

## Chapter 13

# Tax System Integrity and Compliance: The Democratic Management of the Tax System

Valerie Braithwaite<sup>1</sup>

This book analyses taxpaying and tax collecting from a relational perspective. Together the chapters provide insight into how each side in this relationship perceives the other, what each expects and what each gives at a time when the tax authority is moving from a command and control mode of operation to one that is more responsive to the environment in which it must operate. The focus has been on compliance, that is, the extent to which taxpayers do what is expected of them and are prepared to cooperate with the authority. But if taxpayers offer compliance, what does the tax authority offer in return?

The usual answer to this question is government services. While not underestimating their importance, this representation of the obligations on the other side of the contractual arrangement risks narrowing our sensibilities to things that we can buy, in theory, in the market place. Governments supply much more than this:

Somewhat ironically, the continued ability of citizens to act collectively in pursuing their common social and economic goals through democratically elected governments might rest with the ability of tax departments to meet the challenges to tax compliance posed by the disappearing taxpayer. That is to say, what is at stake in the challenge of tax compliance is not just tax revenues, it is democracy itself (Brooks, 1998, p. 33).

Governments are the guardians of democracy, the repository of collective conscience and wisdom for how the democracy should grow, and the decision makers on how the democracy will adapt to the rapid social and technological change accompanying globalisation. In return for taxes, taxpayers should not only receive goods and services, but also sound governance that is respectful and protective of democratic principles and processes.

The capacity of a government to deliver this outcome is referred to here as integrity. If taxpayers offer compliance, the tax office, as part of government, should reciprocate with integrity. This concluding chapter examines the interplay of compliance and integrity in the taxation context. In the first two sections, working definitions of integrity and compliance are developed. Next, the relationship between compliance and integrity is explored under conditions where

efforts are made to take on board the perspective of citizens and under conditions where such considerations are marginalised. The argument developed is that integrity and compliance are most likely to be optimised when a tax authority pursues a citizen-inclusive approach to compliance through policies that encourage dialogue and persuasion, combined with an effective mix of incentives and sanctions. Integrity and compliance are most at risk of parting ways when a tax authority seeks to improve compliance solely through making changes to the administrative or legal infrastructure without regard to the sensibilities of citizens. Finally, the chapter offers some preliminary principles to guide the process of tax reform in a way that puts compliance and integrity at minimal risk. In so doing, recognition is given to the need to take account of the views of experts as well as citizens. In other words, a process of tax re-design must recognize the importance of engagement with the community's perspective,<sup>2</sup> as well as with expert advice from those who know the intricacies of tax law and legal proceedings, of data bases and storage systems, of auditing and enforcement practices, and of taxation's impact on government policy and the well-being of the democracy.

### **Defining Tax System Integrity**

In recent years, the concept of integrity has been extended from the individual to the collective level (Skidmore, 1995; Laufer, 1996). Organisations are said to display integrity when they demonstrate a capacity to engage in ethical decision-making. This capacity involves an awareness of the moral issues in play, an openness to grapple with their complexity, resolve to embed moral responsibilities within business plans, and the follow through to put morally responsible decisions into practice (see Petrick and Quinn, 2000). Nowhere is the tension between doing what is right and gaining the competitive edge more apparent than in the private sector where profits are the bottom line for success. A diminished capacity for integrity, however, is not unique to the private sector. Public sector organisations are not immune from the problem, although its expression takes a different form (Gregory, 1999; Denhardt and Denhardt, 2000).

A system operating within the public sector can be said to have integrity if it has unity and soundness of purpose, and if it has processes in place to reflect on and evolve that purpose in response to community needs. Unity infers neither singleness of purpose nor institutional simplicity. Instead, it conveys connectedness in that an organisation's many goals are pursued and its many processes are implemented with awareness of and responsiveness to each other. In sum, unity implies at least loose coordination among parts such that, through reasoning and reflectiveness, an operational story can be told as to how the parts combine to form a valuable and purposeful whole.

An absence of integrity on the unity criterion may occur when goals are pursued at lower levels of an organisation that are antithetical to the organisation's overarching goals. An example would be the introduction of a collection system for a specific kind of tax that jeopardised protection of the revenue overall. We might call this integrity strain of a vertical kind in that actions taken at lower levels

of the organisation are contrary to those expected at higher levels if the organisation's overarching goals are to be met. At other times, different functional groups at the same level in an organisation may fail to share information and may act in ways that undermine the capacity of the other to meet its objectives. Oversights of this kind describe a shortfall in integrity of a horizontal kind.

While unity conveys some overall coordination of effort, soundness conveys the moral appropriateness of the direction of effort. Within a democracy, the ultimate judge of the soundness of purpose of an institution should be the people. Integrity, in the sense of standing by goals and processes supported by the people, involves not only commitment to the system in its current form, but also commitment to revision of the system so that it can continue to serve those it represents. Service entails responsiveness to government in relation to policy, as well as listening to the community and 'helping citizens articulate and meet their shared interests' (Denhardt and Denhardt, 2000, p. 549).

Unity, soundness of purpose and responsiveness do not in and of themselves satisfactorily denote institutional integrity. Calhoun (1995) has observed that, at the level of the individual, integrity involves more than developing coherent well-reasoned positions on issues and standing by these commitments. Integrity, so conceived, can be deemed self-indulgent. The extra element that needs to be considered to sharpen this analysis of integrity is a social dimension. Integrity requires a person not only 'to stand by' a position, but also 'to stand for' that position when faced with others whose deliberations may have led them to a different outcome (Calhoun, 1995).

When extrapolated to the level of the collective, high integrity involves institutional engagement. But institutions cannot engage: That task must fall to the leadership ranks of the organisation. In the public sector, those with leadership responsibilities demonstrate the integrity of their organisation through communicating to government and the community what they stand for and why it is important. The often-cited public service phrase, 'to give frank and fearless advice to government',<sup>3</sup> exemplifies this aspect of integrity. The institution will fall short on integrity when '[s]ocial circumstances...erect powerful deterrents to speaking and acting on one's own best judgment' and thereby 'undermine the possibilities for deliberating about what is worth doing' (Calhoun, 1995, p. 259). Calhoun hastens to add that while integrity involves having a proper regard for one's own judgment, it should not be conceived as 'just a matter of sticking to one's guns' (p. 259). 'Arrogance', 'bullying', 'defensiveness', 'incivility', 'close-mindedness', and 'deafness to criticism' are not qualities normally associated with integrity. Acknowledging that others 'must themselves abide by their best judgment seems part of, not exterior to, acting with integrity' (p. 260). Integrity, therefore, can pull members of the collective in different directions,<sup>4</sup> creating a diversity of positions and tensions when these differences surface. Consequently, integrity does not imply orderliness in thought and action. On the contrary, it is a concept that reflects capacity to navigate through messiness, showing leadership, while allowing diverse opinions to be expressed, frankly and fearlessly, under an umbrella of an overarching shared purpose, derived through deliberation with citizens.

When this concept of integrity is applied to a tax system, the question arises as to the level at which the analysis should proceed. Should integrity be applied in a more focused way as to how taxpaying records are compiled and used for high wealth individuals, or to the way in which the law is written in relation to business taxation, or to the enforcement practices used by tax office auditors? An analysis of integrity can be undertaken in any of these domains. For the purposes of this chapter, integrity will be discussed at a broader level with reference to the overarching objectives and principles that govern the operation of the tax office.

The purpose of the Australian Taxation Office (ATO) is 'to shape and manage systems which support and fund services for Australians, giving effect to social and economic policy' (Australian Taxation Office, 2000a, p. 2). Associated with this purpose are five guiding principles: (a) to act with integrity; (b) to anticipate, identify and manage issues in real-time; (c) to be open and accountable with each other and clients; (d) to offer solutions that are in the community interest, while matching the individual circumstances of clients; and (e) to meet internal and external obligations (Australian Taxation Office, 2000a, p. 2). To effect these principles, the ATO has 12 standards expressed in the Taxpayers' Charter to guide tax officers in their dealings with taxpayers in the course of administering the tax system (Australian Taxation Office, 1997): Taxpayers are to be treated fairly and reasonably, to have their privacy respected, to be treated as honest in their tax affairs unless the taxpayer acts otherwise, to have decisions explained to them, to be offered assistance, advice, and information in a professional way, and to be helped to minimize their costs in complying with tax law.

Even at the level of general principles and codes of conduct, tensions arise. For example, is maximizing revenue collected 'to support and fund services for Australians' compatible with abiding by the Charter so as to 'be open and accountable'? In theory, the answer is yes, but field staff sometimes appear to be less sure (see Job and Honaker, Chapter 6, this volume). The tension can be illustrated through the following questions: Are authoritarian tactics justified in cases where tax officers are chasing down taxpayers who are evading their tax? Or to put it another way: Are Charter consistent tactics costly for a tax office and the public when dealing with unscrupulous tax evaders?

In order to ease these challenges to system integrity, the ATO adopted their Compliance Model (see Braithwaite, Chapter 1, this volume for a full description). Persuasion and education are the preferred methods for eliciting compliance and are assumed to be the most appropriate starting point for dealing with non-compliance in the absence of information that the wrongdoing is deliberate and likely to be repeated. In this way, the intentions behind the Taxpayers' Charter are put into practice. While education and persuasion denote the preferred starting point, tax officers and taxpayers know of a range of sanctioning options that can be and will be brought into play should taxpayers fail to cooperate. Consistent with the Charter and in keeping with the ATO's obligation to protect the revenue, the Compliance Model puts taxpayers on notice that tax officers will systematically increase the costs of non-compliance, while always holding the door open for a more responsive and cooperative relationship. In this way, the Compliance Model

guides the ATO toward using its full enforcement capacity only when taxpayers have clearly or repeatedly signalled unwillingness to cooperate.

At the level of principles and codes of practice, the integrity story within the ATO is quite impressive. But action does not flow directly from these principles and codes. There is another plank that is necessary to define the way in which tax officers and taxpayers should interact in pursuit of the ultimate goal of supporting the Australian democracy, tax law. Tax law provides the rules that determine taxpayer obligations and the enforcement capabilities of tax officers. In most areas of this large body of law, it is difficult to find principles or guidelines that provide a meaningful template for making sense of these rules, and linking them to the other components of the system (Braithwaite, 2002). Furthermore, there is no evidence of a shared understanding between citizens and their elected representatives about how and why these rules evolve as they do (Ralph Report, 1999). In addition to the rules derived from tax law and ATO rulings, there are rules entrenched in the administrative system that define the work roles of staff, the reward structures of the organisation, record keeping and data storage capacities, and the reasons for and methods of communicating with taxpayers. Communication revolves around an elaborate system of automatically generated letters to taxpayers to inform them of their obligations, to query their actions, to deliver refunds and payments, to communicate failure to comply, and to impose penalties, all of which have an institutional history of their own.

These legal and administrative rules, some formal and some informal, are the centrepiece of operations for the Australian Taxation Office, and for the most part predate overarching objectives, the Taxpayers' Charter and the ATO Compliance Model. One might postulate that in a large bureaucracy, such as a tax authority, practices are more likely to flow from the institutionalised formal and informal rules, and less likely to flow from semi-detached blue prints introduced relatively recently in the history of the organisation to give it greater legitimacy in the eyes of the public. This means that the main challenge for a tax authority seeking institutional integrity is to convert democratically responsive principles of action into concrete operations and routines in the day-to-day practices of tax officers. This is the same challenge faced by corporations seeking regulatory integrity through turning their regulatory blueprints into meaningful practices (Parker, 2002). One of the central propositions of this chapter is that just as regulators look for substantive compliance in the actions of those they regulate, citizens look for substantive integrity in the authorities that seek to direct their actions.

The integrity that taxpayers observe in the tax system and its administration may not be the same as the integrity that tax officers see from within. When integrity is perceived to exist in the system by tax officials and those who are experts in its operation, it may be claimed that the system has passed the test of internal integrity. In the eyes of those who know the system well, the components are connected in such a way that high performance in one part enhances, or at least does not detract from performance in other parts, the overall purpose is sound, and the organisation is responsive, able to evolve to meet community needs. A system that is supported by a democracy, however, has to be accountable to the electorate. External integrity is, therefore, equally important and involves an additional level

of scrutiny. Citizens must be able to observe integrity in the way in which the tax system is designed and operates, and in the way in which the tax authority deals with citizens and other branches of government.

Whether the perspective is internal or external, finding holes in the integrity of a complex system is always going to be relatively easy. Furthermore, to conceive of social systems without a good proportion of messiness is unrealistic and undesirable if any kind of innovation or social change is to occur. Thus, integrity should not be reduced to a score out of 10 on a checklist. The key to assessing the integrity of an organisation does not lie in how problem free the organisation claims to be; but rather it lies in the organisation's capacity to acknowledge difficulties. Where integrity is present, the organisation should be able to demonstrate awareness of and deliberation about departures from the standard, and how the actions taken to improve the situation were in the interests of sound democratic governance.

With this in mind, the focal point for analysis in the remainder of this chapter will be one particular kind of strain on integrity in tax offices worldwide; that which occurs when overall integrity is pitted against compliance. This problem is likely to be particularly acute for all regulatory agencies where short-term gains threaten long-term interests. The pursuit of short-term gains puts citizens and authorities at loggerheads. For citizens, integrity is what is expected of an authority at all times. For tax authorities, on the other hand, the day-to-day business is ensuring citizen compliance. At the organisational coalface, as performance targets are being set for a workforce, compliance is more tightly bound to the tax authority's short-term interests than integrity. Integrity comes into focus when there is time to stand back and consider long-term interest. Integrity also increases in salience, relative to compliance, when a tax office's accountability is called into question, or when legitimacy is called into play to deal with change or failure in the system.

### **What Does it Mean to Comply?**

When direct requests are made of individuals, they may behave in accordance with the requests or not. In the first instance, we witness compliance, in the second, non-compliance (Deaux and Wrightsman, 1988). While the concept is an easy one to understand, it is not as easy to assess. Whether or not a person does what is asked of him or her is not always visible. Furthermore, whether or not a person interprets the request in accordance with its intent is sometimes far from certain.

These problems escalate when the requests for compliance are backed by law, or are made by authorities with the power to sanction compliance and non-compliance. Under such circumstances, non-compliance is far from being as uncomplicated as just saying 'no'. The line between compliance and coercion for an individual faced with a request from an authority with enforcement capacity becomes blurred. In such circumstances, individuals may have no choice but to meet the request, and if they do have choice, they are likely to have a vested interest in keeping their non-compliance out of the view of the authority. Whether

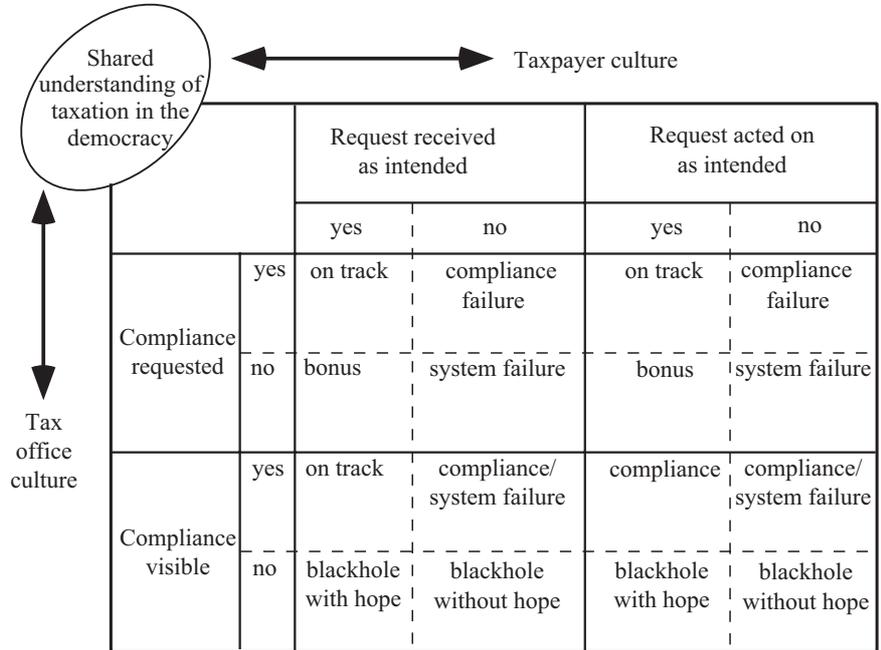
or not they acknowledge non-compliance to others or even themselves will depend on contextual and individual factors. The social process of finding justifications for non-compliance through searching for legal loopholes or proclaiming ignorance complicates the picture even further (see McBarnet, Chapter 11, this volume). Assessing, even defining compliance, slips further from reach.

Difficulties of this kind are common to all compliance research. In the domain of taxation, a third problem warrants serious consideration: Are individuals aware that a direct request to follow tax law has been made to them, and do they have sufficient legal literacy to understand the request? As the law becomes more and more complicated, and as taxpayers turn to tax agents to do their tax for them (77% of Australians use a tax agent (Australian Taxation Office, 2002)), questions can be raised justifiably as to whether or not individuals are aware of their tax obligations (Coleman and Freeman, 1997; Inglis, 2002). Thus, in the area of the payment of income tax by the ordinary taxpayer, we might ask, are the requests received by the taxpayer, is attention paid to such requests, and if so, are the requests understood and remembered for future reference?

This complexity in defining and assessing compliance is represented diagrammatically below. For the moment, let us put to one side the fact that an authority does not issue one request but many, and that there may be third parties such as tax agents who moderate the relationship. In spite of the fact that the elements of compliance that remain in Figure 13.1 represent a simplified regulator-regulatee exchange, the diagram serves the purpose of uncovering the changing face of compliance across a complex set of enmeshed institutions that comprise a tax authority. In the process, insight can be gained into how the pursuit of compliance outcomes in different parts of the organisation can instigate responses within the tax authority and within government that may erode the integrity of the tax system overall.

Figure 13.1 represents compliance outcomes from the perspective of the regulator and the perspective of the regulatee. Behind each perspective is a culture relating to tax collection and taxpaying. The degree to which these cultures are compatible reflects the quality of the dialogue that has taken place between government, tax authorities and citizens. These cultures can comfortably coexist, or they can be sites of serious conflict, depending on circumstances. Periods of social change and tax reform define occasions when dialogue about the tax system needs to take place in a way that is inclusive of all interest groups, not just those elites who appreciate the finer details of tax law and tax administration. At intervals, tax systems must be taken to the polity for discussion in accordance with the best practices of democratic deliberation.

At the coalface, however, issues of shared understanding about the purposes of the tax system are not at the forefront of anyone's thinking; the issue at stake is compliance – will she or will she not, is she or is she not complying with the law? From the perspective of the regulator or tax officer in Figure 13.1, a direct request for an action to be undertaken must be made to the regulatee or the



**Figure 13.1 Possible outcomes when tax office capacities are matched with taxpayer capacities**

taxpayer. Reasons for the non-occurrence of the request might be that the regulator did not make it clear what action was required (the request was too vague or complex) or the request did not reach the target (e.g., a letter was sent to the wrong address, or was not sent at all). The regulator, having made the request, then has an interest in knowing if the regulatee has complied. The required response, therefore, may be one that is visible to the regulator (the regulator can confirm that the correct amount of tax has been paid or that a return has been lodged) or not visible (the regulator cannot routinely check on whether action has been taken, as in declaring cash income).

From the perspective of the regulatee or the taxpayer, the compliance question can be subdivided into two components: (a) receiving the request and processing it cognitively as the regulator expects, and (b) acting upon the request in the way the regulator expects. Failure to receive the request as intended might occur if the taxpayer has inadvertently misinterpreted the request (e.g., misunderstanding the difference between franked and unfranked dividends), or if the regulatee gives the request meaning that undermines the intent of the regulator (e.g., playing for the grey in tax law). Similarly, a failure to act upon the request, as when a tax return is filled out incorrectly, may be due to misunderstanding or carelessness, or it may be a case of just ‘saying no’.

As we focus on each of the 16 cells in Figure 13.1, the many faces of compliance from an administrative perspective become apparent. If we look for the cells in which compliance is 'on track' or 'achieved', we find only four of the 16 possible outcomes meeting the criteria of success. The majority of the possible outcomes deviate from the classic case of compliance.

Taking the 'on track' or 'achieved' compliance outcomes first, it is helpful to ground the discussion by considering the types of tasks undertaken by a tax authority that come closest to meeting the specified criteria of a request being made and received as intended, and being visibly acted on as intended. One such example would be declaring bank interest on an income tax return. Data matching with bank records makes it possible for tax officers to keep a close eye on interest declaration for tax purposes. For the tax officer responsible for monitoring compliance of this kind, attention is likely to focus on detail, such as the integrity of the data bases used to match records and tweaking the system to catch those few who are slipping through the net. Compliance questions are likely to take the following form: Can detection rates be improved? Can data on non-compliance be matched with data of other kinds of non-compliance? Should the taxpayer be relied upon to self-report on tax matters and self-assess his/her tax contribution? It is equally valid to ask how reliable is the official data on non-compliance that is stored by the tax authority? What kind of auditing is necessary to ensure that the standards of compliance are maintained at high levels and that the community's standards match those expected by the tax authority? An equally relevant, but less often asked question for tax officers working with 'on track' or 'achieved' compliance, is how can the public be recognized for their cooperation?

Turning to the system failure cells, compliance now has less to do with assessment and more to do with engaging with the taxpayer. System failure occurs when the tax office has not made a direct request to the taxpayer concerning her obligations. In these cases, compliance means getting people to do something that they have not been doing 'naturally' either because it never entered their heads or because they chose not to do it. In addressing system failure, the focus of attention is likely to be on communication of the message. The clarity of the request, the educational apparatus supporting the request, and the political intent behind the message are important issues for consideration. Whenever questions are raised about system effectiveness, reasonable doubt also is raised over the extent to which a regulatee should be held responsible for non-compliance.

Compliance failure, on the other hand, is likely to be addressed in different ways from system failure. If the system appears to be working well from a communication perspective, non-compliance can be dealt with in either of two ways. One option is to listen to the community and understand the grounds of resistance so that changes can be made to policy and practice. As a result, compliance may be made easier for taxpayers, or the costs of non-compliance may be increased through greater surveillance and penalties. Another option is to change tack altogether. This option would not require taxpayers to understand the message. Technology may be used to engineer compliance that has not been forthcoming previously, and is represented in Figure 13.1 as 'bonus' compliance.

The ‘bonus’ cells are those in which an authority has its messages received and acted upon by a target without the authority having to make a direct request. Architectural strategies (Shearing and Stenning, 1985; Coglianese and Lazer, 2001) may be used by an authority to ensure compliance through making it not only the act of least resistance, but also the act that no longer requires a decision. For example, the provision of software that leads a taxpayer through a series of questions to estimate tax owing creates ‘bonus’ compliance for an authority in that various options for non-compliance are removed from consideration. This is not to deny the possibility of creative compliance while using the software package, but rather to recognize the non-compliance that is avoided through a process that generates compliance among taxpayers prepared to engage with a tax authority on ‘automatic pilot’. The key compliance questions in these circumstances are big picture questions concerning legitimacy: Will segments of the population take exception to the technological imposition of compliance and challenge the authority of the tax office as a result? Or is architecturally guided compliance seen as a time saving and security oriented device that serves everyone’s interests well?

Increasingly, tax officials are searching for ways of combining architectural regulatory strategies with ‘natural systems’ for ‘best practice’. For instance, computer software that has the primary purpose of helping a small business owner manage the business better may also produce information for tax purposes, together with instructions on how to compile these data to meet tax reporting requirements. Key questions emerging from this perspective include how ‘best practice’ is learnt, how requests from regulators can be re-phrased to reflect ‘best practice’, and how compliance costs can be reduced for both regulatees and regulators.

‘Bonus’ compliance is an outcome that in itself has many facets. Other strategies that can be used by a tax authority to cultivate the growth of ‘bonus’ compliance involve reliance on principle versus rule based law (Braithwaite, 2002), or support for professional codes of practice for tax agents and tax lawyers (National Review of Standards for the Tax Profession, 1994). In these circumstances, the application of principles and codes can frame cognitive processing, steering taxpayers and their agents away from risky schemes that are on the border of avoidance and evasion.

The remaining cells in Figure 13.1 are called ‘black holes’ because regulators cannot see what becomes of their requests for compliance. In these circumstances, what it means to comply is the single most important question asked by the regulator. Tax officers search for imperfect indicators that will cast light on whether or not a response has been made to the request, and the options must be evaluated in terms of their relative merits. These are the circumstances where tax officials rely on informants or third parties to report wrongdoing that comes to their attention, and scan data bases in their search for inconsistent patterns that may flag cases of concealed tax evasion.

Among the options to be considered by administrators who oversee compliance problems of this kind is transferring responsibility for monitoring compliance to another party, possibly even the regulatee. Under these circumstances, regulatees would be accountable to the regulator through having procedures in place to

regulate their own compliance, in other words, demonstrable self-regulation. In many complex areas of regulation, regulators require regulatees to outline their in-house strategies for managing risk instead of searching for compliance with externally imposed standards (Grabosky, 1995; Gunningham and Grabosky, 1998; Braithwaite and Williams, 2001).

Different facets of compliance – assessing compliance outcomes for accuracy, defining at least partially relevant outcomes where none are visible, evaluating the delivery of the request, understanding the ‘no’ response, and capitalising on ‘bonus’ compliance – are of interest across the tax office, but differ in their importance and relevance, depending on the nature of the request and the required response. Those with responsibility for the cash economy are likely to focus on ‘black holes’ and be drawn toward the re-design of the tax system to introduce greater transparency and accountability, and the co-option of other regulatory agencies to assist in monitoring and containment (Cash Economy Task Force, 1998). Tax officers dealing with large business might see playing for the grey as their major problem, an example of compliance failure that might be dealt with through developing better intelligence systems, targeting audits more effectively, and building capacity to elicit cooperative taxpaying behaviour (Braithwaite, Chapter 9, this volume). Wage and salary earners who invest in mass marketed tax avoidance schemes present another kind of challenge to a tax authority. Tax officers struggle with system and compliance failure tangled together so tightly that the way forward is uncertain (Senate Economics References Committee, 2001). The priorities are likely to involve tightening laws, building alliances with professional bodies, educating the public, and amending tax returns. Penalties in such circumstances become a regulatory tool that can have mixed results: A penalty indicates seriousness of an offence to the community, but in such circumstances penalties can create a backlash of cries of unfairness that might slow the process of reform (Hobson, 2002; Murphy, 2002a, 2002b). Ordinary taxpayers, on the other hand, who lodge their tax returns late, fail to declare income and over-claim deductions present the most straightforward compliance problem for tax administrators. It is not surprising that tax officers regard compliance in this context as a question of the taxpayer not showing due care; a problem that is most times dealt with through the application of appropriate penalties to impress upon taxpayers the need to give tax matters their most serious attention in the future.

The above discussion illustrates how understanding and improving compliance requires a tax authority to entertain multiple conceptions of compliance and to be able to change the frame of analysis for a compliance problem as attention moves from one area to another, that is, from personal income tax, to large corporate tax, to small business, to the cash economy, for example. For this reason, the question of finding strategies to improve compliance is one that, in the first instance, is best answered at the local level. Field operatives have the intelligence to analyse compliance problems in terms of the request and action framework provided in Figure 13.1; and furthermore, they have the experiential base for compiling a rich array of creative and workable interventions to deal with the problems they have observed. For tax administrations that are risk averse and that traditionally operate within hierarchical structures, devolving problem solving to local areas is a radical

proposal (Job and Honaker, Chapter 6, this volume). Yet, as Sparrow (2000) has pointed out, tax administrations have started to grapple with this challenge and have produced evidence that institutional change is possible. Through setting up special purpose task forces that draw on the local knowledge of field staff and bring together an effective skill mix from different sources, strategies for improving compliance in relation to specific problems have been found.

Improvements in compliance are among the major yardsticks used by tax authorities and their governments to assess their performance. Commonly, compliance gains are considered against compliance costs, which refer to the financial and opportunity costs of compliance borne by taxpayers and tax officers. But there also may be a cost to the integrity of the tax system. Compliance gains may mean integrity loss, at least in the view of the public.

To understand the compliance integrity trade-off, consider the following example, one that is currently eating away at the hearts and minds of ordinary Australians (see Braithwaite, Reinhart, Mearns and Graham, 2001). While tax officers dealing with personal income tax scrutinize data sets to identify irregularities in self-assessed tax returns, tax officers dealing with large corporates and high wealth individuals work to establish cooperative relationships with their clientele in order to collect at least some tax from those who have the capacity to avoid paying any tax at all (Australian Taxation Office, 2000b). From a local compliance perspective, both components of the system, that is the personal tax and large business lines, work well in achieving their goals. For personal tax, data matching software increases the revenue collected at minimal cost to the tax office. A letter is issued informing the taxpayer that their tax assessment has been amended, in all likelihood with an invoice for tax owing plus interest and a penalty. The taxpayer can contest the assessment, but in all likelihood the taxpayer will defer to tax office authority. In the large business line, however, the interaction between taxpayer and tax officer is likely to take a different course. For large corporations, negotiation and regulatory conversation triggered by lawyers' letters will often be necessary to ensure that at least some tax is collected at regular intervals.

The important point to note here is that there is soundness in operations within each of these functional lines in the tax office: There is a consistent compliance goal operating in each part, that is, to maximize the revenue collected as efficiently as possible, given the context. The contexts, of course, differ substantially. Different types of tax are collected, different laws are applicable, and the resources available to take advantage of legal complexity and ambiguity are far greater among corporates than among ordinary taxpayers. At the local level, the compliance activities of tax officers working in personal tax and those in corporate tax seem defensible and reasonable. But there may be an unseen cost to the tax office overall, that is, a perceived loss of institutional integrity.<sup>5</sup>

### The Compliance Integrity Dilemma

Compliance is a localized problem: Integrity involves the whole organisation. How then can a bridge be built between compliance and integrity? Some insight into the barriers to building such a bridge is gleaned when we look at Figure 13.1 as a blueprint for change. Let us assume that a change is made to the administrative and legal system represented in the left hand column of the diagram: A decision is made to improve compliance through making the request clearer to taxpayers. For instance, a new taxpayers' contract is introduced that lists, in painstaking detail, the actions that a taxpayer must take to demonstrate compliance with the tax office and the actions that taxpayers may expect from tax officers as they seek compliance from citizens. In Figure 13.1, this initiative would increase the proportion of citizens who are receiving a direct request to comply from the tax authority, and the dotted line would be expected to move down, indicating an increase in the proportion of people who are 'on track' for compliance (in the top row of Figure 13.1). But the outcome that is likely to be expected by the tax authority is a little different. The rationale for such a change is likely to be that once instructions about what everyone does are clearly articulated, compliance will improve overall. Figure 13.1 can be used to illustrate that tax office expectations need not necessarily become a reality.

The increase in direct requests that elicits 'on track' compliance brings with it a reduction in the 'bonus' compliance cells. What does this mean for a tax authority? Much depends on how taxpayers respond. For instance, a segment of the population may come to realize that their compliance has been engineered by the design of the tax system. They recognize their own 'bonus' compliance, absorb the new ground rules for engaging with the tax office, and decide that their past compliance is a gift that they would rather not give. Other unexpected changes may ensue. Taxpayers generally may not respond cooperatively to the new contract. They may not interpret the message as intended and instead adopt a literalist interpretation that results in challenges to the legitimacy of the tax office's actions in a range of areas. Or taxpayers simply may take exception to the terms of the new contract, and refuse to comply in the future.

Similar risks come into play when changes to the administrative and legal system result in compliance becoming more visible to tax officers (the bottom two rows of Figure 13.1). Greater visibility improves 'on track' compliance. An example of such a change was the introduction of a Goods and Services Tax (GST) in Australia in July 2001 which was implemented with the intention of improving the Australian Taxation Office's capacity to track business transactions. Administrative and legal tax reform of this kind can, in theory, contain growth in some parts of the cash economy. But with increased visibility, the magnitude of 'on track' compliance, system failure and compliance failure all increase. In order to obtain the expected compliance outcome, a tax office needs organisational capacity to follow through on all three issues. If there are impediments to enforcing the law when evasion is exposed, the supposed effectiveness of the change to the administrative and legal system leaves much to be desired.

None of this is to suggest that changes to the administrative and legal system should not occur. Change of this kind is necessary if the tax system is to evolve in response to the environment in which it operates. Such changes and their impacts dominate analyses of how well tax systems are functioning, not least of all because after-effects are often unexpected and complex. But as Figure 13.1 demonstrates, the unexpected and complex outcomes, while difficult to manage, are not a complete mystery. In large part, they lie in a failure to understand the second system shaping the compliance encounter, the human system or more specifically, the taxpayers' culture.

If the vertical dotted lines in Figure 13.1 are moved to the right, the compliance cells increase in size, and the system failure and compliance failure cells are reduced in size. This means an increase in those who understand the request from the tax office and in those willing to act on that request in a cooperative manner. Many of the papers in this volume are supportive of the proposition that outcomes of this kind are achieved through direct intervention in the human system, that is, going further than changing law and administrative procedures to improving the quality of the relationship between the tax office and the taxpayer. Actions might include the tax authority being reasonable and clear in its day-to-day communication with taxpayers, listening to taxpayers, treating them with respect, responding to concerns, and following through purposefully to elicit compliance. Those who engage with the human dimension of compliance in this relational way are likely to reap a double reward. As tax officers listen to taxpayers to better understand the reasons that underlie resistance to compliance, it is unlikely that the feedback they receive is solely related to their localized compliance problem. The functional lines of a tax office are meaningful within the organisation to those familiar with its operations, but are relatively meaningless to most outsiders who are likely to see the tax office and the tax system as one entity. Thus, while listening to the taxpaying community, taxpayers are faced with a reality that is not bounded by a localized compliance problem, and in the process find a bridge to engage with the broader issue of institutional integrity. They learn, through the eyes of those outside, how a localized compliance problem sits alongside compliance problems elsewhere in the organisation to create a picture of institutional integrity overall.

In summary, from a tax office perspective, administrative and legal system management (as represented in the left column of Figure 13.1), involving changes to the way messages are given and responses are monitored, create a complex mix of compliance outcomes for the organisation, as well as various challenges to the integrity of the tax system. In contrast, interventions in human management to improve taxpayers' readiness to cooperate with the tax office (as represented in the top row of Figure 13.1) are more uniform in their effects. Through building more cooperative relationships with taxpayers, tax officials can reasonably hope for improved compliance, as well as improvements in how the tax system is perceived from outside, that is, in its external integrity. Winning approval of this kind in the community may be particularly helpful when a tax system is forced to change through external pressures such as globalisation. Arguably, a community will be

more forgiving of a high integrity system struggling to adapt to change than of a low integrity system placed under pressure from outside.

Compliance and integrity may be more likely to be mutually supportive when tax design deliberations are inclusive of the human system, but it should not be assumed that regulatory conversations of this kind are conflict free. There is an assumption, however, that out of this conflict will emerge acceptance, if not consensus, about how the tax system should evolve. Survey research in Australia during the period of the introduction of a Goods and Services Tax (GST) is supportive of this analysis (Braithwaite et al., 2001). Taxation, while not popular, is generally accepted as a social benefit. Resistance was a common enough response to the tax system in the Australian population (55%), but cynicism in the form of disengagement from the system was contained to a small proportion of the population (7%) (see Braithwaite, Chapter 2, this volume). These findings would lead us to expect some conflict in deliberations about taxation with a significant proportion placing themselves publicly in opposition to the tax office. But because most people are committed to a tax system in general, a process of genuine deliberation will build legitimacy in the long run as the authority demonstrates integrity and citizens accept their obligations to pay tax.

Hostility from taxpayers because the relationship with the tax authority is poor provides one reason why tax authorities need to be ever vigilant that their actions consistently convey soundness of purpose. Failure to communicate and critically analyse soundness of purpose occurs most dramatically in the public view when compliance is prioritized by the organisation above overall integrity. Admittedly, setting priorities for compliance management is not left to chance by any tax authority and remains the subject of much deliberation and debate at the senior levels of the organisation and of government. The question, however, remains: How should trade-offs be made that maximize revenue gained from compliance activities while protecting the integrity of the tax system?

## **Conclusion**

The above analysis reveals why finding the optimal mix of compliance and integrity is no easy task. At the end of the day, the quality of the solution to a compliance integrity dilemma rests on the experience and wisdom of senior bureaucrats. What the above analysis can offer, however, are three principles that may be useful in understanding how good decisions come to be made by senior tax managers when a compliance integrity dilemma arises.

First and foremost, both compliance and integrity can be boosted by investing in the human dimension of taxpayer management. Fundamentally, this means making a concerted effort to build a shared understanding with the community about what a tax system does and how it is best designed. Taxpayer management extends from the general to the specific. At the general level is the task of educating the community about the importance of a tax system and persuading them of its value. Outlining the principles for and methods of tax collection for the public and committing the organisation to the effective monitoring of compliance

are further steps that a tax authority can take in an effort to win public support and establish a cooperative and responsive relationship with the community at large. At a more specific level, taxpayer management involves not only the pronouncement of how tax law is being interpreted, but also accessible explanations for these decisions, along with discussions of penalties and settlement options.

In all these ventures, responsiveness to community concerns is a key feature of effective taxpayer management. Responsiveness means listening, and publicly acknowledging and resolving identified problems. Taxpayer concerns should be taken seriously and engaged with openly, inclusively and thoughtfully against the backdrop of basic system goals and principles. Sometimes, the result may be a change in tax office policy and practice. Other times, it may be insistence that the tax authority's actions are consistent with principles that the community has and continues to endorse. In no circumstances should responsiveness be interpreted to mean appeasing special interest groups at the expense of system integrity.

Investment in the human management dimension in the long term should give rise to a mutually reinforcing relationship between compliance and integrity. Increased compliance should boost the external integrity of the tax system, and the external integrity of the tax system should encourage compliance. Investment in the human management system or taxpayer culture offers a further bonus to a tax authority facing changes to the administrative and legal system. The coordination of taxpayer management strategies is not only desirable, but also practicable and relatively uncomplicated. Just as it can build cohesion in the community, it can provide a basis for unity in a tax authority as difficult trade-offs are made re-designing the legal and administrative system.

The second principle to emerge is that administrative and legal adaptability is a necessary part of building internal tax system integrity, although the immediate effects on compliance can be uncertain, as can the immediate effects on both internal and external integrity. In such circumstances, tax authorities need to be strategic, taking a long-term view, and putting the infrastructure in place so as to manage unexpected outcomes. Part of being maximally responsive to the environment is having a finely tuned intelligence system and a rich network of support that can be part of the process of testing and redirecting change until an appropriate balance between needs for compliance and integrity are met.

While senior managers must take responsibility for making critical decisions about balancing compliance and integrity, knowledge and understanding of how compliance might be best improved lies in the stories of field staff. It is only through drawing on these stories and opening and acting on communications from the coalface, that senior managers are able to pre-empt the trade-off costs for their organisation. Without bottom-up feedback, top-down management of administrative and legal change is likely to be fraught with difficulties and setbacks. Thus, the third principle emerges, one that involves an integration of compliance and integrity action plans. Through adopting a bottom-up approach that carries tales from the field, tax authorities can develop a range of plans of an administrative and legal nature for improving compliance. From a review of compliance management plans, senior managers can choose a preferred sub-set that will improve compliance outcomes and build tax system integrity. To choose

poorly (the top-down process) or to have poor options from which to choose (the bottom-up process) risks long-term damage. Failure to administer the tax system in a way that demonstrates basic respect for the democratic principles of participation and accountability is a dangerous game. A tax authority that de-legitimizes itself in the eyes of citizens limits its effectiveness and short-changes citizens in terms of what they can expect from democracy.

### Notes

- 1 An earlier version of this paper was presented at the 'Compliance Workshop: What Does it Mean to Comply?', organised by the Regulatory Institutions Network, 17 June 2002, Australian National University. My thanks to Barbara Nunn for broadening my perspective on integrity, and to my colleagues, Clifford Shearing, John Braithwaite and Greg Rawlings, for their insightful and constructive criticisms.
- 2 A distinction is drawn between the community's perspective, within a context where consultation is genuine and inclusive, and the community's reaction, within a context where a change is imposed. Community reaction provides a distorted view of the community perspective because resentment at being excluded from the decision-making process can be mixed with genuine deliberation about the substantive issue.
- 3 The importance placed on giving frank and fearless advice is reflected in the public service code of conduct (see Australian Public Service Commission, 2000).
- 4 Integrity can also pull individuals in different directions internally (see Calhoun (1995) and Dobel (1999) for discussions of why integrity is not necessarily at odds with ambivalence, inconsistent actions over time, or value conflicts).
- 5 *The Community Hopes, Fears and Actions Survey* revealed much less community confidence in the Tax Office's capacity to respond effectively to taxpaying defiance from high wealth individuals and large corporates than to ordinary taxpayers and small business (Braithwaite et al., 2001).

### References

- Australian Public Service Commission (2000), *Australian Public Service Values*, <http://www.apsc.gov.au/publications02/values.htm>.
- Australian Taxation Office (1997), *Taxpayers' Charter*, Australian Taxation Office, Canberra.
- \_\_\_\_\_ (2000a), *Strategic Statement 2000-2003*, Australian Taxation Office, Canberra.
- \_\_\_\_\_ (2000b), *Cooperative Compliance: Working with Large Business in the New Tax System*, Australian Taxation Office, Canberra.
- \_\_\_\_\_ (2002), *Taxation Statistics 1999-2000*, Commonwealth of Australia, Canberra.
- Braithwaite, J. (2002), 'Rules and Principles: A Theory of Legal Certainty', *Australian Journal of Legal Philosophy*, vol. 27, pp. 47-82.
- \_\_\_\_\_ (Chapter 9, this volume), 'Large Business and the Compliance Model'.
- Braithwaite, J. and Williams, R. (2001), 'Meta Risk Management and Task System Integrity', *Centre for Tax System Integrity Working Paper No. 23*, The Australian National University, Canberra.
- Braithwaite, V. (Chapter 1, this volume), 'A New Approach to Tax Compliance'.
- \_\_\_\_\_ (Chapter 2, this volume), 'Dancing with Tax Authorities: Motivational Postures and Non-compliant Actions'.

- Braithwaite, V., Reinhart, M., Mearns, M. and Graham, R. (2001), 'Preliminary Findings from the Community Hopes, Fears and Actions Survey', *Centre for Tax System Integrity Working Paper No. 3*, The Australian National University, Canberra.
- Brooks, N. (1998), 'The Challenge of Tax Compliance', in C. Evans and A. Greenbaum (eds), *Tax Administration: Facing the Challenge of the Future*, Prospect Media, St Leonards, pp. 7-33.
- Calhoun, C. (1995), 'Standing for Something', *Journal of Philosophy*, vol. XCII(5), pp. 235-60.
- Cash Economy Task Force (1998), *Improving Tax Compliance in the Cash Economy*, Australian Taxation Office, Canberra.
- Coglianesi, C. and Lazer, D. (2001), 'Management-based Regulatory Strategies', Regulatory Policy Program Working Paper RPP-2001-09, Centre for Business and Government, John F. Kennedy School of Government, Harvard University, Cambridge.
- Coleman, C. and Freeman, L. (1997), 'Cultural Foundations of Taxpayer Attitudes to Voluntary Compliance', *Australian Tax Forum*, vol. 13, pp. 311-36.
- Deaux, K. and Wrightsman, L.S. (1988), *Social Psychology* (5<sup>th</sup> ed.), Brooks/Cole, Pacific Grove.
- Denhardt, R.B. and Denhardt, J.V. (2000), 'The New Public Service: Serving rather than Steering', *Public Administration Review*, vol. 60(6), pp. 549-59.
- Dobel, P. (1999) *Public Integrity*, Johns Hopkins University Press, Baltimore.
- Grabosky, P. (1995), 'Using Non-governmental Resources to Foster Regulatory Compliance', *Governance: An International Journal of Policy and Administration*, vol. 8(4), pp. 527-50.
- Gregory, R.J. (1999), 'Social Capital Theory and Administrative Reform: Maintaining Ethical Probity in Public Service', *Public Administration Review*, vol. 59(1), pp. 63-75.
- Gunningham, N. and Grabosky, P. (1998), *Smart Regulation: Designing Environmental Policy*, Clarendon Press, Oxford.
- Hobson, K. (2002), 'Say No to the ATO: The Cultural Politics of Protest against the Australian Taxation Office', *Centre for Tax System Integrity Working Paper No.37*, The Australian National University, Canberra.
- Inglis, M. (2002), 'Is Self-assessment Working?: The Decline and Fall of the Australian Income Tax System', Paper presented at the 5th International Conference on Tax Administration, ATAX, University of New South Wales, 4-5 April, Sydney.
- Job, J. and Honaker, D. (Chapter 6, this volume), 'Short-term Experience with Responsive Regulation in the Australian Taxation Office'.
- Laufer, W.S. (1996), 'Integrity, Diligence, and the Limits of Good Corporate Citizenship', *American Business Law Journal*, vol. 34(2), pp. 157- 81.
- Murphy, K. (2002a), 'Procedural Justice and the Australian Taxation Office: A Study of Tax Scheme Investors', *Centre for Tax System Integrity Working Paper No. 35*, The Australian National University, Canberra.
- \_\_\_\_\_. (2002b), 'Trust Me, I'm the Taxman: The Role of Trust in Nurturing Compliance', *Centre for Tax System Integrity Working Paper No. 43*, The Australian National University, Canberra.
- National Review of Standards for the Tax Profession (1994), *Tax Services for the Public*, Australian Government Publishing Service, Canberra.
- Parker, C. (2002), *The Open Corporation: Effective Self-regulation and Democracy*, Cambridge University Press, Cambridge.
- Petrick, J.A. and Quinn, J.F. (2000), 'The Integrity Capacity Construct and Moral Progress in Business', *Journal of Business Ethics*, vol. 23(1), pp. 3-18.
- Ralph Report (1999), *A Tax System Redesigned: More Certain, Equitable and Durable*. Report of the Review of Business Taxation, Commonwealth of Australia, Canberra.

- Senate Economics References Committee (2001), *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Interim Report*, Parliament of the Commonwealth of Australia, Canberra.
- Shearing, C.D. and Stenning, P.C. (1985), 'From the Panopticon to Disney World: The Development of Discipline', in A.N. Doob and E.L. Greenspan (eds), *Perspectives in Criminal Law: Essays in Honour of John L.L.J. Edwards*, Canada Law Book, Aurora, pp. 335-49.
- Skidmore, M.J. (1995), 'Ethics and Public Service', *The Annals of the American Academy of Political and Social Science*, vol. 537, pp. 25-36.
- Sparrow, M. (2000), *The Regulatory Craft*, Brookings Institution Press, Washington D.C.