An overview: A new era of tax enforcement – from “big stick” to responsive regulation

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Abstract

Recent developments in regulation and tax administration in Australia inspired this article on tax compliance and responsive regulation. This article analyzes the economics of crime and compliance as the dominant approach to tax enforcement of the past three and a half decades. It evaluates the key advantages and disadvantages of the economic approach as well as its application to tax. The article then explores responsive regulation as an alternative method that draws on the economic paradigm but also supplements this approach with other theories, particularly those involving identity, conflict escalation, and procedural justice. Building on this analysis and a case study of Australian investors in mass marketed tax schemes, the article suggests that the broader, more balanced, and closely tailored method of regulating responsively may enable regulators to draw on the advantages of the economic model while alleviating some of its drawbacks. Responsive regulation may therefore constitute a superior method for regulating compliance.

Keywords: responsive regulation, law enforcement and correction, tax compliance, tax administration, comparative law, law and society, law reform, economic analysis.

Introduction

Preserving the integrity of the tax system has challenged societies throughout history. Tax noncompliance is a serious problem that fosters a climate of disrespect, antagonism, and selfishness in the relationships among citizens and between them and the government and distorts the distribution of the tax burden and wealth in society (Carroll 1989; Cowell 1990; Slemrod 1992; Kaplow 1996). Despite evident benefits of increasing tax compliance, the complexity of the Tax Code, the magnitude and persistent levels of noncompliance, and democratic principles that restrain government interference with the conduct of civilians mandate that no tax system achieves perfect compliance. Still, due to the size of the tax gap (the difference between those taxes that are legally owed and those that are punctually and accurately paid), even a small or moderate reduction in existing noncompliance can yield substantial returns. According to a 2004 Government...
Accountability Office (GAO) report, each 1% reduction in the US net tax gap is likely to yield more than $US2.5 billion annually (GAO 2004). Thus, a 10–20% reduction could add $US25 billion to $US50 billion or more in revenue annually; no small change by any account.

Like other tax administrations in the industrialized world, over the years the Internal Revenue Service (IRS) has taken a number of steps to ease the tax gap including substantially enhancing enforcement efforts and resources (IRS 2004, 2006). Unfortunately, despite some increases in enforcement revenue,1 the net difference between taxes owed and taxes collected in the US remains close to $300 billion per tax year. This raises the question whether the steps taken thus far are sufficient to alleviate the problem of tax noncompliance. If not sufficient, what alternatives are available to government agencies and other regulatory institutions?

This article explores one alternative solution to the problem of noncompliance. It suggests that expansion of the traditional tax compliance analysis to include responsive elements of regulation, as illustrated in the Australian Tax Office’s (ATO) approach to tax enforcement, may yield a more useful and forward-looking approach to tax compliance and enforcement than those available under other systems. The responsive regulation approach is based on the proposition that effective enforcement requires a dynamic and gradual application of less to more severe sanctions and regulatory interventions (Braithwaite 1985). This range of sanctions and interventions balances traditional authoritarian deterrence with strategies that rely on persuasion and encouragement through three states of communication – cooperation, toughness, and forgiveness (Ayres & Braithwaite 1992). The Australian approach also advocates a deeper understanding of the motives, circumstances, and characteristics of taxpayers, so tax authorities can tailor enforcement to effectively deliver compliance (ATO 1997, 1998). With responsive regulation, the intent is to preserve the basic principles of economic analysis that view taxpayers as rational actors seeking to maximize their expected utility. Responsive regulation goes a step further, however, and also considers other parameters, including the way society, morality, and ethics affect taxpaying behavior and, particularly, the manner in which the taxpayer–tax administration relationship shapes compliance.

Section 1 of this article reviews the economic model as the origin of the analysis of compliance with the law and discusses the application of this model to the realm of taxation. Section 2 explores key advantages and disadvantages of the economic approach to tax enforcement, concluding that the economic model is persuasive in many respects but flawed in others. In Section 3, this article introduces the Australian approach to tax enforcement as a method that draws heavily on the economics of the crime model yet moves beyond the economic realm to rely on other complementary theories. This section of the article advances the argument that, as a result of this broader perspective, the Australian approach has the potential to capture the strengths of the economic paradigm while also addressing some of its drawbacks. Section 4 illustrates the supremacy of regulating responsibly with a case study involving tax schemes mass marketed to Australian taxpayers in the late 1990s. Section 5 summarizes and concludes the article, suggesting that the Australian method of regulating responsively may mark the beginning of a new era of tax enforcement. The main focus of this article is personal income tax compliance although much of the discussion provides important insights into other regulatory areas.
1. Economic analysis and tax enforcement: From Becker’s approach to law enforcement to the deterrence hypothesis and its application to tax compliance

Over the past four decades, economic analysis has played a pivotal role in crystallizing the issue of individual and organizational compliance with legal obligations. Particularly, in a regulatory environment such as taxation, where many of the relevant variables are often unobservable and complex, economic models become highly instrumental in simplifying the relationships at hand to produce a coherent framework. Economic modeling of tax compliance has also facilitated an important process in policymaking by enabling the assessment and comparison of the consequences of different enforcement strategies. This, in turn, stimulates the formation of well-informed debates over alternative policies (Creedy 2001).

The principal model for analysing issues of compliance with the law derives from the classic work in utilitarianism of Jeremy Bentham and Cesare Beccaria who laid the foundation for a framework of economic analysis that tells a relatively straightforward and realistic story of human behavior (Bentham 1788; Beccaria 1797). The basic premise of the utilitarian theory is that people behave rationally to maximize their expected utility. In the context of compliance, the assumption is that, facing a feasible set of courses of action, some of which are legal while others are not, individuals choose whether to commit a crime or not based on which option has the better prospect of increasing their utility. The economic approach to compliance, although influential at the time of its conception, received very little attention from later theorists and policymakers until Gary Becker modernized it in his groundbreaking article “Crime and Punishment” (Becker 1968).

Instead of adhering to theories of mental illness and social oppression that dominated discussions of crime during his time, Becker’s analysis returned to the utilitarian premise of Bentham and Beccaria and explored the possibility that criminal behavior is in fact rational. In Becker’s words: “[A] person commits an offense if the expected utility to him exceeds the utility he could get by using his time and other resources at other activities. Some persons become ‘criminals,’ therefore, not because their basic motivations differ from that of other persons, but because their benefits and costs [resulting from compliance and noncompliance with the law] differ” (Becker 1968, p. 176; see also Becker 1993). Focusing on these costs and benefits, the “deterrence hypothesis” emerged suggesting that, if individuals are rational decision-makers whose aim is to maximize expected utility, the way for the authorities to further compliance with the law is to deter individuals from acts of noncompliance by ensuring that the expected utility from noncompliance is lower (i.e. less beneficial) than the expected utility from compliance. In this context, Becker’s analysis advanced the argument that public resources ought to be allocated to policy measures of two kinds – one aimed at detecting noncompliers and the other designed to sanction identified offenders. Under Becker’s doctrine, finding the optimal balance between these two measures becomes the key factor in deterring potential offenders and making compliance the rational choice of behavior (Becker 1968, p. 208).

Compared with the general economic theory of crime, its tax counterpart is a relatively recent development, dating back about 35 years, particularly, to the much cited article, “Income Tax Evasion: A Theoretical Analysis,” by Michael Allingham and Agnar Sandmo (Allingham & Sandmo 1972). Allingham and Sandmo extended Becker’s work on the economics of crime to taxation using modern risk theory. Similar to Becker, they
built their analysis around the utility maximizing individual, this time the taxpayer, who becomes the potential criminal. Allingham and Sandmo’s model presents the issue of compliance as a portfolio allocation problem in which the taxpayer must decide what portion of her income to allocate to various activities, some of which result in income legally declared while others result in income illegally shirked (Allingham & Sandmo 1972, p. 323). Their analysis leads to unambiguous results when it comes to the relationship between the taxpayer’s penalty rate, the probability of detection, and tax evasion (cf. Yitzhaki 1974). Allingham and Sandmo confirm Becker’s findings that a higher penalty rate and probability of detection tend to discourage tax evasion. While the expected tax yield falls with a decrease in the probability of detection, an increase in the penalty rate can compensate for the loss of revenue, such that the two enforcement alternatives emerge as substitutes for one another (Allingham & Sandmo 1972, p. 330).

1.1. An expanded view of taxpaying behavior

While the economic model of compliance provides an intuitively appealing description of the tax evasion phenomenon, real-world tax compliance behavior as well as enforcement mechanisms are much more complex than this analysis suggests. Research efforts designed to add depth and realism to the study of tax compliance resulted in the Allingham–Sandmo framework being the subject of extensive research. These research efforts included, among others, attempts to endogenize critical parameters involved in tax compliance, such as accounting for randomness in the audit rate and in the taxpayer’s true tax liability (e.g. Reinganum & Wilde 1985; Graetz et al. 1986; Reinganum & Wilde 1986) and incorporating additional and more diverse variables, including elements of memory and time (e.g. Engel & Hines 1999) as well as labor market variables (e.g. Cowell 1981). Although the traditional economic analysis of tax compliance has been expanded to include these and other more detailed explanatory variables, its focus on only two key enforcement parameters, punishment and detection, remains unsatisfactory and not on a par with real-world enforcement practices or needs. Further, the underlying assumption of the economics of compliance – that every person is engaged in some type of rational calculation where she will conceal income as long as the return on noncompliance is positive – does not reflect existing findings on taxpaying behavior (Graetz & Wilde 1985; Skinner & Slemrod 1985; Smith & Kinsey 1987). According to survey information, most taxpayers consider themselves to be honest in their tax reporting, and presumably they are, if the available tax compliance rates are accurate (Wenzel 2001). In fact, tax compliance literature has repeatedly suggested that “given the current mild sanctions and low probability of detection … [one] would predict that virtually everyone should be evading tax.” In other words, instead of asking “Why do people evade taxes?” we should be asking “Why do people pay them?” (Hessing et al. 1992, p. 292 (citations omitted); cf. Lederman 2007).

2. A closer look at enforcement strategies: Deterrence and beyond

Empirical and experimental studies tend to support the economic model of compliance to the extent that they generally identify a negative relationship between the probability and severity of punishment and the rate of crime (Andreoni et al. 1998; Eide 2000; Slemrod & Yitzhaki 2002). This effect has also been detected in the area of tax compliance (Friedland et al. 1978; Clotfelter 1983; Witte & Woodbury 1985; Beck et al. 1991).
A closer look at the data reveals, however, that an increase in the severity of punishment may not have the same effect on compliance as a rise in the probability of detection (e.g. Becker 1968, p. 176; Kahan 1997, p. 380). In either case, enforcement efforts relying solely on punitive strategies may ultimately fall short of addressing effectively the problem of noncompliance and might even worsen the situation.4

Specifically, evidence on tax enforcement generally confirms the conclusion that taxpayers are highly responsive to the perceived or actual risk of detection. According to IRS estimates, compliance is most likely where the risk of detection is significant, such as when third-party reporting or withholding takes place. Taxpayers misreport a mere 1% of all wage, salary, and tip income contributing approximately $10 billion to the US tax gap (IRS 2006). In contrast, non-farm sole proprietor income, which is subject to little third-party reporting or withholding, has a significantly higher rate of misreporting of approximately 57%, which contributes about $68 billion to the tax gap (IRS 2006). In terms of the punishment parameter, fines and other types of penalties also tend to improve compliance. When it comes to real-life behavior, however, small changes in penalties are easily overlooked and unlikely to affect compliance (Cheng 2006). Some researchers go so far as to suggest that heavy penalties do not always produce more compliance than lighter ones, especially when detection probability is high (Friedland 1982). In certain studies, the effect of an increase in the severity of punishment is not statistically significant, and a statistically significant positive effect on criminal behavior is also occasionally identified (Eide 2000, pp. 359–360). Ultimately, in most cases penalties serve as less of a deterrent for committing crimes than the probability of detection because the effect of deterrence decreases rapidly, and nonlinearly, with lower probabilities of enforcement, and tougher punishments are often unable to offset these losses (Cheng 2006, p. 659).

Despite the heightened deterrent effect of detection compared with punishment, on the assumption of a fixed enforcement budget, efforts to maximize deterrence and revenue at minimal cost might lead policymakers to favor extreme yet rare punishments (Becker 1968, pp. 180–181). Unfortunately, however, even if effective in improving compliance, an enforcement strategy of extreme and rare penalties may be a poor strategic choice because of the repercussions it is likely to have outside of its immediate ability to coerce compliance. In particular, rare and extreme punishments can provoke community outrage. The idea that the government doles out just punishment is undermined when it disproportionately sanctions offenders (Sandmo 2005, p. 660). When it comes to serious crimes, inflicting heavy penalties on a rare few is also arbitrary, draconic, and highly discriminatory (Cheng 2006, p. 659). Such an approach might even lead to underenforcement as tax administrators become conflicted between their legal obligations and moral judgments (cf. Kahan 2000, p. 608). Imposing rare but severe sanctions may also lead to an increase in the severity of crimes committed as offenders realize that sanctions will be extreme regardless of the actual offence committed and attempt to “maximize” their gain from crime (Cowell 2004, pp. 249–250).

Indeed, taking any form of punitive enforcement to an extreme threatens the democratic nature of society and carries a risk of inflaming a broader conflict between citizens and the government. Such an approach to tax enforcement might backfire because of what Bruno Frey describes as a “crowding out effect” of the intrinsic motivations individuals have to comply with their legal obligations, setting the tone for a taxpayer–tax authority relationship that is dominated by feelings of antagonism and distrust.

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4 S. Leviner A new era of tax enforcement
This type of interaction ultimately diminishes taxpayers’ willingness to comply voluntarily with their tax obligations and might also lead them to actively resist paying their taxes, either legally or illegally (Kagan & Scholz 1984; Lind & Tyler 1988; Tyler 1990b; Feld & Frey 2002; Frey & Fled 2002; Feld & Frey 2006). Authoritarian enforcement presents additional pitfalls by increasing the visibility of noncompliance and, by doing so, not only conveying to taxpayers what is legally forbidden but also coaching them on what they can get away with (Kinsey 1986; Carroll 1989).

From an economic perspective, even when increased enforcement is feasible, conducive to democracy, and results in greater compliance, raising these efforts to the maximum might still be suboptimal. Enforcement expenditures constitute a real cost to the economy while the revenue collected can be viewed as a mere transfer from the private to the public sector (Slemrod 1992, pp. 1–2). Further, increased enforcement of the tax system might also have disincentive effects similar to an increase in the tax rate or broadening the tax base and should therefore be undertaken with caution and restraint (Franzoni 2000, p. 62).

In addition to the considerations that counsel against extreme enforcement, empirical evidence suggests that even moderate means of enforcement may fail to effectively promote compliance. When researchers tested the rate and probability of punishment at moderate (compared with extreme) levels, consistent with actual tax enforcement practices, they found the deterrent effects to be quite small (Alm et al. 1992a). Further, enforcement efforts that rely exclusively on punitive measures and the severity and probability of punishment are likely to be short-sighted at best and counterproductive at worst. Taxpayers adapt, take up new strategies, and become increasingly sophisticated in their risk assessment of being caught and penalized. In an area as complex and controversial as tax, legalistic and authoritarian attempts at shaping behavior are expected to lead to a never-ending process, as efforts to address one type of undesirable behavior leave countless others unattended (McBarnet 2003).

A broader, more constructive approach to deterrence than the one adopted under the traditional economic analysis must reach beyond the use of threat and legal authority to include other factors and mechanisms that will offer complementary means to combat crime. This more holistic method is a familiar practice in regulatory programs generally and it would seek to improve tax compliance not only by curbing illegal activity but also by encouraging legal behavior, including through balancing authoritarian deterrence with positive encouragement and assistance. Such a balanced approach is particularly appropriate in taxation where compliance can be difficult and not always in the short-term self-interest of the regulated, and where the very classification and detection of noncompliance might become challenging as well (Smith 1992).

2.2. The multiplicity of taxpaying behavior
The traditional economic literature on tax compliance examines taxpaying behavior through the decisions of a single individual. As evident in Becker’s early essay and continuing with the work of Allingham and Sandmo, the analysis has focused on the individual taxpayer and her choice of whether or not, and to what extent, she complies with her legal obligations. Set in this way, the economic paradigm fails to put the issue of tax compliance in its broader context and, consequently, misses important explanatory opportunities. One example of this oversight is the limited range of goods examined in the standard analysis, which tends to portray individuals as concerned only with their...
private consumption while displaying total disregard for public goods and services (Cowell 2004). Evidence, however, demonstrates that taxpayers expect to receive certain returns on the taxes they pay (Alm et al. 1992b). Not only do taxpayers care about these returns but they also evaluate whether the tradeoff is equitable compared to what other taxpayers appear to receive (Spicer & Becker 1980; cf. Frank 1985). Moreover, one study that compared the effect of various information sources on taxpaying behavior found that social influence plays a key role. Specifically, the study demonstrated that information taxpayers receive about the compliance of those with whom they discuss taxes have the strongest effect on these taxpayers’ commitment to comply with their tax obligations (Scholz et al. 1992). When taxpayers believed people around them tend to cheat, they were more likely to cheat themselves, and when taxpayers believed others are generally honest, they were more willing to pay their own taxes honestly.

It becomes clear, therefore, that taxpaying behavior is not merely the result of isolated calculations of the monetary costs and benefits taxpayers expect to incur from compliance and noncompliance. Taxpaying behavior is also a social process where taxpayers share information, experiences, attitudes, and patterns of behavior that affect their assessments of costs and benefits and, consequently, their actual compliance with the tax law (e.g. Schwartz & Orleans 1967; Roth & Scholz 1989; Carroll 1992; Lederman 2003a,b; Kirchler 2007; Torgler 2007). One may even go so far as to argue that moral, ethical, and social factors play a more important role in compliance than the threat of legal punishment (Scholz et al. 1992; Steenbergen et al. 1992; Kahan 2001). For example, Grasmick and Scott (1982) find that, while the relationship between the threat of legal punishment and intention to evade taxes is statistically significant, anticipated feelings of guilt and social stigma attached to tax evasion are more strongly associated with deterrence. Similarly, Mason and Mason (1992) argue that an appeal to taxpayer conscience or civic virtue can improve tax compliance more than the threat of legal sanctions. Other scholars clarify that detection and punishment could be complementary strategies to moral, ethical, and social appeals, especially when applied to different groups of taxpayers (Blumenthal et al. 2001a,b; Murphy & Byng 2002; Lederman 2003b; Raskolnikov 2008).

If we put aside the query over the proper weight to attach to various enforcement considerations, simply incorporating non-monetary parameters and influencers into the traditional economic analysis of tax compliance has often resulted in a better description of real-world taxpaying behavior than a theory built only on selfish monetary assumptions (e.g. Allingham & Sandmo 1972 [incorporating reputation into their basic analysis]; Erard & Feinstein 1994 [adding guilt and shame]). To stay within the economic paradigm, the rationality proposition no longer implies narrow materialism or pure self-interest. Instead, rationality now reflects the reality that most people are constrained by a wide range of considerations and that these considerations lead them to obey the law when the sum of all potential costs of noncompliance, including likely moral, ethical, and social sanctions, outweigh the expected gain.

A realistic and effective analysis of tax compliance must account for taxpayer motives other than the desire to increase net income, eventually leading to a much needed reassessment of the role that enforcement policy and mechanisms play in improving compliance. Regulators and scholars in Australia have been involved in this particular line of investigation during the past decade, with results that have important implications for tax enforcement in Australia, as well as in other industrialized countries and in the broader, non-tax, regulatory sphere. The next section of this article will review the
research into motivations and, particularly, those motivational influencers that have been identified as commonly associated with taxpaying behavior. The article will then introduce the concept of responsive regulation and explore the manner in which this approach to regulation brings key elements of tax enforcement together to effectively foster compliance.

3. The Australian approach to tax enforcement: Motivational postures, taxpaying behavior, and service delivery

Innovative research in regulation has identified a group of motivational influencers—best known today as “motivational postures”—that capture the way regulated entities position and think about themselves in relation to the regulatory authority (Braithwaite et al. 1994; Braithwaite 1995). In the context of compliance with tax law, motivational postures describe how taxpayers see themselves as they relate to the tax system and its administration and, particularly, the amount of social distance they wish to place between themselves and those functions (Bogardus 1928; Braithwaite 2003b). This distance indicates the taxpayers’ degree of acceptance or rejection of the tax system and authority, and, consequently, the extent to which taxpayers are open to their influence (Braithwaite & Job 2003).

Strategies for inducing compliance are likely to vary in their effectiveness depending on the motivational posture of the targeted taxpayers. Different regulatory and enforcement measures tend to be successful when dealing with taxpayers who see themselves as law abiding citizens versus those who see themselves as opportunistic. Moreover, taxpayers who feel the tax authority insults them or treats them disrespectfully may respond differently to enforcement than those who feel the tax authority approaches them with integrity and respect (Wenzel 2007). For this reason, tax administrations that seek to understand the taxpayers’ full range of motivational postures are likely to be better situated to encourage taxpayers to “do the right thing” and comply with their tax obligations while monitoring and constraining those motivations that might lead taxpayers down the path of noncompliance (ATO 1998, pp. 23 & 62).

Five key motivational postures have been identified as relevant to the realm of tax compliance. These are: (i) commitment, (ii) capitulation, (iii) resistance, (iv) disengagement, and (v) game playing (ATO 1998, pp. 22–24; Braithwaite et al. 2001; Braithwaite & Braithwaite 2001, pp. 410–411; Braithwaite 2003b, p. 18). The first two postures, commitment and capitulation, are compliant in nature, the former more than the latter. They suggest the taxpayers’ cooperative interaction with and acceptance of the tax system and its administration. The latter three postures, resistance, disengagement, and game playing, represent an increasingly defiant state of mind with the taxpayers’ growing distance from and dislike toward the tax authority, system of taxation, and what taxpayers perceive they stand for.

As Valerie Braithwaite explains, defiant taxpayers generally feel threatened by the tax system and dissatisfied with democracy. These taxpayers tend to hold anti-government and pro-market attitudes, have relatively weak identification with being a citizen and an honest taxpayer, and support the abolition of the tax system (Braithwaite 2003b, p. 24). Persuasion and punitive enforcement are less likely to affect defiant taxpayers, and they are generally more invested in aggressive forms of tax planning (Braithwaite 2003b, pp. 24 & 33). However, committed or capitulated taxpayers do not necessarily refrain
from noncompliance. Behavior is the result of a variety of inputs, only some of which are related to beliefs and attitudes, and so one cannot automatically assume a simple correlation exists between taxpayers’ mental states and behavior. Regulators must acknowledge this disparity between motivational postures and behavior and be responsive to both to effectively manage compliance. Crucially, the tax administration does not only serve as a passive observer of taxpayers’ attitudes and actions, but it also affects them considerably.

In keeping with the influential work in compliance and procedural justice of Tom Tyler, Allan Lind, and others, it is well understood today that taxpayers’ perceptions of the procedural justice of the tax system – how the tax administration treats them and other similarly situated taxpayers – affect the legitimacy that taxpayers attribute to the administration (Tyler & McGraw 1986; Lind & Tyler 1988; Tyler 1990a, b). This sense of legitimacy, in turn, affects taxpayers’ levels of compliance. Taxpayers who believe the tax administration and its officials attempt to be fair and respectful toward them are more likely to assign greater legitimacy to the tax system, align with its administration, and, consequently, be more compliant with their tax obligations than those with more negative perceptions. Further, the tax administration’s positive behavior increases the likelihood of compliance because of people’s tendency to react in a like manner to behavior they experience from others (Smith 1992). In accordance with this rule of reciprocity, helpful and respectful service may also coax a broader normative commitment of compliance when taxpayers believe the administration acts positively toward them as a matter of general practice (Smith 1992; Feld & Frey 2007).

The result of the taxpayer–tax authority interaction may be different, however, for taxpayers who do not trust or respect the tax authority or for those who feel threatened by it. When taxpayers feel uneasy with the tax authority, such as when they anticipate or experience particularly unpleasant interactions, these taxpayers might adopt a coping mechanism to protect themselves from the disapproval of tax officials (Braithwaite & Job, 2003). This coping mechanism often boils down to an acute sense of taxpayer polarization from the tax system and administration, sustained by feelings of alienation and detachment (Braithwaite & Braithwaite 2001; Ahmed & Braithwaite 2005). Under such circumstances, gaining compliance from taxpayers becomes extremely difficult. When the tax administration employs punitive strategies that communicate disapproval, the tension between taxpayers and the administration is likely to increase with the rise in perceived disapproval, exacerbating any existing state of defiance. The challenge for tax officials in these situations revolves around drawing out the more compliant stances from taxpayers. Tax officials may be able do this by offering taxpayers cooperation, positive and helpful service, and open dialogue as a first response to conflicts. With this strategy, tax officials can address and diffuse toxic feelings, including antagonism, resentment, and distrust, enabling the administration to (re)connect with taxpayers on a positive level, and eventually elicit voluntary compliance (Tyler 1990b; cf. Smith 1992; Braithwaite & Braithwaite 2001; Feld & Frey 2002; Frey & Feld 2002).

In cases where taxpayers do not meet the tax administration’s offer of cooperation with compliance, the tax administration must be firm, but also fair, in bringing to account those who do not comply. Whatever steps the tax administration takes must not, as much as possible, adversely affect compliant taxpayers or escalate existing conflicts beyond what is necessary to gain compliance. In most cases, even when taxpayers are resentful and angry, goodwill also exists and, with it, an opportunity to draw out the
more cooperative postures and behaviors (Braithwaite 2003b). The key challenge for the
tax administration, therefore, is not so much to punish noncompliant taxpayers. The key
challenge is to interact with taxpayers in a manner that fosters goodwill and cooperation
so as to lessen the emergence of taxpayer defiance and aid in the management of those
conflicts that nonetheless arise (Braithwaite 1985; Murphy 2005b). The next section of
this article will draw on the Australian experience beginning in the late 1990s to suggest
that an effective approach to managing taxpayer compliance and achieving mutual
respect and cooperation includes a hierarchy of lesser sanctions and regulatory inter-
ventions, the possibility of severe and certain sanctions for noncompliance, and an
understanding of and responsiveness toward taxpayers’ motivational postures and their
compliance related behaviors and circumstances.

4. Responsive regulation and the Australian compliance pyramid

Until the mid-1990s, the regulatory style of the Australian Tax Office, like the regulatory
approach of most tax administrations in the industrial world, was authoritarian
(Braithwaite 2003a). This regulatory method, commonly referred to as “enforced com-
pliance” or “command and control regulation,” developed out of the economics of
compliance paradigm. It called for the establishment of optimal, clear-cut rules for
taxpayers to follow and the forceful enforcement of these rules through threat of detec-
tion and legal punishment (Job & Honaker 2003). Despite its widespread dominance,
opponents of command and control often argued that this strategy misinterprets human
behavior and the meaning of noncompliance and that its one-solution-fits-all approach
is poorly suited for regulating compliance (Bardach & Kagan 1982; Ayres & Braithwaite
1992; Gunningham & Grabosky 1998; Sparrow 2000, Braithwaite 2002; Braithwaite
2007). The many complexities of the tax enforcement challenge suggest the need for
a comprehensive strategy that fosters long-term compliance. Yet “an approach which
relies heavily on detecting noncompliance and imposing sanctions on identified
offenders tends to be short-term in its effect and increasingly resource-intensive”
(ATO 1998, p. 57). The Australian tax administration took to heart the criticisms of
the command and control method and, starting with the release of the 1998 Cash
Economy Task Force Report, embraced a new regulatory approach, one that moved
from authoritarian deterrence to a method of “responsive regulation.”

In their 1992 book entitled Responsive Regulation: Transcending the Deregulation
Debate, Ian Ayres and John Braithwaite conceptualize responsive regulation as an
approach that does not necessarily result in any definitive program or a set of perceptions
prescribing a single best way to regulate. Instead, Ayres and Braithwaite envision respon-
sive regulation as a method that advances the proposition that regulation should be
context dependent and yield different solutions depending on the regulatory circumstances
at hand (Ayres & Braithwaite 1992, p. 5). An administration that adopts responsive
regulation commits itself to investigating and taking into consideration the problems,
motivations, and circumstances of the regulated parties. It emphasizes dynamic operation,
assumes commitment to assisting the regulated actors in their compliance efforts, and
strives to enforce compliance across the board, even when the regulated are highly defiant

Bringing together the idea of regulating responsively and the enforcement challenge,
Ayres and Braithwaite offer a holistic model for regulating compliance (Ayres &
Braithwaite 1992). An expanded version of their model was endorsed in the 1998 report of the Australian Cash Economy Tax Force (ATO 1998), after which the ATO adopted it across the board for regulating tax compliance. The Australian compliance model is represented by a pyramid with each of its three faces articulating one key aspect of compliance, including: (i) the motivational postures taxpayers are most likely to hold toward the tax system and its administration and display in their interactions; (ii) the enforcement strategies at the tax administration’s disposal; and (iii) corresponding regulatory styles (ATO 1998, pp. 22–26). In this model, the motivational postures, regulatory measures, and enforcement strategies have a range of severity. The compliant postures, cooperative enforcement strategies, and less intrusive regulatory styles are set closer to the base of the pyramid. The areas higher on the model are reserved for defiant taxpayers and harsher, more punitive and intrusive enforcement and regulatory practices (Ayres & Braithwaite 1992, pp. 35–40; ATO 1998, pp. 24–26).

The tit for tat (TFT) methodology, a familiar practice in law and economics and the game theory literature (Axelrod & Hamilton 1981; Axelrod 1984), was introduced into the compliance model as the actual means for regulating responsively (Ayres & Braithwaite 1992, pp. 19–53). In adopting the compliance model, with its TFT methodology, the ATO rejected the more traditional deterrence style of enforcement that is grounded in a static calculation of the probability of compliance based on the expected size and risk of punishment. Now, the ATO seeks to balance positive persuasion and encouragement with punitive deterrence and incapacitation in a dynamic fashion. It embraces the understanding that people care about different things in different contexts and that they often possess multiple, even contradictory, selves: people can have a caring, socially responsible self as well as an opportunistic self. Monetary considerations may motivate individuals at one point and a sense of social responsibility at another (Braithwaite et al. 1994; Braithwaite 1995). Accordingly, an enforcement strategy grounded in punishment or persuasion alone is fundamentally deficient as it will either undermine the good will of taxpayers or be exploited by their sense of greed. Both persuasion and punishment have strengths and shortcomings in delivering compliance. The key to successful regulation is not to decide between one approach or the other but rather to establish a workable compromise between the two (Braithwaite 1985; Ayres & Braithwaite 1992).

Embracing the TFT methodology, the ATO is required to balance encouragement and persuasion with punitive deterrence through three stages of communication with taxpayers: cooperation, toughness, and forgiveness. In doing so, the ATO draws on the importance of procedural justice to effectively regulate compliance and the understanding that the tax office and taxpayers are partners in an ongoing relationship. Accordingly, the tax administration will always start interacting with taxpayers at the bottom of the compliance pyramid, soliciting cooperation through assistance, persuasion, and encouragement (ATO 1998, p. 30).

By reaching out to taxpayers, emphasizing education, good customer service, and an open dialogue, the ATO targets taxpayers’ sense of social responsibility and bolsters the prevention of noncompliance, while avoiding, at least early in the regulatory interaction, the use of costly punitive measures that might undermine taxpayers’ goodwill and intrinsic motivations to comply. If taxpayers choose to cooperate, tax officials must proceed with cooperation. When taxpayers withhold cooperation, the compliance pyramid instructs the tax administration to, gradually and proportionally, move to a higher
level of enforcement and regulation (Ayres & Braithwaite 1992, p. 21). This incremental escalation takes the cost of noncompliance up to the point where it becomes rational for taxpayers to comply (Ayres & Braithwaite 1992, pp. 27 & 29–30). As soon as taxpayers choose cooperation, TFT guides the tax administration to reward cooperative behavior by moving down the pyramid, de-escalating enforcement and regulation (Ayres & Braithwaite 1992, p. 21). However, for taxpayers who remain defiant, as well as for the purpose of safeguarding a culture of obedience to the law, sanctions for persistent acts of noncompliance must be severe and certain. To illustrate the importance of balancing punitive enforcement with assistance and cooperation and the general workings and compliance effects of responsive regulation compared with a more traditional authoritarian approach, the next section of this article will discuss the case of tax schemes mass marketed to Australian taxpayers in the late 1990s.

5. The case of mass marketed tax scheme investors

In the late 1990s, the Australian tax administration identified a marked rise in the number of taxpayers involved in tax schemes, particularly those related to tax deductions (ATO 2000; Senate Economics References Committee 2000). Evidence revealed that the amount claimed for scheme-induced tax deductions increased from about $A54 million in 1993–94 to a striking $A1 billion or more in 1997–98. In 1998, as part of an institutionalized attack on aggressive tax planning, the ATO took action against 42,000 taxpayers suspected of investing in mass marketed tax deduction schemes (“investors”). Implementing what seemed at the time to be a firm, no-nonsense approach to noncompliance, the ATO applied the anti-avoidance provisions of Part IVA of the Australian Income Tax Assessment Act of 1936, legitimizing its power to amend the returns of the investors to recover any tax shortfall, with interest and penalties, for up to six years after the tax deductions were first claimed.

Instead of investors accepting the fact they were caught “with their hand in the cookie jar,” and agreeing to comply with the amended returns to avoid further repercussions, the direct authoritarian approach of the ATO produced reactance and resistance as investors put up a fight. In the words of Kristina Murphy: “During much of 1998 and 1999 […] thousands of investors made complaints to the Commonwealth Ombudsman about the Tax Office’s handling of their case, various legal fighting funds were set up to represent investors’ interests, and the majority of taxpayers involved simply refused to pay back their scheme related tax debts” (Murphy 2005a, p. 3). In fact, four years after the ATO mailed out the amended returns, more than 50% of investors remained noncompliant, despite the fact their debts were increasing significantly because of interest and penalties.

In June 2000, the dispute between the tax scheme investors and the ATO transpired into a full blown parliamentary inquiry (Senate Economics References Committee 2000, 2001, 2002). At this point, the ATO realized it needed a different approach to resolve this conflict, and it established a direct, ongoing, communication channel with the investors. The ATO also enlisted the assistance of researchers from the Australian National University and what has become the Centre for Tax System Integrity. The proceeding communication and research efforts revealed, among others things, that despite the vast variety of investors involved in the tax schemes (Braithwaite et al. 2007, p. 13), one common denominator was the investors’ claim that what the ATO categorized as
schemes were in fact investment plans sold to them by accountants and financial planners as a way of legitimately minimizing their taxes. The investors resented the ATO’s implication that they intentionally cheated on their taxes, and they were disappointed that the administration sent the amended assessments before giving them a chance to explain their side of the story. These insights were instrumental not only in explaining the high level of resistance this group of taxpayers displayed but also in realizing the steps necessary to resolve the long-standing dispute.

In 2002, four years after the conflict between the ATO and the tax scheme investors erupted, the ATO was able to effectively address the situation (ATO 2002; Senate Economics References Committee 2002). Based on extensive discussions and investigations, the ATO finally acknowledged that many investors were victims of bad advice from tax scheme promoters. Accordingly, the ATO gave eligible taxpayers the opportunity to settle their debt while waving the original interest and penalties.9 Investors also received a generous two-year interest free period in which to pay back the outstanding amounts. At the same time, the ATO communicated that harsh consequences would apply for persistent acts of noncompliance and that this offer represented a limited window of opportunity to resolve the dispute. Investors initially received two months to accept the settlement offer, later extended by three weeks.

The results of the 2002 settlement illustrate the advantage of a tailored and balanced approach to regulating compliance over the more traditional authoritarian method, with 87% of all investors finally settling their debt (ATO 2002). By seeking to understand the dispute with investors and the context in which it took place, and, consequently, engaging in more closely tailored sanctions and regulatory interventions, the ATO was able to use its resources more efficiently to deal with the most defiant taxpayers who continued to resist compliance. The ATO was also more apt to address the true source of the conflict – the tax scheme promoters (ATO 2003). At the same time, tough enforcement on noncompliers became more procedurally fair, defusing some of the resistance investors initially developed toward the tax administration and promoting better alignment and cooperation of taxpayers with the tax system and its administration (Murphy 2002, 2005a).10 Resolving the dispute with the investors also served as an opportunity for the ATO to further entrench responsive regulation in its organizational culture. To take advantage of this opportunity the ATO worked on changing the regulatory mindset behind its enforcement measures. These changes included training tax agents and administrators to “think responsively” such as by means of storytelling about regulatory encounters with taxpayers and how these encounters played out instead of applying narrowly defined rules and guidelines. Such changes also translated to ground level developments of administrative practices, including various forms of auditing and benchmarks, tailored to different industries and compliance circumstances (ATO 2003, 2007; cf. Job et al. 2007).11

Conclusion

Over the past several decades, research in tax administration has focused on examining the causes and facilitators of taxpayer noncompliance. Experts have conducted these investigations in the hopes of better understanding how to foster tax compliance and minimize the tax gap. While the compliance research is far from conclusive, it does support the economic model to the extent that taxpayers are generally sensitive to the
expected payoffs of compliant and noncompliant behavior. Other things being equal, taxpayers who face higher probabilities of detection or punishment tend to comply more than those who face lower risks. Recent scholarship and regulation, however, increasingly emphasize that compliance involves more than the probability and severity of punishment. Instead of abandoning enforcement policies based on detection and punishment, this article embraces the understanding that these mechanisms should be balanced against other measures that will complement punitive deterrence and offset its negative repercussions. Tax administrators can achieve this balance by broadening the definition of deterrence to include measures that curb illegal activity along with those that encourage legal behavior, such as by nurturing the social consciousness of taxpayers and furthering cooperation between them and the tax administration.

The Australian compliance model offers a viable framework that incorporates a balanced and broad approach in the enforcement of taxes. Drawing on the principles of responsive regulation and the motivational posture doctrine, the Australian model conceptualizes taxpaying behavior as the result of factors that go beyond the needs, desires, and constraints of the autonomous taxpayer. It also considers that environmental conditions, including norms, values, and social habits, as well as the nature of the taxpayer interaction with the tax authority, are influential. Particularly, by focusing on the role the taxpayer–tax authority relationship plays in tax compliance, the tax administration is empowered to own up to its administrative responsibilities and explore different ways to manage this relationship. The idea here is not only to enforce compliance in the face of defiance but also to strengthen and manage compliance more fairly and efficiently to improve voluntary reporting. This emphasis on voluntary compliance is especially important in taxation given that the tax law is complex and constantly evolving. As illustrated in the case of the mass marketed tax scheme investors, authoritarian enforcement alone might be politically undesirable and problematic to execute as well as counterproductive in its effect on compliance. Instead, enforcement policies might be more effective when they start with self-regulation through encouragement and persuasion, and only when necessary responsively move to punitive enforcement and intrusive regulation.

With growing interest around the world in tax administration that focuses on customer service and embraces a dynamic approach to the enforcement of compliance, the Australian model has the potential to generate different, possibly more effective, conclusions for tax enforcement than what we have seen thus far from the traditional economic analysis of compliance. However, the Australian model, by relying on a method that emphasizes the process of enforcement (“managing relationships”) rather than any single defined regulatory or enforcement mechanism, presents challenges in its application. Considerable resources are needed to develop and test the effectiveness of various regulatory and enforcement measures required in different regulatory contexts. It is unclear, for example, which regulatory and enforcement tools best encourage voluntary compliance at the bottom of the pyramid; how tax administrators can effectively present the noncompliance repercussions to taxpayers in a way that encourages them to comply early in the regulatory process; and which deterrent measures tax administrators can carry out, and to what extent, without unnecessarily alienating taxpayers. Furthermore, the heightened flexibility of the Australian model may become especially problematic if tax administrators execute the model in ways that are inappropriate or otherwise unintended by the supporting enforcement policy. This risk is inherent in administrative
practices generally, but the combination of an escalating range of enforcement and regulation, the complex and fluid nature of motivational postures, and the extent of discretion in a dynamic administrative style might increase the risk of enforcement that is too lenient or too harsh compared with a more conventional approach.

In the end, the main advantage of the Australian model may be its ability to offer regulators and researchers a broad, if incomplete, road map for enforcement that incorporates a set of checks and balances on punitive deterrence. More importantly, the Australian model touches on critical issues in compliance and regulation that are well deserving of policy attention and debate. The fact that this model does not come with a self-explanatory guide may therefore constitute an important advantage. It forces tax administrators and policymakers to debate and arrive at decisions that tailor solutions to particular circumstances in a thoughtful and deliberate manner. As research into responsive regulation further evolves in taxation and additional compliance improvement data and prototypes of the Australian model become available, we may continue to evaluate the effect of regulating responsively on the integrity of the tax system and assess the advantages and disadvantages of this method. In the meantime, we should pay close attention to what may be the promising beginning of a new era of tax enforcement.

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Notes

1 From tax year (TY) 2001 to 2005, the IRS reported an increase in enforcement revenue of nearly 40% (IRS 2006, enforcement revenue table).
2 For example, according to IRS estimates, the US tax compliance rate currently stands at 83.7% (IRS 2006).
3 These findings, however, are not entirely conclusive. For a review of additional studies and some contradictory results see Hessing et al. 1992.
4 See pp. 364–365 and 368–369 of this article.

5 Carroll (1989, p. 258) clarifies that this has been the case for efforts to regulate behavior in diverse areas such as shoplifting, drunk driving, and family violence.

6 Smith (1992, p. 223) explains that deterrence based on the detection and punishment of offenses is only one aspect of most enforcement and regulatory programs and that a mix of strategies is generally common among regulatory agencies.

7 The research into motivation postures is still a work in progress. In New Zealand, for example, the tax administration adopted a compliance model similar to the Australian one but featuring only four postures. Here, game playing was taken to be a subcategory within any of the four other postures. See Morris & Lonsdale (2005, pp. 61–62).

8 Compared with Webley et al. (1991), finding that taxpayers who indicate alienation from or negative attitudes toward the law and government are considerably more likely to engage in evasion; Cowell (1990) reviewing the attitudinal and experimental literatures and finding that attitudes and perceptions of the tax system are generally related to compliant and non-compliant behavior. See also Shefrin and Triest (1992).

9 The ATO determined that a small number of investors who were promoters, tax agents, and other tax advisers will be ineligible to accept the settlement offer because they should have been aware of the true tax implications of their investments and will therefore face the full consequences of their actions.

10 Murphy (2005a) analyzes longitudinal survey data collected in 2002 and 2004 to show that investors who were more likely to think the 2002 settlement offer was fair (both in substance and execution) were less likely to hold on to resistant views toward the ATO and more likely to be compliant with their tax obligations in 2004.

11 Similarly, in the area of corporate taxation John Braithwaite (2005) illustrates how responsive regulation may be particularly effective in increasing the compliance of large corporations and, consequently, raising revenue. Braithwaite’s evaluation of utilizing the compliance model to address illegal profit shifting by multinational corporations suggests that for every million dollars invested in responsibly regulating this area an additional billion dollars is collected. Braithwaite also discusses how since the 1990s corporate tax collections generally in Australia have grown three times faster than GDP growth when, in most other industrialized nations, corporate tax collections decreased as a proportion of GDP (Braithwaite 2005, pp. 30 & 89–96).

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