

Chapter 1

A New Approach to Tax Compliance

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In the late 1990s, the Australian Taxation Office (ATO) underwent a series of reforms that set the stage for a new proactive role in building a voluntary taxpaying culture. The evaluation of these measures is being undertaken rather more systematically than reforms in other countries, with results that have implications for all nations' tax regimes. This process of reform is built on the premise that although legislation is one of the basic building blocks for compliance, it is far from sufficient. Tax law is contestable; it is also complex; and it is not beyond the initiative of taxpayers to avoid and evade tax in ways that are costly, both in terms of revenue that will never be collected and enforcement that is resource intensive. The traditional tax infrastructure of law, auditors, penalties, debt collectors, and court cases needs to be supplemented by measures that boost taxpayers' commitment to paying tax with or without the tax authority watching over their shoulders.

At the heart of the reform strategies of the late 1990s was the building of a relationship with the Australian community in which the tax office was to be (a) professional, responsive, fair, open, and accountable in helping taxpayers comply with their tax obligations; as well as (b) effective in bringing to account those who intentionally avoided their obligations. Through adopting such practices, the intent was that the tax office earn (c) the trust, support and respect of the community (Australian Taxation Office, 1997).

The first initiative toward building this relationship was the Taxpayers' Charter (Australian Taxation Office, 1997). The Charter articulated 12 rights of taxpayers and committed tax officers to treating taxpayers fairly and reasonably, to explain decisions, assist with questions, and provide reliable information, to respect taxpayer privacy, to keep the taxpayers' compliance costs to a minimum, and to be accountable, if necessary, through independent review. The taxpayers' obligations, articulated also in the Charter document, were four-fold and involved being truthful in dealings with the tax office, keeping records in accordance with the law, taking reasonable care in preparing tax information, and lodging tax returns and required documents by the due date.

Bringing the Charter to life was no small challenge for the Australian Taxation Office. The traditional regulatory style of the ATO has been heavily weighted toward command and control with the automatic application of penalties for various forms of non-compliance (see Chapter 6). At the same time, the authority has not always used its prosecutorial powers effectively, with a history of slap-on-the-wrist prosecutions that rarely touch major evaders or avoiders (Grabosky and

Braithwaite, 1986). In order for the tax office to change course, it was necessary to show fairness and reasonableness to those who were willing to cooperate, and focus enforcement capacity on those flagrantly ignoring their tax obligations. The companion reform that addressed this issue and enabled the Charter to be mainstreamed in ATO operations was the ATO Compliance Model. Originating in the Cash Economy Task Force (1998),¹ the Compliance Model drew on the work of regulatory scholars at the Australian National University as well as on the vast research literature on tax compliance. Consistent with this literature (see Coleman and Freeman, 1997, for example), the Task Force urged the ATO to better understand not only the business profiles of taxpayers (which auditors traditionally, if partially, do), but also the nature of the industry they belong to, the economic factors that impinge on that industry and society more broadly, and the psychological and sociological factors that frame taxpayers' decisions or non-decisions about the actions they will take to meet their tax obligations. In the words of the Task Force:

none of these factors stand alone as the sole reason for a taxpayer's behaviour, and equally, it is not possible to identify which factors in combination may influence the behaviour of any one particular person. However, it is possible to identify a combination of factors that is more likely to influence behaviour for certain categories of taxpayers (Cash Economy Task Force, 1998, p. 20).

Better understanding of the complexity and interrelationships of factors shaping taxpayer actions was accompanied by an implicit distinction in the Cash Economy Task Force Report (1998) between the detection of non-compliance and the management of non-compliance. The detection problem involved identifying those among us who will be non-compliant. The human management problem involved nudging those of us who are non-compliant toward compliance, 'without adversely affecting compliant taxpayers' (p. 22). The Cash Economy Compliance Model was constructed to provide a methodology for addressing the human management problem, while providing better intelligence to improve detection. The development of the detection problem was followed up more systematically by the Large Business and International line of the ATO. In adapting the ATO Compliance Model to their needs, Large Business introduced a sophisticated risk management component (Australian Taxation Office, 2000).

The core of the ATO Compliance Model, as developed by the Cash Economy Task Force, is presented diagrammatically in Figure 1.1.

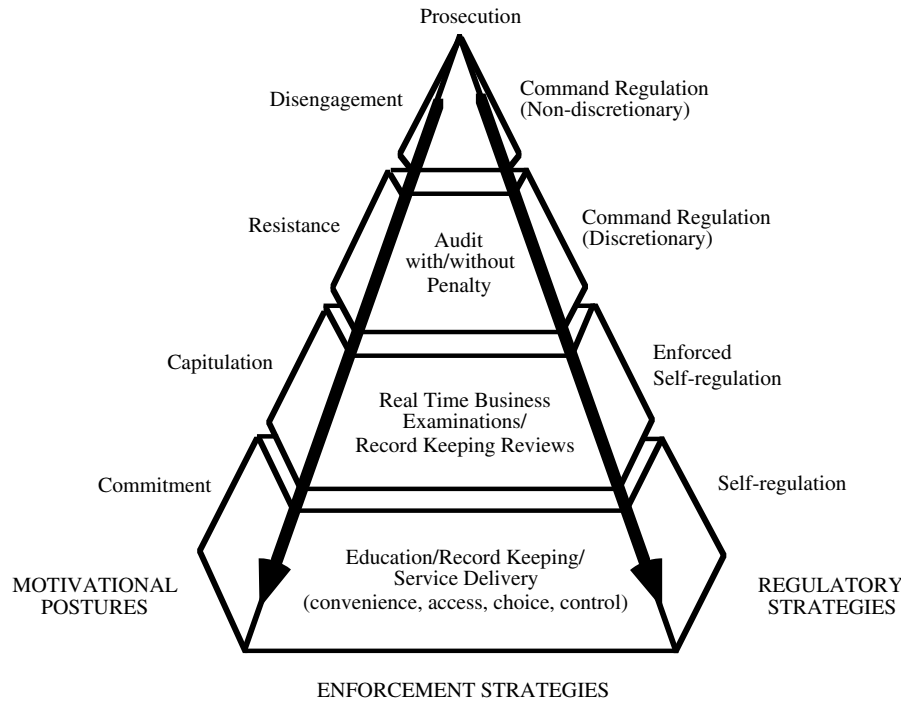


Figure 1.1 Example of regulatory practice with ATO Compliance Model

On the left hand side of the model are the motivational postures. These are the stances that taxpayers openly express in their relationships with the tax authority. These postures were identified in earlier regulatory work (Braithwaite, Braithwaite, Gibson and Makkai, 1994; Braithwaite, 1995) to describe the way in which taxpayers controlled the amount of social distance they placed between themselves and the tax office. When taxpayers were open to admitting wrongdoing, correcting their mistakes, and getting on with meeting the law's expectations, they were likely to be displaying the postures of commitment or capitulation (see Chapter 2 for a more detailed description of the postures). The tax official's task is relatively straightforward in such circumstances. Their authority will be taken seriously, and compliance will follow as long as taxpayers know what they are supposed to do, are treated in a procedurally just manner, and are conscious of the fact that there will be follow through by the tax authority if they do not comply.

The tax official's task becomes increasingly harder as taxpayers put more social distance between themselves and the authority. Capitulation describes giving in to authority without necessarily being prepared to take the initiative to get things right in the future; when initiative is demonstrated, commitment is the more apt description. In contrast, the postures of resistance and disengagement reflect a conscious holding back of cooperation. The relationship is adversarial, and the tax official's approach to gaining compliance needs to be more strategic than would be

necessary with more cooperative taxpayers. The most difficult stance for a tax official to deal with in the model is disengagement. Here the taxpayer has such contempt for the system that the chances of persuasion working are low: In such circumstances, other strategies may be equally ineffective, leaving incapacitation as the only option (through prosecution, imprisonment, or taking away a license to practice).

The courses of action that a tax official can take in response to compliance problems are many and varied (see Chapters 9, 11, 12), although generally speaking, attention seems to focus on penalties in response to law breaking. As important as these are to an effectively functioning tax system, compliance problems are not always black and white in the field of taxation, and in such circumstances, it is helpful for the tax office to have a range of tools at their disposal to manage the compliance problem well. Possible courses of action that tax officials can take are depicted within the framework of the Compliance Model in Figure 1.1 (middle column). They are arranged to represent different levels of seriousness and intrusiveness on the part of the tax office, the general thesis being that if taxpayers are prepared to meet their obligations with minimum interference by the tax office, they should be left alone to get on with it. Needless to say, the courses of action will change as the nature of the compliance problem changes: What is useful for cash economy problems will not necessarily apply to other problems (see Chapter 9).

While local areas need to develop their own compliance strategies (Sparrow, 2000), the principles that guide enforcement are more stable and are represented on the right hand side of the Compliance Model in Figure 1.1. For those who are willing to cooperate, the principle guiding the choice of strategy is self-regulation. If taxpayers are committed to correcting their own mistakes, they should be encouraged and assisted in doing so. The next level of interference might be called enforced self-regulation. Taxpayers have responsibility for correcting their own mistakes, but a mechanism is in place to ensure they do so, and to provide feedback to indicate whether or not the taxpayers' compliance plan is sound.

Above these levels are the traditional principles of tax office enforcement that have a command and control quality. A soft version of command and control regulation is to wave a big stick, but to exercise discretion around using punishment to improve compliance. The hard version is non-discretionary punishment such that a sanction automatically follows when non-compliance is detected, regardless of the circumstances. The principles of enforcement, from the bottom to the top of the pyramid, involve a transfer of power from the taxpayer to the tax office, and a concomitant loss of freedom on the part of the taxpayer.

At the heart of the Compliance Model are the concepts of responsive regulation and regulatory pyramids to guide an authority's response to non-compliance (Ayres and Braithwaite, 1992). Responsive regulation steps away from a command and control approach to regulation and moves regulators beyond a mentality that if they go strictly by the book in dealing with non-compliance, their problems will be over. A considerable research literature supports the failings of command and control regulation when applied indiscriminately in areas where compliance and non-compliance are multi-faceted and complex phenomena (Bardach and Kagan,

1982; Gunningham and Grabosky, 1998; Sparrow, 2000). It is very easy for a regulatory agency relying on a simplistic conception of enforcement to fall foul of accusations of unreasonableness and unfairness (Bardach and Kagan, 1982). Tax administrations across the world have received their share of criticism of this kind (Report of the National Commission on Restructuring the Internal Revenue Service, 1997; The Report of the Committee of Experts on Tax Compliance, 1999; Senate Economics References Committee, 2001).

Regulatory pyramids are designed to promote self-regulation and they advocate only as much enforcement by the authority as the situation requires to gain compliance. Two basic assumptions underlie their effective use. First, most of the population are assumed to be located at the base of the pyramid. In other words, costly enforcement resources are not wasted on those who are willing to comply, but are reserved for the smaller proportion of the population not willing to cooperate with the authority, clustering around the higher levels of the pyramid. Second, regulatory pyramids demand of an authority the capacity and readiness to follow through on non-compliance, escalating the costs to the taxpayer to the point of incapacitation if necessary.

The essential compliance generating dynamic of the pyramid relies on knowing that it is less costly to resolve a problem at the bottom of the pyramid than to allow it to escalate to the top of the pyramid. This applies to both regulator and regulatee, and incorporates costs of a material, social or psychological kind. The knowledge that drives behaviour comes into play at two levels. First, the cooperative approach at the bottom of the pyramid involves persuasion in both directions: Taxpayers have the opportunity to persuade the tax office at the same time as the tax office is trying to persuade the taxpayer. As the conflict moves up the pyramid, taxpayers lose power to persuade as the tax office moves into command and control mode. Second, the regulatory pyramid communicates consequences of non-compliance, and most importantly, it signals that the delivery of the consequences is contingent upon the next move of the regulatee. If the regulatee chooses a cooperative response, the regulator cooperates. If the regulatee's choice is uncooperative, the regulator moves to a higher level of enforcement that imposes higher costs on the non-complier. This treatment sits comfortably alongside the Taxpayers' Charter with its in-built concept of procedural justice (see Chapter 3).

The implementation of the ATO Compliance Model mainstreamed the Taxpayers' Charter, but at the same time challenged traditional ways of working beyond the human management system. The administrative, technical and legal systems were implicated in the change process as well (see Chapter 8). Foremost in everyone's mind was the fact that the ATO Compliance Model came about through transplanting ideas developed in other regulatory contexts to the field of taxation (see Chapter 6). Adaptation across fields was based on intuitive judgement, and to a considerable extent faith on the part of ATO senior management that it might work (see Chapter 7). In order to progress the use of the Model judiciously, there was a need to monitor and evaluate its effectiveness, making adjustments where required (see Chapter 8). With this purpose in mind, a six-year research partnership was set up between the Australian Taxation Office and the Australian National

University in August, 1999 with the establishment of the Centre for Tax System Integrity.

The research program for the Centre for Tax System Integrity revolves around three questions that are relevant to tax administrations around the world: (a) What options do democratic states have for cultivating a voluntary taxpaying culture? (b) How practicable and desirable is the ATO Compliance Model for managing tax compliance and non-compliance? (c) Can evidence-based tax administration be built around a continuing program of experimentation that builds an increasingly rich tool-kit of cost-effective strategies (represented in the middle column of the model) for improving compliance? This volume presents findings from the first phase of our research. Together these chapters present evidence supporting the relevance of the Model to the taxation context, as well as stories of success and frustration as the ATO undertook the systematic process of implementation. Experiences in developing and using the ATO Compliance Model have been shared with a number of other tax authorities including those in Britain, New Zealand, Canada, Bulgaria, Thailand, and East Timor and through training programs for tax administrators in Commonwealth countries in Asia, Africa and the South Pacific. This volume provides an opportunity to share the ideas behind the Model and our current knowledge of its usefulness more broadly with all who are interested in tax administration in the global community of the 21st century.

Part I (The Relationship between the Tax Office and the Community) of this volume examines a set of issues that will be most familiar to readers as arguable causes of non-compliance. In the present context, however, their importance stems from their centrality in establishing a cooperative relationship between a tax authority and the community.

The first question addressed in Chapter 2 is whether or not the concept of motivational postures has relevance in depicting the quality of the relationship of a tax authority with the community. Having established benchmarks for each posture in the community, attention is turned to self-reported compliance. Are individual taxpayers as compliant as their motivational postures suggest? The answer is a resounding no. Non-compliant actions are found among those committed to the system, those who have capitulated to tax authority, those who resist it, and those who have disengaged from it. The readiness of non-compliers to cooperate is varied, as postulated in the ATO Compliance Model.

Chapter 3 addresses one of the most important issues in any relationship between a democratically elected government and its people, perceptions of justice. Michael Wenzel provides a framework for justice research in the taxation context through drawing a distinction between different kinds of justice (distributive, procedural, retributive) and pointing out that justice takes on quite different meanings at different levels of analysis. Justice can be adjudicated at an individual level (am I being treated fairly?) or at a group level (is my group (e.g., taxi drivers) being treated fairly?) or at a societal level (is our tax system fair for all?). Knowing what kind of justice is under consideration is not always clear in tax research that considers justice as a cause of non-compliance. It is particularly important for future research to learn whether or not the kinds of justice that shape non-

compliance are different from the kinds of justice that enable tax authorities to manage compliance and claim legitimacy within the democracy.

The question of tax office legitimacy is of central concern in Natalie Taylor's chapter on social identity (Chapter 4). Taylor takes up Michael Wenzel's distinction between whether one thinks of oneself as a member of a group within society or whether one identifies with a more inclusive group such as Australian taxpayer. Using the written responses of 155 Australians to an open-ended question about the tax system, Taylor demonstrates that it is the superordinate inclusive identities that are associated with the granting of legitimacy to the tax office and the readiness to cooperate with the tax system. Taylor concludes by issuing a challenge to tax regimes that continue to adhere to a narrow individualistic conception of self-interest as the fundamental motivation of taxpayers. What such authorities may be giving away, according to Taylor, is the key to their legitimacy.

The cash economy – the compliance problem that gave rise to the ATO Compliance Model – has always been hidden from view, its size being estimated by economists through a variety of indirect methods. In Chapter 5, Friedrich Schneider 'sizes' Australia's cash (shadow) economy in comparison to other countries. Then follows a microanalysis of individual taxpayers who answered survey questions on shadow economy participation in 2000 and 2002. Using these data, Valerie Braithwaite, Friedrich Schneider, Monika Reinhart, and Kristina Murphy examine the importance of deterrence, justice, identity, and motivational postures in determining who moves into the shadow economy, who moves out, who stays involved, and who remains apart from shadow economy activities.

Part II examines the ATO Compliance Model as Change Agent. The section begins with the story of how the Compliance Model was received by operative staff in the Australian Taxation Office (Chapter 6). Jenny Job and David Honaker present a warts and all account of the early stages of implementation of the Model based on interviews conducted by the senior author. While there were enthusiasts, there were also resisters. From both camps there were some who correctly foresaw how far reaching the changes could be for the tax office and for the way it conducted its business in the future. Along with insightfulness, were feelings of threat and loss. Some complained of being pushed into something that was untried and untested, and there were misunderstandings and myths, not uncommon when innovation is in the air.

While the views from below reflected both excitement and cynicism about the prospects of implementing the ATO Compliance Model, those higher up in the organisation showed no reluctance in owning the Model. Kersty Hobson uses transcripts of interviews with champions of the ATO Compliance Model to analyse the ways in which leaders understood the model and presented it to staff (Chapter 7). Hobson draws an interesting distinction in terms of how the ATO Compliance Model was taken on board by senior staff. Some, in the words of one of Hobson's interviewees, worked 'inside the model', while others stood outside, trying to determine where they and their group should be located within the framework. For the first group, the model was a dynamic tool to be played with and pushed to its limits in analysing and managing compliance. For the second, it was a static entity, that was to be used at worst, as another rulebook, at best a cookbook.

In Chapter 8, the action of the ATO Compliance Model moves out of the office and into the field. Neal Shover collected data from ATO field officers in the Cash Economy Building and Construction Project and from owners of small building and construction firms. These data suggest some progress in the direction of effective implementation and the building of better relationships with taxpayers. Shover warns, however, that it would be premature to claim success for the model at this stage, and recognises some of the real world problems that highlight the need for continuing evaluation. Organisational capacity for reform is fundamental to the introduction of responsive regulation. The ATO provided resources in the early stages, but the organisation was forced to redirect much of its attention to the introduction of a goods and services tax in July 2000. As Shover explains, the ATO lacked ‘a calm environment [that] lends itself to the deliberate and self-reflective decision-making that can nurture and sustain [change]’. Consequently, the opportunity to evaluate ATO Compliance Model implementation in a rigorous and systematic way was lost. At the same time, there was a failure in organisational capacity to make the changes in the administrative and technical system to allow responsive regulation to operate fully.

Taking the ATO Compliance Model out of cash economy and recommending its use in other ATO business lines did not occur without considerable scepticism, most notably from the Large Business and International line. In Chapter 9, John Braithwaite provides a review of the relevance of the ATO Compliance Model to large business, arguing that basic ideas translate across contexts, although there may be need to package the model differently. Braithwaite’s chapter underlines the point that the principles of responsive regulation travel widely, but that regulatory pyramids cannot and should not be treated as cookbooks. Each compliance group needs to find its own strategies that suit the problem, the context, and the available resources. And they need to consult widely with the community to find these strategies. Braithwaite illustrates this point with the proposal of a compliance-tax-rate-spiral for reducing the incentives for game playing among the very large corporates. The idea is that when the large corporates as a group reach a series of benchmarks in extra dollars collected in tax, they be rewarded through a lowering of company tax rates. The idea of the compliance-tax-rate-spiral is not something that Braithwaite envisages as anything other than a point for debate at this stage: instead it ‘signals the kind of world that might one day be possible if only we can learn how to forge a more meaningful business-community-government partnership toward a decent tax system’.

The purpose of responsive regulation and the ATO Compliance Model is to develop, in conjunction with the community, a sophisticated plan that can effectively manage non-compliant taxpayers, while being supportive of those who are compliant. Up to this point, we have assumed that we know what compliance is, and if there is doubt, that the tax office has the authority to clarify things for us. In Part III (Beyond the Compliance Model), the limitations of this worldview are exposed.

In Chapter 10, John Braithwaite, Yvonne Pittelkow and Rob Williams focus on the difficulties of detecting suspected non-compliance in the tax affairs of wealthy individuals in Australia. These authors provide a series of statistical analyses of

risk data from 235 high wealth individuals to show how important the expert analyst's hunch is in deciding where the greatest risks to tax revenue lie: When aggressive tax avoidance is obvious, it has long past its use-by date for those with the money to pay for state-of-the-art financial advice.

The game of tax avoidance is addressed by Doreen McBarnet in Chapter 11. McBarnet points out that compliance or non-compliance is a binary classification that falls apart once tax avoidance enters the scene. Tax avoidance creates what McBarnet calls creative compliance whereby taxpayers adhere to the strict letter of the law, but find loopholes and caveats to minimise their tax without regard for the spirit of the law. The ATO Compliance Model, as it stands, offers little help to tax officers dealing with creative compliance because if no law has been broken, there can be no top to the regulatory pyramid to encourage cooperation at lower levels. In such circumstances, management of the human system cannot meaningfully take place in the absence of revision of the legal system. McBarnet describes the practice of introducing principles that span the law in a bid to ensure that the intention of the legislature provides a backstop for legal interpretation of law. McBarnet, however, is pessimistic that the cat and mouse game of creative compliance can be changed by law itself. The change that is required is more fundamental and attitudinal: Law must be seen as something to be 'respected' rather than 'material to be worked on' to one's advantage.

The industry of tax avoidance rests on the talents of financial advisors. In Chapter 12, John Braithwaite reports findings based on interviews with 27 advisors whose clients include the wealthiest people in Australia. Advisors were invited to comment on the performance of the ATO's High Wealth Individuals Taskforce that was set up in 1996, and were also drawn into discussions of better ways of improving compliance among high wealth individuals and identifying deficiencies in the law. The interviews themselves were evidence of the ATO Compliance Model at work, a willingness by all parties to engage in dialogue and share information, allowing persuasion to work in both directions. At the same time, the interviews yielded valuable policy insights about where enforcement capacity should be focused and ways in which the ATO Compliance Model can be misleading if the object of attention is solely the taxpayer. Braithwaite argues that, in the case of high wealth individuals, the dangers of 'enforcement swamping' are so great that the kind of 'simplistic purism' that focuses on the taxpayer as the object of enforcement has to be abandoned. Instead, the High Wealth Individual Taskforce needs to continue along its current path 'of targeting nodes of control over decisions of major import for tax compliance', be they wealthy individuals and the suite of entities they control, tax managers of large corporations, influential advisors, or promoters of aggressive tax avoidance schemes.

In the final chapter, questions of compliance and what it means to comply are embedded within a model that extends across the human, administrative and legal systems that comprise a tax authority. Local compliance solutions do not always sit comfortably alongside other local solutions. The principle introduced to reconcile tensions within the compliance plan of a tax office is integrity defined as unity and soundness of purpose. The argument presented in Chapter 13 is that effective compliance management and institutional integrity are interconnected. Both can be

optimised when a tax authority understands and works with the community, bringing interested parties into discussions about the tax system, how it should be designed, and what purpose it should serve. The responsiveness to the outside environment, however, must be matched by responsiveness internally. Tax offices need to have the organisational capacity to change their administrative and legal structures, and to ensure that information flows freely up and down the organisation. Through the quality of responsiveness, internally and externally, tax administrations in the 21st century may lose certainty, but gain an assurance that they greatly need: The acknowledgment of the community that they are indeed taxing in the interests of the democracy as a whole.

Taxing Democracy brings together the contributions of researchers from three continents, all of whom have spent time together in the Centre for Tax System Integrity over its first three years, as full-time research staff, visiting fellows, or research affiliates. Our thanks to the Australian Taxation Office and the Research School of Social Sciences at the Australian National University for funding the Centre and its research. Without their support and their cooperation, this initiative would not have been possible.

Like all enterprises of this kind, there are people, whose names do not appear in the pages that follow, who make it all possible. For her generosity of spirit and infinite wisdom, my thanks to our administrator, Linda Gosnell, who keeps the Centre running smoothly, and seemingly, effortlessly. To Sophie Cartwright who meticulously and patiently prepared this manuscript for publication, thank you from us all. And to the postgraduate students, university colleagues and colleagues from the Australian Taxation Office who have provided critical comments, have participated in conferences and seminars with us, and who have opened doors so that this research could be conducted, our most sincere thanks. Among this very large support team is Andrew Stout who has been our master engineer, building bridges between the academic and bureaucratic worlds and generating a continuing dialogue between the Centre and the Australian Taxation Office. We are indebted to him for contributing in such an important way to the richness of the research that we are able to share in this volume.

The name of one visiting fellow that sadly does not appear in this volume is that of our late colleague, Leslie Whittington. Leslie was a tax economist from Georgetown University, who was to spend study leave at the Centre, with her husband, Charles, and their young daughters, Zoe and Dana. Leslie and her family started their journey on September 11, 2001. All were on board the plane that was hijacked by terrorists and flown into the Pentagon. We dedicate this volume to her memory.

Note

- 1 The Cash Economy Task Force comprised 13 members spanning non-government (industry, accountancy and commerce, welfare, and university) and government sectors. The Task Force was chaired by Mr. David Butler, now Commissioner of Inland Revenue New Zealand, and Mr. Neil Mann, now Deputy Commissioner, Australian Taxation Office.

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