's terms the ATO has also moved from one where "work is organised around tools" to one where "tools are organised around work". Sparrow (2000: 201) is unsympathetic toward the common "balanced strategy" in which a range of tools are identified, a balance of the right mix of tools is decided and a procedure manual offers guidance on which tools are right for which targets. Rejecting this is the nub of being a craft: the essence of the furniture-maker's craft is not the right balance among drilling, sawing, planing, gluing, and using the lathe; it is about the integration of these activities in a way that is responsive to the grain of the timber. The ATO has moved from a balanced strategy to what Sparrow calls an integrated strategy – one where lateral coordination allows risks to be identified

and ranked, multifaceted responses are crafted, and often new tools/techniques/solutions are invented for the specific risk.

The ATO that existed up until the mid 1980s manifested all the pathologies that are the subject of Sparrow's book. There was a total absence of lateral organisation able to identify the biggest system-wide threats to the integrity of the tax system. What the tax office did was driven by its hierarchical organisation and by its rather bare toolbox. In fact there were really just two main tools in that box – perfunctory assessment of paper tax returns and intrusive full audits.

One especially important forum for swapping stories of success and failure on aggressive tax planning has been the regular meetings of the ATO Aggressive Tax Planning Committee, many of which I had the opportunity to attend over the last six years. The Committee brings together senior ATO officers from all business lines – with responsibility for large business, small business and individual taxpayers – to share experiences in confronting aggressive tax planning, develop integrated strategies that cut across ATO business lines and commission research that informs their risk leveraging. It has also been an important forum for discussing the need to better integrate the Strategic Intelligence Analysis function, which, as in all large enforcement organisations, is too fragmented, with intelligence known to one area insufficiently informing work in another. A story-swapping institution like the Aggressive Tax Planning Committee might seem a banal solution to the problem, and of course it catalyses little if intelligence information technology systems do not respond by more systematically getting the right stories on the right desks. It has been, however, a useful beginning to putting the aggressive tax planning problems in focus through Sparrow's ideal of lateral organisation. This book is a modest example of something that would not have been possible without this problem-focused group.

My best interpretation of why the ATO has been progressively improving the proportion of revenue it collects from identified high-wealth individuals and large corporations, contrary to opposite trends in most countries, and in the face of considerable pressures from globalising fiscal termites, is speculative. As an ATO-watcher since I used tax office data in my PhD 30 years ago, my interpretation is based on my diagnosis of when aggressive tax planning outcomes turned, when related revenue outcomes fell and rose, and what changes were occurring in the organisation at those times. My interpretation is that the accomplishment is connected to the four elements of the Compliance Model:

- (a) The acquisition of an understanding of taxpayer behaviour that enables identification of the biggest risks so that prevention can loom larger than cure;
- (b) The building of partnerships to address those risks;
- (c) The flexible use of many tools accompanied by creativity in searching for new solutions; and
- (d) Responsive escalation up enforcement pyramids oriented to solving specific problems in an integrated way.

In this chapter, I have sought to, in particular, illustrate the flexible and responsive deployment of tools by showing how the shifting of targeting from taxpayers to their advisers and catalysing of the risk management systems of other organisations can be strategic. Partnership and responsiveness combined

with a shift from risk management to meta risk management together comprise a strategy for shifting from direct enforcement of virtue to enrolling partners – in the professions, the software industry, in corporate tax departments – to be agents of virtue. This begins to look like a more promising approach to direct enforcement of virtue.

So far not so bad. But at the same time, I am deeply pessimistic that these changes have not percolated sufficiently through the organisation (see Hobson, 2003) to be able to keep on top of the fiscal and moral termites threatening the Australian tax system. In tax policy Australia is still “the lucky country”, because it has yet to confront the full force of some of the aggressive tax planning challenges the IRS has had to confront in recent years (described in Part III). To cope with that coming assault, it may be that commitment to evidence-based administration, partnership, and particularly meta risk management of a level never before imagined will be needed.

Part III

AGGRESSIVE TAX PLANNING IN NEW YORK

Taxation is, in fact, the most difficult function of government and that against which their citizens are most apt to be refractory.

Thomas Jefferson

The New York advice market

Interviews in 9/11 America

New York is the home of the most sophisticated tax practitioner community in the world; US tax planning is years in advance of any other market and New York and to some extent Washington are where the most sophisticated practitioners in the US market are to be found.

This discussion of aggressive tax planning in the US is based on 26 interviews I conducted from my base at New York University, though eight of these were conducted with people in other parts of the US; in person with five of them in Washington, and by telephone with three others. Nine of the respondents were elite tax attorneys (some with experience working in accounting firms), seven were from the IRS, five were academic tax specialists (mostly with substantial practical experience with accounting or law firms) and five were from accounting firms or investment banks or with experience in both. Some of the elite tax practitioners interviewed in New York had held government positions up to the most senior in tax policy in the US Treasury, so the data reflects “both sides of the fence”. The bias of these interviews was toward tax attorneys, with only nine of the informants having had any experience working for the Big Five accounting firms. Most of the aggressive tax planning action is in these (now four) firms and, as discussed below, tax attorneys in New York have very different views on tax shelters than accountants, so this is a serious bias. The reason for the bias is that I had a high rejection rate in securing interviews with the people I targeted in the Big Five accounting firms and investment banks and almost universal success in securing interviews with the elite tax lawyers with whom I sought interviews. This appears to be in part a consequence of a difference in professional ethos that I detected in the interviews – a difference between the New York tax lawyers’ ethos of openness and the accountants’ tendency to keep their cards close to their chests.

In part, it was timing. On 11 September 2001, I was in my New York University office, planning the Manhattan interviews for this research, when I looked out the window and saw a plane flying low and fast. Standing in the street, watching as a second plane hit the second tower of the World Trade Center, the interviews could not be further from my mind. They stayed that way for another month. When I did start approaching people for interviews in October 2001, a backlog of work or “still not back in our downtown offices” was a common reason for refusing an interview. The upside of doing New York interviews in late 2001 was that there was abundant compassion and generosity to foreigners like me at that time. During the interviews themselves, informants were remarkably open. Many correctly perceived my concern about the global inequalities arising from the use of tax shelters, and seemed to share it. Some

wanted to defend the tax advice professions but many wanted to spill the beans on what was wrong with their profession and share their views on how more decent tax systems might be forged. I therefore see the American interviews as less representative than the Australian interviews, though they were often characterised by greater openness and revelatory insight about how the system works.

The events of September 11 directly impacted shelter activity in America. Crafting tax shelters is hard intellectual work and the difficulty of hard intellectual work after September 11 was something I myself experienced. I was told that shelter activity was down since September 11 because "everyone is so distracted".

A brief history of aggressive tax planning in America

There are many similarities between aggressive tax planning in Australia and New York, but current Australian aggressive tax planning resonates less with current US aggressive tax planning, than with descriptions of US tax planning prior to 1986.

Prior to 1986

Real estate, oil and gas schemes for individuals with modest sums to invest were common in the US in the late 1970s and early 1980s until a tax reform package was introduced in 1986. This package included passive loss rules which meant that you could not trade losses unless you were an active participant in the loss-making business. So a doctor could not write off losses from a film investment scheme against her medical practice profits unless the doctor was an active business participant in making the film. The passive loss rules apply a basketing approach "under which different types of activities are put in different tax baskets and losses in one basket cannot be used to offset income in other baskets. In particular, losses from businesses in which a taxpayer does not materially participate cannot be used to shelter labor income, nonbusiness investment income (such as interest and dividends), and active income" (Zelenak, 2001: 191). Another important part of the 1986 reform package was a more rigorous alternative minimum tax for individuals and a new alternative minimum tax for corporations. This made a total tax wipe-out less feasible for both individuals and corporations. Wealthy individuals, regardless of how many deductions they could drum up, would still have to pay an alternative minimum tax of 20 per cent of their book income. Many schemes that were economic when they could take the tax rate to zero became uneconomic when the rate could only be taken down to a minimum 20 per cent. Also in 1986, the maximum rates were substantially reduced, further reducing the tax reductions that shelters could deliver (Andreoni, Erard and Feinstein, 1998: 838–9), though as Yin (2001: 218) points out these were subsequently increased without ushering a renewed shelter boom for upper middle class individuals.

The impact of the 1986 reforms

The 1986 reforms killed the shelter market for upper middle class individuals almost instantly. George Yin (2001: 210–211) has shown in a revealing way just how steep the shift out of individual shelters may have been after 1986. For the decade 1975 to 1986 net losses reported by individual taxpayers from their partnership and S corporation investments increased 526 per cent while net income increased 137 per cent. This disproportionate growth in losses is consistent with the boom in individual shelter activity of this period. Between 1981 and 1986 net losses reported exceeded net income reported. This trend reversed immediately and permanently in 1987. For the period 1986 to 1997 net income reported from partnership and S corporation investments increased 308 per cent while net losses reported for the same investments declined 22 per cent.

The boom of the late 1990s

After 1986, some promoters who had been active in the individual retail market transferred their attention and entrepreneurship to corporate shelters, which would form the stuff of a wave of tax avoidance in the late 1990s. Informants saw a surge in the market for corporate tax shelters that really took off in 1995 and peaked at about the same time as the peak of the Australian aggressive tax planning boom: “By 1998 we were reaching the end of a boom cycle in which corporations had used up all their losses. Because losses were harder and harder to find there was a market for getting more creative about losses.” The American informants believed that this shelter boom targeted at large corporations¹ drove the widening gap between book and taxable income. It was seen as an era of burgeoning innovation in tax shelter design. As one IRS official put it: “We are five years behind in keeping the regs up to the continuous development of new financial instruments.”

Unfortunately, there was no silver bullet of the passive loss kind that could work so readily with the corporate shelters:

[I]ndividual shelters were structurally so similar that a one-size-fits-all solution was possible, but that corporate shelters “all involve different areas of the code and they’re different shapes and sizes so we would love to find a silver bullet one-size-fits-all but these things are just too varied to try to get at.” The Treasury White Paper expresses the same conclusion in less colourful language. (Zelenak, 2001: 192, quoting a senior government official)

Instead law reform has proceeded piecemeal, making the law more complex and in some ways creating a vicious cycle: “The legislative remedies themselves create the complexity that the next generation of tax shelters exploits, which leads to more complex responses, and so on” (Department of the Treasury, 1999: 30).

I was told by some practitioners and IRS informants that by 2001 *all* Fortune 500 companies used corporate tax shelters. In its 1999 report on tax shelters, the New York State Bar Association (1999: 883) was more circumspect: “Based on our collective experience, however, we are quite certain that a

1 In the US, in 1997, 9017 of the 4.71 million corporations had \$250 million or more in assets. This group of less than half a per cent of the corporations paid 78 per cent of the corporate tax collected (Yin, 2001: 228).

substantial number of large corporate taxpayers have been persuaded to participate in one or more of these transactions, and the incentives and impetus are there for the frequency of such transactions to increase substantially.” Like all potential corporate rule breaking, secrecy means that accurate estimates of the prevalence of the phenomenon are impossible; all we can do is rely on broad indicators of the prevalence from informed insiders such as those members of the New York Bar who wrote this report and those interviewed for this study. Competition in the tax advice market is now driving the use of shelters down to progressively smaller corporations and to high-wealth individuals that are serviced by second-tier accounting firms rather than the Big Four. Many informants said that there were now many high-wealth individuals with enough wealth in private companies in their control to justify investment in the same kind of shelters developed for the large corporates. So for the first time since 1986 there is now a growing market for aggressive tax planning for individuals, albeit very wealthy ones quite unlike the Kalgoorlie investors discussed in Part II. But by the recession of 2001 and the return of widespread losses to the business scene, the large corporate shelter market seemed to be declining somewhat for reasons that will be considered in the chapters that follow.

The advice market

The biggest similarity between the US and Australia is that, despite the difference in the size of the two markets, each has only dozens of players, perhaps only a few dozen (including both individuals and large players like some investment banks) who account for most of the design and promotion of aggressive tax planning schemes. One senior IRS informant claimed there were only 30–40 promoters of shelters in the US that accounted for nearly all the market, a surprisingly small number, not much different than the ball-park estimate one gets for the number of promoters of schemes in the much smaller Australian market. The number would be much larger if we counted promoters of simple schemes of evasion offshore, such as the supply of offshore credit and debit cards. As the corporate tax director for one investment bank put it: “It’s only a small group of people creative and talented enough to generate new product ideas. Most corporate work is about how to avoid disaster in structuring the transaction.” This is the same as the story of the Sydney and Melbourne market for corporate tax advice. But most of the Australian promoters were promoting to upper middle class individuals rather than focusing exclusively on the big end of town as in the US shelter market of the 1990s.

Shelter shops and the Big Five

In the US, “[t]here are people in small firms who develop tax ideas and sell them – boutique shops if you will”. These are tax shelter shops that present themselves to the world as some sort of finance house but that do nothing but tax shelter work. The number of these is not large however. One disadvantage they have is that the costs of developing shelters are surprisingly high, sometimes millions of dollars, so some of the best shelters risk bankrupting a small firm if they do not get off the ground. This informant went on to conceive the boutique promoters and the then Big Five accounting firms as the biggest promoters of the most

aggressive shelters as of 2001. There is indeed evidence of some level of involvement of all the Big Five in the late 1990s corporate shelter market. Most informants saw the Big Five with their product development groups as overwhelmingly the largest generators and marketers of shelter ideas even though they only recently entered the tax shelter market. As soon as new regulations come out, these product development groups “spend time working on how to abuse them, in some investment banks as well”. The “rocket scientists” in tax product development groups are paid bonuses according to the number of usable new ideas they come up with and are set targets for the number of new product ideas expected of them: “Thanks to rampant industry gossip and clever reverse engineering, sellers find it hard to keep the products proprietary. To keep them fresh, KPMG is said to require staffers to come up with one new idea per week ... Once companies get a taste, they become more comfortable and continue to do it” (on KPMG targets for “new idea” forms submitted to its Tax Innovation Centre, see also US Senate, 2003: 28-30). These outcomes are the backbone of the tax planning ideas service to which corporate clients can subscribe with some major accounting firms. A subscriber whose client has a franchise tax problem in New Jersey can key in “franchise + New Jersey” to search the database, read about some possibilities, and be cued to the right person in the firm to talk to about it. A lot of the burgeoning tax planning advantage of the Big Four globally is connected to the way that new information technology allows them to cue clients to “a little tax planning pill for every ill”. Doing this requires the networking of knowledge nationally across state jurisdictions and globally.

In the past, there were always clever insiders whom people with a bit of wealth could find to leverage them a tax advantage, but it was hard to bump into the right expert with the right insight for a particular tax problem. The transaction costs of navigating the disorganised sea of information about smart tax moves were sufficiently high that many business people preferred to maintain their focus on real commercial opportunities to the exclusion of tax opportunities. But now that sea of information on smart moves is organised with exquisite user-friendliness. And with international arbitrage, what was once a sea of disorganised information is now an ocean of organised information on smart moves, if you can pay the fees to access it.

Investment banks

The 1990s saw a rise in the involvement of investment banks in aggressive tax planning: as one informant put it, “At one time only Bankers Trust were into [shelter] product development. Now most investment banks are to some degree. But not many of the investment banks are creating new ideas; they are re-engineering shelters pioneered by others”.

In the late 1990s investment banks became less aggressive promoters of shelters after some banks, particularly Merrill Lynch in the *ACM case*,² suffered a savaging in the financial press for the imprudence of their more aggressive plays:

2 *ACM Partnership v. Commissioner* 73 TCM (CCH) 2189, aff'd in part, rev'd in part, 157 F 3d 231 (3d Cir 1998), cert denied 119 S Ct 1251 (1999).

"Others like Goldman and Sachs and JP Morgan, that had never been so aggressive sat back smugly. ABN Amro and Rabobank also got caught up in tax planning scandals. So reputational risk grew through the 1990s, especially in the late 1990s. Many clients did not want to become even indirectly entangled in a tax shelter." (2001 New York Interview)

Note, however, that subsequent to this interview in 2001, JP Morgan did receive some bad press over its tax shelter services for Enron (US Senate, 2003). Deutsche Bank also suffered bad publicity over the provision of banking services to KPMG's shelter promotion and the allegation that the bank itself was a promoter and involved in certain of Enron's major tax-driven transactions. In 2003, US Senate investigators received internal Deutsche Bank memos advising its "Tax Department not to create an audit trail in respect of the Bank's tax affairs". This memo also showed that its participation in the BLIPS shelter was kept away from its Reputation and Risk Committee (US Senate, 2003: 73).

One investment bank informant thought his bank was typical as of 2001 in not having a tax shelter idea factory in the same way he saw the Big Five as having idea factories: "Most of what we do is re-engineer a product that already exists. Well, perhaps in one case in 20 we create something new. The rest are old ideas we tweak for a client." His firm was part of the second mover shelter market, concerned not to be positioned by conservative clients or the IRS as an aggressive first mover, but happy to serve clients with a second mover tax shelter service when there is a risk they might take their business to a first-mover promoter.

One role of investment banks is to take a bigger picture for large clients of problems that arise incrementally from the more piecemeal actions arising from the advice of accounting firms: "There are billions trapped offshore for US corporations at the moment. The accounting firms helped them shift it offshore." A niche for the investment banks was to craft investments that would help move it back.

Investment banks like Merrill Lynch were seen as having led the development of offshore shelters, particularly based on financial instruments such as sophisticated derivatives related to their offshore banking activities and to their mergers and acquisitions work. Mergers and acquisitions create large tax opportunities, so during merger booms, such as the US saw in the middle and late 1990s, investment banks become bigger players in the tax shelter market. More importantly, however, investment bankers became notable players in the tax advice market because the corporate tax planning enterprise now overlaps with a wider structured products industry. Most tax shelters in the US today are built from financial instrument building blocks such as options, futures, swaps, collars and straddles. Insurance brokers also developed tax products related to their particular kind of expertise – tax shelters related to insurance. More generally in New York: "Everyone who knows a piece of the business is looking to leverage what they sell through a tax advantage." This is the key to what Part IV of this book concludes to be the new aggression on the supply side of the market for tax shelters.

Appetite for risk and the advice market

New products tend to be test marketed by the big players first by choosing some clients with an appetite for risk ("area champions") who want to go for a first mover advantage and then expanding the circle to a wider client base.

Informants reported that it is because some wealthy individuals do not care as much as large corporates about reputational risk that the market partially shifted toward the provision of shelter advice to wealthy individuals after 1997. More generally, a larger subset of the high-wealth-individuals market has a high taste for risk compared to the corporate market. Another factor was that large corporations were under continuous audit in the US and wealthy individuals were not. Concomitantly, in the late 1990s, there were breakthroughs in the adaptation of corporate shelter products for high-wealth individuals. Possibly the IRS needs something like the High Wealth Individuals Taskforce approach in Australia, which was found in Chapter 5 to have been a moderately successful response to this challenge there.

Scale and the advice market

Another marketing advantage the Big Four and major investment banks have is that if a shelter "is structured into enough big plays, then the IRS is not game to overturn it". There would be too much "dislocation" for the IRS to strike it down. There would be cries of the government changing the rules, thereby "creating business uncertainty and undermining American competitiveness". This reality puts the Big Four and aggressive investment banks in an interesting dilemma. Their general strategy is to keep their new shelter as tightly held a secret as possible so their clients get advantages that their competitors cannot provide. But the point can be reached where the best way to protect clients from hostile IRS action is for the shelter to be "too big to fail". The IRS is also in an interesting dilemma. When a new shelter is being piloted on just a few clients with a high taste for risk, confidentiality might work and the IRS might not find out about the shelter, or they may have vague intelligence of it but the revenue at risk "is too small for them to make an investigation a priority when they are five years behind". KPMG played to this by ceasing marketing of a shelter within one or two years of the first sale – so the shelter would already be ancient history if and when the IRS caught up with it and the IRS would prioritise current risks rather than dead risks (US Senate, 2003: 70). But then if an insurer steps in and declares a willingness to insure tax benefits from the shelter, within months all the Big Four may be offering their own reverse-engineered variant of the shelter and it may be structured into so many deals that it may be too big to challenge without unacceptable commercial disruption. The risk of this dynamic follows in part from the off-on way the IRS responds to issues: "As an issue grows to national attention (eg, lease strips), then we establish a specialist in the office" (IRS Office of Tax Shelter Analysis interview).

The ATO has confronted a similar dilemma with mass marketed schemes that take off quite suddenly – before they know it a scheme that they thought was doubtful, but obscure and resource-intensive to challenge, has become a feature of the tax returns of large networks of people. The New York commercial dynamic is akin to the political dynamic of tax shelters in Australia allowing passive

investment losses to be traded against personal income. So many middle-class Australians negatively gear real estate and other investments (borrowing money for say a beach house and deducting the interest against their salary income because the house is rented at a loss) that to bring in US-style passive loss rules would cost too many votes. I was a member of the Australian Economic Planning Advisory Council at the same time the US passive loss rules came in and saw how Treasurer Paul Keating and Prime Minister Hawke agonised about the economic virtues and the political costs of doing the same in Australia. The widespread Australian phenomenon of negative gearing of real estate investments in a second family property was a major political sticking point. Negative gearing of real estate was indeed disallowed at the time, but this law reform was reversed when the backlash to the decision proved politically unbearable. In a recent national survey, Wenzel, Ahmed and Murphy (2002) found 15 per cent of Australians to report negative gearing (property/shares) on their last tax return.

A shelter becoming too big to fail is the dream scenario for shelter promoters. They have given their inner circle of clients with an appetite for risk a first mover advantage for a period, then in a second phase have marketed the product to such a large number of clients that it is too big to be challenged. With a bit of luck, they have maintained an early mover edge with the mass marketing as well, even though other firms come up with their own version of the scheme. Being the first mover with a widely successful and widely copied product delivers to the promoter not only maximum fees but maximum reputational capital.

Firms in the advice market

While deregulation in the financial sector has eroded many of the traditional monopolies of expertise different kinds of firms once enjoyed in the tax market, some distinctive competitive advantages remain: "Accounting firms can't lend money and investment banks can't give tax opinions." Law firms, on the other hand "can defend actions and execute". This has led to a networking model where an accounting firm like KPMG would develop a shelter, a bank like Deutsche Bank would lend the money for the shelter, a law firm like Sidley Austin Brown & Wood would write opinion letters that the shelter was legal, an investment adviser like Presido would promote it and if necessary an insurer like Hartford would insure it (US Senate, 2003).

Law firms generally do not have ideas factories to create tax products: "Some law firms dream up ideas and circulate them." But accounting firms and investment banks are the players with the client lists they can use to promote products either themselves or through their agents in investment advice firms. The role of law firms is more one of providing advice to them: "Law firms are more service oriented, less product oriented." In general, "[l]aw firms don't serve as the genesis for ideas; they tweak the ideas and add value". Nonetheless, historically, law firms have progressively become more important players in the tax advice market as tax law has become more technically complex. New York is at the leading edge of this historical process; the New York tax lawyers interviewed were remarkably clever people, and remarkably well paid and influential in shaping tax advice. The law firms bill by the hour rather than by results in tax outcomes in the way the accounting firms do by charging "success fees". This

delivers the law firms an air of moral superiority as well as their justifiable air of technical superiority. Many of the lawyers interviewed insisted that they regularly give advice against proceeding with doubtful shelters; that “ethics still counts” with New York lawyers to a greater degree than in the accounting firms. Some of them explained this in terms of their remuneration on a fee-for-service basis compared with the accountants and investment banks marketing shelters on the basis of success fees. One of the investment bankers interviewed described law firm tax lawyers as having “a holier-than-thou attitude to the accounting firms”. It was certainly true that most of the New York tax lawyers interviewed saw the aggressive market for tax advice as having created a problem of abusive tax shelters that needed to be cleaned up. They blamed the Big Five as much as the IRS for the mess. A number of law firm partners were quite condescending about their Big Five clients:

The accounting firms have a huge captive market. But they don’t have many smart people. They can come up with second-level products and then they tend to promote them too widely. The investment banks have smarter people. And the investment banks rely more on smarter people in law firms like ours ... Their ideas factory will test an idea first with an aggressive lawyer who perhaps give them an opinion that the shelter “might” work. That lawyer could improve it so it could be submitted to a law firm with a more conservative reputation who will write a “more likely than not” opinion that it “should” work. Depending on what kind of clients they want to impress, they then might shop for a second “should” opinion from another conservative law firm.

The Big Four mostly promote tax shelters with the support of opinions from their own in-house lawyers. They may consult outside law firms but do not normally use their opinions in marketing material in the way Australian scheme promoters do. The large accounting firms were said to “look for solutions that avoid other parties” as part of their strategy for optimising secrecy. If they need to “[t]hey can afford to hire 100 odd people for a year for more than \$5 million to work on an idea”. Investment banks rely more on outside lawyers. The expert resources they have for tax product development and international marketing are also much less than those of the major accounting firms. As a lawyer from one of the highest profile international investment banks said, there were 70 people in his bank’s tax group worldwide, while when he worked for one of the Big Five accounting firms there were 70,000 tax people worldwide, albeit of lower average technical competence.

Another informant explained: “If someone finds an accounting trick with a tax advantage, a Big Five firm will pick it up, write a paper on it and then market it.” This lawyer was also disparaging of the talent in the Big Five: “Most lawyers in this town think the Big Five are not into sophisticated advice so much as packaging and marketing products.” He continued: “When they do come up with ideas for shelters, they are not that good when you look at them – they’re too literal in their legal interpretations.” Admittedly, the average Big Four lawyer is not as smart as the brilliant young people who work for this managing partner of an elite New York law firm. On the other hand, the Big Four do not put their average people into their New York tax shelter groups; that is where they put their brightest and best.

Joseph Bankman (2001: 153) has identified another difference in philosophy as being that while many lawyers, especially those trained in the last decade or so, are literalists as opposed to advocates of purposive doctrines of interpretation, accountants are much more consistently literalists: "[T]he accounting profession has been more supportive of the literal interpretations that underlie shelters and is opposed to any extension of broad doctrines. Compare, for example, the New York State Bar and AICPA reports on shelter legislation." My interviews, within their limits, support this conclusion. There was no support for a GAAR (General Anti-Abuse Rule) in the accounting profession but there were a substantial number of practicing lawyers who support a GAAR. The unrepresentative sample of elite law practitioners interviewed was surprisingly evenly divided on whether a GAAR was a good idea, slightly more against than for. One of those who were for it said: "In the investment banks, the accounting firms and some law firms, there are tax products groups full of smart, creative people. When the IRS shuts one shelter down, then they open another. That's why we need a GAAR."

Not surprisingly, the views of lawyers on such matters are often animated by a profound concern for the integrity of the law as an institution. As a former American Bar Association Tax Section president has stated: "Many individual tax lawyers with whom I have spoken express a deep sense of personal regret that this level of Code gamesmanship goes on" (Holden, 1999: 369). This kind of persisting professional attachment to the virtues of a tax Arcadia was a recurrent theme of the New York interviews. While the Australian interviews were more about clinging to professional virtues under threat, the American theme was more of virtues lost.

Aggression pays for the major accounting firms

An investment banker added his perspective on how the big accounting firms had changed: "There has been evolution in the accounting firms. They used to provide accounting advice and they used to do it fee-for-service. Now they are partnering. Looking for a share of what they save, without wanting to own a downside risk."

Dear____

As we discussed, set forth below are the details of our proposal to recommend and implement our tax strategy to eliminate the Federal and state Income taxes associated with [the company's] income for up to five (5) years ("the Strategy").

This was how two 1998 letters sent by the Big Four accounting firm Deloitte & Touche opened (Novack and Saunders, 1998). They were sent to two medium-sized US corporations. The letters ask for a contingency fee of 30 per cent of the tax savings from taking the tax liability to zero. PricewaterhouseCoopers were alleged to charge contingency fees ranging from 8 to 30 per cent of taxes saved depending on the originality of the product (Department of the Treasury, 1999: 23). Faber (1999:1) reports that typical corporate shelter fees are in the range of 25 to 33 per cent of tax savings, though "the author knows of one accounting firm that asked for and got a fee equal to 40 per cent of the savings". With more

"turn-key", off-the-shelf, or mass marketed products, the contingency fee is lower, for example, 7 per cent for KPMG to put firms into its BLIPS transactions (US Senate, 2003). These contingency fee arrangements were enabled by a 1991 change to the rules of the American Institute of Certified Public Accountants to allow accountants to charge performance-based fees instead of hourly and fixed rates (Watson, 2003: 1226). Investments in one type of lease-strip shelter were reported to Bankman (1999) as in excess of \$10 million, "generating well over a hundred million dollars of fees to Bear Sterns & Co in a matter of months". As an "idea" becomes more commodified, competition causes the price that can be charged to fall. Indeed, if the government did not step in,

successful shelters would all be copied, their price would fall, and there would be no need for new shelters. It is the requirement that shelters be recreated and thought anew that provides value to the promoters' human capital. "Without the government intervening," one promoter notes, "we'd be in the commodity business. There'd be no money in it for someone like me." (Bankman, 1999: 1782)

In a deal observed by the US Treasury involving one firm, "prospective participants were offered a choice of fees, either an up-front payment of 25 per cent of taxes saved, or a contingent fee of 50 per cent of taxes saved, with no payment if the advice was overturned on audit" (Department of the Treasury, 1999: 23).

In the US, the Big Four seem to have been able to increase their profits substantially through shifts toward such tactics. Individual staffers can secure bonuses up to \$US400,000 for landing deals such as those pursued by the Deloitte & Touche letter above. At the peak of the shelter boom in 1997, Ernst & Young and Deloitte & Touche reported a 29 per cent jump in revenues from tax services. After 1993, Big Five tax revenues grew at twice the pace of audit revenues (Novack and Saunders, 1998: 8). Accounting firms' share of the tax advice market has grown substantially at the expense of lawyers, who continue to do well, but have not grown as fast. The huge transaction costs of aggressive tax planning raises the concern of the waste of "many of America's greatest minds ... devoted to what economists would all say is totally useless economic activity" (Department of the Treasury, 1999: v). The US Treasury estimate the transaction costs in the *ASA case*³ (Department of the Treasury, 1999: vi) at \$24.8 million, 27 per cent of the purposed tax savings of \$93.5 million.

Enter insurers to the advice market

An important feature of the New York market for tax advice is insurers who will insure a tax benefit. This means that if the IRS comes in and knocks out the tax benefit you have insured, the insurance company will compensate you for the value of that tax benefit. I interviewed two New York lawyers who advised these insurance companies on tax schemes. There is also a phenomenon of rescission arrangements where "the parties to the transaction agree to unwind the transaction if the purported tax benefits are not realised" (Department of the Treasury, 1999: 24).

3 *ASA Investorings Partnership v Commissioner* 76 TCM (CCH) 325 (1998).

Insurance is important to promoters because if they can get the insurance obviously they can market the product risk free. The product might have a high cost when the insurance is added in, but so long as known costs are less than guaranteed benefits, the insurance makes aggressive tax planning risk free. These insurers are specialists in prudence, so again the very fact that a prudent insurer will insure against the courts striking down the tax benefit is evidence that the taxpayer has not engaged in intentional illegality. Corporate tax benefits have insurance premiums set on the basis of an assessment of (1) the probability that the IRS will detect the arrangement; (2) a legal view of the probability that the courts would strike down the tax benefit; and (3) the timing of the payout if the benefit is struck down (the insurer gets a premium up front that can generate an investment income for the number of years before a payout is made). Hence, in effect, the so-called “audit lottery” is something a large US company can insure its shelter against.

KPMG’s sales advice to its tax professionals on how to answer an objection to a pitch for its tax product on the basis that it was “too good to be true” installed insurance as a last resort (presumably to avoid the cost deterrent of the premium unless it is needed):

- (1) *“Too Good to Be True.”* Some people believe that if it sounds too good to be true, it’s a sham. Some suggestions for this response are the following:
 - (a) This transaction has been through KPMG’s WNT practice and reviewed by at least 5 specialty groups ... Many of the specialists are ex-IRS employees.
 - (b) Many sophisticated clients have implemented the strategy in conjunction with their outside counsel.
 - (c) At least one outside law firm will give a co-opinion on the transactions ...
 - (e) Absolutely last resort – At least 3 insurance companies have stated that they will insure the tax benefits of the transaction for a small premium. This should never be mentioned at an initial meeting ... (US Senate, 2003; 54-5)

The significance of insurers in the market for tax planning advice is worthy of note. It is part of a new fabric of worry-free aggressive tax planning, of vice without ever being punished for sin. The narrative of worry-free aggressive tax planning goes like this (my words, synthesised from theirs):

You don’t need to pay tax; our fee will be a percentage of the tax we eliminate. You don’t need to lose sleep because of the morality of what you are doing when your company uses tax shelters: every Fortune 500 company does it; you only need to lose sleep if you spurn our offers of eliminating your tax liability because then you will be failing in your duty to your shareholders. It’s virtue you will be punished for, not vice. You don’t need to worry about having to pay penalties if the shelter is struck down because you have opinions from two conservative law firms saying the shelter is legal – you won’t be punished for following their advice even if it is wrong. If other lawyers from whom you solicit an opinion think the shelter is illegal and are concerned for your welfare, they will counsel you not to consult them (a form of solicitous non-advice reportedly common among experienced New York tax attorneys). And now you do not need to worry about budgeting for the tax saving and then losing it, because we will insure you for that.

Insurance epitomises the greater sophistication of the US tax market. It is not a feature of the Australian or British markets. While the most aggressive British shelter investors are not known to insure, they are known to spread risks by investing in perhaps five shelters, believing that if one is struck down, they will still be ahead from the other four.

Combatting worry-free aggressive tax planning

Prohibiting the insurance of unfavourable tax authority decisions would be one way of undermining worry-free aggressive tax planning, though perhaps a draconian one (see Cane, 2002: 245-249). Another would be to follow the surprising advocacy by the New York State Bar Association (1999: 880) in favour of the US Treasury's 1999 proposal for "a strict-liability regime" with respect to lawyers' opinions whereby, "reliance on professional tax opinions would no longer have the effect of eliminating the penalty imposed on corporate taxpayers with respect to corporate tax shelter transactions". One reason they favoured this was concern that: "We suspect that many others of us, whether we would acknowledge it to ourselves or not, feel subtle pressures to give favourable opinions to be 'at the table', to continue to be involved with our clients' transactions, and ultimately to generate our fair share of revenues for our firms" (New York State Bar Association, 1999: 893). One informant said that they did not like the feeling of prostitution in prospective clients saying: "I don't want to waste your time. I'm not interested in your opinion unless you say the shelter is legal." A compromise option here that was also floated by the US Treasury in 1999 is to forbid taxpayers from relying on letters of comfort from lawyers to avoid penalties unless they disclose such a letter at the time of lodging their tax return. This would force taxpayers to choose between abandoning shopping for "more likely than not" opinions and alerting the IRS to the latest shelter they have moved into.

Collaboration and competition in the advice market

Tax lawyers have a community of expert support in New York that goes beyond their own firm: "I will talk with friends on the viability of a shelter." It's often okay for these friends, in return for advice on the shelter, to use what they learn about it with their own clients: "We do some deals and we all make some money. You keep what you kill." This at least is the mentality of the law-firm folk who live on fee-for-service rather than on selling products. Sometimes they'll "ask you to sign a letter to keep an idea confidential. Sometimes you'll refuse to sign. Often it's pointless anyhow because ideas get out and eventually everyone is competing with a new version of that idea". This also happens because the major accounting firms try to steal clients from each other by using great new product ideas to tempt them. But, of course, some of these targets will remain loyal to their existing accountant and tell them of the scheme, at which point their firm may set their product development group to work on reverse engineering their own version of the scheme. Investment banks also do this: "Mr X was the chief financial officer in company Y. He got a call from an investment bank. The man from the investment bank says, 'We hear so and so about your affairs and we have the product to respond to this situation.' " Confidentiality agreements have

also become less popular because under the disclosure rules introduced in 2001 the existence of a confidentiality agreement triggers a requirement to disclose a shelter to the IRS. Sometimes there are problems with international deals where foreigners don't understand why Americans increase their risks by not signing a confidentiality agreement. But as one investment banker explained: "We had an international deal with an American play to it. Explained our situation and got a waiver of confidentiality."

"Gradualism" of the disclosure is now generally used instead of a confidentiality agreement. Instead of laying out details of a shelter up front to a potential client in return for signing a confidentiality agreement, "you disclose just a little verbally – you only gradually reveal more detail as they get locked in to being your client and you develop trust". Promoters will sometimes say to investors, "If you talk about it, the IRS will find out". One tax partner said, "They're still confidential but they don't say they're confidential. There is just no enforceable confidentiality agreement". Idea developers can be strenuous in attempting to protect their idea – even on occasion patenting the structure of a transaction – but it is only a matter of keeping a finger in the dyke to maintain a first mover advantage for as long as possible. This inevitability flows from the nature of the tax advice community in which clients shop for advice. The New York market for tax advice is as much a collaborative community as a market. Ideas are developed collaboratively; by friends bouncing ideas off one another. The ethos was described as, "I'll help you now with this idea; you help me later with one of mine".

To understand the dramatic changes occurring in global markets for tax advice led from New York it is necessary to understand the dialectic between collaboration and competition. This market is a classic example of what Dorf and Sabel (1998) call "learning through monitoring in a post-Fordist information economy". While the differences between law firms, accounting firms and investment banks that have been described are important, more important to understand is the way they monitor each others' moves, learn from each other and set up strategic networks of collaboration with one another when it suits. But not only do they collaborate with one another in more creative ways than they once did, they also compete with one another much more vigorously. Once there was a world of comfortable understandings where mostly law firms only competed with law firms for their kind of business, accounting firms with accounting firms, banks with banks – and all in a mostly gentlemanly way according to settled rules of the game. Late 20th century professional deregulation at the behest of a globalising competition policy, underwritten by the World Trade Organization General Agreement on Trade in Services, has changed that. The accounting firms in particular have led the invasion of the turf of other financial market players, from management consultancy to investment advice to legal services – not always successfully, as illustrated by the now bankrupt accounting firm Arthur Andersen having become the largest law firm in the world by the end of the twentieth century. The deregulation has produced many benefits in terms of management creativity, financial innovation and economic efficiency. It has, however, also produced competition in tax abuse.

Novack and Saunders (1998: 3) argue that in the US, "It has taken a while for inhibitions to be shed and the most outlandish gimmicks to propagate". But

the inhibitions have shed under pressure from the aggressive marketisation of proactive as opposed to reactive advice. Today, as one adviser worried, "If you pay enough you can find a lawyer to write an opinion supporting anything". The advice market, in Australia as well, decreasingly operates through advisers just reacting with specific strategies to cope with the needs of clients as they arise.⁴ If you do not proactively market strategies to substantially reduce the tax liabilities of major clients, you can count on it that competitors will. Once the Big Five reached the conclusion that they would lose business unless they matched that competition from aggressive, proactive promotion of shelters, a level of global sophistication in the engineering of proactive tax planning that is within the competence of the (now) Big Four came into play.

Increased competition is also of great importance on the demand side for aggressive tax planning. Edward Kleinbard (1999: 231) views the growth in corporate tax shelter activity as a "natural outgrowth of an improvement in the efficiency of corporate management, as a result of which corporate income tax liabilities are treated, along with other business liabilities, as costs that respond to modern management techniques. Corporate tax shelters, I believe, are a demand-driven phenomenon, not a supply-side problem. Moreover, this trend is irreversible and will only intensify as corporate managerial arts become more sophisticated". Kleinbard (1999: 234) persuasively argues that the demand for corporate tax shelter advice is about as likely to return to the levels of two decades ago, as it is that "corporate America will ever revert to pre-1970 indolence toward inventory levels". Kleinbard, one of New York's leading practitioners, is worth quoting further at length:

[S]enior corporate managers now perceive a corporation's tax liability, not as an inelastic and inevitable misfortune, but rather as a necessary cost that responds to aggressive management, just like other corporate expenses ... [O]ver the last two decades, corporate management skills have been progressively refined and successfully applied to a wide variety of previously difficult to control costs ... Corporations today aggressively manage a wide variety of regulatory liabilities. For example, companies bring professional discipline to bear on their environmental liabilities, whether through implementing "greener" processes in the production process, environmental due diligence in corporate acquisitions, or legal challenges to overreaching or unclear environmental regulations. The same phenomenon is true for pension liabilities, tort claims, and – I submit – tax liabilities. (Kleinbard, 1999: 234)

Kleinbard (1999: 234) illustrated what he sees as the demand-driven nature of the problem with respect to relationships with investment banks: "[I]n my personal experience it has now become commonplace for a sophisticated corporation to approach an investment bank with a self-developed tax-advantaged financing that the corporate client instructs the investment bank to execute."

Other interviewees felt the shelter phenomenon to be much more supply-driven than Kleinbard: "Tax practice was a transaction practice – crafting a

4 In any case, within the Australian market, an adviser "looking at the ball from different angles, will often come up with an opportunity for one client. Then he applies it to a few more clients. Then the idea might get out and some financial planner or little accountant might market it widely".

product to meet a client's needs. That has shifted. Instead of a client looking for a transaction to solve their tax problem, we have transactions looking for clients." My own view after talking about this to so many deeply knowledgeable observers of the New York scene is that there were drivers of the explosion in shelter activity in the late 1990s from both the demand and the supply side, that indeed these drivers drove each other forward. New corporate demands to control these costs, even to make the tax department a "profit centre" (Bankman, 1999; Novack and Saunders, 1998) attracted the interest of new nodes of supply. At the same time, the emergent deregulation of competition among accountants, investment banks and law firms on the supply side engendered new product innovations that caused CFOs to see tax as a neglected way of aggressively managing short-term improvements in the bottom line.

American short-termism is also a factor in the US being years ahead of Europe, Japan or Australia in the growth of corporate tax shelters. As the New York State Bar Association (1999: 882) explained, the ever-increasing attention being paid to current corporate earnings on Wall Street make management coups in tax-cost control career enhancing. On the supply side, the best law schools have obliged the demand for tax advisers with finely honed skills in literalist lawyering, and university IT departments have trained the software developers needed for very complex tax avoidance transactions of global sway. On the demand side, business schools offer, "increasingly sophisticated finance programs, teaching cutting-edge mathematical techniques and advanced computer technologies", creating a taste for sophisticated tax shelter engineering (Department of the Treasury, 1999: 27).

Obversely, in this environment the extremely common phenomenon of a manager who wants to feel good about her company as one that pays its fair share of tax is at risk of becoming an endangered species. This pressure is also becoming evident in Australia where I have spoken to tax managers of large corporations who felt they were being vilified because their company was paying ("rightly", they thought) more than their competitors in the same industry. "Fiscal termites" (Tanzi, 2000) on both the supply and demand side therefore become "moral termites" eroding the moral commitment of old-fashioned managers who want their company to pay its fair share, or just killing off those managers. Competition policy drives both the supply side and the demand side for tax advice to the view that substantial tax liabilities are something that aggressive management can and should get innovative about. We can engineer around it; we can insure against it.

Tax liability is driven by more aggressive competition to no longer be thought of in terms of the professional virtue of correct application of legal norms. It is something the firm can demand and continue to demand to be eliminated until a supplier steps forward that will do so. It is something the aggressive supplier can thrust at virtuous managers who are attached to taxpaying norms with the pitch that the market will punish you and ultimately remove you for being virtuous. At the same time, the very language of informants in the major accounting firms as they pushed shelters betrayed a sense of ambivalence, irony that there may be vice in their deeds or even something disgusting. KPMG memos that refer to the decisions to start and stop

selling a shelter read: "I think it's shit OR get off the pot. I vote for shit"⁵ (Head of KPMG Tax Services Operations, US Senate, 2003: 37). This was in response to a memo from the head of tax at KPMG who used the same metaphor as he recommended "that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit ...".

⁵ "I vote for shit" was a construction of its author, but "shit or get off the pot" is an American expression which is a distasteful form of the expression "fish or cut bait". Historically, it is believed to be a crudity of American soldiers, associated with the game of craps and with the word "pot" referring to money pot.

International arbitrage

It does not surprise anyone when I tell them that the most important tax haven in the world is an island. They are surprised, however, when I tell them that the name of the island is Manhattan. Moreover, the second most important tax haven in the world is located on an island. It is a city called London in the United Kingdom.

Marshall J Langer

New York leads an internationalisation of the advice market

Structural discontinuities, like those created by different tax treatments for the same transaction in different nations, open up arbitrage opportunities. Corporations can double dip, taking one position on the meaning of a transaction for US tax purposes, and another in a second country in a way that creates tax benefits under both sets of rules.

When national systems collide, as they inevitably do with global businesses, sometimes the chips will fall to produce double benefits and, sometimes, double costs for the transnational entity. There can be no integrity or coherence in this. Indeed incoherence worsens because sophisticated tax planners seek to skew the clash of systems to maximise double benefits and eliminate double costs. Occasionally tax planners can go one better than double-dips at a tax advantage for the same transaction (say depreciation, leasing double-dips) in two different countries and secure a triple-dip (tax relief in three countries for the same expenditure, for example cross-border leasing where a deduction for lease of say aircraft is claimed in three different countries).

A common form of double-dipping involves obtaining tax relief for investment in plant and machinery in both the US and the UK. Plant operated in the US is acquired by a UK bank, which leases the plant back to the US company. One way of manufacturing capital losses is to use two trusts in two tax havens. They enter matching options linked to a share price straddling two tax years. Similarly, informants in late 2001 interviews cited cross-border derivatives that may be characterised in different ways in different jurisdictions as the emerging growth area of arbitrage. Vito Tanzi (2000: 12) lumps derivatives together with hedge funds as one of his fiscal termites. It is estimated that about a trillion dollars moves through hedge funds annually. He points out that earnings from derivatives pose huge problems of identification of individual beneficiaries, of transactions, of incomes, and of jurisdictions where people live or transactions occur.

Some informants saw the comparative rigour of US tax administration and enforcement as creating incentives to look offshore for opportunities: "Foreign tax systems can be easier to get around. They are more primitive in the way they deal with financial instruments and hybrid entities." One knowledgeable IRS informant estimated that with shelters based on financial products such as swaps, options or other sophisticated derivatives engineered as shelters, 75 per cent were based on international transactions. With these kinds of products there can be as many as 300 corporate and high-wealth-individual investors buying one financial product shelter from one promoter. International arbitrage with "hybrid entities" can mean treating an entity as a partnership for US tax purposes and as a corporation for foreign purposes.

As capitalism becomes more globalised, a consequence of more effective national tax administration is a shift of intellectual energy into international arbitrage of tax laws: "I recently saw a 37-step transaction for a client, with different steps in different parts of the world. The ultimate benefit for the client was not a US tax benefit but a UK tax benefit. With global collaborations, the ultimate clients for much of the work are European companies" (New York Adviser). I was also told during the interviews that some products designed for US corporations were being adapted for European and Australian corporations. The shift toward global holism in tax planning has been an intellectually demanding shift for tax professionals: they work long hours to master complex national tax laws; to seek to master all the complexities of the world's two hundred tax systems, or even two or three, in order to find ways to play one system off against another requires a big new investment in knowledge acquisition. As we saw from the Australian interviews, this is accomplished by global networking of knowledge – linking a Sydney office with knowledge of Australian tax law to a New York office with knowledge of US law; moving people between national offices to facilitate the conceptual insight to seize an arbitrage opportunity; employing "rocket scientists" – theorists of tax arbitrage – who come up with conceptual insights and who then confer with a network of national experts with detailed knowledge to see if there are a set of tax laws that can exploit the arbitrage insight.

Very few firms can afford to employ these rocket scientists and to provide them with such global networks of detailed system-specific knowledge. So it becomes increasingly true that the really big money in tax advice comes to be made by an ever-smaller number of players – major accounting firms and investment banks: "Most law firms are less internationally organised to globalise products and optimise jurisdictional arbitrage." When the bigger players pick up arbitrage opportunities often these opportunities will eventually become widely known and used. For example, in 2001, it was widely known that the *Nova Scotia Companies Act* permitted the incorporation of a company that has no limit on the liability of its members (the Nova Scotia unlimited liability company), and that this corporate form could be treated as a partnership for US tax planning purposes and as a corporation under Canadian law with several consequential advantages in cross-border tax planning. Similarly, the *Compaq* case in 1999 (see Box 2) is based on the fact that fertile minds "at some point realised that corporations with capital gains could therefore benefit from buying stock just before a declared dividend was paid and selling the stock for a loss just afterwards ...

Box 2: Compaq v Commissioner 113 TC No 17 (September 21, 1999)

From presentation notes of Sean Foley and Tony Russo, International Branch, IRS, on how Compaq eliminated a large capital gains tax liability.

July 1992, Compaq sells its interest in Conner Peripherals and recognises \$232 million in long-term capital gain.

August 1992, Twenty-First Securities Corporation writes to Compaq offering two "strategies that take advantage of capital gain".

September 1992, Compaq decides to go forward with one of the two strategies termed an ADR arbitrage transaction. An ADR (American Depositary Receipt) is a trading unit of a trust that represents ownership of stock of a foreign corporation deposited with the trust. ADRs are the customary form of trading stocks on US stock exchanges. The ADR arbitrage transaction involves buying and immediately selling ADRs across a dividend record date in such a manner that the ADR is purchased with the dividend attached and sold ex-dividend. The strategy takes advantage of the fact that while normally settlement takes place four days after a trade, settlements can also be arranged by agreement to occur the next day.

September 16, 1992, Compaq purchased \$887 million ADRs of Royal Dutch Shell Petroleum with settlement September 17.

September 16, 1992, Compaq sold \$868 million ADRs of Royal Dutch with settlement September 21.

September 18, 1992, the record date for payment of Royal Dutch dividend worth \$22 million, less \$3 million withholding tax.

Results:

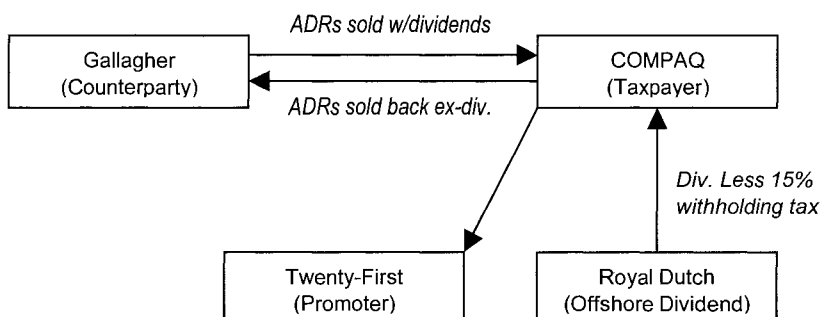
Compaq pays \$1 million commission to Twenty-First.

Compaq reports on its 1992 return:

\$19 million capital loss

\$22 million dividend income (grossed up for FTC)

\$3 million Foreign Tax Credit

COMPAQ v Commissioner

Dividend-stripping is a conceptually simple tax arbitrage play that relies on a couple of basic mismatches in the income tax law" (Shaviro, 2000: 224).

Another sense in which more effective tax enforcement in one country promotes the internationalisation of tax planning strategies is that "US tax reforms of recent years are a tax planning manual for foreign countries". That is, by reading on US government websites what it has been important to block by US law, tax planners can learn what is not blocked in other nations.

Arbitrage in self-executing and non self-executing tax systems

Practitioners described some tax systems as more "self-executing" than others. The US was seen as an example of a highly self-executing tax system, the Netherlands as one that is not. By this they meant that in the US it is possible for the tax lawyer to assess from reading cases and laws what the tax implications of a high proportion of transactions will be. For the Netherlands, in contrast, the view was that you could not be sure what the tax implications of most complex corporate transactions would be until you sat down with a Dutch tax official to negotiate an interpretation that would be made "with little reference to rules". Rule systems that are self-executing in theory are not always so in practice. Informants said that in the US at times IRS officials can adopt the attitude: "Let's make a deal because I can't figure this out." This works fine for making the tax official's life easier when the deal suits the wealthy taxpayer, but in a self-executing system, any such deal that disadvantages the taxpayer is likely to be challenged in the courts. This is much less true in a more negotiated system such as prevails in the Netherlands (or Japan (Sakurai, 2002)). Three propositions are thus suggested for further research:

1. In self-executing tax systems technically incompetent tax officials resort to negotiated compliance in ways that systematically favour wealthy taxpayers.
2. In non self-executing tax systems, negotiated compliance more systematically favours the revenue because there is little certainty of success in appealing negotiated offers and high costs in souring relationships for future negotiations.
3. Non self-executing tax systems create fewer opportunities for international arbitrage than systems that are dense with bright-line rules.

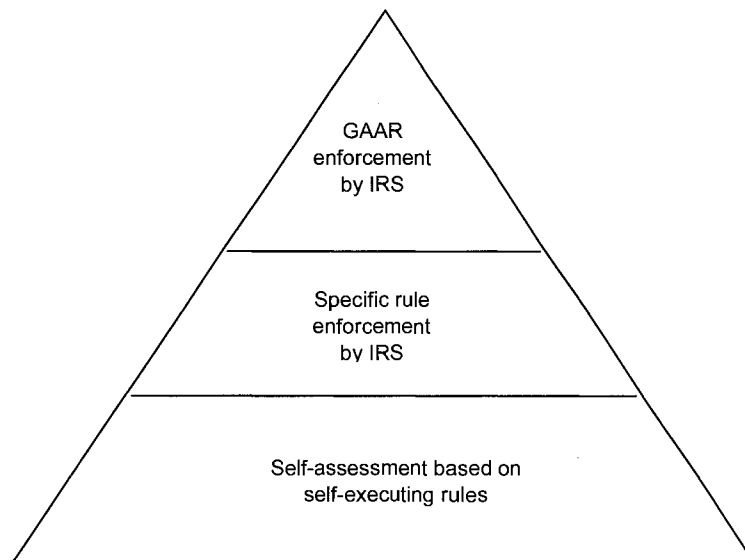
The implication of these three propositions is that tax systems that opt for the self-executing route of clear rules must make a large investment in technical competence in the tax authority if they are to fight off the dual threats of (a) bad deals negotiated as a result of an incompetent grasp of their own rules; and (b) being targeted for international arbitrage. The US is large and rich enough to make this investment to defend a self-executing system. While it makes a much larger investment in tax-technical competence than any other tax authority in the world and enjoys considerable success in defending the US revenue from these two threats, it is also true that it often fails to do so. It follows from all of this that it might be rational for a tax authority with a much smaller agency budget than the IRS, such as the Netherlands tax authority, to opt for a non-self-executing system of large corporate tax compliance.

A general anti-avoidance principle: Is it possible to have the best of both worlds?

Is it possible to have the best of both worlds – to have the greater business certainty that comes from self-executing rules, while giving priority over these rules to binding principles? Part IV of this book argues it is. The argument there is that it is possible that a regime of binding principles interpreted by non-binding rules derived from those principles (a) is a defence against international arbitrage of the rules derived from the principles; and (b) allows negotiated compliance based on the principles where the deal is less likely to be overturned by subsequent litigation that invokes the rules derived from the principles.

One of the overarching principles in such a dispensation would normally be a general anti-avoidance principle that states that schemes are illegal when their dominant purpose is a tax advantage. One of the bases of opposition to a general anti-abuse rule (GAAR) in the US interviews was that “it helps tax officials get lazy”. It has a “corrosive effect on the bureaucracy” because officials can get away with doing what suits the revenue by invoking the GAAR, neglecting the cultivation of rules that deliver the business certainty necessary to attract investment. Other informants were very attracted to the notion of a tax culture that supports a concrete framework of rules that clearly communicate what is expected across most normal circumstances but then rely on a GAAR to cover the gaps left by these rules. I drew a “GAAR pyramid” for two of these informants to ask them if this was what they meant (Figure 11):

Figure 11: A general anti-abuse provision pyramid



They agreed that this was what they meant – most tax decisions would not be negotiated with tax officials but would be self-assessed based on self-executing rules. When the taxpayer got the rules wrong, there would be specific rule enforcement by the IRS. Only when the IRS believed that the rules were interpreted in a way that was inconsistent with the principles of US tax law would the GAAR be invoked.

Opinions differed greatly, however, on whether a culture of routine reliance on rules could be sustained when the technically lazy path of relying on a GAAR was routinely available to a tax authority.

Defenders of a more wide-ranging GAAR in the US still defended the need for certain bright-line or foot-fault rules. These informants saw the need for contextual wisdom to see where you need a foot-fault rule to be clear. Wisdom is also needed to envision where a foot-fault rule will be used to “game” the rules, for example, through international arbitration. It often happens, they pointed out, that a foot-fault rule works well for many years, giving business a laudable level of certainty, then a legal entrepreneur invents a way of gaming the rule, perhaps because a new rule in another country opens up a new opportunity for international arbitration. The rule is then suddenly a source of uncertainty.

An opposite dynamic is where a new principle in a new law is “too general”: “people react to it by thinking, ‘We can do what we want’”. Such principles both fail to protect the revenue and fail to deliver business certainty until they are fleshed out with more specific rules that give more concrete guidance: “The philosophy [of the tax authority] is often that people will be unsure where the line is and therefore they will be cautious. But often they are mistaken in this belief because what people actually conclude is that there is no line.”

Some informants saw the remedy to this problem to be to define general principles in the law and then to specify concrete examples of how each principle would apply to the most common kinds of concrete transactions or business arrangements. This approach is picked up in the policy analysis of Part IV. Whatever they thought of this approach, there was general agreement that “getting the dialectic between rules and standards right” was a crucial challenge of tax administration and that contextual wisdom, foresight and fine-tuning based on experience were necessary. Some advocated making it easy to see the principle (or standard) underlying the rules by adopting the drafting practice of stating, “the reason for this rule is that it implements the more general principles X and Y”. Again, this idea is taken up in Part IV.

Many accepted the importance of more general principles or standards in tax law, but suggested that for them to actually shape compliance they had to have two or more of the following qualities. To work, principles, must be short (brevity in drafting), articulate (richly communicative of meaning), and capable of being contextually attuned. In the US that contextual attunement comes from the way new principles are connected to older principles and concepts in the common law. This means that principles get their power from a metaphorical quality that is quite different from what gives rules their regulatory power. The regulatory power of principles is about metaphorical pungency rather than precision. Useful principles are short and evocative and have fecundity. While they are fertile in prodding our imagination to see their meanings, they also prod us to contextual deliberation of the possible limits of their meaning. This is why

informants suggested that principles needed to be complemented by concrete examples that show us both what they are not (as well as a concrete array of things that they definitely are).

I enjoyed interestingly elaborate discussions with some informants on how they saw US tax law as having its self-executing qualities grounded in a set of shared sensibilities that are based on a mix of common law understandings, some foot-fault rules that have stood the test of time, and some more general principles that are given greater or lesser salience depending how they have been brought to life by recent decisions of appellate courts. Public pronouncements of the principles the IRS intends to bring to life in particular contexts and to defend in the courts in those terms are also part of this mix of inputs that allow “most tax lawyers to agree on what does not pass the smell test.”

There is a list of types of shelters that all reasonable and sophisticated experts would agree should be covered by the GAAR.

Experienced tax professionals can usually readily distinguish tax shelters from real transactions. (Canellos, 2001: 51)

Good tax lawyers know when they are pushing hard at the edge of the envelope. (Gergen, 2001: 136)

As another informant said: “You wouldn’t start with such a messy system.” But then he went on to argue that this blend of ingredients does make US tax law fairly responsive. Its working depends on a particular history of building up shared understandings. Perhaps what follows is that no country can afford to shatter those shared understandings embedded in their history by some grand top-down reform process. Nor can a global agreement deal with the inescapably global nature of contemporary tax avoidance work by imposing a globally uniform top-down solution. Somehow global reform needs to harmonise principles based on attuning these bottom-up shared national understandings.

Globalisation of tax policy?

At a more normative level, we might say globalisation of tax policy can only proceed effectively and should only proceed by preserving the Dworkinian integrity (Dworkin, 1986) of each national tax system, or preserving its doctrinal coherence at the level of a national system (Teubner, 1998). This is easier said than done. When you have a British tax tradition based more on form and a US tax culture based more on substance, a difference a number of informants pointed to (see more generally Atiyah and Summers, 1987), international arbitrage opportunities are grounded in financial engineering that plays to form in the UK and substance in the US.

Critics of the OECD Fiscal Committee said, “they do sit around the table endlessly in Paris”. But perhaps this sitting and chatting is the stuff of acquiring mutual understandings of the different shared sensibilities of different national tax cultures. Even when they fail to harmonise, perhaps they are at least each beginning to learn how to do their national tax system strategic planning in a way that is mindful of the strategic planning that other tax authorities are doing.

International arbitration poses new intelligence challenges for tax authorities. When effective enforcement does happen, it seems almost by accident. A leasing tax attorney with a major investment bank claimed that the IRS moved against the “extremely, extremely attractive” LI-LO cross-border leasing arrangement after a Swiss diplomat brought it up with a US official at a cocktail party. Only then, he claimed, were serious questions asked about it.

It has become clear that a fundamental problem is that markets in tax shelters have become increasingly global in their marketing and increasingly based on global arbitrage of tax rules. The global nature of competitive markets in tax vice is consistent with a general development of increasingly competitive markets in vice – be it paedophilia on the Internet, gambling marketed to children, bribery to secure contracts, gun running, people smuggling, trading weapons of mass destruction or illicit drugs. To be more systematic about an enforcement response to the rapid growth of international arbitrage of tax laws, we must confront problems in the very structure of national laws themselves. Part IV argues that virtue can grow nationally in response and in resistance to the international arbitrage of rules, that such virtue must be principle-based, and that a principle-based law is more than just a way of resisting the international arbitrage of rules. Part IV argues that principles constitute the language of virtue; gaming rules is the legal language of vice in a global competitive economy of legal entrepreneurship.

We will find a number of the perspectives described in this chapter extremely useful tools for conceiving a radically different way of thinking about the relationship between rules and principles in tax law that might help us confront international arbitrage. Disclosure of aggressive tax planning, the topic of the next chapter, is also an approach that might help tax authorities to detect shelters that might otherwise disappear over the national horizon.

IRS enforcement initiatives

This chapter outlines some innovative steps the US has taken in its efforts to improve enforcement against aggressive tax planning. The most important of these will be considered first – the requirements for the registration and disclosure of corporate shelters. This is a very different development from what we have seen in Australia. Then we consider a number of developments that follow a more similar path to the Australian initiatives discussed in Part II – the IRS becoming less risk averse about announcing a belief that a scheme is an illegal shelter, attempts to use strategic cases to shape crucial case law, a Taxpayer Bill of Rights and a debate about strategic use of tougher penalties. It will be concluded that if the US wants to make responsive tax enforcement work, it has some more formidable tools than Australia to enable escalation up an enforcement pyramid. But at the same time the IRS's responsive regulatory capability has been undermined by the sequential collapse of the quality of its relationships with American taxpayers, particularly in terms of their trust, followed by a collapse of its audit capability as a misguided remedy to that collapse of trust.

Disclosure of aggressive tax planning

Since 1984, promoters in the US have been required to register “potentially abusive shelters” with the IRS from the day of first offer of a shelter for sale and to maintain lists of investors in such shelters which are to be made available to the IRS on request. Taxpayers in turn must disclose the registration number of a shelter they rely upon to claim a deduction or other tax benefit. But it is the promoter's registration at the moment of first promotion that is more important for early detection of shelters because, especially with large corporations, it may be some years before the tax return is examined. New Zealand and Canada have now also legislated for registration of shelters. In 2004, the UK began putting in place a registration and disclosure regime for shelters rather similar to that in the US (Freedman, 2004).

In 2000, the US introduced temporary rules that required registration by promoters of transactions: “(1) that have been structured for a significant purpose of tax avoidance or evasion, (2) that are offered to corporate participants under conditions of confidentiality, and (3) for which the shelter promoter may receive fees in excess of \$100,000” (s 6111(d)). From 2000, taxpayers were also required to disclose if they used any one of a number of listed transactions and to disclose any transactions that are expected to reduce income tax liability by more than \$5 million in a single year or more than \$10 million in multiple years and that have characteristics common in corporate tax shelters. The shelter registration requirements for promoters (as opposed to the taxpayer disclosure requirements)

had already resulted in 1200 shelters having been registered by the end of 2001. By November 2001 however, there had been only 268 disclosures by taxpayers, a number that was disappointingly small to the IRS in the interviews. The disclosure triggers promulgated were not as broad as those proposed in the 1999 Treasury white paper:

[A] book/tax difference in excess of a certain amount; a rescission clause, unwind provision, or insurance or similar arrangement for the anticipated tax benefits (other than customary representations and warranties found in non-shelter transactions); involvement with a tax-indifferent party [often a foreign entity that can absorb the taxable income]; contingent adviser fees or fees in excess of a certain amount; a confidentiality agreement; the offering of the transaction to multiple taxpayers (if known or the taxpayer has reason to know); a difference between the form of the transaction and how it is reported (with exceptions for certain specified common transactions where the form and the reporting differ, such as repurchase agreements) ... (Department of the Treasury, 1999)

Since 2001, the ambit of the disclosure rules has been widened somewhat and what was in 2001 a couple of hundred disclosures was a couple of thousand by 2004. The IRS uses the investor lists disclosed to it by writing to all the investors on a promoter's list before they lodge their tax return with what is in effect the message: "If you lodge with this scheme, we will audit you." And when the IRS audits any company the IRS asks whether they have been involved in any of the transactions of the kind in the list of prohibited shelters.

One Wall Street firm has been prosecuted for failing to register a marketed transaction. Ernst & Young settled with the IRS for \$15 million in 2003 over allegations of compliance failure in respect of the shelter disclosure rules (Gary, 2004: 37). Sometimes taxpayers who should have disclosed are detected as a result of promoters who register shelters and sometimes promoters who fail to register are detected as a result of taxpayer disclosures. Cross-checking of disclosures has thus become an important part of IRS enforcement strategy.

The IRS has also established a "tax-shelter hotline" from which I was told they had "got some meaningful information" even though it was "not ringing every day". An example of where this can be useful is that disgruntled losers in takeover battles sometimes disclose to the IRS doubtful tax practices in their takeover target. There was also a proposal to extend rewards to corporate tax shelter informants (Department of the Treasury, 1999: 133). Some informants on the tax shelter hotline have now been paid rewards.

The interviewees' views on how well these disclosure rules could work ranged from the belief that it was "a lot of hot gas" to "[d]isclosure coupled with strong penalties is the key to a solution; it could cut out 90 per cent of the shelter market." For the cynics, the IRS getting a shelter disclosed is a limited advance when the IRS is snowed with disclosed information and "[i]t takes a couple of hundred pages and a couple of years work to figure out the nature of the transaction. Then you have to apply the law." Both over inclusiveness and under inclusiveness of disclosure can make the job of the IRS difficult: "The problem for the IRS is that the disclosure is generic. We are not required to give all the info to the IRS. We can say such and such a transaction exists and we believe it complies with this law and that law. The IRS has the burden of analysing the transaction. The taxpayer can provide the IRS with as little information as possible." This is a

general problem with disclosure to the IRS, not only a problem with marketed shelters: "With mergers, you don't disclose 80 per cent of the facts about the merger because there are no tax issues in these facts. You only have to disclose tax issues. So the IRS cannot work out the whole picture of the merger when you have short, vague, generic disclosure."

Whichever side of the debate on the value of disclosure informants were on, they agreed that if the IRS were to make the best use of the disclosures, they would have to "[q]uickly focus. Quickly analyse. And don't vacillate on the politics".

The problem is: analyse what? Neither the US nor any other government has yet crafted a set of factors to cue disclosure of abusive shelters without expanding the disclosure requirement to cover everything – too much to allow quick focus and quick analysis. Most of those interviewed were of the view that the IRS had made just this mistake of over-inclusiveness in its disclosure rules. In fact the opposite mistake seems to have been made: the disclosure rules are too narrow and too little is being disclosed. The narrowing was a response to political pressure invoking the spectre of overly vague over-inclusive laws. But it is actually not so important to eschew overly broad disclosure rules as it is to eschew overly broad proscriptive rules. Broad proscriptions prevent all manner of productive activity from going forward; broad disclosures do not. They simply require the paperwork of disclosure. There are, of course, substantial costs with making disclosures too broad as well – costs for both the writers and the readers of the paperwork – but they are costs of a different order from overly broad proscriptions.

One of the enforcement features that buttress the US shelter disclosure regime is the enrolled agent requirements outlined in IRS Circular 230. An enrolled agent is a person who has earned the privilege of practicing, that is representing taxpayers, before the IRS. Circular 230 was said by interviewees to pose the risk of "a death sentence for a tax lawyer". Not to be able to represent taxpayers before the IRS as a result of complicity in covering up a shelter that should have been disclosed was something that exercised the minds of practitioners. On the other hand, it was said that Circular 230 simply imposed strictures against unprofessional advice that you could cover by writing longer opinions. Circular 230 does not require you to be right. On this cynical view Circular 230 might be what Daniel Shaviro (2000: 223) would describe as "an inefficient set of rules", being rules that simply require smart practitioners to waste clients' money by jumping through some extra hoops in their opinions without changing the realities of tax planning. On this view Circular 230 does not trap the venal, just those who are clumsy at jumping through the hoops.

A longstanding distinctive feature of the US disclosure regime is the requirement to disclose and explain book-tax differences on corporate tax returns, that is discrepancies between accounting income disclosed to the stock exchange to inform investors and taxable income reported to the IRS. Schedule M on US tax returns, which documents the gap between accounting income and taxable income, is a focus of audit activity with respect to shelters. It is generally believed that "most shelters trigger a book-tax difference". And there is a requirement on the Schedule that you explain the discrepancy. Auditors ask for a discursive account of it as one of the first issues they raise in the audit process. This is not a feature of Australian audit activity directed at shelters. In the US

market the belief is that opportunities to reduce taxable corporate income are not attractive to executives if they also reduce reported earnings. So it is the shelters that produce losses for tax purposes but not for accounting purposes that produce a book-tax difference, that are most often used.

Vice flourishes in darkness, virtue in sunlight. This is why disclosure is the first line of defence against aggressive tax planning. While the light cast by the US shelter registration and disclosure regime is extremely patchy, if tax authorities can become learning organisations, then over time more light will be cast into the darker recesses of the shelter business. In the next section we consider subsequent stages of the US enforcement process that will be used later to illuminate some interesting comparisons with Australia, from announcement of intent to attack shelters through to litigation.

IRS announcements

As with the ATO, the IRS generally believes that when it announces an intention to attack a shelter, most prudent corporations stop using the shelter. In both the US and Australia it is probably not an overstatement to say that the main game of preventing aggressive tax planning is to get these announcements right. As with the ATO policy shift in 2001, in the same year the Office of Tax Shelter Analysis claimed that it had shifted its philosophy toward being less risk averse on such announcements: "It's better to issue the notice and possibly be wrong."

How strategic court cases make a difference

According to interviewees, an important factor in stemming the flow of aggressive tax planning at the end of the 1990s was decisions by the courts to support IRS efforts to strike them down. During the 1990s the IRS won a run of seven straight critical cases against tax shelters. The New York State Bar Association (1999: 879) reported on the effect of these cases: "In our experience, the government's recent victories in well-publicised court cases have had a perceptible impact on the willingness of corporate taxpayers to enter into these transactions, and the Treasury Department's aggressive exercise of its regulatory authority has also been helpful." But with the new decade came a new Republican administration less aggressive toward shelters, even tax havens (with Assistant Treasury Secretary (Tax Policy) Weinberger even withdrawing support for the OECD campaign against tax havens by an Administration that "will not support efforts to stifle tax competition"),¹ and some court decisions that tipped the balance back toward the shelter promoters. At different points in US history and in different Circuits of the US federal appeals courts, different weightings in evaluating shelters are given to an objective test of the underlying economic substance of a transaction and a subjective test based on the business purpose behind the transaction. A challenge for the US courts, as with the Australian courts, has been to assess how major the business purpose of a transaction has to

1 Letter from Assistant Treasury Secretary Mark Weinberger to the Honorable Bill Archer, PricewaterhouseCoopers. This when Robert Morgenthau, Manhattan District Attorney, was saying that in the Cayman Islands alone more than \$800 billion was on deposit, nearly one-fifth as much as all dollar deposits in the US (Tax-News.com, 19 July, 2001).

be in comparison with a purpose to avoid tax before a shelter will be allowed. As with the Australian courts in the 1990s, the climate of crisis over aggressive corporate tax shelters helped many courts to support a more expansive interpretation of a purpose to avoid tax. Just at the point in history when a shelter explosion was blowing out of control, the IRS was managing to plant some seeds of its control through support in strategic court cases.

The tax manager of one of the firms involved in one of the major US court cases of the middle and late 1990s conceded, in conditions of anonymity, that their deals at that time were “probably abusive. We should not have been involved”. He said in the climate of the late 1990s tens of billions of dollars in cross-border deals of the kind they were involved in were being done out of the US and that the competitive pressures to join in were great. However, after his firm suffered a lot of adverse publicity as a result of the case, a very different competitive reputational dynamic became salient for his firm. And he saw this adverse publicity effect happen to other investment banks in the late 1990s. Amongst the interviewees, not only those with investment banks, there was a frequently mentioned desire not to “want to read about yourself on the front page of the Wall Street Journal”. The perception was that this was “not a career-enhancing thing for a corporate tax director” – a sentiment presumably with more momentum since Arthur Andersen’s (corporate) career-ending problems with Enron and other clients.

Family reputation can also be an issue for newspaper exposure of pillars of business respectability. One of Joseph Bankman’s (1999) informants said, “You feel like asking some of these promoters whether their momma knows what they spend their time doing”. Even narrowcasted publicity in a professional publication like *Tax Notes* is something to worry about: “No one wants Lee Sheppard [a journalist who writes in *Tax Notes*] to talk about their shelter publicly.” The import of this widespread kind of perception among insiders is that it engenders a conventional wisdom that if you get caught up in a court case that comes to be seen as a strategic one, there is no predictability to the damage you will suffer because of the presence of tenacious financial journalists like Lee Sheppard. Fisse and Braithwaite’s (1983) study *The Impact of Publicity on Corporate Offenders* more systematically revealed the same informal deterrence dynamic in non-tax cases.

Relationships with the IRS

Tax manager for investment bank: “The problem is that the IRS treats you with distrust.”

JB: “Yes, you would think Advance Pricing Agreements would be about changing cat-and-mouse to the-lion-lying-down-with-the-lamb. At the Centre for Tax System Integrity we are interested in how APAs and measures like this can rebuild trust.”

Tax manager: “Good luck.”

The American investment banker in the exchange above, went on to explain that he wants IRS trust and that he is critical of the IRS for not trusting him, but he does not believe he could ever come to trust them.

The same dilemmas of distrust that were evident in the Australian interviews were even more present in the US fieldwork. US informants were more pessimistic than their Australian counterparts about any good coming of government-business collaboration on tax matters. Large corporations, they believed, would not give candid advice to the IRS on how to confront the tax shelter problem: "The two sides have totally different objectives."

The sheer scale of the IRS bureaucracy – 100,000 people – and its interface with other large state income and sales tax collection bureaucracies makes interface with clients an extraordinary challenge. In 1996, the US Congress passed a Taxpayer Bill of Rights, which is quite different from the highly readable ATO Taxpayers' Charter. While the Australian Charter is a principle-driven document, the Taxpayer Bill of Rights is an unreadable miscellany of rather specific claims taxpayers can make against the IRS. The Bill of Rights does, however, establish the office of the Taxpayer Advocate within the IRS to take up and resolve concerns of taxpayers and to advocate for fair treatment of taxpayers. The Taxpayer Advocate functions are similar to those of the Tax Ombudsman in Australia, located in the office of the Commonwealth Ombudsman.

As in Australia, there was a perception among practitioners that audit activity was down (see Johnston, 2003) so that objective risks of shelter enforcement were reduced. As in Australia, this perception was accurate at the time of interview in 2001. In 1980, 77 per cent of US companies with assets over \$100 million were audited; by 1997 this figure was down to 35 per cent, though with inflation the number of companies worth \$100 million had increased greatly (Department of the Treasury, 1999: 29). There was also a perception that the IRS was becoming more "reasonable" with George W Bush in the White House. Moreover, there was a perception that shelters would not necessarily be detected when audit did occur. It's "not hard to get things by them [the IRS]". Or as another elite law firm tax partner put it: "The real issue is that the IRS aren't smart enough to find these deals on a tax return." From a quality of professional life perspective, informants actually wanted an IRS that had the ability to focus on things of substance rather than waste their time on irrelevancies: "You're better off with a smart than a dumb agent." A number of older informants pointed out that 30 years ago IRS jobs were competitive with the private sector, but the upwards competitive pressure on tax adviser incomes makes this gap ever wider. A number of informants commented favourably on the competence of Large & Mid-Size Business IRS Commissioner Larry Langdon. He moved to that job from Hewlett-Packard "as a retirement service", an act of virtue. With the stupendous incomes tax practitioners earn at an early age it becomes an increasingly feasible strategy for public-spirited high-flyers who feel they have made their money to move on to a period of their life dedicated to public service in an organisation like the IRS. A few interviewees seemed to me almost itching at the thought of being invited to serve in a senior capacity at the IRS when I discussed this with them.

Taking up such options on a wider basis could reverse some of the current psychology of tax enforcement as a result of a revolving door that moves mainly in the opposite direction. As one IRS official put it, you have to deal with "your former boss sitting on the opposite side of the table". Sometimes a subtle kind of intimidation, or rather a "draining of confidence" was reported in this regard. Reportedly, there are more former senior IRS officials in the private sector than

there are senior officials in the IRS. This is the same as the situation reported in the Australian interviews.

Penalties

One of the differences between the Australian and the US interviews was on the issue of penalties. Even though US tax penalties in both the statutes and practice are higher than Australian penalties, the need for higher penalties was not raised in the Australian interviews (except in respect of the need to introduce promoter penalties). But in the US, many tax advisers suggested higher penalties as one of the most needed solutions to the tax shelter problem: "There's not enough penalty to bite at the moment. You need 20-40 per cent penalties being imposed regularly to incentivise being honest." The need for criminal penalties to be used more often in tax shelter cases was mentioned in several of the US interviews but if it was discussed at all in the Australian interviews it was in the context of arguing that criminal sanctions had no useful role when large corporations were playing for the "grey" as opposed to the rarer phenomenon of outright black and white evasion. Even in its official report on the tax shelter problem, the New York State Bar Association (1999: 879) said, "Concrete steps should be taken to increase the risk associated with entering into corporate tax shelters", and went on to refer to "the insufficient deterrence effect of current law".

Potential strategic uses of penalties

One strategy for encouraging early intelligence on shelters could be that the first to report a new shelter could not only be forgiven penalties on their use of the shelter but could also be given a percentage of all the penalties collected from other shelter users. Another possibility would be to have differential penalties depending on whether involvement in a shelter was disclosed prior to or after an IRS announcement that it planned to attack the shelter – encouraging early disclosures that enable the making of the announcement in the first place. The kind of corporate taxpayer that might jump at this inducement is an early mover into a shelter with less of a taste for risk than the promoter counts upon. Given that we know from the interview data in Chapters 3 and 6–9 that there is a lot of supply-driven aggressive tax planning, there are bound to be cases of taxpayers who too late come to the realisation that they have locked into a shelter that far exceeds their taste for risk. Such a scheme investor might have a sleepless night over the shelter that causes him to seek the advice of a more cautious adviser likely to counsel immediate disclosure prior to any prospective IRS announcement. Sunlight disinfects a sleepless vice.

Just as with disclosure rules for shelters, at the sharper end of enforcement, the US has some tools and some sensibility that is lacking in Australia on the need to use them more often at the peak of an enforcement pyramid. If the conclusions in Part IV – including that a pyramid with a high enforcement peak that enforcers are willing to use is critical for flipping markets in vice to markets in virtue – are correct, then in this regard the US has a much more developed capability to do so.

Part IV

CONTROLLING AGGRESSIVE TAX PLANNING

Comparing the drivers of and responses to aggressive tax planning in Australia and the US

Contagion and aggressive tax planning cycles

Contagion is an important aspect of all four booms in aggressive tax planning considered in this book – the booms in the US and Australia of the late 1970s to early 1980s and of the late 1990s. The contagion is typically started by promoter entrepreneurship to seize structural opportunities, with a growing herd then following to take up those opportunities. The literature on contagion suggests that, at a private level, in a considerable variety of circumstances where one's personal knowledge of a phenomenon is truncated, it can be rational to follow the herd (Bikhchandani and Sharma, 2000). Information can be too costly for investors who are not insiders, so an investor might benefit from looking at the market reaction to a tax scheme. With aggressive tax planning contagions, in those circumstances where there is economic rationality in following the herd, often the benefits are greatest for those who follow early, before ending the contagion becomes a policy priority. Contagion also becomes rational when the use of a tax arrangement becomes too big to stop. The losers then are those who fail to jump on an unstoppable bandwagon.

The deeper causes of the Australian boom of the late 1990s

A way of describing the history of the late 1990s Australian tax scheme boom is that the tax advice industry lived in fear of tough enforcement of Australia's general anti-avoidance provision from the end of the aggressive tax boom in the early 1980s until more than a decade of failure to use it by the ATO and the courts led to doubts that it had teeth. Aggressive promoters of schemes first narrowcast their promotion to individual taxpayers with a taste for risk. When they got away with it, this attracted more aggressive opinion writing on the legality of schemes and in some cases favourable rulings from one regional office or another of the ATO. Then broadcasting of schemes became more common, combined often with broadening the aggression of schemes beyond what had received a tick from the lawyers. A trickle of hundreds of investors in aggressive tax planning schemes became a stampede of tens of thousands. As ordinary people became more aware of acquaintances who had been getting away such scheme investments for years, who received tax refund cheques from the ATO without any questioning of the taxpayer's self-assessment, more risk averse

taxpayers began to ask their accountants whether they should get involved. What started as a supply-driven phenomenon became more demand driven.

But there are deeper causes for Australia experiencing a re-run of its late 1970s to early 1980s aggressive tax planning boom. Primary among these is that it failed to use the opportunity of the boom's aftermath to wipe out loss trading, as the US did in 1986 by introducing passive loss rules. Negative gearing of investments in a second rental property was so widespread in middle Australia that this kind of scheme was too big to fail. Treasurer Paul Keating wanted to introduce measures such as passive loss rules, but he and the then Prime Minister Bob Hawke in the end judged that doing so could cost them government.

Secondly, as discussed above, while the 1981 enactment of the general anti-avoidance provision (Part IVA) had succeeded in raising a new spectre of effective ATO counterattack against aggressive tax planning, the ATO feared that the High Court would emasculate its effectiveness as the Barwick court had emasculated its predecessor, s 260, and was too timid to deploy it immediately after 1981.

Thirdly, as the 1980s and 1990s proceeded, the *Income Tax Assessment Act* 1936 (Cth) quadrupled in length. As rules were written to cover loopholes, they opened up new ones. The very complexity of the tax law expanded opportunities for arbitrage, a trend that was almost as bad in the US, but much worse in the US and Australia than in other developed economies.

The deeper causes of the US boom of the late 1990s

In contrast to Australia, the US did make the big tax law reform needed to confront its tax scheme problem. The introduction of passive loss rules in 1986 delivered a near-fatal blow to the kind of schemes Australia saw repeated in the boom of the late 1990s. However, the underlying causes of aggressive tax planning – limited audit capability, poor relationships and weak collaboration between the IRS and its clients, slowness of enforcement response to new shelters, and deficit in the tax-technical competence in the IRS in comparison to its private sector adversaries – continued in the US as in Australia. This meant that there was every reason for the US tax advice industry to search for new types of shelters once the passive loss rules closed off the old retail-style shelters. In a highly complex system of law such as US tax law, “hundreds of loopholes exist, of which only a small portion has been exploited” (Keinan, 2001: 3). For example, of PricewaterhouseCoopers database of 1000 mass marketed tax planning ideas, only 30 were actually marketing in the peak year of the shelter boom, 1998 (Keinan, 2001: 5). In addition there were four new structural causes (as identified in Part III) of the late-1990s boom in corporate tax shelters led from New York:

1. *Deregulation in the professions and the finance sector*

This drove greater competition on the *supply* side in the promotion of shelters, such as competition in letters of comfort, promotion and insurance, and among law firms, investment banks, accounting firms and boutique financial advisers. The results – opinion shopping and tax planning rewarded by success fees of a proportion of the tax obligations eliminated – are particularly critical drivers of more risk-free use of corporate tax shelters.

2. *More aggressive management of costs*

On the *demand* side, competition in more aggressive management of costs has resulted in tax being no longer seen, like death, as "something that will always be with us". The tax department did become in the late 1990s a profit centre rather than a manager of public obligations. Crocker and Slemrod (2004:2) report systematic evidence of this from a 2001 survey of corporate tax departments in the US manufacturing sector. The most widely used of the various measures of tax department performance in 2001 was the savings or value added they provided. The effective tax rate relative to goal increased considerably as a cited measure to evaluate performance (in most cases actually affecting compensation) between 1997 and 2001. In contrast, "The number of mentions of each of three possible performance measures that included the word 'accuracy' declined substantially between 1997 and 2001." (Crocker and Slemrod, 2004: 2). A performance market in accuracy can be interpreted as a market of virtue; reward for getting effective tax rates down as a market in vice.

3. *Globalisation*

Globalisation expanded opportunities for international arbitrage. Global linkages among and within firms enhanced capability for exploiting these opportunities.

4. *Financial engineering*

Financial engineering of derivatives and other new financial instruments created a new generation of shelter products.

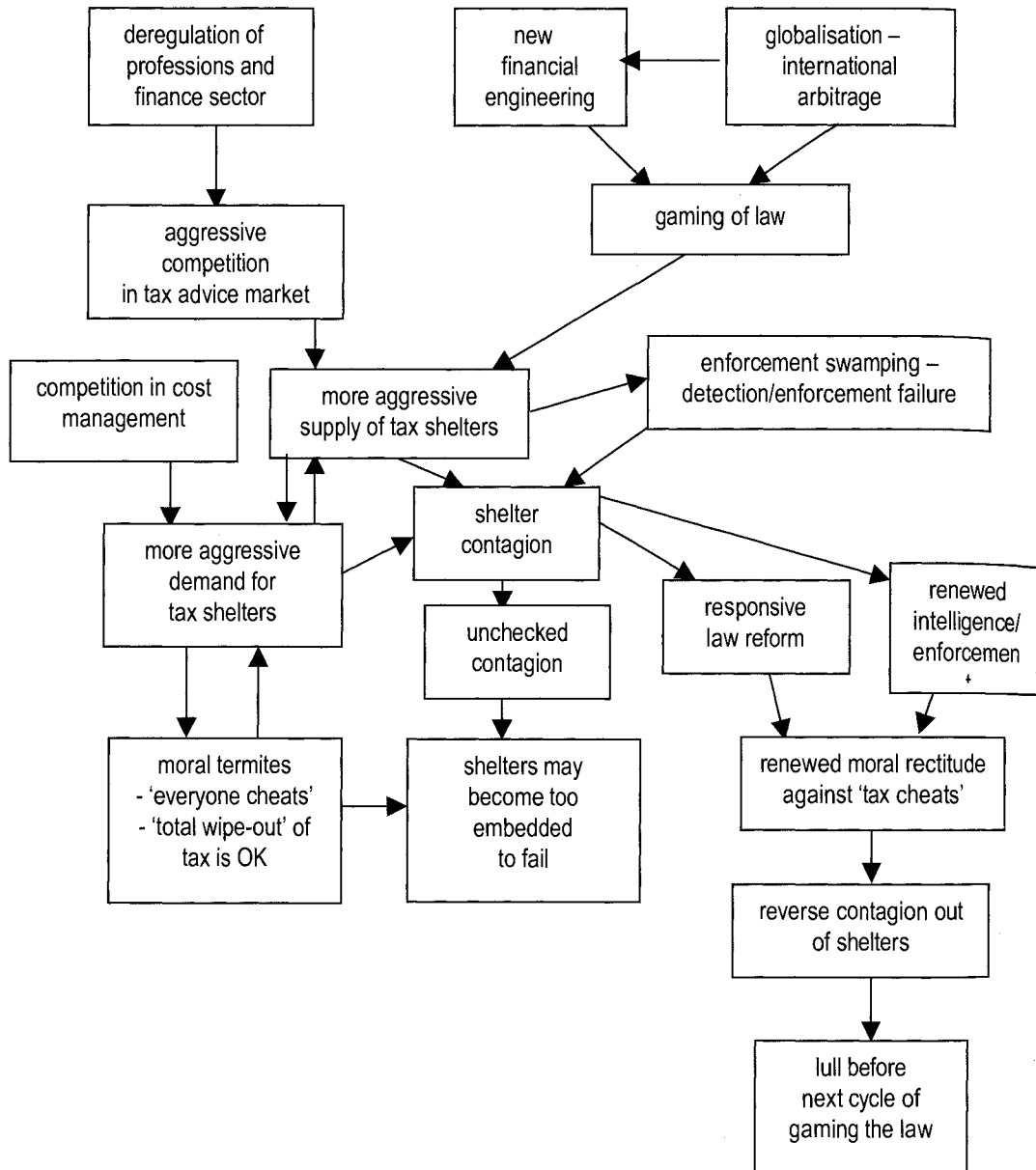
These structural drivers have been mutually reinforcing. More competitive and creative supply was important to enabling more aggressive demand for shelters. What Vito Tanzi (2000) has called the "fiscal termites" of globalisation may in turn engender "moral termites".

Contagion becomes part of the problem here. There is empirical evidence in tax-compliance research that when one believes that everyone is cheating, one is more likely to believe it is alright to cheat oneself (Scholz, 1998). Joseph Bankman gives an interesting account of the mutually reinforcing relationships among these drivers:

The role of investment banks as intermediaries to shop opinion letters leads to more aggressive opinion letters which makes it possible to design shelters with less economic risk, which leads to greater corporate interest in shelters which leads to greater profits for shelter promoters which leads to expansion of tax products departments in investment banks and accounting firms and tempts tax lawyers within firms to consider developing or expanding their own tax products practice which leads lawyers to think more positively of shelters when asked to write opinions or give advice on shelters, and so on. (Bankman, 1999: 1785)

Bankman regarded it as inevitable that Silicon Valley companies, which he found to be generally resistant to entering the shelter market, would respond to this vicious circle by joining in: "Companies that now make one shelter investment a year will consider making two: other companies will feel forced to emulate their example. If two shelters are better than one, three will seem better than two." All true, yet Bankman's work does underestimate the possibilities for reverse contagion.

Figure 12: Drivers of the aggressive tax planning market: fiscal and moral termites



The possibilities for reverse contagion

Figure 12 models the drivers of shelter cycles from this recent US experience. Three fiscal termites are identified that are more abstract than Tanzi's (2000) original list of purely global fiscal termites. These supply factors are "deregulation of the professions and the finance sector", "new financial engineering" and "globalisation / international arbitrage" and these drive gaming of the law and more aggressive supply of tax shelters.¹ When followed by swamping, detection failure and enforcement failure, these cause a shelter contagion to begin. Yet the recent empirical experience of four shelter booms in Australia and the US shows that following of the herd into shelters can be reversed. The integrity of the law can be reasserted by the legislature or the courts, or by both. If there are general anti-avoidance principles in play, enforcement might even be renewed without renewing the law – for example by the announcement effect of the tax authority declaring it will attack the shelter under the general anti-avoidance principles. Either way, we have seen that shelter contagions can be thrown into reverse. We have seen that announcements by the Australian or US Commissioner of intent to attack a scheme can result in an overnight stampede away from that scheme. Accordingly, Figure 12 summarises the empirical conclusions of this book.

The interviews revealed in the aftermath of such reverse contagions much holier-than-thou pontificating by practitioners who may have been involved in other equally egregious schemes. Participants in the aggressively competitive market for tax advice would ruthlessly seize upon opportunities to sully the reputations of competitors who put their clients into schemes that were struck down. But there are also many people in business who simply prefer their company to pay their fair share of tax, who would not want their "momma" to know about their tax shelter activities, many tax professionals who hate the pressure to put people into schemes or write favourable opinions on the legality of doubtful schemes. This is not just a matter of the personal integrity at work that most of us like to think of ourselves as having; it is also about nurturing a culture of integrity for everyone in our workplace. One of Bankman's (1999: 1785) senior business executives said: "If you cheat, your employees will notice that, and they'll cheat you." This executive is applying a general principle about how cultures of white-collar criminality that start out for the benefit of a large organisation come back to bite the organisation. We have seen this with bribery, financial fraud, market manipulation and scientific fraud (Fisse and Braithwaite, 1983; Braithwaite, 1984).

Hence, just as the drivers of the emerging global market for tax advice produce shelter contagion, they also allow reverse contagion out of shelters. On the other hand, excessive delay in detecting or moving against shelters can allow a shelter to become so embedded into deals of large corporations or expectations of people in marginal electorates to make it politically infeasible for the aggressive tax planning to be attacked. The enforcement challenge is to flip shelter contagions into reverse contagions before they pass that political point of no return.

1 These are the abstracted termites for the *supply* of aggressive tax planning. *Demand* factors such as more aggressive management of costs enter lower down the model.

Conclusion

The New York experience of corporate shelter contagion summarised in Figure 12 helps us to see more clearly that the same fundamental drivers were at play in the Australian aggressive tax planning of the past decade. The dynamics of Figure 12 apply to Sydney, Melbourne and Kalgoorlie as much as to New York. But what the rest of the world can see more sharply from studying New York is the sophistication and depth that the three drivers at the top of Figure 12 can run to. Australian competition policy has increased competition between accounting firms, investment banks, law firms and other players in the finance sector, but it has not reached the extent of the Big Four touting total tax wipe-outs to large corporations in return for a third of the tax avoided. Nor do the Big Four seem to do this in the British market, though some investment banks might. Australia, like the UK, has not seen a market for insurance against unfavourable decisions of the ATO that can eliminate uncertainty for a wide range of aggressive plays. Australia has its rocket scientists of tax shelter design, but in comparison to those of New York, they look like Saddam Hussein's scientists in comparison to those of the Pentagon. Their financial products engineering is admittedly in the process of catching up, as is their international arbitrage, though crude money laundering into tax havens like Vanuatu rather than sophisticated arbitrage is the more common form the globalisation termites take. Australia has increasingly aggressive shopping for lawyers' opinions, but the Australian culture of opinion shopping does not yet lead to jokes of the genre reported by Joseph Bankman: "You can get a tax lawyer to write an opinion that JFK is alive and living on a tropical island with Marilyn Monroe."

Accordingly, it is possible to conclude that the fundamental dynamics in both countries are dynamics of contagion with the same drivers, as listed in Figure 12, but that New York is a generation, a cycle, ahead in the sophistication with which those dynamics have been played out. Many of the New York informants felt exactly the same was true of Europe; this was one reason they found US-Europe arbitrage a game of choice, just as they did US-Australia arbitrage. As a result the debates around some countermeasures in the US have been pushed a generation ahead of the Australian tax policy debate – the most notable being the debates over trading passive losses, shelter disclosure, banning contingency fees and penalties. On the other hand, in the remainder of Part IV it will be argued that the Australian tax compliance debate involves a more sophisticated understanding of the regulatory craft than the US one. This arguably puts Australia in a much better position than the US to weather the next aggressive tax planning wave that we should expect to arrive some time after 2010. It is also why the integrity of the Australian tax system has recovered from the 1970s and 1990s waves in better shape than the integrity of the US tax system.

In the remainder of this Part and in Part V, it is argued that a responsive regulatory strategy can be more successful than in the past for flipping stampedes into aggressive tax planning over to reverse stampedes out of shelters. This is because Part III shows even more dramatically than Part II that the stampeding herds of tax avoiders are mostly led by a few dozen promoters. Moreover, New York helps us to see that changes in the technology of aggressive tax planning and its increasingly global nature means that it is the Big Four that have ever-widening competitive advantages over other players in this market, even as they

collaborate with elite law firms and others in the New York tax planning community. It follows that a sophisticated regulatory strategy aimed at the compliance cultures of the big players can have knock-on effects with large ramifications for tax system integrity. When KPMG is motivated to self-regulate to become more virtuous, as arguably it has been by the adverse publicity over its shelter practices and other vices, the whole world becomes more virtuous. While the ethnography of the New York advice market attempted in Chapter 6 is crude and limited by the timing of the research, it is perhaps good enough to partially illuminate a thicker description of the micro-processes that underlie the macro drivers in Figure 12. Come the next wave of stampeding into shelters, it would be wise to do a better ethnography than the crude effort here and to do it in real time as the wave rises, as it will some years hence. The drivers may in future be configured differently from Figure 12 and the cultural norms of the way New York lawyers and accountants compete, collaborate and eat what they kill in the shelter market are bound to become different from those described in Chapter 6. Figure 12 is not advanced as a general theory of aggressive tax planning that applies to all societies. It is no more than an inductive explanation that fits four waves of aggressive tax planning in two societies.

Reforming the law

Lots of people talk about simplifying the tax law. And lots of people agree that simplifying the tax law should be a policy priority. But the problem is that simplification is complicated, and it is politically dangerous work.

George Guttman

I hold in my hand 1379 pages of tax simplification.

Delbert L. Latta

In this section, it will be argued that while rules can make law certain and effective in simple and stable regulatory domains, a different approach is needed to make the law more certain and effective for more complex, dynamic domains. The discussion in Chapter 7 proposed that a principle-based tax law might be more effective than a rule-based law in preventing international arbitrage to avoid tax. This chapter makes the case for this sort of tax law – one of binding principles and rules derivative from and subject to those principles – arguing that international arbitrage and gaming rules would be less productive under this principle-driven approach and that a law based on principles that people understand and accept is less likely to be eroded by moral termites.

Principles and rules defined

There is debate on the difference between rules and principles, or standards as the Americans prefer. I simply define rules and principles in the way chosen by Joseph Raz: “Rules prescribe relatively specific acts; principles prescribe highly unspecific actions” (Raz, 1972: 823). Safe driving in light of road conditions is a principle; a proscription of speed over 80 km per hour is a rule. Those who do not like this way of making the distinction might prefer to consider the argument as one about how to integrate general and specific rules.

Integrated use of principles and rules

An interesting feature of the contemporary private law of contract is that it is regulated by principles, many of which are imported from the public law of consumer protection (Collins, 1999). The literal language of a contract can be overridden if it is unconscionable: for example, if an immigrant who could not read English was told only that local custom required her signature. Or the duty of good faith can be used to require each party to act consistently with the real purpose of a contract even if the written detail of the contract appears to offer one of the parties an escape from that purpose. Unconscionability and good faith are

examples of far-reaching principles that connect the different rules of contract. We see the same approach with traffic rules. The speed limit gives us a bright-line rule, but keeping under the limit will not protect us if we drive too fast in unusually dangerous conditions, like fog. There is no safe harbour in this law; meeting the bright-line standard does not shelter us from prosecution for excessive speed; it only tells us how to keep out of trouble with the law in normal circumstances. Moreover, road safety authorities put a lot of effort into educating us of the need to honour the underlying principle of cautious driving that is watchful for special hazards. It is that principle that trumps the foot-fault rule the law has given us to guide our driving.

The argument in this section is that tax law needs this kind of integration between rules and principles more than other areas of law.¹ Of course this is much harder to achieve with tax than with traffic law because tax principles need to be fleshed out with much larger bodies of rules than the modest number of rules needed to make the principles of traffic law work. The argument is very much based on a synthesis of ideas from the practitioners I interviewed, though none of them might endorse all aspects of the proposals packaged here.

Instead of combining rules and principles in the way proposed here, what most common law nations have tended to do with complex domains of business law has been to endure a see-sawing historical contest between advocates of the view that a rule of law means a rule of rules on one side, and on the other, attempts at grand simplifying projects to shift to a rule of principles. The rule of rules is more often in the ascendency in this contest and grand reform projects (such as the latest in Australia – the Ralph review of business taxation (Ralph, 1998)) fail to catalyse fundamental change toward a more principle-driven law. As one Australian practitioner lamented: “Every simplification review of the last 15 years – company law or tax – has resulted in more complexity.” Simplifying projects are commenced without being completed. Or overarching principles are added to the law without repealing any of the thicket of rules that necessitate the principles, so the simplification project of adding principles actually renders tax codes longer and more complex.² By see-sawing back and forth between the rule of rules and the rule of principles we can, and usually do, end up with the worst of both worlds.

Uncertainties with rules

In respect of simple, stable phenomena that rarely involve large economic stakes (conditions that do not generally apply to tax), rules deliver satisfactory consistency in legal decision-making. It is only in domains that are complex, dynamic, and where litigants may find the economic stakes high enough to invest in legal advice to see if there is a way around the law, that precise rules fail to deliver consistency on their own (Braithwaite, 2002). Why?

1 A not dissimilar aspiration is articulated by Michael D’Ascenzo’s hope that tax law “will be written in a way that exposes the underlying principles” (D’Ascenzo, 2000).

2 On failure of simplification projects in the UK, US, Australia and New Zealand, see Mumford (2001: Chapter 6).

Rules possess a penumbra of uncertainty

HLA Hart pointed out that rules have a core meaning and a penumbra where their meaning is more uncertain (Hart, 1961). The more complex and changing the phenomenon being regulated, the wider that penumbra is likely to be. A factor that drives much uncertainty is that wealthy legal game players aim for the penumbra, playing the game in ways that expand the grey area of the law. Flux is particularly important here. The penumbra of simple rules that regulate stable phenomena is small. It does exist, as in Lon Fuller's example of a statue of a truck in a park where vehicles are prohibited (Fuller, 1958). The unforeseen rare event of the failure to encompass the truck statue in the rule will never cause great problems in regulating the static phenomenon of parks. But in dynamic domains like tax, uncommon things like concrete trucks can be rendered common by game playing investors seeking a tax advantage.³

Juxtaposition of rules creates uncertainty

The penumbra problem is not the only game-playing threat. Rules look more certain when they stand alone; uncertainty is created in juxtaposition with other rules. When regulating simple phenomena, it is easy to draft simple rules so that there is no conflict between a rule that says A is proscribed and another that says X is specifically allowable. The conflict arises when A and X are both correct descriptions of an action.⁴ In complex terrain, however, economic and technological change can suddenly create new conflicts of this sort. It can be hard for the state to see this coming, especially when there are well paid legal entrepreneurs on the lookout for opportunities to expand the penumbra of one rule to slightly overlap the penumbra of another, creating compliant non-compliance (McBarnet and Whelan, 1999). Indeed, with tax, the discovery of such an overlap can be widely used for years without the state being aware of it.

This problem multiplies as the state enacts more and more rules to plug loopholes opened up by legal entrepreneurs. As seen in Chapter 6, some of the important tax planning ideas of the 1990s were a product of a new loophole being opened up in the process of closing off another. The resulting thicket of rules becomes a set of sign-posts that show the entrepreneur precisely what they have to steer around to defeat the purposes of the law.

Rules unpredictably exclude the unforeseeable

Another problem is that where rules define the proscribed behaviour, for example, by defining A, B, C, D, E and F as forms of the behaviour, it nurtures the plausibility of a legal argument that another form of the behaviour, G, must be legal because the clear intent of the legislature was only to proscribe A to F, when in fact the legislature had never thought of G. For this reason, a broad prescription against a phenomenon, like insider trading, can engender more certainty.

3 "Uncommon transactions that are taxed inappropriately become common as taxpayers discover how to take advantage of them" (Weisbach, 1999: 869).

4 See McBarnet and Whelan's (1999) account of the use of "ex-files", express exemptions, in British accounting standards.

Discretion to pick and choose from a thicket of rules

Further legal uncertainty arises from the fact that a thicket of rules engenders an argument of a form that some judges will buy and others will not. This produces one kind of very strong predictability in the law. If you know which judges you will and will not get, you can predict the outcome of your case with a high degree of certainty. In a multiple-discriminant analysis of House of Lords decisions, over 90 per cent of tax and criminal cases could be correctly predicted (in terms of whether the state or the other party – the taxpayer, the defendant – won) and more than 80 per cent of public, constitutional and civil cases could be correctly predicted in advance by knowing just one fact about that case (Robertson, 1998). That fact was which judges would sit on the case. Of course, this kind of predictability is not much use in pre-litigation decisions as to whether to back one view or another of what the law means.

Contriving to capture rule interactions

A smorgasbord of rules engenders a cat-and-mouse legal drafting culture – of loophole closing and reopening by creative compliance (McBarnet and Whelan, 1999: 28). As the law grows in this loophole closing game, the “interaction costs” of drafting new rules to ensure that the various provisions work together expand. Once started, the process causes law to grow exponentially because “the number of interactions is approximately proportional to the square of the number of rules” (Weisbach, 1999: 871). If n rules exist, a new rule interacts with n prior rules, the next rule with $n+1$, and so on. Moreover, loophole closing cat-and-mouse engenders a structurally inegalitarian form of uncertainty. The law thus engendered becomes so complex that those people who cannot afford sophisticated legal advice do not understand it. Interestingly, even those “rocket scientists” of shelter design interviewed said that they have to be careful with complexity in that “the more words you use, the more you trip over your own tongue”.

In practice, a particular law may be certain in its meaning and as a guide to actions to lawyers, but uncertain to lay people, perhaps because they perceive it to be complex or are not able to access legal advice. The rich, in contrast, deploy legal entrepreneurship to make the law uncertain in practice. As citizens go about activities like paying taxes, creative compliance creates a law that is perceptually unclear to ordinary people, and therefore uncertain for them, and uncertain in practice for the rich who more clearly perceive advantage in and pursue this uncertainty. This structural problem with rules is not true of simple regulatory domains. There is no important sense in which traffic rules in a legal system are more incomprehensible to the poor than the rich, or that they work in a way that enables the rich to make them more legally uncertain in practice in their application to the driving of the rich.⁵ The rich may be more able to bribe police and magistrates in traffic cases, but this is not a matter of uncertainty in what the law says.

5 Even so, ironically, traffic regulation, as stated in the introduction, is one of the domains where the prescription of this argument has been adopted in many jurisdictions – precise rules that can be overridden by a principle (combined with community education about the principles of safe driving). An example is Illinois ILCS ch 625, 5/11-601(a): “No vehicle may be driven upon any highway of this State at a speed which is greater than is reasonable and proper with regard to traffic conditions and the use of the highway, or endangers the safety of any person or property. The fact that the speed of a vehicle does not exceed the applicable maximum speed limit does not relieve the driver from the duty to decrease speed when ... special hazard exists with respect to pedestrians or other traffic or by reason of weather or highway conditions.”

One result of a protracted dynamic of rules multiplying exponentially is that no one can keep them in their head. Ordinary people certainly cannot have conversations that make any sense about much of tax law. Even the most expert tax lawyers increasingly limit their expertise to particular domains and, for much of the law, cannot conduct a coherent conversation without being able to pull a volume of the law off their shelf and pore over it to prepare for the conversation.

Legal entrepreneurship when economic stakes are high does not work simply by exploiting change and complexity that is inherent in post-industrial societies. It also works by contriving change and complexity. When the Australian government privatised Qantas on terms it thought were generous for the new shareholders, it wanted only Australian citizens who had funded Qantas over the years through their taxes to gain the benefit. The Macquarie Bank responded by creating a new financial product called a QanMac to get around this rule; foreign QanMac owners secured identical functional economic benefits to Australian owners of Qantas shares. Financial engineering to create new products that have never been conceived by the law is a growing phenomenon of particular importance to corporations law and tax compliance at the big end of town: "The same minds that figured out how to split a security into a multitude of different cash flows and contingent returns are now engineering products in which the tax benefits are split off from the underlying economics of a deal" (Novack and Saunders, 1998).

Financial engineering is just a newer modality of a more longstanding tradition of contrived complexity. Multinational corporations have long exploited their capacities to contrive complexity in their books, organisational complexity and jurisdictional complexity in order to escape liability even for comparatively simple criminal laws such as those against bribery (Braithwaite, 1984). Complexity in the books is used to enable the laundering of slush funds and deployment of a network of subsidiaries to contrive off-balance-sheet financing. Jurisdictional complexity can be exploited, for example, to shift losses to the jurisdiction where they will deliver maximum tax deductions and profits to jurisdictions where gains are untaxed. Organisational complexity can take the form of the appointment of a "vice-president responsible for going to jail" to ensure there will be no corporate or CEO criminal liability, or more commonly it takes the form of a smokescreen of diffused accountability, where everyone can credibly blame someone else: there seem to be little bits of blame in many places without the possibility of aggregating this to a pattern that satisfies the rules of criminal responsibility (Braithwaite, 1984). Poor criminal defendants cannot contrive this kind of complexity into their affairs, which is why most inmates of our prisons are poor even though the evidence is clear that it is the rich who commit the criminal offences that cause greatest loss of property and injury to persons (see Braithwaite, 1991). With respect to criminal law, this hardly plays out as a major source of uncertainty: a detected serious criminal offender of limited means is fairly certain to be convicted; major corporate criminals are almost certain never to be convicted, partly because they are less likely to be detected and partly because of entrepreneurship in excuses and contrived complexity. Put another way, there is uncertainty that is structurally predictable by features of power in society rather than by features of the law.

Frederick Shauer argues: "In many cases, indeed in most cases, the result indicated by applying a rule will be the same as the result indicated by directly applying the rule's background justifications ..." (Schauer, 1991: 100). What I am arguing is that this is true of the law of fraud applied to welfare cheats, false for the law of fraud applied to top management of large corporations. As we criminologists put it, the best way to rob a bank is to own it.

A possible solution: a principled integrity of rules

One article that has influenced me greatly on law reform is David Weisbach's "Formalism in Tax Law": "Rules must specify the treatment of a greater number of transactions than standards [principles] and, therefore, they are systematically more complex than standards" (Weisbach, 1999: 867). This is because, according to Weisbach, "rules can less afford to overlook uncommon transactions than can standards" (Weisbach, 1999: 867). While I agree with this, the argument here is that tax law can list rules for transactions that are common, leaving judicial enforcement of the principles and in particular, a general anti-avoidance principle to mop up when unusual transactions are in contest. This hybrid of rules and principles would actually put the brakes on economically wasteful legal entrepreneurship to manipulate the rules. It is a strategy for reaping the benefits of rules – clear guidance to taxpayers in common situations – while limiting their pathologies: exponential growth in legal complexity, burgeoning compliance costs, expanding waste of private and public resources on legal game playing and countering it, a tax system that ordinary people cannot comprehend and therefore has low legitimacy and reduced prospects of voluntary compliance.

It is proposed that the best way to integrate rules and principles in complex areas of tax law is as follows:

1. Define the overarching principles that are to be binding on taxpayers.
2. Include amongst the overarching principles a general anti-avoidance principle which states that schemes are illegal when their dominant purpose is a tax advantage, even if the scheme "works" as a shelter from detailed tax rules.
3. Define a set of rules to cover the complex area of tax law.
4. Legislate, perhaps through an Acts Interpretation Act,⁶ that in a contest between a rule and an overarching principle, it will not be the rule that is binding. That is, the principle is not merely used to assist in interpreting the rule. Rather it is the reverse. The principle is binding, with the rules to be used only to assist in applying the principle (just as in the speed and safe driving conditions example).
5. Write specific sets of rules for the most commonly used types of transactions or business arrangements. This might involve a dozen different sets of rules to regulate concrete arrangements. Such rules are not exhaustive; they are introduced explicitly as no more than examples of how the principles apply.

⁶ Other elements of the legislative history of specific statutes can also be mobilised to this end, for example, explanatory memoranda and second reading speeches in the Australian parliamentary context.

6. Follow each of the dozen sets of illustrative rules with the explanation that the reason for the rules being this way in this concrete situation is to honour the overarching principles. This is a way for the legislature to make it clear to judges, practitioners and taxpayers, that it is the principles that are the binding feature of the law and that should a legal entrepreneur attempt to get around the law by re-engineering financial product number 11 as "11A", or corporate structure number 9 as "9A", judges must go back to the principles to decide what to do.
7. Enact, should judges revert to old habits of privileging rules, a simple statute that says the 11A shelter violates named principles in the tax law and should be disallowed in future. Its effect is simply to strike down the court's precedent in the 11A case and to engage the judiciary in a conversation with the legislature on the clarity of its intention to have a principle-driven tax law.⁷
8. Foster educative dialogue with judges, company directors and the community about the principles in the tax law in the hope that conversations among judges and tax practitioners, around the boardroom table and around the table of dinner parties will develop shared sensibilities on what those principles mean.

In this way, tax laws can be written by setting down binding principles, of which one is a GAAR, complemented by detailed rules that illustrate how the principles should be applied to common concrete commercial arrangements (see generally Jones, 1996). For example, if there are 1000 ways of setting up a particular arrangement, but only a dozen of these are used with any frequency, then rules can be used to define how the principle applies only to these 12 arrangements.⁸ This means business is not left to flounder as it tries to apply the broad principles in its normal operations⁹ and that it is warned to be wary of tax advisers who counsel that the principles are so vague that a legal case can be made to justify almost anything.

The inclusion at the end of each set of rules of an explanation that the rules are defined in this way because they instantiate the named principles would further safeguard against lawyerly tendencies to privilege rules that can then be gamed. Another such safeguard would be, perhaps by an Acts Interpretation Act, such as those revised in New Zealand and Australia to complement their GAARs,

7 I am indebted to conversations with Daniel Shaviro and Ernst Willheim for this thought.

8 Writing rules to cover the other 988 is precisely the drafting error it is wished to avoid. Or, more precisely, the aim is to avoid having to foresee them all and to avoid making the law iteratively more complex to cover them as they are used one after the other to game the law.

9 Another way to decide which arrangements should be defined by illustrative sets of rules would be to apply Louis Kaplow's theory of when law should regulate through rules versus standards (principles in my/Raz's usage). Simplifying, Kaplow (1992) contends that because rules have higher promulgation costs in deciding how to craft them *ex ante*, rules should only be written when the law will be applied frequently. Standards have lower promulgation costs than rules but higher application costs (costs in determining how they should apply to specific situations). Hence, standards are more economically efficient in application to arrangements that arise only rarely.

a requirement that courts give effect to the purposes of Acts¹⁰ or more specifically, of those Acts that defend the “the integrity of the tax system”.¹¹

In spite of all of these measures, courts would still be likely at times to indulge their proclivity to privilege rules over principles, for example, in response to a taxpayer whose advisers game one of the sets of rules that cover a concrete financial product or form of corporate structuring (9) into a minor variation (9A) that shelters income. If this situation arises, there is an alternative to writing new rules to plug the loophole. It is for the legislature to enact a simple law that says the 9A shelter violates specified principles in the tax law and should in future be disallowed, striking down the precedent. The simplest drafting device for doing this is for the new statute to state that the 9A shelter comes within the scope of Section X under the old statute. This not only strikes down the judicial precedent in the 9A case, it also widens the scope of the old statute by making a legislative intent clear to apply the offended principle in the law to a wider range of structurings than the judiciary understood.

Empirical findings motivate the centrality of Julia Black’s (1998) idea of regulatory conversations in the shared sensibilities part of the theory above (point 8). A comparison of nursing home regulation in Australia, which involved 31 broad and vague principles/standards, with that in the US, which involved over a thousand more precise rules, found that it was the vague Australian principles that were subject to more consistent adjudication (measured by having two inspection teams rate compliance of the same homes independently at the same points in time) (Braithwaite et al, 1991; Braithwaite and Braithwaite, 1995). The main conclusion of that research was that superior regulatory conversations – among regulators, among nursing home staff and between regulators and staff – was possible under a rule of a few principles than under a rule of many rules. Rules can be very important in fostering conversations that lead to shared sensibilities about the law’s requirements, but only if they are limited in number and are interrelated in ways that are not incomprehensibly intricate.

Civil liberty safeguards

While the strategy of attacking a shelter first in terms of rules and then if this fails in terms of a GAAR or other principles, may have more general relevance beyond tax law, it is not likely to be appropriate for conduct where the community wishes to criminalise and imprison offenders. Where imprisonment is at stake, people are entitled to know with some precision, and in advance, what puts them at risk of losing their liberty. In saying this, however, we have seen that we cannot assume that precise rules actually do protect us against arbitrary exercises of the most frightening state power when the economic phenomena at issue are complex.¹² Fortunately, the criminal law is only occasionally the instrument the regulator who wishes to be effective in these areas wants to use. So the

10 Sections 15AA and 15AB, *Acts Interpretation Act* 1901 (Cth).

11 Section 6-6B, *Tax Administration Act* 1994 (NZ).

12 Charles Black (1986) writes, “Some lawyers talk as though they thought maximum clarity always desirable even though they wouldn’t have to probe very deeply to find that fraud, and fiduciary obligation, and undue influence, have been carefully isolated from exact definition ...”.

prescription here would be to never deprive a person of their liberty in circumstances where there is conflict between what is commended by a precise rule a citizen has relied upon and what is commended by the principle that justifies that rule.

The general anti-avoidance principle

When Australia's tax authority targets a shelter used by a wealthy individual or corporation it can go after it first under specific rules in the law and if that fails the tax authority can attack it under the general anti-avoidance principle.¹³ Australia's GAAR, Part IVA of the *Income Tax Assessment Act 1936* (Cth), depends on showing that there exists a scheme, that there is a tax benefit in relation to it, and that a person who put the scheme in place did so for the purpose of securing that tax benefit. ATO Second Commissioner Michael D'Ascenzo has argued "the High Court decisions in *Peabody*,¹⁴ *Spotless*,¹⁵ and *Consolidated Press*¹⁶ provide 'important and consistent statements of principles' which can help guide the weighing up of tax and non-tax purposes" (D'Ascenzo, 2002a). These principles are distinctively Australian. Australian courts have rejected the "Ramsay principle" developed by the UK courts¹⁷ and have distanced themselves from US doctrines such as "substance over form" and the "step transaction" doctrine.¹⁸ Section 177D(b) defines eight factors as, in effect, badges of avoidance: "These provide 'warning lights' about the possible application of Part IVA. For example, a round robin [one of the eight factors in s 177D] may well be legally effective to record a loan and a repayment, but it may well assist in drawing the tax avoidance conclusion" (D'Ascenzo, 2002a). Transactions that are not objectionable by themselves may constitute avoidance in combination. Consistent with the approach advocated in this article, the Full Federal Court in *Consolidated Press* stated in relation to s 177D:

The section requires the decision-maker, be it the Commissioner or the Court, to have regard to each of these matters. It does not require that they be unbundled from a global consideration of purpose and slavishly ticked off. The relevant dominant purpose may be so apparent on the evidence taken as a whole that consideration of the statutory factors can be collapsed into a global assessment of purpose.¹⁹

As a result of High Court decisions such as *Peabody* and *Spotless* combined with the clarification of the ATO's position in public rulings and the publication of the ATO's administrative approach in a variety of other ways, Michael D'Ascenzo

13 At least this is the case under Australian law and administration. Nations with a GAAR include Australia, Canada, Hong Kong and New Zealand in the common law world, and a variety of civil law jurisdictions including Germany, France, Belgium, the Netherlands, Spain and Sweden (see Cooper, 2001). Freedman (2004) would like to see the UK acquire one.

14 *FCT v Peabody* (1994) 181 CLR 359.

15 *FC T v Spotless Services Ltd* (1996) 186 CLR 404.

16 *FC T v Consolidated Press Holdings* (2001) ATC 4343.

17 *John v FCT* (1989) 166 CLR 417.

18 *ANZ Savings Bank Limited v FCT* (1993) ATC 4370.

19 *FC T v Consolidated Press Holdings (No 1)* (1999) 99 ATC 4945, at 4971.

concludes: "These reference points arguably provide a more certain basis than is available in other jurisdictions as to when the General Anti-Avoidance Rule (GAAR) is likely to be applied, or, in jurisdictions which do not have a GAAR, as to when the courts will intervene on the basis of judicial doctrines that have been developed in those jurisdictions to counter tax avoidance" (D'Ascenzo, 2001). External tax law consultants are routinely involved on the ATO's Part IVA Panel as part of its strategy to cultivate consistently shared sensibilities on what passes the "smell test" and what does not. On the other hand, one partner of a major law firm complained to me that "[t]he law is a long way down the list of what the ATO is concerned about. It tries to make law by press release". He saw the UK Inland Revenue as better at developing shared sensibilities by a process of white and green papers, and wide ranging discussion with everyone in business so that expectations were clear in advance of a particular press release.

Notwithstanding the recent growth in ATO confidence in the clout of its GAAR revealed in the interviews, it was a common view among the tax advisers interviewed that the ATO still underestimates the power of Part IVA. One elite adviser said he did not think there are "realistic corporate shelter opportunities because of the climate and the fear of IVA that had been induced by the Commissioner". Other representative comments from elite advisers were:

Tax advisers talk people out of a lot of things because of Part IVA. The ATO don't see the prophylactic effect of IVA.

Rulings don't protect you against the courts taking a view against your arrangement under IVA.

We don't think the ATO respects the power of Part IVA as much as we do.

Part IVA always worked. The ATO has not had the backbone to persist with it.

Australian professional indemnity insurers equally worry about the power of Part IVA, some recently excluding from their cover those liabilities that arise from the ATO applying Part IVA to a tax scheme.

Many tax experts interviewed in the course of this research think the GAAR something of an irrelevance because in jurisdictions that have it the courts rarely apply it, perhaps because they think it opens the door to giving too much discretion to the tax authority.²⁰ If that is so, the implication of the argument made in this chapter, is that we need to persuade such courts that the reality is the opposite of their intuitions – a rule of rules that closes the judicial door on a

20 I am particularly grateful for a discussion with Reuven Avi-Yonah on this question. The empirical observation that the GAAR is rarely used to decide cases in the courts in Australia and Canada is accurate, but it may not be correct that the reason for this is the courts fearing to give too much discretion to tax authorities. It may also be that the GAAR effectively deters schemes pre-litigation (see Cooper, 2001: 127). Rick Krever in commenting upon the ideas in this chapter made the point that GAARs are only used in practice "to deal with tax expenditures, not tax measures". On this view, what is needed is not a GAAR, but a remedy to the problem of politicians wanting to introduce tax expenditures "without specifically spelling out who the intended beneficiaries are because it would be politically dangerous to explicitly identify the intended beneficiary group".

GAAR actually reduces certainty and increases administrative discretion.²¹ But it may be that for this to be true, judicial conversations need to be open to sharing the sensibilities of regulatory conversations between regulators and regulatees.²² Indeed, in some way that does not threaten the separation of powers and judicial independence, judges need to become part of those conversations – Lord Mansfield’s project with making English commercial law relevant to the needs of merchants two centuries ago. To the extent that judiciaries prove incapable of this, then the case is strengthened for specialised courts such as the US Tax Court.

Radically restructuring the substance as well as the form of tax law

The solution proposed here could never be a panacea, even if the theory that underpins it is right. It may be just one of many things that are needed for a high integrity tax system. While simple in its conception, implementation of this approach is necessarily difficult when what is being responded to is complexity and flux. Selecting the right examples of arrangements that are specified as covered by the principle, and getting the examples right in how they are described, is no easy matter. Just as rule writers hopelessly clutter and complexify the law by seeking to cover all contingencies, implementers of the theory in this chapter could easily make the mistake of cluttering the statute “with descriptions of things that never happen”.²³

The current tax systems of common law nations are a major cause of growing, and perhaps justifiable, citizen distrust in their governments. Good tax administration involves virtuous circles of trust begetting trust instead of vicious circles of distrust begetting distrust. There are a number of obstacles to flipping the vicious circle into the virtuous circles that ANU’s RegNet research group²⁴ has documented to exist in other domains of regulation – such as Australian nursing home regulation in the late 1980s and early 1990s (Braithwaite, 1994). The final chapter of the book returns to this theme of promoting virtuous circles and foiling vicious ones. It is not my objective here to catalogue all of the obstacles to social capital formation and economic growth through a high integrity tax system. It has been just to argue that one of them is certainly a pathological tax law that makes the mistake of supposing that a rule of law is best accomplished by a rule of just rules.

21 An additional reason for this with tax is that when one nation treats a particular kind of transaction more in terms of form and another state more in terms of substance, global firms can arbitrage substance and form by structuring transactions so that a part that gets a benefit under a form conception is located in the state that privileges form and another part that does better under a substance conception is channelled to a state that so treats it.

22 From my conversations with elite tax lawyers, there would be a much but not universal agreement with the following claim by David Weisbach (1999): “I believe David Halperin’s [1995] claim that tax lawyers are sufficiently trained and share a sufficiently common understanding of the tax law to be able to determine which transactions anti-abuse rules target and which they do not.”

23 I am grateful to the Australian Taxation Office’s Second Commissioner and Chief Tax Counsel, Michael D’Ascenzo, for this point and the words in quotes.

24 <<http://regnet.anu.edu.au>>.

In addition to getting the conceptual structure of tax law right, each nation must of course fix and keep refixing a raft of specific laws that threaten tax system integrity. It follows from Chapter 2 that tax expenditures secured by business lobbies are prominent among these. Rick Krever's concern (see fn 20) that we remedy the problem of politicians wanting to introduce tax expenditures "without specifically spelling out who the intended beneficiaries are because it would be politically dangerous to explicitly identify the intended beneficiary group" might be addressed by political demands for less resort to tax expenditures (replacing them by more transparent corporate welfare as direct budget expenditures). But it might also be addressed with the rules/principles strategy suggested here. This means articulating the principle that motivates a tax expenditure, then outlining the actual examples of intended beneficiaries, and perhaps ones that are not intended, as instantiations of the principle. The political challenge is that these are rather abstract ideas around which to rally social movement politics for egalitarian tax reform.

A less abstract idea is that of a robust minimum tax. The US introduced in 1986 an alternative minimum tax to ensure that both corporations (with revenues above \$7.5 million) and wealthy individuals pay a minimum amount of tax regardless of the tax deductions, exclusions or credits they could claim. The latter has become politically unpopular as bracket creep is bringing increasing numbers of upper middle class people within reach of the alternative minimum tax. But political leaders are wary of the revenue loss that would result from abolishing it. Doyen of New York aggressive tax planners in the service of very rich individuals, Jonathan Blattmachr of the law firm Milbank, Tweed, Hadley and McCloy says, "There are lots of things you would not even think about because of the alternative minimum tax ... But if you repeal it then there are all sorts of things to start thinking about" (Johnston, 2003: 116). The minimum company tax was calculated at 20 per cent of a tax base reconstructed from the ordinary tax base. India's minimum corporate tax works by applying the normal tax rate to 30 per cent of the company's reported accounting profits. This means that whatever tax deductions a company claims, it cannot eliminate tax on 30 per cent of accounting profits. One effect of this, of course, is to reduce incentives for corporations to lobby for tax expenditures in the first place. Another effect is that incentives for risky aggressive tax planning practices that generate a total tax wipe-out would be eliminated. Canada, Colombia, Pakistan and Venezuela are other nations with some form of corporate minimum tax. A political path to community demand for a corporate minimum tax could be first to campaign for public disclosure of the tax paid by large corporations. If PAYE taxpayers saw the evidence of numerous profitable corporations paying no tax on a regular basis, demand for a minimum corporate tax might grow.

More radical ideas like a progressive expenditure tax perhaps with no tax returns, by voluntarily opting in to paying for all purchases in ways recorded by designated financial institutions, or through implementing elements of Edward McCaffery's (2002) or Daniel Shaviro's (2004) model for a progressive expenditure tax, are one prospect for a simpler, less gamed, tax system for most people. Another is replacing company tax with an equity tax as advocated by Schluny (2001) and Levin (2001) and discussed in the next chapter.

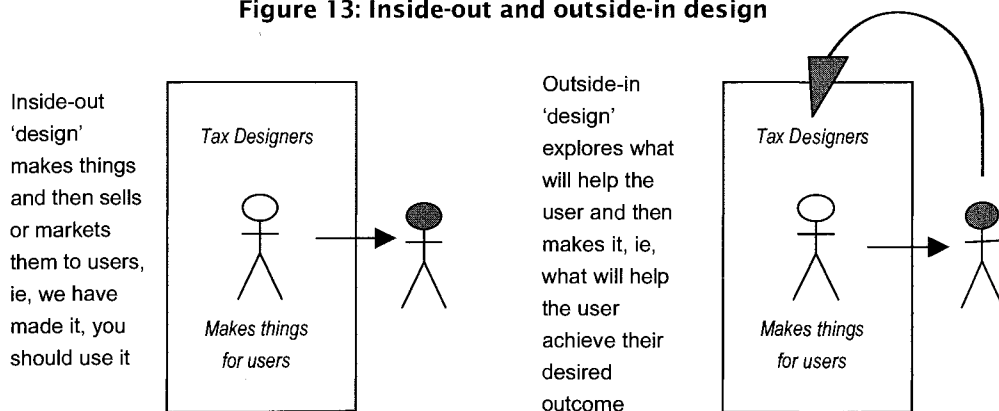
Meta risk management using natural systems

Tax systems can be designed to take advantage of natural systems within companies and industries in order to manage the risk of non-compliance. Chapter 5 explained the shift in ATO thinking from risk management to meta risk management – the risk management of taxpayers’ risk management systems. The move is from the ATO having a risk management system to regulate taxpayer risks to taxpayers having risk management systems and the ATO managing those. The Registered Software Project and the Transfer Pricing Record Review and Improvement Project were documented as examples.

“Inside-out” and “outside-in” design

Meta risk management involves a shift from “inside-out” to “outside-in” design. Tax administrations have historically been inside-out designers: they design the tax system to suit their administrative purposes, and then tell taxpayers to use it. It would be outside-in design if a tax authority asked taxpayers what systems they use and what tax systems would be administratively convenient for them, and then shaped the tax system to go with the grain of user systems (Figure 13). Consequently, meta risk management requires a principle-driven as opposed to a rule-based approach to tax law. This is because highly prescriptive rules are too inflexible to allow for governance by the risk management systems that come naturally to business.

Figure 13: Inside-out and outside-in design



Source: Consolidation Project Blueprint, 2002: 82

Outside-in design could mean collaboratively crafting a tax collection system that is completely new. But its greatest comparative advantage over inside-out design is obtained with the use of natural systems that exist and have a useful economic purpose independent of the tax system. As an example, consider what was once one of the more complex features of Australia's regime of excise taxes on oil and petroleum: the diesel and alternative fuel rebate. Truckers are granted rebates on diesel and alternative fuels; as are farmers as part of a government effort to reduce the off-road fuel costs of those who till the vast continent. Until 2002, transport operators claiming the rebate had to fill out 70 to 80 pages of forms each year, suffered delay in getting their money and spent a lot of time matching fuel receipts to their odometers. Implementation of the E-grant system means that 50,000 Australian truckers can now swipe their fuel card at the bowser and receive the payment immediately. The grant is made by deducting the rebate from the cost of the fuel at the moment of purchase. The old inside-out design method was for the government to announce a grant and then design paperwork for the bureaucratic system by which it could be claimed. The outside-in design method involves talking with the recipients, in this case, truckers and farmers, about what natural systems they currently use, in this case, for buying fuel. In this case, the answer was they mostly use electronic fuel cards. And so why not adapt the pre-existing system (for adding excise on to the price the retailer charges) by deducting the grant from the price for truckers or farmers who purchase fuel using a smart card that specifies the level of grant to which they are entitled? This not only cuts the paperwork costs of the tax system, it also cuts cheating. You can't get a grant by exaggerating how far you travelled, as happens frequently when truckers fill out the form, because there is no form; you only get the grant in proportion to the fuel you actually buy. This is a simple example of how outside-in design that picks up natural systems – in this case systems in day-to-day use for paying for fuel for commercial vehicles – can improve the integrity and efficiency of a tax system.

Advance Pricing Agreements (APAs), as discussed in Chapter 5, offer a more complex illustration of responding to the natural integrity of the systems business use, in this case, to the business systems used by transnational companies. APAs do not involve the tax officer saying, "Here is how we want you to calculate your transfer prices". Rather, the tax officer says, "You can choose any one of these widely used pricing methodologies or you can persuade us to accept unique features of your own system so long as they satisfy our transfer pricing principles". There are no uniform rules, only principles that apply to all.

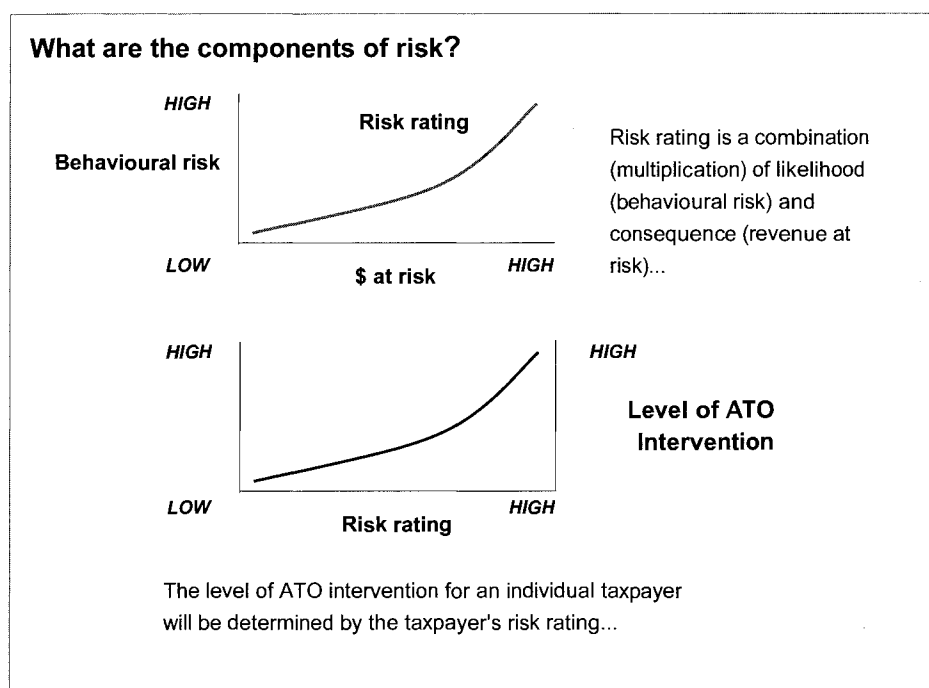
The same "natural business systems" approach apparent in APAs is being extended by the ATO to a Client Risk Review for Australia's top 100 corporate groups. The Client Risk Review involves developing an understanding of the taxpayer's business and its operating environment, comparing it to like businesses, in order to assign the group a risk rating. Soula McFall of Deloitte in *Tax Management's* "Transfer Pricing Report" for April 3, 2002, describes the Client Risk Review as "a domestic version of an APA". *Tax Management* interprets this expansion of the natural business systems approach as a result of the "tremendous revenues the [Transfer Pricing Record] Reviews have produced".

Likewise, the Registered Software Project discussed in Chapter 5 is not about uniform rules, just principles and outcomes that high integrity software must satisfy. Innovative software does not have to be certified by the ATO; self-certification that the software meets the performance standards is all that is required in circumstances where the marketplace consequences of false certification by software producers would be dire.

The Consolidation Project

The ATO's project on consolidation of corporate groups has also adopted an approach based on understanding the risk of a natural system, which is demonstrated in Figure 14.

Figure 14: ATO model of how to assess the risk of natural systems



Source: Consolidation Project Blueprint, 2002: 18

Prior to commencement of the Consolidation Project, each corporate entity in a wholly owned group was taxed as a separate entity. Consolidation allows groups of entities to be taxed as a single entity. This means that gains realised within a consolidated group are recognised only once and losses only once, a single tax return for the group, and removal of double taxation of capital gains. For the

ATO it delivers simplified tax return administration and reduced tax avoidance opportunities (such as value shifting to create artificial losses where there is no actual economic loss, or loss cascading by the creation of multiple tax losses where there is only one economic loss). The Consolidation Project is advancing the development of thinking on outside-in design in respect of corporate taxpayers to utilise natural systems. At this stage, the Project has not led to any actual radical implementation of the natural systems approach. As with APAs, the philosophy being developed is: "We will not treat everyone the same (but we will treat everyone equitably)". One manifestation of this is the fact that groups that naturally fit together can choose to consolidate or not as they choose (though on a one-in-all-in basis). A design principle is that the tax system not impede the formation/restructuring of consolidated groups.

Responsiveness to natural business systems means the ATO would become less demanding in checking transactions, putting more emphasis on intelligence derived from conversational regulation of tax assessment. That is, it would be more about relationship management than checking transactions. The ideal is that the relationship with the consolidated client assures that transactions are checked by the taxpayer and their accountants in accordance with protocols that emanate naturally from its business systems, or from systems it has learned to produce for other purposes such as disclosure to the stock exchange. There is also agreement on how the ATO can check that the taxpayer and its accountant are internally checking their own transactions with integrity. This is done by rejecting a one-size-fits-all approach in favour of risk profiling for an enforcement pyramid under which most would be trusted to be committed to sustaining the integrity of the natural business system – the response designated at the base of the enforcement pyramid.

Monitoring natural systems and raising the bar on tax obligations

The "data analysis from targeted sources" represented in Figures 9 and 14 might involve a radical departure from checking transactions. Currently, ATO transfer pricing audit risks are determined by a publicly disclosed interface of how "commercially realistic" the company's profits are and the integrity of its processes and documentation (see Chapter 5, particularly Figure 9). Judging the integrity of the processes and documentation offered up by natural business systems is bound to be a qualitative assessment where profound errors of judgment will at times be made. But such errors can be checked by objective assessment of the taxable profits reported. Twenty-first century data analysis capabilities can make the quantitative assessment a progressively more sophisticated way of bootstrapping compliance. For example, Syed and Kalirajan's (2000) ATO work on benchmarking corporate tax compliance illustrates the possibilities for multivariate analysis that might estimate, for example, that controlling for variables such as the industry sector, size, stockmarket performance, and ratings agency assessment of the company, the reported taxable income was X per cent below the tax normally paid by competitors (see also Braithwaite and

Wirth (2002) on regression-based risk leveraging). Even for small businesses – say hardware retailers, fishmongers or bakers – industry norms of expected taxable income can be calculated per thousand dollars of hardware, fish or flour inputs. Unless the behavioural, procedural and documentary assurances of compliance are extraordinarily good, the fishmonger earning 50 per cent lower taxable income than the industry norm for their kilo volume of inputs of fish can expect an audit that temporarily abandons trust in her internal compliance processes. And she should be told she is 50 per cent below the norm so she knows how much things have to change before she is above the bar and relieved of intensive monitoring of her affairs.

One concern about this approach is that some industries have worse cultures of compliance than others. Yet one of the advantages of meta risk management is that the emphasis on client relationship management engenders a superior flow of intelligence relevant to this judgement. Over cups of coffee with clients, tax officers learn of the horror stories that occurred at “the firm down the road where I used to work” or that “I heard on the grapevine at an industry association meeting about my competitor”.

When the judgment is made that there is a culture of tax cheating in a particular market segment, the industry norm revealed in the multivariate analysis would still be used to target those furthest below the norm for audit and other compliance tools. But more of them would be targeted than in other industries. And when they are caught out by the audit, the bar they are required to reach before they are released from targeted surveillance can be raised a little higher than the industry norm. As the taxable income of the worst ten compliers in the industry rises from way below the old norm to above it, the norm itself rises. Then in the next year, the taxable income of a new “worst ten” is raised above that higher norm. This raises the bar again. In this way, it is possible to keep raising the bar represented by the X-axis in Figures 14 and 9 in problem industries until they are paying their fair share in comparison to other industries, and in comparison to non-business taxpayers.

Transparency and outside-in design

Because these fair share issues involve political judgements of considerable import to distributive justice, arguably they should be made with maximum openness. At a minimum, data on how much tax is being paid by this industry sector versus that, when such data is produced by the analyses described in the last paragraph, should be public. Then the public could mobilise concern when it believed the bar has not been raised high enough for particular industries, and industries believing they have been discriminated against by having their bar lifted higher than for others could also raise their voices. In both circumstances, it would be expected that the tax office would give an account that justified what it had collected in terms, for example, of the extraordinarily difficult or profitable times experienced by the industry in the period that is the subject of the democratic conversation.

Arguably, however, accountability for the tax authority should go further. Making public the amount of tax paid by public companies would make it clear to the public that tax authorities are collecting almost no tax from many large companies. This is also about accountability of corporations who get benefits that individuals do not – like limited liability in the face of bankruptcy and registration so that they can be listed to raise capital from citizens on the stock exchange. Arguably, organisations with such public qualities should be held to account for paying a fair share of the public infrastructure they use. But the more important accountability issue arises from the characteristics of contemporary democracies, in which political parties depend heavily on campaign contributions from large corporations to buy television advertising. Both the campaign contributions and the tax paid by corporate groups should be public so that the public can raise legitimate concerns when a powerful corporation pays large campaign contributions but no tax.

This is a not-so-radical idea that has precedent in no less pro-business a nation than the US, in which corporate tax returns were public for a few short years from 1909. This feature of President Taft's corporation excise tax was shut down by intensive lobbying by business concerned with keeping its tax affairs secret. But the issue did not die and corporate tax returns were disclosed again in 1936 and 1937. A recent Wall Street Journal article and statements by the ranking Republican on the Senate Finance Committee, Charles E Grassley, calling for public disclosure of corporate tax returns rekindled the debate (Stratton, 2002: 220). A starting point for the recent debate has been the observation of the vast difference between the numbers in Enron and WorldCom's tax returns and financial statements. The argument is that if investors had had access to the tax return data, analysts might have detected the shonky books before the company went down. Canellos and Kleinbard (2002: 2) have argued that this would not work: what would be more useful for both tax auditors and investors would be to have access to a public book-tax reconciliation schedule which would "provide a useful platform for highlighting transactions which are likely to involve manipulation for tax and accounting concepts".

During the 1920s, the US Treasury Department routinely released individual tax returns, and newspapers regularly published lists of the taxes paid by local millionaires (Thorndike, 2002). The amount of tax individuals pay has always been open to the public in Sweden. It must be said, however, that there are some privacy issues and rights that arise in respect of private individuals that should not be at issue in respect of public corporations.

Defiance, gaming and natural systems

One of the beliefs of ATO officers who favour meta risk management characterised by outside-in design based on natural systems is that it reduces defiance (Sherman, 1993) and gaming of the system. Systems imposed from above by a remote governmental bureaucracy are resented more than systems that governments co-design with business, especially when the state makes a

special effort to adapt its systems to business systems rather than the reverse. Thus ATO officers have discovered for themselves an advantage long claimed for regulatory design effectively delegated by the state to business (see some of the examples going back many decades in domains such as mine safety in Braithwaite's (1982) article on enforced self-regulation).

We might eliminate game playing altogether if the owners of the natural systems harnessed are third parties rather than those who suffer the tax liability or gain the deduction. This is the case with the E-grant system. It is not a natural system owned and controlled by truckers or farmers that is harnessed here; it is one controlled by fuel card issuers. This is the design genius of the single most important innovation in the history of tax compliance, PAYE deduction at source, which is controlled by employers rather than the employees who suffer the consequences of the tax bill. Ditto with deductions of tax on interest by banks. Virtue is more likely to flourish in systems using actors with no interest in vice.

Likewise with the blue-sky tax reform of taxpayers opting into a progressive expenditure tax (the more they spend, the higher their expenditure tax rate, so the rich pay more) that would eliminate the need for them ever to fill in a tax return so long as they contracted to channel all their expenditures through a smart card. Such a taxpayer could make purchases from traders without e-commerce technology using a single-use card (like a disposable phone-card) that the seller can use to draw on the purchaser's account, just as a cheque is used now. The bank that issues the smart card would deduct the tax on each transaction and send it direct to the tax office. Again, the bank is a third party who gets no benefit from cheating and therefore will only cheat accidentally. Cheating can only occur by a breach of the contract to always purchase through the smart card. But it is an easy enforcement challenge for the tax authority to test contract compliance by tempting the taxpayer with an offer of a discount for a large cash transaction.

Obviously, this is a blue-sky idea for the future with innumerable practical obstacles and objections in the here and now. These need not delay us as I am not advocating this as a practical reform in the present, merely signalling how far one might conceivably push the design idea of using pre-existing financial systems to recruit disinterested third parties to deduct tax at source.

Another blue-sky proposal is that of Levin (2001) and Schluny (2001) for an "equity tax" that replaces company tax with government share ownership. A one per cent equity tax would mean the company would issue one new share to the tax authority for every 100 existing shares in the company. The government would sell these when it needed revenue. As usual the devil is in the detail, and I do not propose detailed advocacy of it here. But the reason why the idea is worth considering is that it harnesses natural business systems. The corporations tax is gamed so assiduously because it is founded on an utterly artificial construction of taxable income that bears no relation to the income reported for any other useful purpose. A company's share price would be more difficult to game to avoid tax because it has a deeply embedded business purpose. Managers work to maximise shareholder value. It would be a strange decision for a CEO to manoeuvre the value of the 99 per cent of stock held by shareholders downwards in order to

reduce the revenue the tax authority would get from 1 per cent of the stock. So the benefit of an equity tax is that the virtue of tax integrity would be assured by the natural system: in managing to maximise shareholder revenue managers would also effectively be managing to maximise tax revenue instead of managing to minimise it, as they do now.

Limits of the natural systems approach

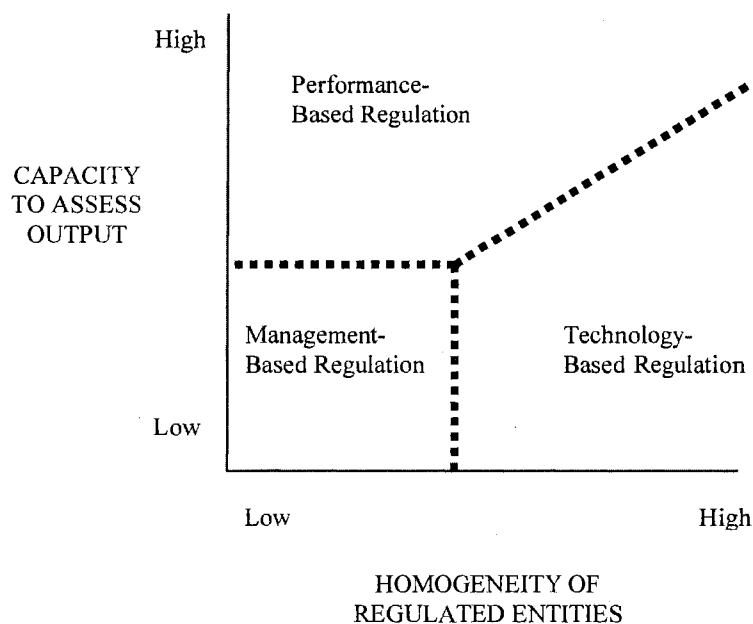
The limit of the natural systems philosophy is that often there will not be good natural business systems to work with. Harvard regulatory scholars Cary Coglianese and David Lazer have come up with an evocative way of conceptualising how to make choices about when to rely on natural business systems (Coglianese and Lazer, 2003). Figure 15 (p 164) is a succinct summary of their thinking. In their view, when the ease of measuring a regulatory output is high, performance-based regulation will be the best way to go. So, for example, when it is easy to measure how much pollution a factory produces, a tax on the amount of pollution they produce is likely to be the best regulatory strategy. A value-added tax (VAT) or goods and services tax is another example common in tax policy. In most circumstances, measuring outputs is not hard because a high proportion of sales that are outputs for one firm are sales to another firm (which are recorded by them as inputs on which they seek a VAT rebate). The fact that so many of a firm's outputs are verifiable against the inputs of other firms means that most firms opt for high integrity measurement of VAT outputs.

This, however, is not universally true. Businesses where most of the outputs are services provided direct to retail consumers, such as restaurants or drycleaners, are not tightly subject to this natural verification of outputs by other firms' business systems. When such businesses are paying lower amounts of VAT than would be expected for the amount of inputs to the business, a visit is needed to secure agreement on a more management-based form of regulation. With a family-owned restaurant this could take the form of a restorative justice conference. In such a conference, the tax inspector and the family and any staff would sit in a circle and the tax inspector would explain that the restaurant is under special surveillance from the tax office because it is paying so little tax compared to other restaurants of a similar size. The tax inspector might then explain that his observations and interviews with members of the family and other restaurant staff indicate that the restaurant has a low-integrity system for managing the till and the receipts it produces. An agreement might be signed by all staff in the conference to comply with a superior system for managing the receipting of cash payments, specifying that these always go through the till. The idea behind this agreement between the tax office and the restaurant staff is to increase the prospect that if the boss continues to require staff to divert cash payments from the measured outputs of the restaurant, the staff will refuse to break the law. If a member of staff is fired for refusing to break the undertaking, they will be able to report this to the tax authority and receive a payout for unjust dismissal after testifying against the former employer.

According to Coglianese and Lazer, management-based regulation like this will work best when measuring outputs is fraught with difficulty and where regulated firms are highly heterogeneous. The difficulties of measuring profit shifting through transfer pricing by multinational corporations trading from and to highly diverse international markets is a classic case of Coglianese and Lazer's joint conditions for the effectiveness of management-based regulation.

According to the model in Figure 15, technology-based regulation works well when output is hard to measure with integrity and when regulated actors are homogenous. An example is the E-grant scheme: distances driven by individual truckers are difficult to measure with integrity; monitoring whether claims are simply fabricated on forms that document travel is an impossible challenge. But because commercial truckers are rather homogeneous in that they tend to purchase fuel using electronic funds technologies (a natural business system), it has been possible to introduce standardised technology-based regulation in the form of a smart card, and bring high integrity to a formerly low integrity regulatory system.

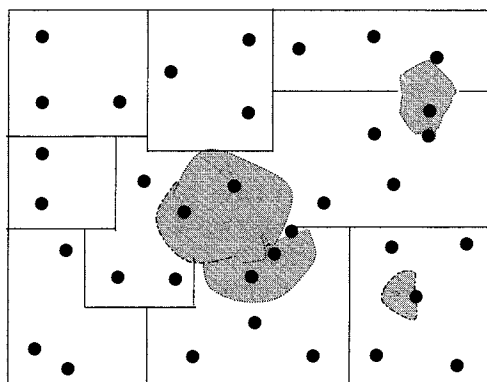
Figure 15: Framework for selecting regulatory strategies



Source: Coglianese and Lazer, 2003

**Figure 16: The world vision of the Strict Legalist (A)
versus the Meta Risk Manager (B)**

A: Tax cases as bounded by certain rules with a few grey areas
● = cases



B: Tax cases as a morass of uncertainty with some islands of certainty (boxes)
● = cases

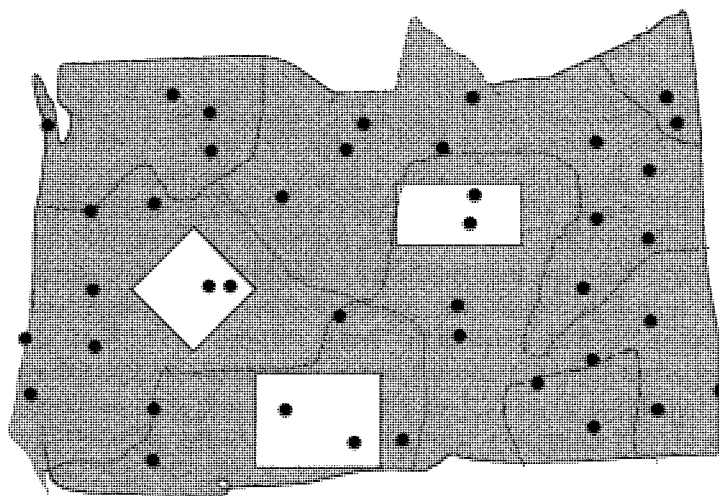


Figure 15 should also cause some pause about the oversimplicity of Figures 14 and 9. These figures imply that dollars at risk (or measurable commercial realism of profits) and assessments of systems for managing risk should be given more or less equal weight by tax officers. The lesson from Coglianese and Lazer's (2003) work is that where an output like the commercial realism of profits is harder to measure and where different firms have heterogenous natural business systems,

more emphasis should be given to undertakings to improve the integrity of financial systems such as procedures and documentation. So not only is meta risk management not a one-size-fits-all approach, there are many contexts where meta risk management does not fit.

Finding pathways through a morass of complexity and uncertainty

The ATO's former Consolidation Pathway Custodian Mark Jackson explained to me that those attracted to meta risk management and a principle-based law that responds to natural business systems have a different view of the world than legalists. Figure 16 (p 165) shows these two different world views. The legalist who believes that rules can be written to classify tax behaviour with certainty into clearly defined boxes sees a few grey areas clouding this perfect world. Mark Jackson's meta risk manager, on the other hand, sees a number of islands of tax law certainty where rules work with precision within a morass of flux and unfathomability. The foot-fault rules that define these exceptional islands of certainty are worth preserving; but we should not delude ourselves into thinking that most problems can be covered by such rules.

Another implication of the Jackson perspective is that no taxpayer can ever comprehend the complexity of the whole tax system. In fact, even the Commissioner for Taxation cannot comprehend anything like the vast totality of its flows and forms and systems and rules. What taxpayers can imagine is their pathway through the system. If they can just imagine that and the principles that point the way along the path, then they might follow this simple, principled path. Client relationship management is not about explaining the tax system to citizens but helping them to picture their particular pathway through it. If it is a simple pathway for a taxpayer with simple affairs; information packages can allow them to picture it on their own. If their affairs are more complex, they will need a tax preparer to help them see their pathway through the system. Australian readers of this picture will recognise the basics of their own system, and might feel satisfied, but the UK does much better in this respect.

Risk management of natural systems implies not only a different approach to helping taxpayers to find their pathway through an uncertain tax system, but also a different approach to intelligence and to tax office culture. Meta risk management requires a tax office culture that is experimental, collaborative and flexible, that learns from evidence of failures and from storytelling about successes and failures. It eschews over-control by inside-out, one-size-fits-all policies. The next chapter takes up the theme of how an intelligent tax office culture avoids our natural human proclivities to over-control.

Intelligent tax office culture

Rethinking intelligence

Meta risk management using natural systems has major implications for how intelligence works.

The importance of client relationships

Figure 15 shows how building client relationships to draw out intelligence is integral to the design of meta risk management. Quality intelligence on tax shelters comes from quality relationships, and trust and respect from large sections of an industry for the fair objectives the tax authority is seeking to secure. Outside-in design with industry partners is important to intelligence gathering because high integrity industry participation in the co-design means that the industry players will say that this or that will not work because it will open up a loophole which this or that kind of scheme can exploit.

Many of the Australian interviewees said that Nick Petroulias was doing the right thing in cultivating relationships with tax planners over cups of coffee to ascertain what was going on. Indeed, a number saw him as having major success in uncovering schemes that the ATO was able to successfully attack. What they almost invariably objected to, however, was the lack of accountability surrounding Petroulias's deals with promoters.

Stimulating new intelligence sources by rewarding shelter discovery

The introduction of public disclosure of corporate tax returns was advanced above as a useful measure for improving the accountability of tax officials with respect to large corporate taxpayers. Theodore Sims (2002) has advanced an additional intelligence-improvement rationale for making corporate returns available on a website. This is that it would enable a system of rewards for private auditors who bring new schemes to light. To motivate private auditors to pick over corporate tax returns in search of shelters, Sims suggests a bounty, of say 20 cents in every dollar recovered by the tax authority, payable by the taxpayer to the private auditor on top of any other tax penalty: "The most effective way of channelling sufficient resources into prevention is to make it as profitable to police corporate shelters as it has obviously become to purvey them" (Sims, 2002: 736).¹

¹ On the effectiveness of private bounties for detecting corporate wrongdoing generally, see Fisse and Braithwaite, 1983: 251-254, 283.

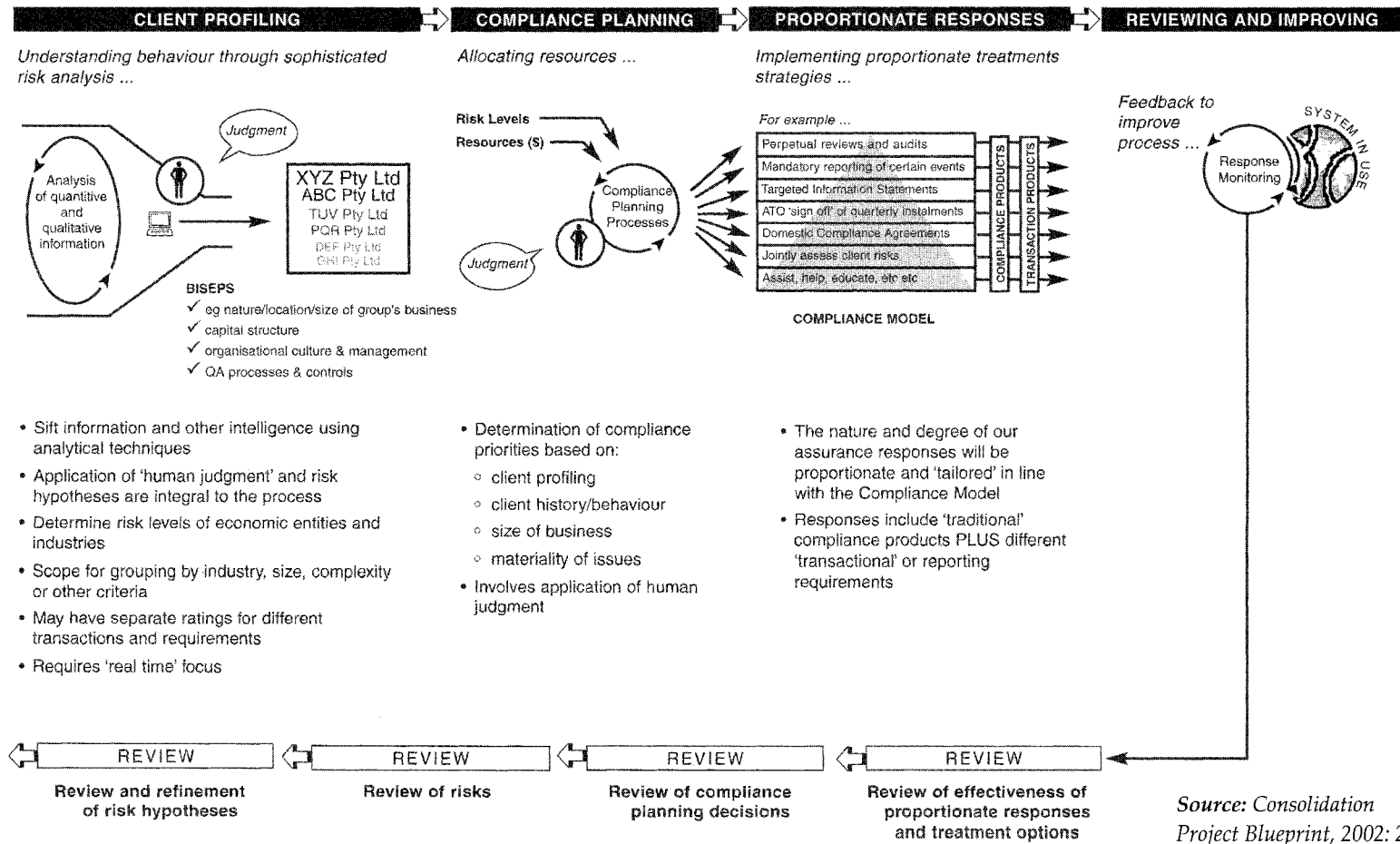
As discussed in Chapter 8 the registration and disclosure requirements for corporate tax shelters implemented in the US are not an unbounded success. The problem is that it is so hard to get the detail right, in this case, of what the law requires tax preparers, promoters and taxpayers to disclose. Over-inclusiveness swamps the tax authority; under-inclusiveness opens up safe harbours of non-disclosure into which the most ruthless promoters can sail the worst shelters while merrily disclosing the innocuous ones. Tax law enforcement is a difficult process of learning over time to get things right. So we should be patient with new policy directions such as shelter disclosure regimes. Shelter disclosure regimes are a fertile policy direction and, in time, could become very effective, especially if married to a promoter penalty regime with teeth and nurturance of markets in professional virtue (as discussed in the final chapter of this book). For example, if the private market for rewarding shelter discovery discussed in the preceding paragraph were implemented, this would make a difference to the effectiveness of mandated disclosure of shelters. That is, if heavy penalties awaited tax agents who failed to disclose their clients' shelters appropriately and if private auditors had incentive and access to public returns to detect those failures, then enforcement swamping that gives us too little shelter enforcement too late might be solved.

Expanded returns for scheme participants

The intelligence function within the ATO was only one important means of detecting the new shelters of the 1990s. Also important was a request to taxpayers who had been involved in a scheme for two or more years to fill out a schedule with their current year tax return. In effect this was a request to provide an expanded return containing more detail than is normally required under self-assessment. The majority of taxpayers voluntarily complied with this request. In Chapter 5 we saw that similar expanded returns achieved considerable success in improving tax collections from high-wealth individuals who had been paying little or no tax. Intelligence in respect of high-wealth individuals is often particularly useful because the boutique schemes designed for the super-rich today are often "sold down" tomorrow as mass marketed schemes to the moderately rich.

Self-assessment accords with the meta risk management philosophy of movement away from the impossible task of the government pretending to check all transactions by passing responsibility for managing risks to the taxpayer, in dialogue with their accountants. But self-assessment has its downside. This is that it enables the smart operator to cover up involvements in aggressive tax planning. As with any shift in the direction of meta risk management, self-assessment requires that evidence of subverting the responsibilities of self-assessment must be responded to with tax office assessment. Two years of participation in aggressive tax planning is evidence of the likely abdication of integrity in self-assessment. So it becomes reasonable and necessary to require the disclosure of the item-by-item investments that were disclosed before the introduction of self-assessment. Then and only then can self-assessment's advantages of delegated self-regulation be secured without throwing out the benefits of the old system. The large intelligence payoff of expanded returns with high-wealth individuals, promoters and scheme participants in Australia demonstrates this. In addition, enforcement responses to low integrity under meta risk management escalate far

Figure 17: Compliance planning in the Consolidation Project



over and above the disclosures required prior to the introduction of self-assessment. This is illustrated by the pyramid at the top right corner of Figure 17, which shows the proportionate responses in the compliance design of the Consolidation Project.

Transforming tax office culture

The ultimate key to improved intelligence is the analytic and interpretive abilities and tax-technical competence of tax office staff. Beyond that, it is having a staff that reject the view that “strategic intelligence is something done by a specialist group so the rest of us can get on with our day-to-day work”, and understand that strategic intelligence is a process of cyclically sensing and making sense of risks, electronically recording them in ways that channel them to the right desks and following through to ensure that treatment of the risk has not fallen through the cracks of the organisation. Unfortunately, there is a problem inherent to the culture of tax authorities that obstructs staff from having such an understanding and from following this process. It is the problem of “narrow perfectionism”.

The problem of “narrow perfectionism”

Why do tax authorities around the world with good intentions to tackle aggressive tax planning fail to do so? Why do they fail to learn the lessons of the last cycle of aggressive tax planning or, if they do, fail to act on them in order to prevent the next cycle? Why do good people in such organisations allow such bad things to happen? In the aftermath of a cycle of aggressive tax planning, why do so many tax officials say it was obvious to them that the upswing into the contagion was coming, yet did nothing to stop it? Sometimes political interference to protect powerful interests from having to pay their fair share is the answer to this last question. But for most of the good people who do bad things the answers are more mundane.

Martin, Archer and Brill (2001) have used the research of Harvard organisation psychologist Chris Argyris to find these answers. The Argyris research program shows that people are universally predisposed to counterproductive behaviour – actions contrary to their hopes and wishes. This counterproductive behaviour is driven by a set of values that are focused on winning, staying in control and avoiding embarrassment. When pushed beyond our comfort levels, we will engage in defensive behaviour aimed at avoiding failure and the resultant embarrassment and loss of control. We will avoid telling the truth or asking questions, especially if it involves challenging the opinions of others in a manner that threatens to produce embarrassment. The result is that we will cover up our mistakes, even if it means making a bad situation worse (Martin, Archer and Brill, 2001: 2).

Within organisations, people commonly respond to the fear of failure in one of two ways. One is to “fight”, in which case we seize total responsibility for success, the other is to “flee”, in which case we abdicate responsibility in order to distance ourselves from failure. When we decide to fight, we fall into the trap of seeking unilateral control over the problem to make sure that we are not distracted from winning by going off on tangents recommended by others. Argyris (2000) finds this to be a universal habit. So fear of failure causes us to be

over-responsible, to make the mistake of failing to consult others with a genuine openness to their ideas. On the other hand, when we choose to flee, we become under-responsible. We make the case that this is someone else's responsibility and there is absolutely nothing we can do about the failure if it occurs. In both fight and flight mode, Roger Martin (2003: 40-43) finds that we are prone to what he calls "narrow perfectionism". Narrow perfectionism means narrowing the range of our responsibility to the point where we can assure ourselves that we have acquitted that responsibility perfectly, thereby avoiding failure and maintaining control.

We see this with the auditor who wins by getting a "good result" from his audit, perhaps a "big win" of a million dollars in extra revenue. He tells his boss that this might be a boutique shelter and that the tax adviser might be in the process of "selling it down" as a mass marketed scheme. He views follow-up such as referring it, for example, to the Promoters Taskforce, and recording the details that justify this suspicion in a way that tells the story for the strategic intelligence or law reform groups, as his boss's job. He knows that as she has not been involved in the audit, she is not sufficiently in touch with the story to write it up in a way that will attract the attention his worry demands. But he tells himself that his responsibility is to do his job perfectly, which he has done with this big audit win, and it is his boss's responsibility to do hers. When the tax authority is vilified in the parliament for failing to act on the mass marketed scheme, he says, "I found that bloody scheme, nailed it for a million dollars. I warned them it was likely to be mass marketed and they did nothing".

When driven by narrow perfectionism, Martin says that people put severe limits on how much of their thinking they share and how much they inquire into the thinking of others. It seems best to limit the opportunities to discuss their actions so that more expansive expectations of their responsibilities do not put them at risk of failure or loss of control.² For example, a tax official might shy from discussions with business and their advisers in order to iron out mistakes, for fear that they might be misled by business in ways that expose them to more work! This in turn leads to a cycle of first responding to an identified risk by being over-responsible for it and then moving to under-responsibility (see Figure 18). First the tax fieldworker sees some aggressive tax planning and takes personal charge of putting a stop to it. As he begins to be outmanoeuvred by a team of smart lawyers on the other side as a result of his failure to share responsibility with a tax office network of expertise, his fear of failure causes him to refer the case to the legal group in his agency. When the problem gets further out of hand because the legal group, preoccupied with other priority cases, fails to give it immediate attention, the fieldworker has moved from fight to flee, from being over-responsible to under-responsible. Now he says there was nothing he could do because the legal group let the file sit in their in-tray, failing to mobilise the resources needed. They are responsible for the loss, not him.

2 The partner of one major law firm argued that the technical incompetence of ATO staff chilled dialogue with business and their advisers as well: "They don't know whether business is misleading them. So they don't like to discuss things openly to iron out mistakes." Other advisers alleged such a tendency for the ATO to eschew dialogue that might reveal their lack of understanding of the law.

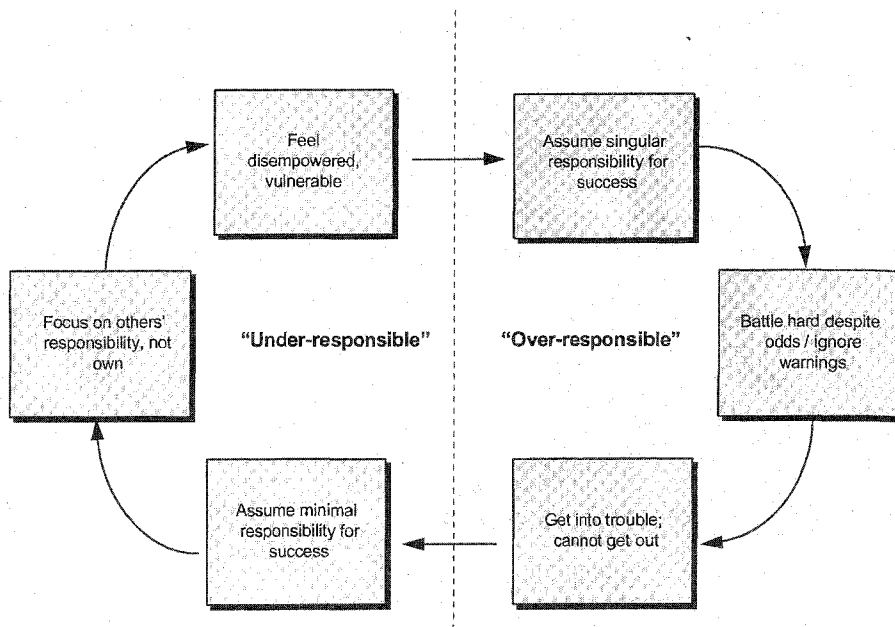


Figure 18: The cycle of over/under responsibility

Source: Martin, 2003: 27

The natural and universal human tendency to respond to risks of catastrophic failure by moving from over- to under-responsibility and narrow perfectionism is enormously difficult to resist in a large tax bureaucracy. What is needed is a culture where errors are explored as interesting challenges to be corrected (learning opportunities), where people work together collaboratively instead of seeking to win against one another: "Rather than protect themselves with narrow definitions of responsibility, members of the organisation attempt to continuously explore expansion of responsibilities" (Martin et al, 2001: 37).

Asymmetry of punishment over reward

Unfortunately, these things do not happen most of the time in tax authorities because as one New York tax adviser put it in his interview: "[In the IRS] there is no reward for initiative and lots of punishments." In the ATO it is also the case that rewards and punishments are asymmetric.³ The rewards for successfully

³ One senior ATO officer in commenting on a draft of this section questioned whether there is asymmetry in rewards and punishments in the ATO. He pointed out that "if you are successful that helps in your career" and that the ATO is "risk tolerant". On the other hand, he conceded that prudence is needed in rewarding "mavericks": "the ATO gets its strength from working as a team, and mavericks often have the effect of reducing community confidence. From personal experience, you can get things to happen in the ATO if you have the ability to persuasively articulate your proposals and benefits, particularly when you take into account and address competing arguments".

experimenting with a high-risk solution to a large problem are low and the punishments for failure high. Colleagues shy off collaborating with those who pursue high-risk solutions. If they fail, colleagues feel vindicated in declining to join with them in sharing responsibility for the venture; if they succeed, the narrow perfectionists share gossip with each other about how lucky she was this time that it did not blow up in her face. With a problem like aggressive tax planning, moreover, the narrow perfectionists are invariably right that next time (or the time after) she will indeed fail. If you are a risk taker who seeks to conquer ever-expanding challenges, eventually you will put yourself in the position of tackling something beyond you. This would be true even if your colleagues were collaborating with you. But in organisational environments where your colleagues increasingly shy away from sharing responsibility with you as you become more ambitious about the dragons you would slay, the structural inevitability of failure is greater.

To the extent that there is organisational asymmetry between punishment and rewards in tax authorities, and a structural inevitability of failure when tax officials accept responsibility for tackling ever more challenging aggressive tax planning crises, it is compounded by the fact that their adversaries do not work in organisations pathologised by this asymmetry. If their adversaries experience an organisational asymmetry, it is the reverse. Scheme promoters get stupendous multi-million dollar rewards for the period when the scheme works. As a result their colleagues seek to collaborate, contributing their ideas for making a scheme work better so they can claim a share of the rewards. In the absence of an effective regime of promoter penalties, any punishments when a scheme fails are small in comparison to the rewards reaped while the scheme was making hay. Hence, just as the vice of narrow perfectionism is structurally inherent in tax bureaucracies, the virtue of collaborative exploration of expanded responsibility is structurally inherent in the tax planning market.⁴ As demonstrated most dramatically in the super-competitive New York market, tax advice organisations flourish when they work in collaborative networks of diverse expertise that share in the kill; they fail when they retreat into themselves. As a monopolist, the tax authority does not benefit from the natural selection for collaboration of a market that allows the formation of packs, and for each participating wolf to eat of what the pack kills. On the contrary, the asymmetry of punishment and reward in tax authorities means natural selection for non-collaboration, for narrow perfectionism.

The technical complexity and transnational commercial flux of the tax shelter game favours collaboration as a winning strategy over narrow perfectionism. This becomes ever more true as international arbitrage becomes the more dominant form of aggressive tax planning, when no narrow perfectionist can be an expert of the tax laws of a dozen nations at once.

4 Though the same senior ATO officer quoted in the last footnote questioned this, saying, "I would argue there is more collaboration in the ATO amongst its better officers than would occur in private practice".

Pay, asymmetry and culture

It is a commonplace and correct observation that the best tax-technical brains are not attracted to working for tax authorities when the best people in the tax advice industry are paid many times as much. Yet it is also true that idealism about public service, job security and other factors also attract some fine minds into tax authorities. The problem is that asymmetries of punishments over rewards compound the difficulty in attracting talent, because tax authorities fail to collaborate and share responsibility effectively with the brains they have got.

These problems seem structurally inherent, suggesting that a radical structural solution is required. One such solution would be to totally deregulate pay rates in tax authorities, so that the pay of those working at ensuring compliance at the elite tax shelter end of the market becomes competitive with the private sector. The public purse can and should win a bidding war for the people with the best tax-technical brains. Ironically, when it does, the remuneration for people with the best tax-technical brains will fall because the market for aggressive tax planning will progressively contract. But achieving brainpower parity is only one reason for making this needed reform. Another, perhaps bigger, reason is that it is the only strategy that can defeat the problem of asymmetry of punishment over reward. In an integrated public-private market for the most ambitious tax shelter minds, the largest remuneration within the tax office goes to those who tackle the most challenging tax planning adversaries. But more important still, when they fail to slay these adversaries, because they are people who are competitive at the highest levels of the private advice market, they are at a level where they don't need to worry that the consequence of failure is a slide down the hierarchy of the tax office. Their remedy in the face of that scenario is simply to move back into the elite private practitioner market. In an integrated private-public remuneration market for tax-technical advice, the highest rewards for those in the tax office will go, as in the private sector market, to those who risk collaborating in sharing responsibility for the big kill. Narrow perfectionism would no longer be the dominant strategy for tax officials facing the daunting challenges of aggressive tax planning.

All of the interviewees who commented on this issue, in both the US and Australia, felt that the revenue authorities were "penny wise and pound foolish" in their remuneration practices. Unprincipled pay envy and principled public sector pay equity are the factors that prevent the required reform here.⁵ Top treasury officials would resent the idea of middle-ranking tax office officials being paid several times their salary. Public sector unions would oppose the inequity of a handful of technical experts getting private sector salaries when top people in many departments could also multiply their salaries by moving to the private sector. Where would it end and how would the taxpayer afford it? The suggestion made here is only for a special exemption from normal principles of public sector remuneration for aggressive tax planning advice. The taxpayer can

5 As one barrister I interviewed put it, there are two competing mentalities within and without the ATO – that what is needed is better technical competence and that what is needed is better strategic management of risks. Those who are in the latter camp tend to be among those lukewarm about the idea of higher pay for technically oriented excellence. Yet as this barrister went on to say, both views about the kind of excellence needed are right: "They need both, not a choice between them."

certainly afford this limited exemption, and indeed would save money from it, whereas a general move to private sector pay levels would be extremely costly. The equity argument against can be refuted, on the grounds that the creation of a small enclave of inequity inside the public sector is morally justified to defeat the massive national inequity that aggressive tax planning drives (outlined in Chapter 2). It is a matter of tolerating a speck of pay injustice to crush a boulder of economic injustice. Perhaps a more persuasive concern is one of change in collegial climate, raised by a senior ATO official: "I would be concerned if the heroes of the ATO were individuals rather than projects and activities, such as our response to mass marketed schemes. This is because the ATO often takes innovative and creative responses to resolve issues which usually involve the talents of many." On the other hand, much private sector teamwork seems to flourish despite large differences in the individual salaries of team members.

From procedures manual to storybook; from a process improvement to a problem solving culture

Narrow perfectionism is also nurtured when a tax authority has a procedures manual culture as opposed to a storytelling culture (Shearing and Ericson, 1991) in which the stories that count are stories of solving problems. A procedure manual helps narrow perfectionists sustain the argument: "this is where my responsibility ends because the responsibilities of my job as an auditor are clearly set out in the procedures manual". Chapter 5 argued that, in fits and starts, the culture of the ATO has been changing from a rulebook culture to a storybook culture. This change could also be described in the terms of Malcolm Sparrow (2000), who has written on the virtues of a shift from a process improvement to a problem solving culture, with the latter being a culture that values those who pick the most important problems and fix them.

The Compliance Model is part of the change within the ATO that manifests what Sparrow (2000: 100) sees as the three core elements of regulation becoming a craft:

1. A clear focus on results (like reducing aggressive tax planning investment levels);
2. The adoption of a problem solving approach (like the Promoters and High Wealth Individuals Taskforces); and
3. An investment in collaborative partnerships (as in the Consolidation Project and the process that produced the Compliance Model itself).

Sparrow (2000: 157) says, "When regulators tell me that their agency routinely identifies important problems and solves them, but they cannot name a single project that has been closed, or tell me how many are open, or enumerate their recent risk reduction achievements – then I remain sceptical of their claim." Such scepticism would definitely have been Sparrow's response to the token enforcer ATO of twenty years ago. But as of 2004, the ATO could give him a creditable list of answers to his questions.

In today's ATO, tools are more organised around problems and work less organised around tools (like audit). Just as well. When adversaries, de Bono style, cultivate thinking outside the square, it is not possible to confront them successfully with a mentality confined to a standard toolbox. However, with the

problems that are hardest to solve, like aggressive tax planning, there is still unwillingness to reward teams that experiment with creative and plausible risk leveraging innovations that fail. There has been, for example, limited willingness to support or suggest Centre for Tax System Integrity risk leveraging experiments that randomly assign cases to different risk treatments (however for some instances where randomised controlled trials have been tackled see Wenzel, forthcoming; Wenzel and Taylor, 2004). It seems one reason is that such experiments will inevitably be of mixed success (in fact seek to explore variable success), and while they might lead to strong conclusions, successes, and successful evidence-based practices, they will also produce evidence of failures, which remains a cultural no-no at most levels of the organisation.

Finally, there has clearly been a shift at the ATO in the past decade or so to the results orientation that is the first pillar of Sparrow's reform package. The results achieved by problem-oriented groups – like the Aggressive Tax Planning Steering Committee in ending the 1990s upswing in the aggressive tax planning cycle; the High Wealth Individuals Taskforce in improving collections for high-wealth-individuals; the Transfer Pricing Record and Review Improvement Project in reducing profit shifting by multinationals; the Promoters Taskforce; and earlier projects that have not been discussed in this book like the Large Case Program that increased revenue from targeted large Australian corporations – have contributed to cultural changes towards an ATO craft of tax system integrity.

Conclusion

The vices of over-control, under-control, narrow perfectionism, organising problems around tools, allowing the procedures manual to trump the systemic wisdom from the storybook, are fundamental to understanding how good people in organisations do bad things, like letting a tax shelter contagion run rampant. While these vices are still apparent in the ATO, cultural changes away from the vices (described above) together with a general anti-avoidance principle and a move away from a strict legalism of tax rules that has been sustained by some Australian courts help account for the comparative success of Australia in resisting the global tide toward tax regressiveness.

Reforming enforcement strategy

Hopping off the punishment/persuasion see-saw

The worst thing a regulatory agency can do is slide into a politics of persuasion as an overreaction to critiques of heavy-handedness, then revert to a politics of punishment when non-compliance gets out of hand as a result, and then see-saw back and forth, as each leader fails to strategically integrate punishment and persuasion.

This is very much the enforcement history of the IRS. The culture of the IRS in the early 1990s was adversarial, punitive, about getting notches on guns and meeting quotas (Yancey, 2004). Congressional hearings in the late 1990s vilified this approach and legislated to change it. When businessman Charles O Rossotti was brought in to run the IRS in 1997, his analysis of enforcement action was that because it brought in only 2 per cent of the revenue, it was not centrally important. What mattered was improved customer service to consolidate the 98 per cent of the revenue that came in voluntarily (Johnston, 2003: 163). Today Rossotti concedes that this analysis was myopic; enforcement during his watch became too weak and this weakness became the major threat to the voluntary compliance bringing in most of the revenue. The problem was that the voluntary compliance of the majority is contingent on their seeing cheats being nailed. Unfortunately, in recent years, in the US, there have been instances of tax protesters bragging in the media about evading tax and then suffering no enforcement repercussions (Johnston, 2003: 196-198). Rossotti now bemoans the fact that voluntary compliance is jeopardised in a world where, to cite just two of his concerns, the IRS does not pursue 60 per cent of unpaid tax cases and 79 per cent of offshore tax evasion cases (C Rossotti's final report to the IRS Oversight Board, cited in Johnston, 2003: 294).

Accordingly, as the ATO moved from 1998 onwards towards the Compliance Model, one concern has been that some within the ATO with a cooperative, anti-enforcement, anti-audit, anti-tax-technical mentality have seized upon the Model as vindication of their arguments to shift resources from activities like audit in favour of customer service and preventive systemic solutions.¹ During fieldwork in Sydney and Melbourne in 2001-2002, I found it worrying that many tax advisers were of the view that the ATO had permanently shifted away from audit. It was with some relief that I watched the substantial reinvestment in audit commence from 2002.

Notwithstanding the internal bureaucratic battle between those seeking to build systemic prevention and customer service empires and those seeking to reinforce audit empires, the shift to a problem-oriented culture has handed both

¹ Sparrow (2000: 57-8) has observed the same phenomenon at the IRS.

groups wins and losses. The sharp end of criminal enforcement was certainly sharpened. In the financial year ending 30 June, 2004, the ATO secured 166 convictions in serious tax fraud cases, with 81 people imprisoned. The ATO has long been the most prosecutorial regulatory agency in Australia. In 1983 Grabosky and Braithwaite (1986: 162) counted 102,345 ATO criminal prosecutions. But these were overwhelmingly petty prosecutions for failure to lodge returns and sales-tax breaches that produced slap-on-the-wrist fines. Braithwaite, Walker and Grabosky's (1987) principal components and hierarchical clustering analysis of 105 enforcement variables for 96 Australian business regulatory agencies classified the ATO as a "Token Enforcer". This has changed. Then the ATO was rarely putting people in prison, nor securing other severe criminal penalties in serious fraud matters. Today it is, with a new record fine of \$53 million being imposed in one 2003 case. Of particular interest is the impact of the Promoters Taskforce and the Serious Non-Compliance Group on enforcement patterns: as of March 2002 the ATO had 26 tax agent matters with the Director of Public Prosecutions, one under investigation with the Australian Federal Police and 32 at varying stages of investigation by the ATO Fraud Section (D'Ascenzo, 2002b: 11).

Combined with newer compliance products like expanded returns, Client Risk Reviews, special purpose schedules that target monitoring on a specific problem, Transfer Pricing Record Reviews and more, at the time of writing, prudent advisers should be telling clients that the risks of enforcement actions through audit are at heightened levels, and that there is a considerable risk that cheating will be detected through one of a creative range of newer compliance tools.

This is what responsive regulation is about: it is sending clear signals through concrete enforcement actions that the agency is willing to escalate in order to create a culture where systemic preventive solutions and good relationships with taxpayers will do most of the compliance work.

Responsive regulation in action

The aggressive work of the ATO with barristers in the state of New South Wales (NSW) in the Legal Profession Project is an example of responsive regulation at its best, and shows how much the ATO has changed from the "Token Enforcer" of the 1980s. In 1999, an alert tax officer in Sydney noticed that members of the legal profession in her patch had unusually high debts to the ATO; the rate of debt default by NSW barristers was ten times higher than that of the rest of the Australian population. Further investigation revealed that bankruptcy was repeatedly a cause of these tax debts. Was the legal services market in Sydney really going belly-up? The answer was, of course, no. It turned out that rich lawyers were dodging income tax by serially going into bankruptcy with the ATO being their only real creditor. Some had been bankrupt in this way three times in a decade. The ATO identified 62 barristers holding practising certificates who had moved into bankruptcy in the ten years to 2001, a third of them serial bankrupts within that period. The ATO was the sole or principal creditor in 56 of these cases. There were cases such as that of Mr Stephen Archer (see Box 3 below), who had been convicted twenty times for failing to lodge a tax return but

was still appearing in high profile cases like the defence of Laurie Connell against corporate crime charges. Further analysis revealed that barristers were also one of the demographic groups most disproportionately investing in mass marketed aggressive tax planning schemes.

Box 3: Rich Lawyers Dodging Income Tax

By Paul Barry, *Sydney Morning Herald*, 28 February, 2001

Mr Stephen John Archer, Laurie Connell's famous former counsel, who has also acted for Ms Gina Rinehart in the multi-million-dollar battle for Lang Hancock's fortune, has accumulated tax debts of \$3.1 million.

Mr Archer, who lives in an elegant Paddington terrace and is one of Sydney's most formidable advocates, has been bankrupt for nearly 10 years, yet he still earns a top living at the Bar.

Court records examined by the *Herald* show that back in December 1991 he was bankrupted by the Tax Office over unpaid income taxes of \$2.5 million. Then in 1997 he went broke a second time, avoiding a new tax debt of \$640,000. He will remain a bankrupt until 2005.

Mr Archer has no assets to his name, because everything is owned by his wife, Sarah. As a result, his key creditor (the Tax Office) can't sell the Paddington house to satisfy its debt ...

Other NSW barristers who have gone bankrupt in the past two years with big unpaid tax bills include a senior counsel in the Land and Environment Court, Mr Bill Davison, SC, who owes \$1.9 million in income tax back to the 1980s.

Mr Davison has told his bankruptcy trustee, Mr Max Donnelly, that he has an annual income of \$600,000. Despite this, he also has no assets – all are owned by his wife, Vicki, or a family company – yet he and his wife each drive a Mercedes and last year he spent \$133,000 from his personal bank account.

Another serial bankrupt is the well-known criminal advocate Mr Robert Somosi, who has accumulated \$835,000 worth of unpaid taxes and penalties.

Mr Somosi was convicted in 1996 of failing to file tax returns over a period of 17 years. At his trial, he admitted that he had paid no tax during all his years at the Bar.

Pursuant to the Compliance Model, the ATO started at the base of the enforcement pyramid and raised the problem with the NSW Bar Council to see if there might be a self-regulatory solution. The Bar Council took the view that making practising certificates conditional on tax compliance was not a matter of self-regulation, but of regulation by the NSW Legal Services Tribunal. The Bar Council had taken a tax complaint to the Tribunal just once before, in 1997: Mr Tom Harrison had been convicted of 30 offences of failing to lodge a tax return over 14 years. The three senior lawyers on the Tribunal found Harrison not guilty of professional misconduct on the basis that "his omissions were the result of an involuntary inertia rather than an attempt to avoid his responsibilities". They were caused by "a psychological block" which he had tried but failed to overcome (*Sydney Morning Herald*, 27 February, 2001, p 4).

Finding the Bar Council not as responsive as it had hoped, the ATO moved quickly up the pyramid in the worst cases, pursuing more bankrupt barristers more aggressively in the courts. The Commissioner spoke out publicly on the problem in some speeches and in his 2000 Annual Report. This got investigative journalists from the *Sydney Morning Herald* interested, who perused court records, sat in on cases, and ran a series of front-page stories on the bankrupt barristers and their lifestyles. Both the Commonwealth and State Attorneys-General said, on record, that reform of bankruptcy law might be needed. The issue dominated a meeting of all Australian Attorneys-General. Facing the spectre of a law prohibiting any recent bankrupt from practicing law, the NSW Bar Association became interested in dealing with the problem.

In the end, there was some modest law reform (eg, amending the definition of misconduct under the *Legal Profession Act* 1984 (NSW) to incorporate tax misconduct of the sort revealed by the *Herald*), action to remove the practicing certificates of barristers like Mr Archer (see Box 3), and substantial self-regulatory reform to improve the tax ethics of the Australian legal profession. In his 2001 Annual Report, the Commissioner was able to record that net tax paid by NSW barristers had increased by 36 per cent (compared to 1998 in terms adjusted to the consumer price index (Commissioner of Taxation, 2001: 61)). He also reported that 160 barristers had been referred to the ATO's in-house prosecution area for non-lodgement and other offences. This pressure was still on three years later with 54 lawyers being convicted for criminal tax offences in the year ending 30 June, 2004. One of the simple things done by the Legal Profession Project was to obtain a membership list of the NSW Bar Association and check whether each barrister was in the tax system. Unbelievably, five were found who did not have a Tax File Number (a number issued by the ATO to identify individuals, companies and others who lodge an income tax return). One of these, John Cummins QC had practiced at the Sydney bar for 40 years without lodging a tax return. One of the lessons learned from the Legal Profession Project was the value of such simple checks. On 30 June, 1999, only 56 per cent of the NSW bar were current with their tax returns. A year later this figure had increased to 70 per cent. Remember, this entire project started with checking patterns of debt.

The area of debt is one in which the ATO has been successful in making improvements across the board as a result of its shift to an outcome orientation. Collectable debt as a percentage of all ATO collections halved (from 4% to 2%) between 1994 and 2000, though it increased to 2.2 per cent in 2001. Yet during 2001 there was a 33 per cent fall in the debts owed in high-level debt cases involving NSW barristers and a 14 per cent fall in the total debt owed to the ATO by all NSW barristers (Commissioner of Taxation, 2001: 63). This debt has continued to fall since.

When I first heard about the bankruptcy problem among NSW barristers, proposals for establishing the Legal Profession Project were being blocked by a narrow perfectionism at certain levels of the ATO concerning the job of debt recovery officers. The procedures for collecting debt, according to processes laid down in bankruptcy law, were being followed impeccably: "This was all it was our responsibility to do." For officers who could see a pattern of deeper concern in the legal profession, a profession of unique importance to the integrity of the tax system, there were lots of reasons to shy away from a more expansive view of

responsibility. Many of the people under suspicion were extremely influential politically, and at the top of a powerful profession: there were judges, barristers appointed by the government to Royal Commissions, appointed to represent the police force, even the ATO! Wouldn't this be embarrassing to the government? Wouldn't the ATO be criticised for allowing so many barristers to get away with not paying tax over so many years? Some barristers were verbally aggressive and prone to threaten libel suits with such threats carrying a special credibility because of their makers' legal expertise.

Fortunately, Commissioner Michael Carmody was a leader who encouraged people to go and talk to him directly when opportunities to treat big problems were being missed. When it was put to Carmody that there was a big problem in NSW and beyond, in a profession that represented every taxpayer who resisted tax compliance in the courts and whose personal experience of the tenacity of the ATO would affect the advice they gave to clients, he gave the go ahead for establishment of the Legal Profession Project. The Project's reports became an important part of the work of the Aggressive Tax Planning Steering Committee.

Most of the dire predictions of the narrow perfectionists came true. The ATO was attacked in the media for not tackling the problem earlier and more vigorously. The tax debts of judges and even a member of parliament who was a former barrister were discussed in the media. The Victorian government suffered the greatest embarrassment in the media frenzy over "white wig criminals", when County Court Judge Robert Kent was convicted of five charges of failing to lodge a tax return by a Queensland judge flown in to hear the case. During the case, it came out that Justice Kent had six prior tax convictions at the time he was appointed as a judge, something he had not disclosed at the time of his appointment, nor been asked to disclose! (*The Age*, 9 March, 2001).

This then is a case study of simple problem-oriented information analysis resulting in backing from the top for the collaborative problem solvers against the blocking of narrow perfectionists. At first, efforts were made to solve the problem through professional self-regulation (the base of the enforcement pyramid). When this failed, the issue was escalated to the courts and the media. Now a de-escalation phase is beginning as the ATO and all the legal profession bodies are working constructively together towards permanent self-regulatory solutions that, in time, might allow the Legal Profession Project to be shut down.

Adequate and escalating penalties

Adequate penalties are important to making responsive regulation work. Substantial prison terms are a credible sanction in serious fraud cases. In the administrative penalty middle of tax enforcement pyramids, however, there does not seem to be enough latitude for escalation when non-compliance has been very serious. Penalties on tax liabilities of 25 per cent and 50 per cent are common in Australia and the US. But any analysis in respect of offences with low odds of detection, would show penalties at least of 200 per cent, 300 per cent or 400 per cent must be frequently imposed in order to be rationally deterrent, especially in corporate cases where there is no individual who can go to jail. In circumstances where criminal charges could be laid with a reasonable chance of conviction,

there are often good reasons (for example, saving the expense of criminal prosecutions for the worst cases) for instead negotiating a settlement that involves very high administrative penalties. Threatening escalation to administrative penalties of four times the tax liability might also motivate participation in the kinds of restorative justice processes we will discuss in the next section, with all their possibilities for motivating future compliance commitments.

In tax shelter cases, blameworthiness is often shared between a taxpayer and their professional adviser. The data in this book suggest that aggressive tax planning is more supply driven than demand driven and that promoters misrepresent to clients the meaning of tax office rulings, of lawyers' opinion letters that in fact apply to a slightly different scheme, and so on. It follows that imposing penalties on promoters in such cases is more important to prevention than imposing penalties on investors. Deterrent messages to promoters are likely to work and deterrent messages to investors likely to fail in circumstances where the investor believes what they are doing is perfectly legal and the promoter knows it is not. The ATO has erred in the past in sending messages about intent to tackle schemes to promoters who did not pass those messages on to investors and has conceded that it needed to communicate more directly with investors (Fitzpatrick, 2003). All tax systems, including those of Australia and the US, have an imbalanced emphasis on penalising taxpayers to the neglect of penalising promoters. Promoter penalties have been supported by the Commissioner in Australia but, at the time of writing, have not attracted enough political support to translate into law reform. It is the old story of concentrated, well organised interests in the tax advice industry shoring up a legal framework that irrationally exempts them and passes all the liability onto the diffused and disorganised interests of taxpayers. But in all countries there also continues to be some political support for more balanced treatment of taxpayers and promoters by the law. A speech in the Australian Senate on 26 June, 2001 by Senator Watson is an example:

Had the promoters of these schemes – be they highly regarded QCs, tax lawyers and accountants – committed their views in a corporation prospectus, they would certainly now be serving a jail term or have a severely diminished bank account because of the false and misleading information.

Inter-agency target swapping

So far the focus of this book has been on the enforcement strategies of tax authorities and the self-regulatory strategies of those they regulate. This section argues that other state regulators sometimes have more strategic leverage for nabbing a tax cheat than does the tax office. Conversely, the tax office sometimes has more strategic leverage than other regulators for nabbing offenders against the statutes of those other regulators. Two Australian case studies of inter-agency collaboration will illustrate both possibilities. Collaborating regulators who share lists of key targets and their capabilities to convict them can help one another to become much more effective.

Intelligence sharing for broader community interest

In action that is important from a broader national interest perspective, the ATO has begun to show leadership toward collaborative taskforces to net Australia's worst white-collar criminals. It has long been my view that in Australia there are a comparatively finite number, perhaps only a few hundred, of persistently fraudulent business people. And that it is these few who are recurrently causing problems for all the major regulatory agencies – the tax office, the competition and consumer protection regulators, the Australian Securities and Investment Commission, Independent Commissions Against Corruption, police units concerned with money laundering, arms sales, people smuggling and other forms of organised crime. They are not all men in black hats and white shoes; some are CEOs of respected major corporations that trade globally and many are seemingly respectable small business owners.

The national interest may be served by the Al Capone strategy of multiple agencies sharing intelligence and then collaborating on taskforces, in order to put together the best evidence to take out the worst offenders. As with Al Capone, it will often be the tax office that has the best intelligence, especially of the use of tax havens, and the prosecutorial capability to cut the offender's cancerous growth out of national business culture. In Australia, the Commonwealth should therefore provide substantial additional resources to the ATO for netting those people who are not top priority in terms of risks to the revenue, but who pose other special white-collar and organised crime risks to the Australian community.

In 1997, the Commonwealth did provide special purpose funding to the National Crime Authority to target organised fraud on the Commonwealth, including tax evasion, money laundering and associated or underlying offences, particularly drug offences. The ATO became a central player in the exemplary inter-agency collaboration that became known as the Swordfish National Taskforce. Interestingly, as a result of this taskforce, some tax advisers, accountants, tax scheme promoters and financial advisers are being caught in a net oriented to ensnaring drug barons. Tax intelligence is also being improved through realisations, for example, of the centrality of identity fraud in the networks of systemic business criminals, and of the significance of international links, requiring net widening to international investigative collaboration. In reorganising the National Crime Authority as the Australian Crime Commission with new priorities, Australian government policy is now putting this kind of work at risk.

The ATO investment in Swordfish has already paid for itself, with \$45.2 million in extra tax recovered out of \$152 million assessed (including penalties) as of 2002 (D'Ascenzo, 2002b: 14). Payment has also been withheld on \$22 million in fraudulent refund claims and the tax office also estimates a deterrent tax compliance effect on the revenue of \$34 million per annum in a segment of one particular industry that has been cleaned up. This is not a lot of extra revenue compared, for example, to that generated by the High Wealth Individuals Taskforce. But given the national interest in cleaning up the corrupt corners of Australian business, it is easy to argue that the tax office needs to take a wider view of its responsibilities for aggressive enforcement, and indeed, it is beginning to do so.

When other regulators can help the tax authority

Inter-agency collaboration will not always be a case of the tax authority cost-effectively solving an enforcement challenge central to another regulator. There are domains of aggressive tax planning where it is other regulators who can control a tax integrity problem more cost-effectively than the tax agency. The leading example of this is the role the Australian Securities and Investment Commission (ASIC) could play in a more rational world of public governance to eliminate Australia's huge problem with mass marketed agricultural investment schemes to obtain an illegal tax advantage. It is worth explaining this case at length, as at the time of writing, ASIC is considering playing a more aggressive role in regulating primary production schemes (ASIC, 2003).

One of the problems with product rulings is that promoters informally market the message that the ruling implies some sort of government approval of the quality of the investment (see discussion in Part II). This is an even more acute problem with ASIC approval of prospectuses, as most people would understand ASIC to have an investor protection role not shared by the ATO. Prospectuses for agricultural products have been widely marketed with "ASIC Approved" embossed on the front cover in the design of a stamp of approval and then with another stamp on another corner of the page saying "Product Ruling".

The CEO of Van Eck Capital, David Marshall, told me that in five minutes he can tell whether an afforestation or agricultural product prospectus is "rubbish" as an investment or worth spending another hour analysing. Then after one hour he claims he can assess whether those worth a second look might be sound investments. Marshall's firm supplies analyses of the viability of Australian agribusiness investments to some of Australia's and the world's major banks and stockbrokers. Marshall asks, if he can do this kind of triage, why can't ASIC hire someone, perhaps not as expert as him, but someone who could learn to reject the majority of agricultural prospectuses promoted as tax products after a couple of hours analysis in each case? Marshall claims that the prospectuses of 90 per cent of agricultural tax products of recent years should not be approved by ASIC, and therefore should not be going to the ATO for the much more expensive (to the public) assessment for a product ruling. Marshall has concluded with these products, on average, 50 per cent of the money can be ascertained to be going into the pockets of promoters,² 15 per cent to sales agents, with only less than 35 per cent of the investment on average going into the ground. When under 35 per cent of the investment is ploughed into real economic activity one can almost guarantee that the investment will make a loss. It should therefore not be approved on fundamental investor protection grounds, especially as it is a product widely pitched at unsophisticated small investors.

David Marshall says the deadly simple diagnostic question ASIC should be asking when these prospectuses are presented to them is: "What is the net amount that will go into the ground?" Where the data show these estimates differ from the industry norm by a big margin, ASIC can also enquire of promoters: "Please tell us where you get the figure of X tons per hectare?" Marshall's view is that perhaps as many as 90 per cent of Australian agribusinesses prospectuses could be stopped in this way, saving hundreds of millions in tax deductions a

2 Promoters' gross profit as a percentage of scheme revenue can be as high as 68 per cent.

year (\$700 million in one year for which he says he looked at the numbers). And that this could be achieved for an outlay in the ASIC budget of less than half a million dollars a year, with the ongoing effects of saving the Australian economy from the diversion of billions of dollars of its scarce capital into loss-making activities and saving the environment from wasteful imposition.

Marshall's view is that after the 1990s schemes boom abated, many of the promoters of agribusiness tax-effective investments continued to be con-men even as they put clients into investments with product rulings from the ATO (or claim with only partial accuracy that a product ruling applies in the case of the particular investment). Since the problem is one of con-men who compromise the integrity of not only tax law, but consumer protection law and companies and securities law, a whole of government strategy is appropriate. His analysis is that the best leverage point is up-front ASIC approval of agribusiness prospectuses before they arrive at the ATO for a product ruling. An argument against this approach is that if it worked in eliminating 90 per cent of this uneconomic investment, the promoters concerned would just shift to other schemes, for example, for uneconomic films. If so, perhaps ASIC would have to retrain analysts of agricultural prospectuses to become analysts of film prospectuses, which might be a more complex matter. Again, the top priority for both ASIC and the ATO is to achieve criminal convictions that put some of the worst promoters in jail, or better yet, to win a court order that bans the promoter for life from being a director of any company or manager of any investment or financial services business.

Another simple corporations law reform would be to require that any one lodging a prospectus for a managed investment scheme with ASIC indicate, perhaps by simply ticking a box, whether or not special tax advantages were important to the viability of the investment scheme. ASIC could automatically and electronically refer all "yes" prospectuses to the ATO, who would then have intelligence on new schemes in advance of the prospectus being despatched to the first client.

The Australian Competition and Consumer Commission could also play a useful role if such a rational set of governance arrangements were implemented. Under the *Trade Practices Act 1974* (Cth), criminal prosecutions of promoters have long been possible for misleading representations to consumers of financial services advice, and indeed, representative actions (class actions) to recover some of the losses suffered by the tens of thousands of consumers affected is another option. This action is designed to implement an enforcement strategy of pursuing unscrupulous scheme promoters into bankruptcy until they abandon the advice market.

Tackling enforcement swamping

Managing a tax authority is challenging because of the constant creation and recreation of aggressive tax planning angles. There are never the resources to tackle them all. For example, there are always new mass marketed schemes emerging, and promoters readily move into new types of products and client bases – boutique schemes for the rich, corporate shelters or overseas tax havens for individuals with a taste for risk – when domestic mass marketed shelters are

under effective attack. One response to this movement is to target aggressive promoters, as in the Promoters Taskforce (Chapter 5), rather than the ever-changing kinds of schemes they promote. But there is an enforcement problem with this too; they are many and when there is a demand for what they promote, knocking one out of the market may result in someone else entering their niche. But really this is too pessimistic. There are not so many aggressive promoters; the top priority promoter targets number in the dozens rather than the hundreds in Australia and even perhaps in the US. It is not necessary to target everyone who ever promotes anything and it is important not to respond to an enforcement-swamping problem by just randomly picking up enforcement wins where you can, resigned to the fact that there is too much going on to be able to tackle most of it. Undoubtedly, this is how most regulators respond. The important thing is acting strategically.

For promoters, this means starting with an attack on an “A list” of the most aggressive promoters, demanding their client lists and subjecting the clients who pay the biggest fees to the promoter to audit, or where the promoter markets to a stable of accountants, targeting for audit the clients of the accountants who are paid the most commission by the promoter. Once the A list is conquered, the regulator can move on to a B list, and later, a C list. The alternative, of just taking the easy kills when they walk into your sights in the way so many police forces respond to their enforcement-swamping problem in respect of drugs, will rarely touch the most sophisticated end of aggressive tax planning.

It is not true that destroying the business of the most aggressive promoters will simply shift the demand to other promoters. First, we have seen that aggressive tax planning is more promoter driven, at least before booms take off, than demand driven (see Figure 13). Knock out the promoters and you take out those who are creating much of the demand. But more than this, attacks on the client lists of the most aggressive promoters reduce what demand for aggressive tax advice there is. It sends the message to taxpayers that “if I want to increase my chances of getting an audit, the best way to do that is to seek the services of an aggressive adviser”. If I have been audited and hit with tax penalties and never want to suffer that again, and if I know that I was audited because my adviser was targeted by the ATO as an aggressive adviser, I am likely to move to a conservative adviser. In this way, the client list strategy simultaneously attacks supply and demand. Simply attacking the highest risk taxpayers, whoever their advisers are, does not accomplish this.

With tax, enforcement swamping is backlog driven. Auditors are slogging away collecting tax penalties on serious corporate tax avoidance that occurred five or six years ago knowing that in the five years since there would have been all manner of avoidance they are not even thinking about. Generally it is better to respond to backlog swamping by letting go all but the worst problems of the past and concentrating on real time enquiries. One reason is that real time enquiries give you intelligence on where the tax planning market is moving now, so that better targeted systemic prevention is enabled.

But to see the more fundamental reason for the real time response to a backlog-swamping problem, consider the following scenario. A major intelligence coup delivers to the Commissioner’s desk evidence that will enable effective (but resource-intensive) enforcement against ten different shelters, each

with thousands of clients in them and dozens joining daily. The Commissioner can only scrape together a hundred extra officers to act on the new intelligence. Investigating the thousands of files associated with just one shelter requires a hundred officers. Option A is that the Commissioner decides that Shelter X is the worst of the ten, so back taxes and penalties will be collected by investigating all the taxpayers who have invested in Shelter X. Option B is that the Commissioner puts out a press release announcing that the agency plans to attack all ten shelters: "Anyone who invests in these shelters from today's date will be guaranteed an audit and the full force of the law will be applied to impose tax penalties upon them. We will also be taking selective enforcement action against taxpayers who have invested in these shelters before today. However, we are offering generous settlement terms of payment of back taxes owed without penalties on these ten shelters to those who submit an acceptance of our settlement offer by 30 June." Until 30 June none of the 100 auditors are deployed to the old cases but are standing by to pounce on the new cases. Experience in both the US and Australia suggests that very few investors continue to go into such shelters the day after such an announcement and that adviser sentiment immediately flips to counselling taxpayers against jumping in once such an announcement has been made. So, hopefully, under Option B most of our 100-officer taskforce can be devoted to just processing the settlement acceptances that flow in from old cases until 30 June. After that, some strategic backlog cases can be targeted with a lot of publicity and on the back of that, a second, less generous settlement offer is issued.

Obviously, Option B is likely to have a bigger impact in stemming the aggressive tax planning. Prioritising the real time cases after chilling them by an enforcement promise means that Option B stops dead new entries into all ten shelters; Option A accomplishes this only for Shelter X. Admittedly, under Option A much more revenue and penalty is collected from Shelter X cases, but under Option B some is collected.³

There is a general quality to this strategic choice that can be taken up by a tax authority that seeks to be proactive rather than reactive. For example, in respect of corporate income tax in a targeted industry, one resource allocation choice is to audit firms with the biggest book-tax difference (difference between accounting income and taxable income) in recent years. An alternative is to announce to a targeted industry that next year, any firm with a taxable income more than 50 per cent lower than its accounting income will be audited. Audits of firms above that bar would only occur on the basis of independent grounds for reasonable suspicion. If this succeeds in chasing nearly all of the industry above the 50 per cent bar for the resource investment of a press release without having to undertake any promised audits consideration could be given the next year to

3 In commenting on a draft, Kristina Murphy said, "Isn't it possible that more would be collected under Option B from Shelter X cases. Option A could generate resistance such as in the mass marketed schemes of the 1990s. Shelter X investors might resentfully assert 'We want the same deal as them'". On the other hand, a senior ATO officer commenting on this expressed the concern that the ATO must be careful not to send the message that "if something is hidden for long enough, then it will be okay". My response would be that while there is a need to maintain a semblance of enforcement against serious cases hidden for a long time, the more cost-efficient response to this real problem is to invest in the timeliness of intelligence (eg, shelter disclosure) so that all shelters are attacked earlier.

raising the bar to taxable income more than 40 per cent lower than accounting income. Sometimes this second kind of option would be superior to simply auditing all those firms with the biggest book-tax differences and sometimes it would not, depending on the circumstances of particular industries. One risk is that firms with a taxable income well clear of the 50 per cent bar might believe its risk of audit to be minimal so long as they are above the bar. This is why it would be necessary to announce the continuation of the normal multivariate regression-based targeting of audits across all industries that target firms whose statistical profile suggests that they should be paying much more in tax. An outcome-orientation combined with a strategic bias for real time means these kinds of options should more often find favour with tax authorities. The Transfer Pricing Record Review and Improvement Project is one example of a project that did in a sense set a new bar that can be characterised as both quantitative and behavioural, and gave firms time to get above the bar before being subject to various interventions (Chapter 5).

Tackling the culture of compliance of the Big Four accounting firms and the “Big Few” investment banks

Particularly in the US, but also in Australia, there is a need to confront the big accounting firms and big investment banks that are likely to be the biggest generators of risk in future cycles. At the time of my 2001 New York fieldwork, the Big Five accounting firms were the most important marketers of aggressive tax planning. Investment banks were also involved in aggressive tax planning and a small number of leading investment banks were moving into a more conservative posture after some of them had been burnt when excesses of aggression were uncovered. In the same year, a small number of investment banks in Australia were aggressive tax planning leaders, while in the Australian market the Big Five were much more conservative than in New York, for example, eschewing contingency fee arrangements for tax shelter work. An exception was Arthur Andersen, which was important in both the Australian and the US aggressive tax planning markets. Arthur Andersen also played hardball with the ATO on profit shifting, advising clients not to cooperate with the ATO on the Transfer Pricing Record Review and Improvement Project.

The fact that the behaviour of the Big Five has been much more aggressive in New York suggests that Australia has much to gain by going on the front foot with them. It may be able to prevent what otherwise looks to be inevitable – that Australia’s next round of aggressive tax planning will be substantially led by the largest accounting firms in the mould of the US wave of the late 1990s.

Most people would think the world a better place for Arthur Andersen being bankrupted by the criminal indictment in the Enron matter, even after considering the hardship of the thousands of Arthur Andersen employees who lost their jobs around the world. I am not so sure. Certainly the world is better off without an Arthur Andersen that was complicit in the fraudulent practices that saw the collapse of so many companies in the US, Australia and elsewhere and without an Arthur Andersen that was a lead player in undermining the integrity of the world’s tax systems. Even apart from the further economic hardship caused by the collapse of Arthur Andersen itself, we might generally prefer to see

such wayward empires reformed than crushed. The reason was well articulated in a talk to the Centre for Tax System Integrity in 1999 by Joseph Murphy, doyen of American corporate compliance professionals and former compliance chief at Bell Atlantic. Murphy said that if you ask the question, “which is the corporation who has the most advanced and effective compliance systems that are pulling the rest of the business community up to higher standards?”, be it in environmental compliance, consumer protection or antitrust, the answer is usually the company that was in most trouble with a regulatory agency last year. Many in the compliance business agree with this. It follows that when a company that is in deep trouble in the courts is ended through bankruptcy, this opportunity for leadership is lost. In order to survive its *annus horribilus*, Arthur Andersen would have had to, amongst other things, design the next generation of self-regulatory procedures to sustain more effectively the ethical standards of accounting firms. It would have also had to demonstrate the effective and ineffective elements of their self-regulatory procedures through independent evaluations reported publicly for the market. That would have been a good thing for tax system integrity and for accounting standards integrity.

If all the major white-collar crime enforcement agencies in Australia or the United States had swapped intelligence in the 1990s in the manner of the Al Capone strategy advocated in this chapter, Arthur Andersen would surely have been on their list of shared targets. But what could the agencies have done before precipitating events like the collapse of Enron, WorldCom and, in Australia, HIH?

Consider the following scenario, which captures actual experiences of two interviewed senior Australian tax officials. A Big Four partner gets one of their wealthy clients into a lot of trouble for tax non-compliance. A more senior partner then visits the senior ATO officer handling the matter and says, “This is a rogue partner and we are going to get rid of him. We would hate you in the ATO to think that other partners condone what he did”.

Now consider the suggestion that such an encounter creates the opportunity the ATO needs to tackle the ethical climate in the major accounting firms and investment banks. Arguably, the senior ATO Officer should reply, “It’s good that your other partners do not condone this. I’m pleased to hear it because we at the ATO were disturbed by the non-compliance. With something of this gravity, we are always concerned that it might reflect a culture of non-compliance in the firm. Could we have a meeting to discuss this with all your partners?” Regulatory experience with restorative justice suggests that the partners would agree to this. And when they did, the ATO could request that the meeting be facilitated by a restorative justice practitioner. This facilitator, in line with restorative justice principles, would insist on the attendance of the “rogue” partner. This partner would be the first person asked to speak by the facilitator. She would be asked to tell in her own words how the incident that had got her into hot water had occurred. It might turn out, if this were Arthur Andersen, that the “rogue” partner was not a rogue partner at all, but a fall-guy who was actually following the culture of the firm. The facilitator would then encourage a conversation about the harm that had been done by this incident. At the conclusion of this, again in line with restorative justice principles, everyone in the restorative justice circle would be asked what they think needs to be done to ensure nothing like the incident happened again. If someone else did not suggest it, the Tax Officer could

suggest the need for an audit of the firm's systems for compliance with ethical standards, to be conducted by an external consultant whose independence enjoys the confidence of both the firm and the Tax Office. The consultant's recommendations would be reported back to a reconvened meeting of the restorative justice circle, which would discuss whether the recommendations went far enough. A year later the circle might be convened again to receive a report from the accounting firm and the independent consultant on how thoroughly the reforms to the compliance culture had been implemented.

I suggested this strategy to the Aggressive Tax Planning Steering Committee and later to the Commissioner. As I did so, I noticed a great deal of squirming in seats: "That's not how we do things. It just doesn't sound like us sitting in a circle with a bunch of partners while one of them pours their heart out about how he was just doing what the firm expected." I was content to plant it as a seed of an idea for tackling the culture of some of the most influential players in the advice market.

It would be easier to motivate active engagement of promoters with such restorative justice processes in a world where promoter penalties were credible and where the Tax Office could threaten a firm's licence to offer tax advice. A Legal Aid or pro bono strategy to support class actions by investors against promoters would be another possible lever for getting promoters into a settlement circle.

There is now encouraging evidence, with both traditional crime and corporate regulation, that restorative justice strategies can have a positive impact on lowering the incidence of reoffending and offenders' perceptions that they have been listened to and treated fairly by the regulator (Braithwaite, 2002: Chapters 1 and 3). However, the applicability of restorative justice to tax non-compliance is limited because in most instances the dollar magnitude of the problem, would not justify the level of investment involved in the kind of process described above. In my view, such an investment would have been a more than justified in respect of a problem of the magnitude of the ethical culture of Arthur Andersen in the 1990s. As argued earlier in this chapter, it would also sometimes be a cost-effective strategy for extracting commitments from a small family business managing its till so that a lot of the sales do not go through the accounts. Indeed, a less formal version might be an effective strategy for building future compliance by individual taxpayers, especially with taxpayers who are new immigrants to the country. For example, where an audit has revealed some substantial problems, this less formal version could be a chat one evening at the taxpayer's home that explained the situation and what changes were needed, for example, the need for the family to use the services of an ethical, conservative tax preparer, and so on. Where the taxpayer is from and involved in a particular ethnic community, it might be desirable that a respected elder of that community attend such a conference. While this could communicate the different sort of expectations that apply in their new country compared to their country of origin and build the commitment of the taxpayer and/or their whole family to these new expectations, it would be resource intensive and might not justify the costs. This is a strategy that would be ideal for a risk-leveraging experiment that measured whether benefits exceeded costs in comparison to a randomly assigned control group. It might turn out, for example, to be cost-effective with high-wealth families but not average-income families.

International collaboration towards enforcement

There is already international collaboration towards enforcement of tax-compliance. An important step toward more effective international collaboration was agreement between the US, UK, Canada and Australia to establish a joint task-force in New York. The intention is for these nations to work together to combat tax avoidance schemes that play one country off against another (*Guardian*, 24 April, 2004). In October 2001, the IRS submitted an affidavit in federal court estimating that illegal offshore schemes cost \$70 billion in lost tax revenues a year (Novack, 2001). Robert Morgenthau, Manhattan District Attorney, said that in 2001 in the Cayman Islands alone, more than \$800 billion was on deposit, nearly one-fifth as much as all dollar deposits in the US (Godfrey, 2001b). If the Edwards Report's (1998) estimate of \$6 trillion held offshore by US taxpayers is correct, this is wealth equivalent in value to one-third of global gross domestic product. Hampton and Christensen (2002) plot the growth as \$11 billion in offshore bank deposits in the late 1960s, \$385 billion in the late 70s, \$1 trillion in the early 90s and \$6 trillion by 1998. As discussed in Chapter 7, shelters based on international arbitrage and cruder evasion through tax havens is where the growth is to be found in tax compliance problems.

In respect of global tax policy, the big policy maker states – the US and the EU – have a heavy responsibility to the smaller policy taker states like Australia. Swank's (2002: 2) study of tax policy in 16 nations found that "changes in US tax policy influence subsequent reforms in other polities; in the long term, all nations tend to move their tax policy toward the US position", with the response being quicker where linkages with US markets are stronger, domestic economic stress deeper and right-party government more frequent. Avi-Yonah (2000 a, b) pointed out that the US abolition of withholding tax on interest paid to foreigners in 1984 had the disastrous effect of making it impossible for any major capital-importing country to impose such a tax for fear of driving mobile capital elsewhere. Various interviewees said that the IRS "had limited interest in collecting tax on mobile capital". In US-EU trade negotiations, the one needs to be focused on preventing the other from tax policy debacles that initially leaves the other worse off but ultimately leaves everyone worse off. There are the beginnings of coordinated international action focused on shutting down tax havens. There needs also to be international agreement, perhaps coordinated through the OECD, on how to tax mobile capital. Avi-Yonah (2000b) argues that what is needed is coordinated imposition of withholding taxes on international portfolio investment and has developed a plausible theory of how this could be motivated on the basis that it would be rational for all cooperating states.

Paris (2003: 154) argues that growth in international e-commerce will force a movement toward global coordination of tax policy for two reasons: "first, because states will not allow an ever-increasing volume of international digital commerce to escape taxation, and second, because states cannot effectively tax this new form of commerce without close cooperation with other states". While the Paris argument is compelling in the long run, for the moment e-commerce has not assumed the proportions necessary to compel global institutional change.

While international cooperation can reduce some opportunities for international arbitrage and shut down tax havens, it can never eliminate all of them. To some extent the now considerable demand for international avoidance

strategies will flow to the opportunities that remain. Since some of the worst suppliers of opportunities will always be beyond the reach of both national and international control, national enforcement on the demand side has to be the bulwark of offshore enforcement. The way forward is aggressive action like that taken by the IRS in 2002, when it issued a summons for the records of all US American Express and MasterCard clients who had signature authority over cards issued by or through any financial institution in a long list of tax havens. This led to the disturbing conclusion that between one and two million offshore credit cards had been issued to Americans while only 117,000 had disclosed an offshore account on their tax return, though as soon as credit cards were targeted smart tax evaders shifted from offshore credit cards to offshore debit cards (Johnston, 2003: 212-3). Another aggressive IRS operation (in 2001) involved the arrest of offshore trust promoters who had offered to their clients (in fact undercover IRS agents) to launder offshore the proceeds of a bankruptcy fraud and bank fraud. Of course, once such people are under arrest they have every reason to mitigate their sentence by handing over their client lists.

These strategies are invaluable, but do not tackle the growing demand that is being fuelled by the promotion of offshore accounts on the Internet. Tax authority investigations will normally reveal the promoters and their client lists to be offshore. In these circumstances, it makes economic sense for wealthy countries to offer to fund the conduct of enforcement operations to seize client lists in the countries in which the promoters are domiciled. Of course, when the promoters have their offices in a tax haven into which they are pulling business, that jurisdiction will spurn a raid. Yet this kind of major enforcement obstacle can also be an opportunity. The economies of many tax havens make it difficult for the OECD campaign to persuade tax havens to shut down (see Rawlings, 2003). In the most extreme cases, a tax haven can have 90 per cent of its government revenue originating from offshore financial services (Hampton and Christensen, 2002: 1). Obviously, however, the revenue collected by the haven is small in absolute terms compared to the revenue lost from the country from which the money was exported – otherwise it would be irrational to risk exporting it. In circumstances where the only chance for collecting tax from the clients of an Internet promoter domiciled in a tax haven is the cooperation of that state in a raid on their office, it would be rational for a large state losing revenue to offer half the windfall revenue to the tax haven in return for its cooperation and a binding agreement to follow Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, San Marino, the Isle of Man, the Netherlands Antilles and the Seychelles in signing an OECD “advance commitment letter” to eliminate “harmful tax practices” permanently. Without an advance commitment letter, this strategy risks a moral hazard that countries will continue as tax havens precisely to keep collecting such mega-windfalls. While the windfall from a share in the offshore revenue gains from shutting down the Internet promoters in their jurisdiction could be massive, an argument against taking it would be that it would be a one-off windfall, while tax haven revenues could continue in perpetuity. The rational political leader does not retain power in perpetuity, however. She may be tempted to take the line that there will be no perpetuity in holding out against the combined might of an OECD re-energised in its money laundering enforcement since September 11: the

national, international and the personal political interest of the leader may be seen as aligned with taking the windfall that is currently on offer.

Earlier in this chapter it was suggested that national enforcement agencies should meet to swap lists of the criminals they would most like to take out and share out the targets, according to who can be the most effective lead organisation. Rational enforcement agencies would undertake this kind of collaboration at the international level to take on targets that trade internationally. The consolidated target list of one country could be tabled alongside the target lists of two or three trusted ally states, or among all the states of the EU, or between the EU and US. The US could agree to put substantial resources into an effort to put X behind bars if France would agree to the same for Y and Poland for Z. Unilaterally none of this is likely to happen if X is not a top enforcement priority for the US, Y is not France's top priority, nor Z vital to Poland. But multilaterally, Poland will invest in collaring Z if in return the US and France will collar X and Y.

A more credible peak to the enforcement pyramid

While Australia has expanded its investment in enforcement and in audit in a period when the US has contracted its investment in these areas (Johnson, 2003; Johnston, 2003; Lederman, 2003; Kenney, 2004) and is no longer a 'Token Enforcer', much more is required than putting 60 or 80 egregious offenders in prison each year. Both countries have a lot to do to display credible willingness to escalate to formidable enforcement when needed.

The key idea of responsive regulation is that the enforcement pyramid will make it rational for a corporation to be virtuous, undercutting the market returns to vice. System capacity overload (Pontell 1978) results in a pretence of consistent law enforcement where in practice enforcement is spread around thinly and weakly. Unfortunately this problem is at its worst where vice is most widespread. Hardened offenders learn that the odds of serious punishment are low for any particular infraction. Tools like tax audits that are supposed to be about deterrence are frequently exercises that backfire by teaching hardened tax cheats just how much they are capable of getting away with (Kinsey, 1986: 416). The display of the pyramid itself channels the rational actor down to the base of the pyramid. Non-compliance comes to be seen (accurately) as a slippery slope that will inexorably lead to a sticky end. In effect what the pyramid does is solve the system capacity problem with punishment by making punishment cheap. The pyramid says unless you punish yourself for law breaking through an agreed action plan near the base of the pyramid, we will punish you much more severely higher up the pyramid (and we stand ready to go as high as we have to). So it is cheaper for the rational company to punish themselves (as by agreeing to voluntary payouts or paying for new corporate compliance systems). Once the pyramid accomplishes a world where most punishment is self-punishment, there is no longer a crisis of the state's capacity to deliver punishment where it is needed. One of the messages the pyramid gives is that "if you keep breaking the law it is going to be cheap for us to hurt you because you are going to help us hurt you" (Ayres and Braithwaite, 1992: Ch 2).

Paternoster and Simpson's (1996) research on intentions to commit four types of corporate crime by MBA students reveals the inefficiency of going

straight to a deterrence strategy. Paternoster and Simpson found that where the MBAs held personal moral codes, these were more important than rational calculations of sanction threats in predicting compliance (though the latter were important too). It follows that for the majority of these future business leaders, appeals to business ethics will work better than sanction threats. So as Michael Wenzel's (2004) work confirms with tax, it is best to try such ethical appeals first and then escalate to deterrence for that minority for whom deterrence works better than ethical appeals. But that will not work if there is no credible peak to the pyramid. The paradox of the pyramid is that if the top is lopped off, there is no capacity to drive regulation down to the cooperative base of the pyramid.

It follows that as a general claim beyond tax compliance, a responsive regulatory pyramid with a credible peak to which the regulator can and will escalate can flip markets in vice to markets in virtue by persuading regulated actors to punish themselves when they slip into vice.

Part V

VICE TO VIRTUE

Flipping markets in vice to markets in virtue

Competition policy has been a good thing for the wealth of the world. Yet we have seen it has its downside. Just as competition can deliver improvements in things we regard as virtuous, competition in vice is also a reality. The very idea of a corporate tax department being a profit centre is that it is a department that competitively pursues goods (sometimes non-virtuously), rather than one that controls bads (costs, non-compliance). Enron's tax department was so much a profit centre that it was set annual revenue targets (Johnston, 2003: 297). Referring to the profits that can be made by trading losses, one of my informants joked that when large corporates are finding the Tax Department the biggest profit centre in the company you know the economy is in recession. Ed Kleinbard (1999) may be right that the growth in corporate tax shelter activity is an integral part of competition for efficiency in corporate management – corporate tax liabilities are treated, along with other business liabilities, as costs that respond to aggressive management techniques to turn them into benefits. One New York lawyer put it poetically:

In Arcadia, tax lawyers would discuss with each other what was a fair interpretation confident that the IRS would be looking for that fair interpretation and that the courts would be looking for it as well. The worm in the apple was progressively more ruthless competition for tax business that was not under the control of any single set of professional norms, certainly not those of tax lawyers alone. Accounting firms, investment banks, financial advisers, all with in-house lawyers compete with law firms for advice.

Arcadia crumbled under deregulated markets that progressively broke down professional monopolies. Investment banks like Merrill Lynch seem to have played an important role in setting new standards of aggression in the New York shelter market of the mid-1990s only to back away from it by the end of the 90s when their aggression threatened the reputational capital so important for them to flourish in other domains like stockbroking and investment banking. But by the time the most aggressive investment banks in the corporate shelter market were becoming more conservative, the Big Five accounting firms were competing ruthlessly with one another for what Bankman (1999) described as the "lion's share" of that market. This is despite the fact that the entrance of the large accounting firms to the shelter area is "relatively recent" (Bankman (1999: 1790)). Our Australian interviews suggest that it is not yet accurate to suggest, as it probably is in New York, that the aggressive tax planning market is dominated by the (now) Big Four. So for Australian policy makers it still may not be too late to save the large accounting firms in their country from dominating this particular market in vice. The level of global sophistication in the engineering of

proactive tax planning to wipe out the obligation of multinational corporations to pay taxes that is within the competence of the Big Four, but not law firms or many other players, is the kind of competition in tax abuse that must be avoided in more Arcadian tax systems like Australia's.

Rational virtue

The empirical literature on tax compliance suggests that most individual taxpayers are irrationally compliant and most tax advisers rationally compliant. Where tax penalties at risk are less than 100 per cent of tax evaded, odds of detection must be better than one-in-two for it to be economically rational for the taxpayer to comply. That is why the last chapter argued for double and quadruple administrative penalties. Prison is a risk for egregious frauds that involve a lot of money, but for everything else penalties are always well below 100 per cent. Odds of detection and sanctioning are never better than one-in-two even for the most detectable forms of cheating like failure to declare bank interest. The odds of an individual getting an audit in the US in 2001 were 0.58 per cent, lower still in Australia, though in Australia they have moved up a lot since 2001. Yet we know that most individual taxpayers comply with most tax laws most of the time (V Braithwaite, 2003).

Admittedly, it is also true that 48 per cent of Australian taxpayers self-report that they may be failing to fully comply with something each year (V Braithwaite, 2003), just as they self-report that they comply with most of the things on which it would be economically rational for them to cheat. In the factor analytic research on preferred types of tax advisers by Yuka Sakurai and Valerie Braithwaite (2003) the most popular cluster of tax agent characteristics defined the "honest and low fuss" adviser followed by "cautious minimising with conflict avoidance" advisers, with the least preferred being the "creative accounting, aggressive tax planning" type. There is a demand for preparers who keep taxpayers out of trouble. This is what makes it rational for most tax advisers to be virtuous agents of the law. And the evidence is that mostly they are. Klepper and Nagin (1989) and Klepper, Mazur and Nagin (1991) have found that using a tax agent discourages non-compliance on legally unambiguous income sources but encourages non-compliance on ambiguous sources. At least where the law is clear, tax agents do a lot of the tax authority's work in educating taxpayers on what the law requires. There is a minority group of taxpayers, 24 per cent in the Sakurai and Braithwaite (2003) study, however, who are substantial enough in number, and who are looking for a tax agent with an orientation to "creative accounting, aggressive tax planning". For them, agents help in exploiting avoidance possibilities with ambiguous income sources.

But even in ambiguous regions of the law, such as transfer pricing by multinationals, sophisticated tax administration can flip advisers into being agents of compliance. One ATO official said of the interest of large accounting firms in the Transfer Pricing Record Review and Improvement Project: "they have an interest in sending the message that unless you employ us to get your method in order you'll be audited". Both creating business among those who want to cheat and business among those who wish to avert cheating are possible market niches for the tax adviser. The trick of institutions of taxation is to cause

advisers to move from the first to the second niche. Nine of the simpler strategies for flipping markets in vice to markets in tax virtue that have been discussed in this book are summarised below.

1. Heavy promoter penalties

Promoters are going to find the honest taxpayer market niche more attractive when promoter penalties are heavy in aggressive tax planning cases and, as a result, promoters create less demand for vice (see Figure 13). Because excess in indulgence of vice – from problem gambling to tobacco to illicit drugs – is initially created by sophisticated promotion (Braithwaite and Drahos, 2002), heavy promoter penalties is a general strategy. If the vice is people smuggling, we can shift the most severe punishment from those who are smuggled to the promoter who organises the people smuggling, from sex workers to promoters of the sex trade.

2. Restorative justice

When investors in illicit schemes face bankruptcy, divorce and suicidal depression, as we found has happened to a troubling degree in Australia in recent years, the public interests at stake are wider than the integrity of the tax system. Rituals of healing are needed after such terrible life events. There is now a lot of experience in helping people move on with their lives derived from restorative justice practice and evidence that doing so builds perceptions of procedural fairness and commitment to comply in future (Braithwaite, 2002). The other kind of case where the social damage at risk justifies a large investment in restorative justice is with the Arthur Andersen of aggressive tax planning. Here the public interest we have discussed is Joseph Murphy's idea of flipping this year's ethical laggard into next year's ethical leader, one who pulls the advice industry to a new level of best practice as their only way out of deep trouble with the government. The heavy promoter penalties advocated above are also necessary to motivate the next Arthur Andersen or the next Merrill Lynch to sit in the restorative justice circle out of fear of those penalties and indeed of corporate capital punishment at the peak of the enforcement pyramid – losing their licence for tax practice. Likewise with the Mum-and-Dad scheme investors who are about to lose their home, draconian promoter penalties need to be hanging over the head of their promoter and tax adviser. Then the promoter and the adviser will come to the conference and more readily agree to pay a share of the investors' penalty and interest as an alternative to promoter penalties and being struck off as a tax agent. Again restorative justice is a strategy of general import. Braithwaite (2002: Ch 8) argues that its relevance is general because our deepest disputes over injustice consistently tend to have disturbing relational meanings to disputants and are markers of identity. If it is the case that there are human relationships that stakeholders would like to see healed and identities under threat that they would like to be vindicated, restorative justice may have relevance.

3. Targeting the clients of "A list" promoters

We have seen that the enforcement swamping of illicit drug markets is a risk once a contagion of aggressive tax planning has taken off. Like heroin addiction or problem gambling or child pornography, however, once we have made the mistake of allowing the aggressive marketing of vice to fester undeterred, we then have a demand-driven problem on our hands that is harder to manage. Even in markets as sophisticated as New York, contagion is a powerful force. There is a herd instinct when "you want to believe that everyone is doing something that will benefit you even if the truth is that everyone is not, just a lot of players are doing it". So people rationalise following where they think the herd is charging: "I've got a good opinion on this. I can see others doing it. How bad can it be?"

I have argued that the strategy of attacking an A list of promoters' employed by the ATO Promoters Taskforce was the right strategy for tackling the problem of a supply-driven market that had transformed into a demand-driven contagion. The promoters I interviewed agreed. Not all promoters can be tackled at once when there is an enforcement-swamping crisis. But if the clients of an A list of promoters are attacked, clients will learn that they had better not end up in the clutches of an A-list adviser. Demand will shift further to the "honest, no fuss" advisers. With less business going to aggressive advisers, they will in turn create less demand through their promotion of aggression (see Figure 12). And "honest, no fuss" advisers will act as agents of the state to pull aggressive clients back to prudent compliance lest they tarnish their reputational appeal in the market in virtue as someone whose clients the Tax Office is less likely to target. The Promoters Taskforce strategy is therefore one for flipping the vicious circle of enforcement swamping, in which aggressive supply generates aggressive demand, generating more aggressive supply and so on, ever-lowering odds of enforcement for all promoters and investors, as shelters move towards becoming too big to fail (Figure 13). This vicious circle is flipped into a virtuous circle of reduced demand for aggression among investors who want to avoid being audited, leading to less supply of aggression, leading to a further reduction in demand for aggression.

Because enforcement swamping is a general problem with markets in vice, targeting A lists of recruiters into vice, targeting the most criminogenic gatekeepers (Kraakman, 1986; Gunningham and Grabosky, 1998) to virtue or vice, as opposed to the perpetrators of vice, is a general strategy. Even if we wanted to do it, targeting all promoters of pornography on the Internet would impossibly swamp any anti-pornography enforcer. But targeting an A list of those who maximally exploit images of children, for example, might shift demand to pornographic sites that comply with codes that prohibit images of children.

4. Ban contingency fees

It is inconceivable that promoter penalties could ever be heavy enough to deter the rewards of contingency fees. These can be as high as 40 per cent of the tax saved by corporate shelters that can be worth hundreds of millions of dollars. The interviews have revealed the phenomenon of promoters retiring on the investment income from the millions they have made from just one scheme in a

short period of months. In 2002, the US revised its IRS Circular 230 (which sets professional standards for practice before the IRS) to ban contingency fees in a range of circumstances. The New York State Bar Association (2001) was among the supporters of a ban on contingency fees. Such a ban is also needed in Australia, and all other nations where the Big Four does business, before contingency fees take off in these nations. The more general strategy here is that standards of professional ethics that strike down structural inducements to profit from the vice of one's clients are important. This returns us to the observation in Chapter 1 that competition law enforcement must be designed to allow for balancing the benefits from allowing certain professional monopolies that are constrained by professional ethics against the cost of lessened competition. An obvious example is licensing doctors, but only doctors, to legally prescribe certain kinds of psychotropic drugs and proscribing doctors from accepting payments from manufacturers in proportion to the quantum of the drug they prescribe. This restricts competition in the sales of these drugs, but in a way in which professional virtue is allowed to curb a potential market in vice.

5. Strict liability

It is surprising to learn that in 1999, the elite tax practitioners of the New York Bar Association supported the US Treasury's proposal for "a strict-liability regime" with respect to lawyers' opinions whereby "reliance on professional tax opinions would no longer have the effect of eliminating the penalty imposed on corporate taxpayers with respect to corporate tax shelter transactions". One reason they favoured this was concern that: "We suspect that many others of us, whether we would acknowledge it to ourselves or not, feel subtle pressures to give favourable opinions to be 'at the table', to continue to be involved with our clients' transactions, and ultimately to generate our fair share of revenues for our firms" (New York State Bar Association, 1999: 893). The market of shopping for "more likely than not" tax opinion letters in both New York and Australia is a classic market in professional vice. A compromise option here that was also floated by the US Treasury in 1999 is to forbid taxpayers from relying on letters of comfort from lawyers to avoid penalties unless they disclose such a letter at the time of lodging their tax return. This would force taxpayers to choose between alerting the IRS to the latest shelter they have moved into and abandoning shopping for "more likely than not" opinions. This compromise seems appropriately less oppressive for individual investors who are sometimes plain naïve. The strict liability standard to counter shopping for letters of comfort could be limited to corporations above a certain size. It is difficult to say whether this is a strategy with more general import beyond aggressive tax planning because it is a rather extreme reaction that might only be justified when markets in vice have become as virulent a threat as they have become to tax system integrity in New York. The more general strategy could be formulated as ensuring that responsibility is imposed on all who are responsible (Fisse and Braithwaite, 1993). This means not allowing principals to slide away from responsibility by blaming their advisers, not allowing some who bear part of the responsibility for any vice – be it mistreatment of prisoners of war or insider trading – impunity simply because a scapegoat has been found.

6. Shelter disclosure and book-tax disclosure for corporations

In Chapter 8 we saw that the recent US shelter registration and disclosure requirements need a lot of fine-tuning before they will work well. The same would be true of the Canellos and Kleinbard (2002: 2) proposal for both tax auditors and stock investors to have access to a public book-tax reconciliation schedule which would “provide a useful platform for highlighting transactions which are likely to involve manipulation for tax and accounting concepts”. Nevertheless, here the US debate is showing nations like Australia with less pernicious corporate shelter problems a productive direction to head in future. This is another strategy that is rather specific to tax. But of course disclosure and transparency is a more general strategy; sunlight disinfects many different vices. And the Canellos and Kleinbard proposal is about disclosure with a view to harnessing a form of private market in the virtue of detecting cheating. The next step in this general strategy is paying a share of large fines for corporate offenders to whistle-blowers and private analysts who detect fraud or breaches of other laws. This is a general strategy Brent Fisse and I have advocated for a long time and that seems to have assisted with cleaning up defence contracting fraud in the US (Fisse and Braithwaite, 1983; Braithwaite, 2004, 2005).

7. Integrating the private and public markets for tax advice

Chapter 12 suggested that the main argument for tax authorities to compete on price to buy the best professionals from the private sector is that it would undercut narrow perfectionism and encourage entrepreneurship in virtue in the public sector. However, it would also have some effect in reducing the incentives for the worst excesses of entrepreneurship in vice in the private sector. This would happen because excess in vice would render a professional unemployable with the biggest employer in the market – the tax authority. Perhaps more fundamentally, late career service to the tax authority would be a way to complete a worklife of virtuous practice mainly in the private market. Encouraging precedents were the appointment by the ATO in 2002 of Justice Tony Pagone, a Victorian Supreme Court judge with a distinguished career in private practice¹ and the appointment by the IRS of Larry Langdon from a stellar career at Hewlett-Packard. One-offs like this are useful. But they do little to effect the wholesale transformation of a market in vice into a market in virtue that is at issue with how we integrate markets for elite public and private tax advice. This may be another strategy of limited general applicability, simply because the public purse cannot afford a general strategy of parity with private sector incomes.

8. Educate investors to the risks

Educating investors to the risks is precisely what virtuous tax professionals do in competing with aggressive advisers. The fact is that many advisers who are aggressive in ripping off the revenue are also aggressive in ripping off clients.

¹ The Tax Counsel Network, various rulings panels, the Part IVA Panel, and Centres of Expertise also bring a wealth of outside talent to the disposal of the ATO. The ATO also has a visiting professor initiative.

Tragic stories of lives ruined by investments in tax shelters are worth repeating in the educative work of both the tax authority and responsible tax professionals. A large proportion of the 1990s Australian shelter investments were downright commercially irrational. We have seen that both recent waves of aggressive tax planning in Australia were fundamentally commission-driven. It follows that consumers need to be educated to be commission-suspicious and to get second opinions when they smell risk motivated by fat commissions. Consumer protection law for commission disclosure is also important here. A recent Australian Securities and Investments Commission study found that 28 of 92 offer documents for primary production schemes did not meet legal standards on the disclosure of commissions (ASIC, 2003: 12). When more consumers are commission-suspicious, the market in professional virtue will become more lucrative than the market in professional vice. This is a strategy of the most general relevance to any market in vice. The 1970s disclosures of multinational markets in the vice of bribery to sell products from aircraft to pharmaceuticals (Fisse and Braithwaite, 1983; Braithwaite, 1984) showed that slush funds and other loose accounting practices to enable bribe payments supposedly in the interests of shareholders were also widely used by management and bribe-paying middlemen like Adnan Khashoggi in the Lockheed case (Fisse and Braithwaite, 1983: 148) to rip off investors. There were many who suffered in those scandals from being duped by shady characters into believing that they would be beneficiaries of the riches that would flow from paying the bribes, when in fact they ended up being counted among the victims.

9. Corporate certification of continuous improvement in tax integrity

The idea of “continuous improvement” has been crucial to the ratcheting up of standards in regulatory domains like environmental protection, occupational health and safety and Equal Employment Opportunity (Braithwaite and Drahos, 2000: Ch 26; Parker, 2002). This involves a shift away from the notion that regulation is about lifting everyone above the floor defined by a legal standard. Environments are often improved more when regulation expects everyone to keep improving. This is because the leaders that move up through a ceiling can pull others up toward them (Parker, 2002). There are fundamental reasons why replacing pushing minimum standards above a floor with a shift to pulling standards up by continuous improvement through ceilings will not work as well with tax. Most people want environmental protection to improve “beyond compliance” to the maximum extent possible; no one wants taxes to increase to the maximum. Firms get some real benefits and competitive advantages in the marketplace from better environmental protection; they get competitive disadvantages from paying more tax. But tax integrity is not about maximisation in the way occupational safety is about minimisation (eliminating all injuries being the best result). Tax integrity means paying the right, the just, amount of tax, not the maximum amount. So continuous improvement in tax integrity means continuous improvement in quality assurance systems to ensure that no tax avoidance and evasion, nor any unintended overpayment of tax, occurs.

What would be required to encourage it would be for a voluntary standards association like Standards Australia to draft collaboratively a Tax Integrity

Continuous Improvement Standard. It would include protocols on specific issues like transfer pricing (as in the Transfer Pricing Record Improvement Review), evidence of the Board being active in demanding stronger evidence that triangulates on adherence to the principles in the law, that the firm steers away from shelters that might be struck down by the courts, a proactive Board Audit Committee that encourages whistle blowing on tax integrity problems and deals effectively with the issues brought to it, continuous improvement in the software, sampling and variety of checks performed by internal audit, continuous improvement in staff training on tax integrity issues, effective prompt cooperation with external auditors and the tax authority, open sharing of concerns as soon as an issue is detected (not holding findings until strategically advantageous), and so on. External auditors would certify each year whether there had been an improvement over the previous year's performance in the terms laid down in the standard. The hope is this would, year-by-year, company-by-company, ratchet up integrity standards. When the tax authority undertook a full audit of the company's accounts, it would also meta-audit the outside auditor's review of compliance with the Tax Integrity Continuous Improvement Standard. The Commissioner could publish in his Annual Report the names of companies and accounting firms whose Tax Integrity Continuous Improvement Certifications the authority's audit was unable to verify.

Why would corporations spend money on a process like this? What would be in it for them? Sometimes it would rectify tax over-payments as well as under-payments. If meeting the standard succeeded in improving integrity, it would show up as a preventive factor² (as opposed to a risk factor) in tax office multivariate analyses that predict returns from audits. If indeed returns were less from audits of firms who were certified as continuously improving in most recent years, then these firms would not be targeted for audit. Relieving such firms of the burdens of audit would also make sense for the tax authority as a strategy to encourage lead firms to innovate with new software that increases transparency and other technologies that hold out the prospect of lead firms pulling tax integrity standards up through existing ceilings. If the firm did make a mistake that put it at risk of heavy tax penalties in the courts, its certification would be a mitigating factor when the level of penalty was set. All this would make its insurance premiums against adverse tax decisions and professional indemnity cheaper. Finally, as someone who sat on the Reputex Ratings Committee that rated the corporate social responsibility of the top 100 firms in Australia on a variety of criteria, including financial ones, I know Reputex would love to have access to a list of companies that had met a credible Tax Integrity Continuous Improvement Standard. Reputex and like ratings matter to companies first for the positive and negative direct publicity in the media the companies who come out top and bottom receive. Second, and more importantly, they matter for the way they drive the now substantial investments of ethical investment funds. Third, in extremis, they can affect judgments of ratings agencies like Standards and Poors that decide how much interest they will pay for money they borrow. The Chairman of Reputex is the retired CEO of Standards and Poors in Australia. Henderson Global Investors is one firm which has written to the FTSE 350 in the

2 The terminology of preventive factors versus risk factors comes from public health. A risk factor increases the chance of disease; a preventive factor reduces it.

UK inquiring, in the context of risk management, how the company decides tax policy and tax avoidance matters (Christensen, 2004: 1).

This final strategy for flipping markets in vice to markets in virtue – Corporate Certification of Continuous Improvement – has already been advanced as one that drivers like Reputex might give more relevance in domains like environmental stewardship, affirmative action and occupational health and safety where firms have a more profound interest in taking the virtue of their performance up through ceilings.

Webs of influence

None of the strategies above has any prospect on its own of flipping markets in vice to markets in virtue. While promoter penalties are extremely important, we have seen that in markets where killings to retire on can be made in a few months before a scheme goes bad, it is implausible that odds of early detection and severe penalties could ever do the job on their own. While each strand in a web of influences to create markets in professional virtue might be weak, together they might weave a fabric that effectively restrains vice. Crucial to that accomplishment is the way the strands are tied together, each to reinforce the other. So, for example, we have seen that credible penalties are needed to motivate people to sit in the restorative justice circle about their tax affairs. Equally, of course, procedural justice is needed to motivate sitting in the circle. Business people and tax practitioners will participate in a restorative justice conversation with tax authorities because in the words of one Sydney practitioner: “Our most valuable asset is our reputation with the tax office ...”.

Restorative justice circles can work at strategic junctures (like that Merrill Lynch faced after the shelter it crafted for Colgate-Palmolive blew up) in securing commitment to future tax compliance. This is possible because the interviews show that individual citizens who work in such organisations actually do feel ashamed of some of the things their organisation does and do believe in the virtue of a high integrity tax system. Faced with the spectre of heavy penalties in the aftermath of a crisis, many will grab the opportunity restorative justice holds out to flip the organisational dynamic from the pursuit of vice to the pursuit of virtue. Many won’t. But one advantage of a regulator with the club of heavy penalties behind their back is that they can respond to an executive who is a hard target by adjourning the restorative justice circle and then reconvening it with his boss in the circle. If the boss turns out to be an even tougher nut, the circle can be widened again until a soft target that can be deterred by shame or by a simple appeal to their integrity becomes the senior corporate player in the circle. It is naïve to respond to the empirical evidence from tax compliance research that shame and ethical obligations to comply with the law predict compliance better than the severity of sanctions (Ahmed et al, 2001; Braithwaite, 1989; Grasmick and Bursik, 1990; Grasmick and Scott, 1982; Schwartz and Orleans, 1967; Scott and Grasmick, 1981) by thinking that penalties don’t matter. Penalties mostly matter because of the way they interact with informal social control. So, John Scholz’s program of research suggests that, in spite of low penalties, most people irrationally comply with tax laws because they think it is the right thing to do. However, this ceases being true if they believe that dishonest taxpayers are

getting away with cheating without any punitive consequences (Scholz, 1998). Strong penalties and moral reasoning reinforce each other when tied together in a web of influence for flipping vice to virtue. Voluntary ethical commitment to continuous improvement in tax integrity is reinforced by regulatory commitments to target the worst compliers through “lifting the bar” strategies (Chapter 11).

And of course flipping vice to virtue is far from the only dynamic that matters on the rocky road to tax system integrity. Quality intelligence matters because it lets the tax authority put people on notice sooner rather than later that a scheme is illegal. Meta regulation, the shift from a tax authority culture that is a rulebook to one that is a storybook about how problems can be solved, all the things we discussed in the last three chapters, are strands of webs of influence that improve integrity in ways that are not connected to the logic of competitive markets. Nevertheless, the same point holds about single strands in the web being weak while the whole fabric of control might be strong. The partial conquest of the late 1990s wave of aggression is testimony to the possibility of a web of controls working. This is evidenced, for example, by Kristina Murphy’s survey of a random sample of 2301 Australian scheme participants that saw 44 per cent say they thought people were “much less prepared...compared to five years ago to go in for tax schemes that rely for their success on loopholes in the law”. Only 11 per cent thought people were “much more prepared”, with 14 per cent saying “don’t know” and the rest falling between these extremes (Murphy and Byng, 2002: 18). Also a majority said they would always rely upon an ATO product ruling in future before going into a tax-effective investment scheme.

Of course, webs of control have only worked in both Australia and the US in very partial ways. As I write, more fertile minds than mine are burning the midnight oil to craft new shelters that are more ingenious than the last generation, especially in the way they play off one nation’s tax laws against another’s to craft modes of international arbitrage that no one has yet imagined.

The ninth strategy for flipping markets in vice to markets in virtue – the Tax Integrity Continuous Improvement Standard – is a blue-sky one. Yet if our goal is to reverse the contemporary decay of the integrity of the world’s tax systems documented in Chapter 2, an approach of continuing with more of the same will fail. In addition to continuous improvement at the level of the firm, we need it at the level of national policy through measures such as the strategies discussed in Chapter 11 for each year raising the bar a little higher on those industries that are not paying their share, and we need it at the international level, as with the OECD’s “standstill and rollback” strategy in its Harmful Tax Competition campaign. That is, nations must agree to not introduce any new harmful tax competition (standstill) and must also agree to progressively rollback harmful tax competition. Braithwaite and Drahos (2000) have argued that the ratcheting up of regulatory standards is in fact as common in the world system as races to the bottom. Moreover, strategic interventions can flip downwards ratchets into upwards ratchets of integrity. However, the contemporary competitive race to the bottom in tax integrity would be among the hardest dynamics to flip to an upwards ratchet into virtue. It might require a synergy of the following: a rise of corporate interest in continuous improvement in tax integrity,

regulators that progressively raise the bar on segments of the community that do not pay their share, and international collaboration that takes seriously the benefits of the OECD prescriptions of standstill and rollback of harmful tax competition.

The aggressive marketisation of proactive vice (as opposed to reactive tax advice) that arrived in New York in the 1990s and is rising in Australia can be resisted by an effective web of regulatory influences. In assessing the plausibility of this, we must not lose sight of the extremely common phenomenon of the ethical individual taxpayer who views taxation as the price of civilisation and the surprisingly common phenomenon of the executive who wants to feel good about her company as one that pays its fair share of tax. We should remember a Sydney suburban accountant I interviewed who had an old-fashioned attitude that was quite the obverse of treating the Tax Department as a profit centre. He said, "I educate clients to treat income tax as an expense. If you pay \$1 million in tax, you're earning \$2 million, so try to double your earnings so you can pay \$2 million in tax". This accountant continued, "The ATO should be more visible. They should go to the accountant first and then one or two of their clients and ask to check something. Some visibility and dialogue at low cost. Then I can tell clients how the ATO does drop in now and then and ask to check client's returns on things like this". It is the rather common (and empirically much in demand) "honest, low fuss" tax agent like this one who can do most of the spadework of markets in virtue. We should remember the tax managers of some large corporations interviewed who felt they were being vilified because their company was paying ("rightly", they thought) more than their competitors in the same industry. The latter are more exceptions to their world than my Sydney suburban accountant to his. But they do exist and to the extent they do, they can become shoulders to the wheel that moves markets to virtue.

Perhaps the most missing element in the web of influences needed to flip markets in vice to markets in virtue is a more aggressive social movement politics for tax justice. A semblance of that in the US is Citizens for Tax Justice, Citizen Works, and The Bermuda Project, and in Australia the leadership Julian Disney showed in past decades communicating issues of tax justice on television and in forging the Australian Council of Social Service as an agitator for tax equity. In 2003 a global Tax Justice Network was forged at the World Social Forum in Porto Alegre. There are two major impediments to social movement politics becoming the vital force needed to flip markets in vice to markets in virtue. One is the way Chapter 2 described social movement politics shifting from a politics of redistribution to a politics of recognition. The other is that tax is worse than just a boring topic to politically engaged young people who would never imagine themselves dating an accountant; it is also technically obscure, indeed incomprehensible, to them.

The single most important reform to overcome these two obstacles would be for states to make public the tax paid by named large corporations. When a multinational corporation from a country wealthier than our own puts trucks on roads we pay for without their corporation making any contribution to pay for those roads, revealing that the multinational pays no tax does trigger a politics of identity. This is the politics of poorer people from a poorer country feeling ripped off by richer people from a richer country, of little people having to pay while

powerful corporations ride free. Public corporate tax returns in a comprehensible format, or interpreted for ordinary people in a comprehensible way, would also reduce the arcane and technical to the simple concrete fact that corporation X, who I work for, or that owns the factory in my town, pays no tax. Combined with bounties for private auditors who uncover under-payments, publishing some version of corporate returns on a website would also create a private enforcement market that would help flip markets in vice to markets in virtue.

Admittedly, if the citizens of democracies knew in concrete detail the shocking truth of how little tax their employers pay compared to the percentage of their income average people pay, the will of ordinary folk for voluntary tax compliance would likely be further undermined (Scholz, 1998). But we would only shy away from this risk if we thought it inevitable that the rich and powerful will never pay their fair share of tax. An objective of this book has been to show that this is not inevitable. There are a lot of things we can do to craft a fairer tax system. The major obstacle to doing them is political will. That will is often captured by corporations and wealthy individuals who pay no income tax but do pay political campaign contributions. It follows that we should not shy from political will formation to do the range of things that would create a web of influences to conquer aggressive tax planning in the long term, for fear that in the short term it will dent the voluntary compliance of ordinary people. Moreover, seeking to prop up crumbling compliance by keeping people in the dark about how bad things are is not a principled response consistent with democratic ideals. Voluntary compliance of ordinary people will rebound to new heights when they see evidence that the integrity of Western tax systems has been restored to the levels it had some decades ago. This accomplishment is within our grasp, technically and politically.

Wider lessons

In seeing how to grasp that accomplishment, I have tried to draw some wider lessons on how to flip markets in other kinds of vice into markets in virtue. These are reordered and recrafted below as hypotheses of more general import about how to flip vice to virtue:

- Do not place too much reliance in any single strand of a web of controls; work the web as a fabric that is tied together at a variety of nodes;
- Regulate in a collaborative and conversational way; the conversations at nodes of governance pull together intelligence about the vice (connect the dots) and build up a storybook of successes and failures that constitutes shared sensibilities, that makes for systemic wisdom about a web of controls, that explores errors as interesting challenges to be corrected (opportunities to learn how to solve problems);
- Organise controls into a responsive regulatory pyramid that encompasses a consideration of the elements below;
- Organise regulatory tools in response to problems rather than problems around tools from a standard tool-kit (discursively creative regulation as opposed to procedures manual regulation);

- Enact laws based on principles that technically untrained people can understand;
- Connect laws to natural systems people use in their business and social lives as opposed to artificial systems contrived to be convenient for the administrative purposes of the state;
- Experiment with meta regulation – regulated self-regulation, to discover where it works;
- Enact heavy penalties for promoters of vice, as opposed to perpetrators of vice (in response to the commercialisation thesis, target commercialisers);
- Target enforcement on the clients of A list promoters of vice, as opposed to perpetrators of vice (in response to the enforcement swamping and system capacity theses, target to increase demand in the market for virtue and reduce demand in the market for vice);
- Pay bounties to private detectors of corporate vice; mandate more detailed disclosure of the affairs of large corporations (as illustrated by shelter disclosure and book-tax disclosure) to create the market for bounty hunting;
- Educate consumers and investors for commission-suspicion; market the stories of middle-men who promise to make consumers the beneficiaries of a vice and end up making them victims of it;
- Experiment with restorative justice near the base of enforcement pyramids that elicit responsibility from all who are responsible without necessarily imposing punishment for that responsibility. This goes, for example, to preventing taxpayers from denying responsibility by simply saying they relied on bad professional advice. It goes to preventing impunity based on scapegoating;
- Redesign competition policy to protect and strengthen standards of professional ethics that strike down structural inducements to profit from the vice of one's clients (eg, contingency fees on taxes avoided);
- Certify large private and public sector organisations for continuous improvement in reducing vice and promoting virtue of specified kinds; pulling virtue through ceilings as a strategy for pushing vice above a floor.

This is a menu of options to be considered for the task of crafting a contextually attuned integrated strategy for flipping specific markets in vice into markets in virtue. I hope that tax policy, especially Australian enforcement against aggressive tax planning, has served in this book to illustrate that it can be an instructive policy menu. But it is no recipe. Every market in vice will have its own contextual distinctiveness that requires the kind of detailed consideration I have only begun to deploy here with tax.

In particular, it is necessary for competition policy makers to think diagnostically about what level of competition to nurture. Chapter 1, for example, discussed how competition between health insurers can be competition in cost-shifting instead of cost-reduction and competition in cutting corners on quality, creaming the well rather than competition in curing the sick. To get health sector competition that actually improves health, Porter and Teisberg (2004) argue that competition needs to be at a more micro-level – disease by disease, patient by patient. The tax case shows how more ruthless competition, if it is at the wrong

level, can become competition in cutting corners on professional ethics. Competition in letters of comfort from lawyers is one example where we have been able to discuss legal remedies that might steer competition back to competition in legal integrity, professional competition to give the legally correct answer when a shelter does not pass the smell test instead of writing a letter to deodorise it. Regulatory reform can not only constrain competition against being competitive in vice; it can also enable competition in virtue. When a tax authority creates a website that enables the testing of accounting software against scenarios to ascertain that it comes up with the right answer, competition among software manufacturers is likely to ensure that software is marketed that gives the right answers (Chapter 5). When a health regulator publishes on a consumer-friendly website data on which health care facilities have the greatest numbers of bedsores per patient and which have had the most success in reducing that number, it encourages competition in the virtue of preventing bedsores. Just and effective competition policy design, that succeeds in flipping markets in a vice to markets in virtue, is bound to be much more micro than the contemporary practice of competition policy.

A reviewer illustrated the particularity of policy needed by querying how the explanatory framework would apply to the following:

Institutions facilitating idealised capitalist competition (ie, freer trade, arm's length transactions in thick markets, rapid movement of financial flows) also end up providing opportunities for more illicit activity. Examples: freer trade makes drug trafficking and terrorism physically easier because fewer containers entering a country tend to be inspected, financial organisation and technology across borders lowers the cost (and increases the ease) of laundering money.

This is indeed an interesting perspective on a way more vibrant markets in goods can facilitate stronger markets in bads. But it is not at all amenable to the theoretical framework developed here. The strategy for flipping markets in vice to markets in virtue developed herein is grounded in an explanation based on the demand for vice and the creation of demand by suppliers. The explanation in the quote is about opportunities – how the flow of goods creates opportunities for the flow of bads. A strategy for countering this is likely to be about stemming opportunities rather than flipping demand in markets.

The same reviewer raised another distinction between trade in legal, economically beneficial activities (eg, casino gambling) that may conduce to some vice, versus illegal trade in utterly economically unproductive commodities such as heroin. Here my hypothesis is that the explanatory framework of “markets in vice, markets in virtue”, applies to both. For example, flipping heroin markets to demand for, and supply of, less destructive substitute drugs for heroin addicts could possibly be worthy of consideration using the framework here. Legality and economic value are just two possible reasons why something might be defined by citizens as a vice or a virtue. However they decide what is a vice, the analytics of the theory are that more vibrant or more virulent markets will engender that vice with greater productive efficiency.

As with tax, so in other domains as we consider the dot points above for application to disparate vices, technical competence needs to be mobilised at nodes of governance that tie together stands in a web of controls. As with tax,

neglected nodes of governance are crafted by and with citizen groups who care about the vice. Governance works more decently and effectively in the conditions of an information economy when it networks with webs of influence resulting from collaborations of governments, business and NGOs (Castells, 2000; Shearing and Wood, 2003). The most important reason for this is that what is vice and what is virtue, and how to respond to it, must be deeply and contextually contested in a democracy.

It is because virtue is diffused through community networks that webs of controls that include many informal strands are critical to flipping markets in vice to markets in virtue. That is also why stories, principles, education and natural systems are more important for the business of flipping markets than rules about state-constructed systems; people in civil society think and act on stories and principles more than on technical rules.

Even though I argued in Chapter 2 that we are on the cusp of a crisis of inequality fuelled by aggressive tax planning, there is no general normative contribution of this book to clarifying what is vice and what is virtue beyond the conclusion that webs of control should be designed to render this deliberately contested. Normative scholarship on what should be regarded as a vice or a virtue is of great import. But the interest here is in the analytic point that if markets enable the more efficient production of goods, this also applies to the more efficient production of bads (however defined). The interest is in the sociological point that if vice is perceived by large sections of the community, advocacy of virtue will be a reaction that in a market society will run to a market in virtue. The interest is in the economic point that these counter currents mean that markets in perceived vice will be more cyclical and more prone to herding than other markets. Being more cyclical, norms of virtue do take hold during the virtuous period of the cycle. We see this in the hearings in the US Senate at the time of writing, where one major accounting firm after another are appearing to condemn their own conduct during their period of vice in the late 1990s. We saw the same phenomenon with business speeches post-Enron, just as we did when the “greed is good” cycle of the 1980s on Wall Street collapsed.

Rather than be cynical about this normative flip-flop, it can be seen as a resource for working at strategies that more deeply embed norms of virtue and evidence-based compliance policies that are effective – that help the upswing last longer against the drivers of the next downswing into vice. Because virtue and compliance innovations flourish during the reaction against the period of vice, regulated self-regulation makes more sense than with non-cyclical problems. Self-regulation can work well during the period of upswing into virtue; its failure during the descent into vice becomes an opportunity for responsive escalation to tough enforcement that sets new benchmarks for the next upswing. When this works, we get a higher ceiling through which the lead producers ascend, setting new expectations for the laggards. This can lift the floor below which the community is intolerant of vice.

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