

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

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**Published**

2004

**Journal Title**

British Tax Review

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

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## Abstract

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

## Introduction

IN 1998 a pyramidal model of *responsive regulation* was introduced into the Australian Tax Office (“ATO”) as a means of improving its management of taxpayer compliance.<sup>1</sup> In developing this model, the ATO incorporated regulatory theory that had been developed by regulatory scholars working in other fields of regulation (e.g. mining regulation, environmental regulation, etc.),<sup>2</sup> as well as psychological theories that had been developed in the study of nursing home regulation.<sup>3</sup> Six and a half years on, the ATO’s Compliance Model is being used routinely by ATO staff to help them develop more effective compliance strategies.

Since being introduced into the ATO in 1998, several other tax authorities around the world are beginning to recognise the value of the Compliance Model. For example, the OECD has expressed interest in the model<sup>4</sup> and both the United Kingdom and New Zealand have since taken the Compliance Model and developed similar models to suit their own local contexts.<sup>5</sup> The Pennsylvania State Revenue Department in the United States

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<sup>1</sup> Cash Economy Task Force, *Improving Tax Compliance in the Cash Economy* (Australian Taxation Office, Canberra, 1998).

<sup>2</sup> I. Ayres & J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, New York, 1992).

<sup>3</sup> V. Braithwaite, “Games of Engagement: Postures within the Regulatory Community” (1995) *Law and Policy* 17(3), 225–255. See also V. Braithwaite, J. Braithwaite, D. Gibson, & T. Makkai, “Regulatory Styles, Motivational Postures and Nursing Home Compliance” (1994) *Law and Policy* 16(4), 363–394.

<sup>4</sup> S. Hamilton, “Putting the client first: The Emerging Copernican Revolution of Tax Administration” (2003) *Tax Notes International*, February, 569–576.

<sup>5</sup> For a public pronouncement on the adoption of the Compliance Model in the UK Inland Revenue see *Inland Revenue—The Government’s Expenditure Plans 2002–2004* (2002); see also *Inland Revenue Managing Customer Relationships: What Does Compliance Mean in The Future?* Inland Revenue

has also recently expressed interest in the Compliance Model and has begun conducting research, in collaboration with the University of Pennsylvania, to test the effectiveness of some of the principles outlined in the Model.

The aim of the present article will be to first discuss why and how the ATO came to develop their Compliance Model (Part 1). It will also discuss some of the success stories the ATO has had with the Compliance Model in improving attitudes and compliance among taxpayers (Part 2). In Part 3, the article will then move on to provide the reader with some background information about the regulatory principles that underlie the concept of responsive regulation—the concept that underpins the Compliance Model (these principles also underlie the United Kingdom and New Zealand Models).

### Part 1: Bringing Responsive Regulation to life through the ATO Compliance Model

As discussed in detail by Job and Honaker, the ATO was facing a serious legitimacy crisis during the 1990s.<sup>6</sup> Constant media reports about poor ATO practices, bully-boy tactics and accusations of excessive and unfair use of power were rife.<sup>7</sup> There were claims that the ATO was “out of touch” and “lacked understanding”<sup>8</sup> and that poor use of penalties “threatened the integrity of the tax system”.<sup>9</sup> Criticism and demands for change therefore came from community and government alike.

In response to political questioning and regulatory policy debate, the ATO adopted several measures intended to make it more open and sensitive to the concerns of taxpayers. These measures included the introduction of the *Taxpayers’ Charter*—a document that sets principles and standards for the way the ATO conducts its dealings with taxpayers<sup>10</sup>—and perhaps more importantly the move away from the long-established style of command-and-control enforcement to a programme of responsive regulation.<sup>11</sup> This took the form of the ATO’s Compliance Model, which was publicly released for use in the ATO in 1998.<sup>12</sup>

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Workshop, June 2001; M. Lamb, P. Tuck and K. Hoskin, *Enabling Change in the UK’s Inland Revenue: The Character of Strategic Discourse*, paper presented at the Interdisciplinary Perspectives on Accounting Conference, Madrid, July 2003; for a public pronouncement in New Zealand see New Zealand Inland Revenue, *Inland Revenue Business Plan: The Way Forward 2001 Onwards* (2001).

<sup>6</sup> J. Job & D. Honaker, “Short-Term Experience with Responsive Regulation in the Australian Taxation Office in *Taxing Democracy: Understanding Tax Avoidance and Evasion* (V. Braithwaite ed, Ashgate, Aldershot, 2003) at 111–129.

<sup>7</sup> W. Gumley & K. Wyatt, “Are the Commissioner’s Debt Recovery Powers Excessive?” (1996) *Australian Tax Review* 25(4), 186–201.

<sup>8</sup> Anonymous, “Carmody and the Critics” (1997a) *Taxation in Australia* 32(4), 188–192; Anonymous, “The Critics” (1997b) *Taxation in Australia* 32(4), 193–194; Anonymous, “Monsterring the Tax Minimisers” (1997c) *Taxation in Australia* 32(6), 286–288.

<sup>9</sup> P. Chamberlain, “Large Jump in Tax Complaints” (1996) *The Age*, September at 19.

<sup>10</sup> S. James, K. Murphy & M. Reinhart, “The Taxpayers’ Charter: A Case Study in Tax Administration” (in press) *Journal of Australian Taxation*.

<sup>11</sup> See Job & Honaker, *op. cit.* n.6; N. Shover, J. Job & A. Carroll, “The ATO Compliance Model: A Case Study of Building and Construction”, in V. Braithwaite ed, *op. cit.* n.6 at 159–176; K. Hobson, “Championing the Compliance Model: From Common Sense to Common Action?”, in V. Braithwaite ed, *op. cit.* n. 6 at 131–157.

<sup>12</sup> The author would like to acknowledge the work undertaken by Jenny Job in developing the Compliance Model. When working for the ATO in the area of small business compliance, she was tasked with the job of developing a model for dealing with non-compliance in the cash economy. The ATO’s Compliance Model was the result of her work.

Prior to the introduction of the Compliance Model, the ATO was quick to escalate their enforcement strategies as soon as problems arose. Little or no consideration was given to a taxpayer's individual circumstances, and no thought was given to achieving future compliance. In an area such as taxation, the behaviour that is being regulated is continuous and fundamental to the long-term health of the community. In such a regulatory context, field officers must display patience and tolerance rather than legal authority, for the goal is not to punish but to secure long-term voluntary compliance.<sup>13</sup> The overarching aim of the Compliance Model, therefore, was to create an environment that promoted compliance and provided a situation where long-term voluntary compliance and the systemic integrity of the tax system could be achieved.

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

### *The ATO Compliance Model*

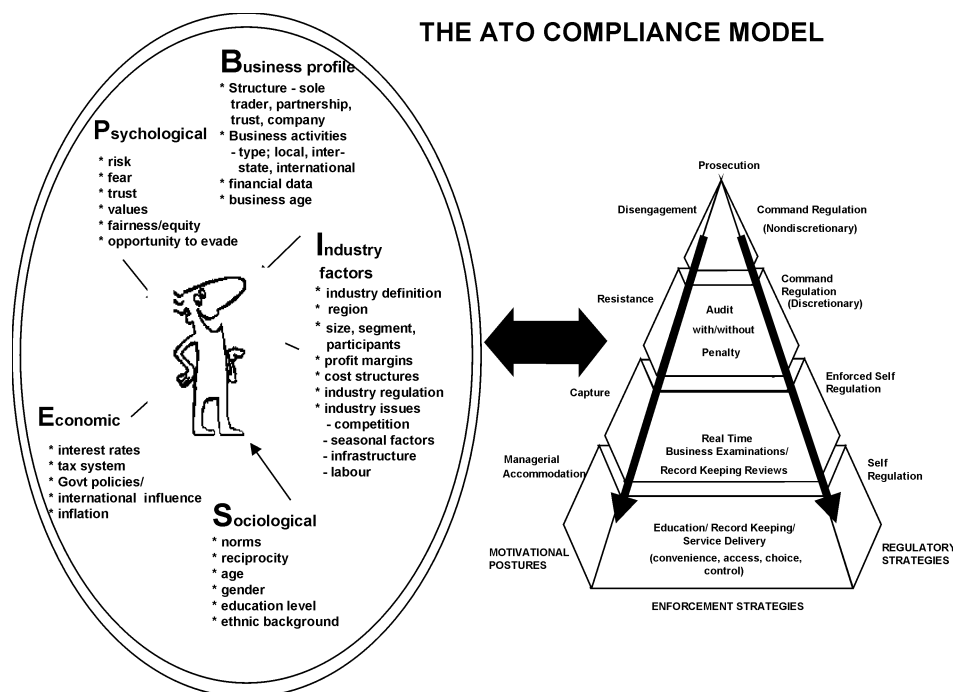
The ATO Compliance Model is depicted graphically in Figure 1 below. The work of Ian Ayres and John Braithwaite on strategies of regulation,<sup>14</sup> and the work of Valerie Braithwaite on motivational postures,<sup>15</sup> strongly influenced the design of the model.

<sup>13</sup> K. Hawkins, *Environment and Enforcement: Regulation and the Social Definition of Pollution* (Clarendon Press, Oxford, 1984) at 197; J. Black, *Managing Discretion* (Unpublished manuscript, London School of Economics, UK, 2001) at 7.

<sup>14</sup> Ayres & Braithwaite, *op. cit.* n.2.

<sup>15</sup> Braithwaite, *op. cit.* n.3.

<sup>16</sup> Source: Cash Economy Task Force Report, 1998, at 58.

Figure 1: The ATO Compliance Model<sup>16</sup>

As can be seen in Figure 1, there are three parts to the ATO Compliance Model:

- (a) understanding the whole of the environment in which the regulatory act occurs at the far left of the model (*i.e.* the BISEP factors);
- (b) the attitude of the taxpayer to their taxation obligations on the left-hand side of the pyramid; and
- (c) the range of available regulatory strategies on the right-hand side of the pyramid.

There is also an additional part to the Model that cannot be depicted graphically. This part involves matching the taxpayer's attitude to compliance to the appropriate enforcement strategy that should be used by the regulator (*i.e.* how to manage the compliance).

The BISEP component of the model (*i.e.* Business, Industry, Social, Economic and Psychological factors) enables the ATO to understand the environment in which the regulatory act occurs. It allows the ATO to understand why a person may or may not be complying and it highlights that many different factors may be impacting upon their attitudes (*e.g.* trust, ethnic background, etc.). Hence, the first step in applying the Compliance Model is to determine which factors influence a taxpayer's attitude to compliance.

The concepts presented on the left side of the pyramid were initially developed in the 1990s by Dr Valerie Braithwaite as part of her research into the Australian nursing-home industry. The left side of the pyramid looks at different attitudes and behaviours of the taxpayer (*i.e.* their motivational postures). A good understanding of a taxpayer's BISEP factors allows the regulator to understand why a person has a certain attitude towards paying tax. As can be seen in Figure 1, there are four attitudes to compliance that a taxpayer could adopt: commitment, capture, resistance, and disengagement (for a fifth attitude, game playing, see below). These postures represent the ways in which individuals

could position themselves in relation to a regulatory authority, and they are predispositions to compliant or non-compliant conduct.<sup>17</sup> Taxpayers who adopt a committed or captured posture are generally compliant, while those who are resistant or disengaged are generally more likely to be non-compliant.<sup>18</sup> One very important aspect to understand about the left side of the enforcement pyramid, however, is that attitudes and behaviours can change; they are dynamic not static. A taxpayers' posture towards the ATO and paying tax can change on a daily, weekly or monthly basis. They can change in relation to different topics and they can change in response to the person they are dealing with.

The attitude of commitment represents taxpayers who are ready, willing, and able to comply with their tax obligations. They are committed to meeting their obligations and they consider there is a moral or ethical obligation to comply with the law. They usually regulate their own compliance. It has been found that approximately 92 per cent of the Australian taxpaying population endorses a committed posture towards the tax system.<sup>19</sup> The second attitude of capture represents those taxpayers who may not be happy with the ATO or tax system, but they acknowledge that paying tax is a part of life and accept their role as taxpayers. Furthermore, captured taxpayers often require additional assistance in meeting their obligations as they may not have the skills or knowledge to get things right (73 per cent of Australian taxpayers have been found to endorse a captured posture).<sup>20</sup> Most people say they want to meet their tax obligations because they want to, or because they have to. It is obviously in the interests of the tax regulator to ensure that most taxpayers remain committed, or at least captured by the system. The 73 per cent of captured taxpayers need to interact with a fair and respectful tax system that treats them with integrity. These results also indicate that almost all Australian taxpayers will respond positively to co-operative and respectful treatment from the tax regulator. The attitude of resistance represents those taxpayers who actively resist the self-regulatory system. They are likely to view the ATO with antagonism because they feel the ATO is actively pursuing people to "catch them out" rather than to help them, and they are likely to believe that people should take a stand against the ATO. Here, this may involve trying to avoid meeting their compliance obligations. Fifty-five per cent of taxpayers in the general population were found to endorse a posture of resistance.<sup>21</sup> This means that they have concerns about the system and will avoid their obligations if given an opportunity to do so. Stronger sanctions need to be emphasised with this group if they reject initial respectful and co-operative overtures by the tax regulator. This group might participate in the cash economy as an act of political defiance if they have the opportunity to do so. They may also engage in other acts of creative compliance,<sup>22</sup> such as underestimating income or overstating deductions because they have concerns about the integrity of the system. They therefore need to understand the increased risks and costs of their potential forays into non-compliant territory.

<sup>17</sup> V. Braithwaite, "Dancing with Tax Authorities: Motivational Postures and Non-Compliant Actions" in *Taxing Democracy: Understanding Tax Avoidance and Evasion* (V. Braithwaite ed, Ashgate, Aldershot, 2003) at 15–39.

<sup>18</sup> Braithwaite, *op. cit.* n. 17

<sup>19</sup> Braithwaite, *op. cit.* n.17.

<sup>20</sup> Braithwaite, *op. cit.* n.17.

<sup>21</sup> Braithwaite, *op. cit.* n.17.

<sup>22</sup> D. McBarnet, "When Compliance is Not the Solution But the Problem: From Changes in Law to Changes in Attitude" in V. Braithwaite ed, *op. cit.* n.6 at 229–244; D. McBarnet & C. Whelan, *Creative Accounting and the Cross-Eyed Javelin Thrower* (John Wiley & Sons, New York, 1999).

The fourth attitude of disengagement represents those taxpayers who do not care that they are not doing the right thing by the ATO and they believe the ATO cannot do anything to them if they choose not to pay their taxes. In other words, these taxpayers no longer want to participate in the system (about 7 per cent of taxpayers report being disengaged from the system).<sup>23</sup> Disengaged taxpayers still deserve a respectful and co-operative first step. However, their responses to the regulator, and probably their history, will indicate a very rapid escalation to the top of an enforcement pyramid. The worst cases of disengagement are not usually regulated by a single agency in Australia. These hardcore transgressors generally require the co-operation of multiple regulatory agencies to join forces to incapacitate them.<sup>24</sup>

In her book *Taxing Democracy*, Valerie Braithwaite describes what she sees as a fifth attitude to compliance in the area of tax.<sup>25</sup> Although not physically depicted on the ATO Model, this fifth attitude represents taxpayers who are game players. These taxpayers enjoy the game of finding the grey areas of tax law and the challenge of minimising their tax (about 13 per cent of taxpayers). They do not necessarily think they are doing the wrong thing by the ATO, and they often believe they are fulfilling their obligations under the law.<sup>26</sup> This group of taxpayers is unique as they can sit anywhere along the left side of the compliance pyramid. Regulatory strategies for this newly identified group require further research.

It is indeed possible for these postures to be held simultaneously, depending on the context (thus, the explanation for the overlap in taxpayers endorsing a particular posture; 92 per cent committed, 73 per cent captured, 55 per cent resistant, 7 per cent disengaged, 13 per cent game players). For example, a taxpayer may be genuinely committed to the tax system while at the same time being resistant to it. Those who resist most vocally, who challenge ATO decisions and who are openly critical of the institution, are not necessarily more non-compliant as a group than taxpayers who choose other ways of engaging with the system. Instead, they might just be exercising their democratic right to protest against a particular decision or rule that they feel to be unjust. In such a situation, resisters may be able to provide valuable feedback for tax administrations about the operations of their tax system.<sup>27</sup> These factors therefore need to be considered when deciding upon an appropriate enforcement strategy.

The right-hand side of the Compliance Model represents the different strategies of regulation that can be used when dealing with taxpayers. The concepts presented here were inspired by the work of Ayres and Braithwaite.<sup>28</sup> At the base of the pyramid, the activities are persuasive and focused on self-regulation. In other words, responsibility is

<sup>23</sup> Braithwaite, *op. cit.* n.17.

<sup>24</sup> Ayres & Braithwaite, *op. cit.* n.2 at 30.

<sup>25</sup> Braithwaite, *op. cit.* n.17.

<sup>26</sup> See K. Murphy, "Procedural Justice and the Australian Taxation Office: A Study of Scheme Investors" *Centre for Tax System Integrity Working Paper No.35* (The Australian National University, Canberra, 2002); K. Murphy, "An Examination of Taxpayers' Attitudes Towards the Australian Tax System: Findings from a Survey of Tax Scheme Investors" (2003a) *Australian Tax Forum* 18(2), 209–242; K. Murphy "Procedural Justice and Tax Compliance" (2003b) *Australian Journal of Social Issues* 38(3), 379–408; K. Murphy & K. Byng, "Preliminary Findings from 'The Australian Tax System Survey of Tax Scheme Investors'" *Centre for Tax System Integrity Working Paper No.40* (The Australian National University, Canberra, 2002).

<sup>27</sup> For a more detailed discussion of this see Braithwaite, *op. cit.* n.17.

<sup>28</sup> Ayres & Braithwaite, *op. cit.* n.2.

given to the taxpayer to regulate their personal tax compliance behaviour. For self-regulation to occur, the tax authority needs to make things simple for the taxpayer, *e.g.* educate them and make information easily accessible. According to the ATO, its preferred approach is to develop and apply strategies that encourage self regulation, or voluntary compliance, emphasising co-operation and the building of relationships. At the next level, sanctions increase and self-regulation may need to be enforced. Here, taxpayers may need assistance to comply. Strategies the ATO can use to gain compliance here would include sending out reminder letters, conducting real time reviews, or providing information. Small fines could be required to persuade people to comply.

Further up the right-hand side of the pyramid, the style of engagement becomes progressively more punitive and has more of a command and control quality. At the command regulation with discretion level, the ATO would advise taxpayers of top-end sanctions they may face if they continue to resist the ATO's attempts at encouraging compliance. Strategies that may be used here would be to conduct audits, to impose penalties, or to initiate enforceable undertakings.<sup>29</sup> At this level of enforcement, there would still be discretion in the actions that the ATO undertook against a taxpayer.

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

The arrows in the Compliance Model represent the desirability of the ATO to apply strategies that encourage a downward movement of taxpayers from resistance to the preferred level of self-regulation.<sup>30</sup> The beauty of the model, however, is that it also allows the ATO to move to stronger enforcement methods if and when resistance is met. The added advantage of an enforcement pyramid such as this is that sanctioning options can be *tailored* to a particular industry or individual as in the case of large businesses.<sup>31</sup>

When the ATO commences a regulatory conversation, their understanding of the taxpayers' environment and attitude to compliance leads to a dialogue on the appropriate mix of persuasion and sanctions required to maintain an acceptable state of compliance.<sup>32</sup> When required, a sticks-and-carrots' approach that allows for "a short period of 'stick' followed by a longer 'carrot' period of reintegration" can be initiated to manage the compliance of a taxpayer.<sup>33</sup> If successful this managed position will cause a behavioural change and improved attitudes towards future compliance.

## Part 2: Stories of success with the ATO Compliance Model

The previous section briefly described the reasons behind why the ATO introduced their Compliance Model in 1998, and it discussed how the Model was developed. But has the ATO Compliance Model been successful and has it been a good policy decision to

<sup>29</sup> An enforceable undertaking is an undertaking given to a regulator that is enforceable in a court. They are generally accepted by the regulator as an alternative to civil or administrative action where there has been a contravention of the legislation they administer.

<sup>30</sup> Cash Economy Task Force, *op. cit.* n.1.

<sup>31</sup> J. Braithwaite, "Large Business and the Compliance Model" in V. Braithwaite ed, *op. cit.* n.6 at 177–202.

<sup>32</sup> J. Black, "Regulatory Conversations" (2002) *Journal of Law and Society* 29(1), 163–196.

<sup>33</sup> Ayres & Braithwaite, *op. cit.* n.2 at 43.



introduce a model of responsive regulation into such a large regulatory organisation? Two and a half years after the Compliance Model was introduced into the ATO's everyday compliance strategies, researchers from the Centre for Tax System Integrity at The Australian National University (ANU) conducted a series of in-depth interviews with 25 senior tax officers from within the ATO. The main objectives of the interviews were to gain information about how the Compliance Model was being accepted into the organisation, and to gain information about some of the success stories that the ATO had achieved when using the Compliance Model.<sup>34</sup> While a formal evaluation of the Model's effectiveness has still to be conducted, anecdotal evidence from these interviews indicates that the Model has proved to be successful in affecting taxpayer attitudes and behaviour. This section of the article documents just a few of the ATO success stories that were raised in the interviews.<sup>35</sup>

*Case Study 1: Small family-operated business*

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

*Case Study 2: Building and construction industry*

“We visited businesses and talked to them and we were just there, doing some examinations of their current records and things like giving them advice, and where

<sup>34</sup> The author was one of the interviewers involved in the research. While these interviews have not been published in their entirety, for readers interested in hearing more about what was said in the interviews see Hobson, *op. cit.* n.11.

<sup>35</sup> In preparing this paper for publication, I made a number of enquiries with the Inland Revenue in the UK to ascertain the level of commitment to their Compliance Model. I was told that at this point in time, rather than being implemented externally on taxpayer groups, the UK Compliance Model was used internally within Inland Revenue in training sessions and in presentations and had a significant life as an educational tool to promote cultural change within the organisation.

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

*Case Study 3: Restaurant and café industry*

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

*Case Study 4: Filing behaviour*

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

These case studies provide just some examples that were raised by senior managers within the ATO in their interviews with Australian National University researchers. They show that the principles underlying responsive regulation can be introduced and implemented effectively into a large regulatory organisation such as the ATO, and they show that the move away from a regulatory approach that relies on threat and legal coercion can still be effective in gaining voluntary compliance. For those interested in learning more about the concept of responsive regulation, the following section goes on to discuss the theoretical principles underpinning the Compliance Model.

### **Part 3: Theoretical background to responsive regulation and the Compliance Model**

A long-standing debate in the regulatory literature has been between those who think that

individuals and firms will comply with rules and regulations only when confronted with harsh sanctions and penalties, and those who believe that gentle persuasion and co-operation works in securing compliance with the law.<sup>36</sup> These two alternate approaches to regulation have been termed the “deterrence” and “accommodative” models of regulation. As will be discussed shortly, responsive regulation combines the best of both approaches.

For those advocating a purely deterrence view, individuals and firms are seen to be “rational actors” who are motivated entirely by profit seeking. They carefully assess opportunities and risks, and disobey the law when the anticipated fine and probability of being caught are small in relation to the profits to be made through non-compliance.<sup>37</sup> Advocates of this view therefore believe that harsh sanctions and penalties should be used to ensure compliance.

The deterrence model of enforcement has been criticised on a number of dimensions. One criticism has been that it does not satisfactorily explain the high levels of voluntary compliance observed in many situations. If people were simply rational actors motivated purely by self-interest, one would expect that compliance with rules and regulations would be significantly lower than what has currently been observed. Take, for example, the issue of tax compliance in Australia. The tax system in Australia is based largely on self-assessment and voluntary compliance by taxpayers. The probability of receiving an audit from the ATO is low. The chance of being caught avoiding tax is also, on the balance of probabilities, unlikely, and if a taxpayer is caught, the culpability penalties are relatively minor when compared to the potential for economic gain. Yet the majority of Australian taxpayers still comply with their obligations and pay their taxes with good will.<sup>38</sup> This is much like the situation in countries such as the United Kingdom or the United States.<sup>39</sup>

In the 1980s, therefore, many researchers began to question the value of deterrence in regulating behaviour. Regulatory scholars began to focus their attention on researching compliance rather than deterrence and began to realise the importance of persuasion and co-operation as a regulatory tool for gaining compliance. Many regulatory agencies followed suit by adopting accommodative models of regulation.<sup>40</sup> Regulatory agencies advocating the accommodative model of regulatory enforcement tend to view business firms and individuals not as “rational actors” but as “social actors” who are ordinarily inclined to comply with the law, partly because of belief in the rule of law, and partly as a matter of long-term self-interest.<sup>41</sup> Regulatory agencies adopting the accommodative model tend to be more oriented toward seeking results through co-operation rather than by coercion, and prefer to see themselves as consultants rather than as strict law enforcers. These agencies are more likely to give second chances, they give advice about how to comply, and may agree to ignore one violation in return for a correction to another violation.

<sup>36</sup> See Ayres & Braithwaite, *op. cit.* n.2.

<sup>37</sup> For a discussion see R.A. Kagan & J.T. Scholz, “The Criminology of the Corporation and Regulatory Enforcement Strategies” in *Enforcing Regulation* (K. Hawkins & J.M. Thomas eds, Kluwer-Nijhoff Publishing, Boston, 1984).

<sup>38</sup> V. Braithwaite, *op.cit.* n.17.

<sup>39</sup> K.W. Smith & K.A. Kinsey, “Understanding Taxpayer Behaviour: A Conceptual Framework with Implications for Research” (1987) *Law and Society Review* 12(4), 640–663.

<sup>40</sup> P. Grabosky & J. Braithwaite, *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies* (Oxford University Press, Melbourne, 1986).

<sup>41</sup> Kagan & Scholz, *op. cit.* n.37.

*The pros and cons of punishment and persuasion*

Both the deterrence and accommodative approaches to regulatory enforcement have their advantages. It should be noted, however, that each approach also has major disadvantages if regulators choose to adopt one exclusively over the other. Specifically, it has been shown that the problem of a mostly punitive policy is that it fosters resistance to regulation and may produce a culture that facilitates the sharing of knowledge about methods of legal resistance and counterattack.<sup>42</sup> For example, when a taxpayer with good compliance records inadvertently violates tax laws because the rules are complex or ambiguous, they are likely to regard punishment by the tax authority as unreasonable and unfair. If regulators adopt a purely punitive method of regulating, whereby they assume that individuals are solely self-interested and motivated by money, this may be perceived as unreasonable and will dissipate the will of well-intentioned individuals to comply, leading to potential resistance to the law.<sup>43</sup> In addition to the negative psychological effect of deterrence, punishment is often very time consuming and therefore very expensive.

Arguments usually put in favour of adopting an accommodative (or responsive) approach, are that it involves an efficient use of resources. If persuasion works, both sides avoid expensive enforcement and litigation procedures and more resources will be left to expand regulatory coverage. While research on the effectiveness of the accommodative approach is only in its infancy, there is growing evidence to suggest that co-operation with regulated entities increases compliance.<sup>44</sup> For example, support for a regulatory enforcement model based on co-operation and trust comes from examining the ATO's recent approach with 42,000 taxpayers who were accused of being involved in tax avoidance schemes.<sup>45</sup> After realising that their traditional deterrence approach for dealing with non-compliant taxpayers was not working, *i.e.* more than 50 per cent of taxpayers refused to pay back their taxes, the ATO decided to take on a more co-operative approach by first acknowledging that the taxpayers involved had been the victims of aggressive marketing and bad advice (thus, trust in investors' honesty was brought to the foreground). Secondly, those that had been the victims of aggressive marketing and bad advice were given a concession on their scheme-related tax debts. This concession came in the form of a settlement offer, whereby culpability penalties and interest on scheme-related debts were abolished. After four years of active resistance, this strategy resulted in the ATO receiving a flood of settlement acceptances, with 87 per cent of all scheme investors finally agreeing to settle their debts with the ATO.<sup>46</sup>

<sup>42</sup> E. Bardach & R. Kagan, *Going by the Book: The Problem of Regulatory Unreasonableness* (Temple University Press, Philadelphia, 1982).

<sup>43</sup> See for example, K. Murphy, "The Role of Trust in Nurturing Compliance: A Study of Accused Tax Avoiders" (2004) *Law and Human Behavior* 28(2), 187–209.

<sup>44</sup> J. Braithwaite & T. Makkai, "Trust and Compliance" (1994) *Policing and Society* 4, 1–12; J.T. Scholz, "Cooperative Regulatory Enforcement and the Politics of Administrative Effectiveness" (1991) *American Political Science Review* 85, 115–136. For similar findings see also L. Feld & B. Frey, "Trust Breeds Trust: How Taxpayers are Treated" *Centre for Tax System Integrity Working Paper No.32* (The Australian National University, Canberra, 2002); B. Fisse & J. Braithwaite, *Corporations, Crime and Accountability* (Cambridge University Press, Cambridge, 1993); B.S. Frey, *Not Just for the Money. An Economic Theory of Personal Motivation* (Edward Elgar Publishing, Cheltenham, UK, 1997).

<sup>45</sup> Murphy, *op. cit.* n.43.

<sup>46</sup> Commissioner of Taxation, *The Australian Taxation Office Annual Report 2002–2003* (Canberra, Commonwealth of Australia, 2003). For more on this case study see Murphy (2002), *op. cit.* n.26; Murphy & Byng (2002), *op. cit.* n.26.

It is acknowledged, however, that adopting a *purely* accommodative model of regulation, which basically views all individuals as good and honest, would be naïve. This regulatory style fails to recognise that there are individuals who are not so honest and who will take advantage of being presumed to be so. For example, one study conducted in Canada found that the same companies continued to violate health and safety regulations, despite being given lenient treatment.<sup>47</sup> It was found that repeat violations accounted for 31 per cent of the approximately 200,000 violations recorded between 1984 and 1986. Yet, regulators seldom imposed penalties on employers with repeat violations. In another study, Harrison compared compliance rates between pulp and paper industries in Canada and the United States and found lower compliance rates in Canada.<sup>48</sup> Harrison attributed this finding to the fact that Canadian enforcers tend to be more lenient than their American neighbours when addressing non-compliance.

Hence, a regulatory enforcement strategy based solely on accommodation does not appear to work, nor does one based solely on deterrence. The following section describes the responsive regulatory approach to enforcing compliance. This approach allows regulators to “speak softly, while carrying very big sticks”<sup>49</sup>; that is, to be legalistic in some cases but accommodative and helpful in others. In other words it is an approach that seeks to establish a synergy between deterrence and accommodation.

#### *Moving forward: Responsive regulation*

In his book *To Punish or Persuade: Enforcement of Coal Mine Safety*, John Braithwaite argued that sound regulatory enforcement could not be developed unless regulators understood the fact that sometimes those being regulated were motivated solely by making money and sometimes they were motivated by a sense of social responsibility.<sup>50</sup> In other words, it is possible that an individual or firm may be a responsible citizen and social actor today but a rational actor calculating costs and benefits next month. Braithwaite therefore rejected a regulatory strategy based totally on persuasion or a regulatory strategy based totally on punishment. He proposed a convergence of the two approaches. This new theoretical approach to regulation is known most widely as *responsive regulation*, and it is now being recognised that regulatory agencies that do best at achieving their goals are those that strike some sort of sophisticated and dynamic balance between the deterrence and accommodative models of regulation.

The basic contention of Braithwaite’s theory of responsive regulation is not whether to punish or persuade, but *when* to punish and *when* to persuade.<sup>51</sup> Along with Ian Ayres, John Braithwaite clearly envisaged the possibility of stylistic choices within an agency, as staff encounter differing motivations among industries and individuals. Ayres and Braithwaite further suggested that regulatory officers should be prepared to shift from strict regulators to educators and back again according to their analysis of a particular

<sup>47</sup> R. Brown, “Theory and Practice of Regulatory Enforcement: Occupational Health and Safety Regulation in British Columbia” (1994) *Law and Policy* 16, 63–71.

<sup>48</sup> Harrison (1995), cited in S.A. Shapiro & R.S. Rabinowitz, “Punishment Versus Cooperation in Regulatory Enforcement: A Case Study of OSHA” (1997) *Administrative Law Review* 49(3), 713–762.

<sup>49</sup> Ayres & Braithwaite, *op. cit.* n.2, at 40.

<sup>50</sup> J. Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (State University of New York Press, Albany, 1985). See also Kagan & Scholz, *op. cit.* n.37.

<sup>51</sup> Ayres & Braithwaite, *op. cit.* n.2.

case.<sup>52</sup> They also suggested that this flexibility in regulatory style could be adopted through the use of an enforcement pyramid of regulation.

### *The Regulatory Pyramid*

One version of regulatory responsiveness involves the use of a hierarchy of graduated responses to non-compliance (as is used in the ATO's Compliance Model). John Braithwaite was the first to argue that compliance is most likely when an agency displays an explicit enforcement pyramid.<sup>53</sup> According to Braithwaite, "defection from co-operation is likely to be a less attractive proposition for business when it faces a regulator with an enforcement pyramid than when confronted with a regulator having only one deterrence option".<sup>54</sup> As can be seen in Figure 2, an enforcement pyramid consists of a number of layers, each layer representing a different enforcement activity a regulator could use to gain compliance from a regulated firm. As one escalates up the pyramid in Figure 2, the regulatory strategy changes from persuasion at the bottom through sanctions of increasing severity to licence revocation at the top. Ayres and Braithwaite (1992) suggest that a pyramid such as this should be used in conjunction with a "tit-for-tat" strategy.<sup>55</sup> If the firm or individual being regulated is being cooperative, the regulator should respond in turn by being cooperative. If the regulated firm or individual is being uncooperative, the regulator should escalate up the pyramid through a range of compliance options that eventually lead to harsh sanctions. Thus, an enforcement pyramid such as this subjects regulatees to escalating forms of regulatory intervention if they continually refuse to respond to regulatory demands. Clear communication in advance that a regulator is willing to escalate their enforcement strategies up the pyramid in response to uncooperativeness also gives incentives to those being regulated to comply with their demands. It is also important that regulators follow through with this enforcement action if it has been threatened, otherwise they may risk undermining the integrity of the system.

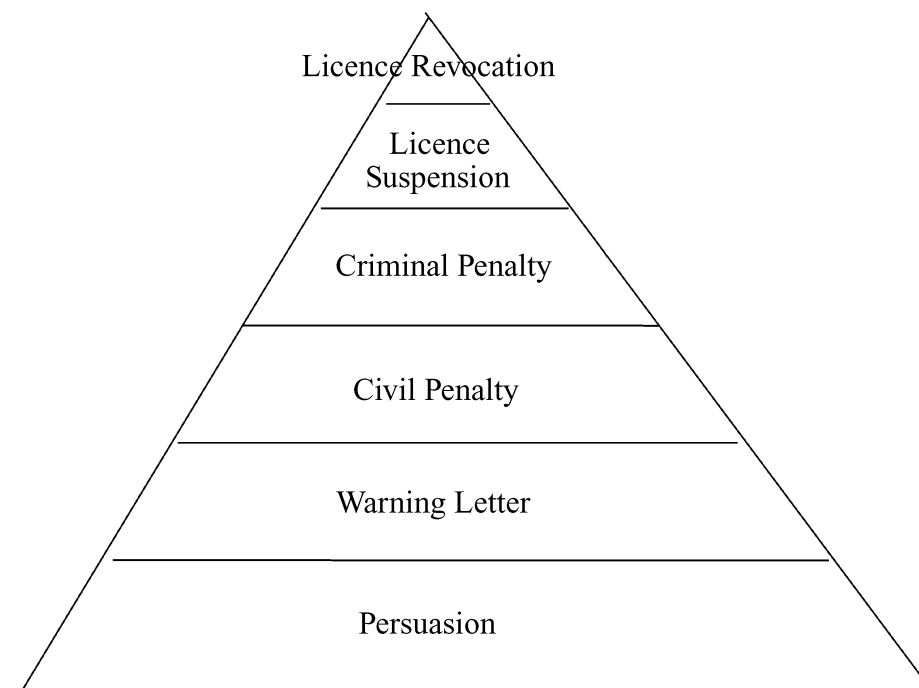
<sup>52</sup> See also Black, *op. cit.* n.13; Kagan & Scholz, *op. cit.* n.37.

<sup>53</sup> J. Braithwaite, *op. cit.* n.50

<sup>54</sup> Ayres & Braithwaite, *op. cit.* n.2 at 37.

<sup>55</sup> Ayres & Braithwaite, *op. cit.* n.2; see also J.T. Scholz, "Deterrence, Cooperation and the Ecology of Regulatory Enforcement" (1984a) *Law and Society Review* 18, 179-224; J.T. Scholz, "Voluntary Compliance and Regulatory Policy" (1984b) *Law and Policy* 6, 385-404.

Figure 2: Ayres and Braithwaite's enforcement pyramid<sup>56</sup>



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

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

<sup>56</sup> Source: Ayres & Braithwaite, *op. cit.* n.2 at 35.

According to Ayres and Braithwaite, persuasion should be the strategy of first choice because preserving the perception of fairness is important to nurturing voluntary compliance.<sup>57</sup> This is because research has found that people are most likely to challenge a situation collectively when they believe that the procedures are unfair and that they personally suffered because of the injustice.<sup>58</sup> This is not to say that there is no place for punishment. While Ayres and Braithwaite argue that persuasion should be the strategy of first choice, they also suggest that if a regulated firm or individual continues to be non-compliant, the regulatory authority should increase the severity of the regulatory response accordingly. In fact, “regulators should always retain the capacity to apply tough sanctions, because a strategy based entirely on persuasion and self-regulation will be exploited when actors are motivated by economic rationality”.<sup>59</sup> If regulatory agencies fail to punish rule breakers, others will start to question their own compliance. In her examination of tax enforcement, for example, Margaret Levi stresses that active prosecution of violators is crucial because perceptions of “exploitation” will encourage non-compliance in other taxpayers.<sup>60</sup> However, regulators should not lose sight that a portrayal of toughness should also be balanced with a respectful and co-operative approach in the first instance.

Finally, Ayres and Braithwaite argue that the greater the heights of tough enforcement to which an agency can escalate (at the apex of the enforcement pyramid), the more effective the agency will be at securing compliance and the less likely that it will have to resort to tough enforcement. “Regulatory agencies will be able to speak more softly when they are perceived as carrying big sticks”.<sup>61</sup>

For example, consider the enforcement pyramid presented in Figure 3a. Here, it can be seen that the heights to which the regulatory agency can escalate its enforcement strategies are rather limited. There are not enough options for dealing with different types of non-compliers. In this situation, a regulator may have someone who has continuously violated regulations receiving the same sanction as someone who may have inadvertently violated a law for the first time. In the case of the pyramid in Figure 3b, however, the heights to which the regulatory agency can escalate its enforcement strategies are quite varied. In the case of the first time offender, a slap on the wrist might be considered more appropriate than revoking their operating licence. In the case of the repeat offender, however, previous attempts to bring them into compliance have obviously failed and it would seem prudent in this situation—once the facts of their case have been determined—to take more serious action against them (because after all, they have been given several chances before).

<sup>57</sup> See also Murphy (2002; 2003a; 2003b), *op. cit.* n.26; T.R. Tyler, *Why People Obey the Law* (Yale University, New Haven, CT, 1990); T.R. Tyler & E.A. Lind, “A Relational Model of Authority in Groups” in, *Advances in Experimental Social Psychology Vol. 25* (M. Zanna ed, Academic Press, New York, 1992).

<sup>58</sup> Murphy (2002; 2003b), *op. cit.* n.26; Murphy (2004), *op. cit.* n.43; T.R. Tyler & H.J. Smith, “Social Justice and Social Movements” in *The Handbook of Social Psychology Vol II*. (D.G. Gilbert, S.T. Fiske & G. Lindzey eds, 4th ed, Oxford University Press, New York, 1998).

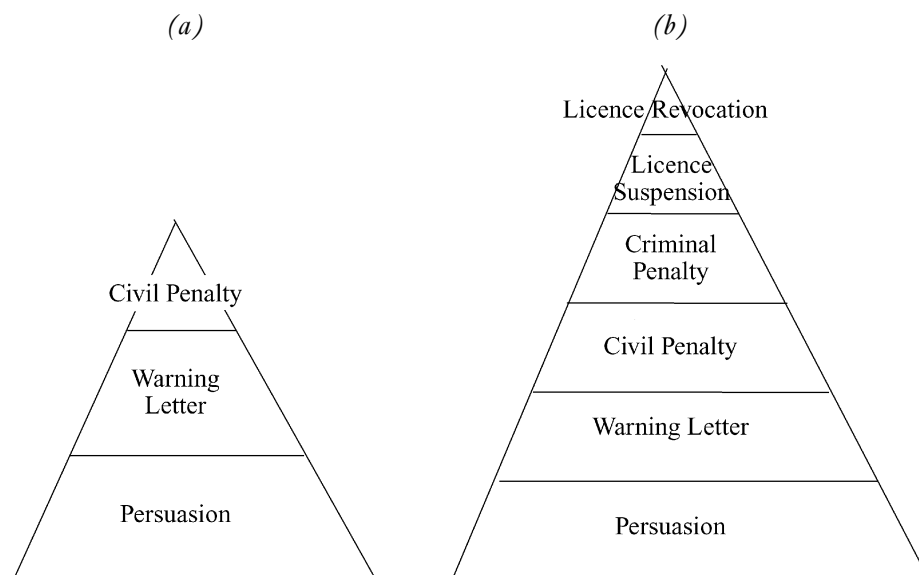
<sup>59</sup> M. Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems and Managing Compliance* (Brookings Institution Press, Washington, D.C., 2000) at 40.

<sup>60</sup> M. Levi, *Of Rule and Revenue* (University of California Press, Berkeley, 1988).

<sup>61</sup> Ayres & Braithwaite, *op. cit.* n.2 at 6.



Figure 3. Regulatory enforcement pyramids that (a) provide regulators with a limited range of regulatory responses and (b) provide regulators with a range of regulatory responses to choose from<sup>62</sup>



Thus, the advantage of having a range of sanctions is that the regulator can pick and choose a strategy they think is most appropriate given the circumstances. In addition, in the case of the enforcement pyramid in Figure 3b, the more punitive the sanction at the apex of the pyramid, the more likely an individual or firm will think the regulator is someone who should be listened to and co-operated with.

So in summary, responsive regulation is a mix between the accommodative and deterrence models of enforcement. It has been suggested that one way to use responsive regulation effectively is to use an enforcement pyramid whereby the regulator can start with persuasion and escalate up the pyramid, skipping levels if necessary, if co-operation is not forthcoming. Finally, the advantage of using an enforcement pyramid such as this is that it offers regulators a range of sanctions to choose from; it allows them to match the persuasive or sanctioning strategy to the level of observed non-compliance.

## Conclusion

In conclusion, the ATO Compliance Model has now been in operation within the ATO since 1998. The present article has provided an overview of the principles and concepts underlying the Model, has provided a detailed description of how the Model was constructed by the ATO for use in the area of taxation administration, and has discussed a number of success stories that have been achieved as a result of the Compliance Model's use. While it is unclear at this stage whether the ATO has had overwhelming success with the Model in bringing about *long-term* compliance among those they regulate, the case studies discussed earlier, along with findings presented in other papers,<sup>63</sup> appear to be

<sup>62</sup> Taken and adapted from Ayres & Braithwaite *op. cit.* n.2 at 41.

<sup>63</sup> Hobson, *op. cit.* n.11; Job & Honaker, *op. cit.* n.6; Shover, Job & Carroll, *op. cit.* n.11.

encouraging. From these reports, therefore, it appears that the ATO has made a good policy decision by introducing a style of regulation that is responsive to the needs of both taxpayers and tax officials. As one ATO executive said in his interview, “I just think that it’s a good tool for us to use really”.