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Ms Sharon Bryant
Inquiry Secretary
House of Representatives Standing Committee on Tax and Revenue
Parliament House
Canberra ACT 2600

Dear Ms Bryant,

Please accept the following submission (overleaf) as supplementary material to my participation on the 9 July 2018 in the hearing addressing “**Employing a formal ‘Regulatory Philosophy’ at the ATO – House Standing Committee on Tax and Revenue Hearing**”.

Yours sincerely

Valerie Braithwaite

Evidence on why digitisation may inadvertently undermine the relationship of taxpayers with their government and the ATO: A new role for the Taxpayers' Charter and the Compliance Model

Professor Valerie Braithwaite

The ATO describes itself as “[contributing] to the economic and social wellbeing of Australians by **fostering willing participation** in our tax and super systems.”

(<https://www.ato.gov.au/General/Building-confidence/>). In order for the ATO to foster “willing participation”, the ATO needs to be trustworthy in the eyes of the community and act with integrity at all times – true to its mission and conducting its business in accord with the highest standards of a democratically accountable public institution. This submission provides evidence for why and how the trustworthiness of the ATO (like other public institutions) has to be earned, and why this involves solutions beyond digitisation.

On its website, the ATO recognises the importance of building taxpayer and community confidence through collecting revenue with reasonableness and fairness. The ATO’s future strategic directions recognise benefits in making it easier for taxpayers to engage with the tax system, informing taxpayers promptly of any problems in their payments, and improving systems for managing non-compliance. In its bid to offer taxpayers greater simplicity and clarity, particularly through greater digitisation of tax-relevant information, there is scope for false facts on both sides – the taxpayer’s and tax official’s. Taxpayers may report incorrectly, tax officials may record and make inferences incorrectly. This places confidence in the tax system and willing participation at risk, unless special measures are adopted by the ATO to resolve differences in understanding and acceptance of evidence of non-compliance. Digitisation is no substitute for the continuous work needed by the ATO to explain taxpayer obligations and ATO decisions and actions.

Empirical evidence for why people cooperate with a tax authority

Empirically we know that cooperation or willing participation with a tax authority (and therefore the success of the self-assessment system) depends on the community seeing the ATO delivering benefits to self and community, working to ensure justice in both a distributive and procedural sense, and nurturing the community’s moral obligation to pay tax (Braithwaite and Wenzel 2008). None of these are self-evident truths in a global, highly networked world: We are not protected from news of tax monies being used for harmful purposes rather than good, of tax injustice, or of rejection by some of an obligation to contribute to a nation’s revenue base. A review of international tax compliance research which has shown the relevance of all these factors for willing participation is captured in the Wheel of Social Alignments presented in Figure 1 (see also Braithwaite 2009a).

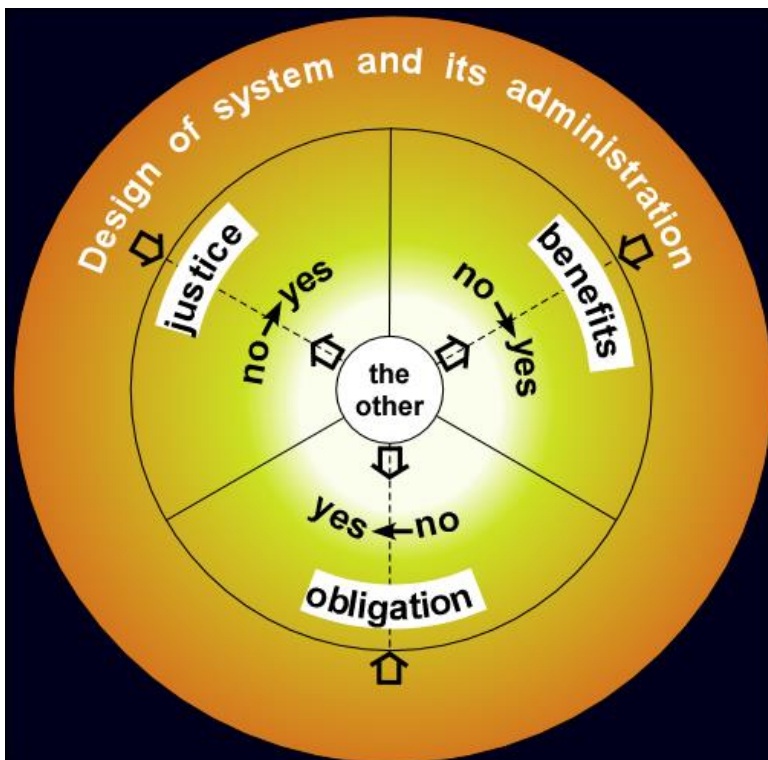


Figure 1: The Wheel of Social Alignments (Braithwaite 2009b)

The outer band of Figure 1 represents the tax system that shapes our activities: laws, rules, practice guidance notes, codes of conduct, management protocols, the ATO strategic priorities and the ATO regulatory philosophy. It represents how ATO conducts its business.

The second outer band represents the perceptions of the public and is divided into three segments: 1) Does the public perceive paying tax as beneficial - to themselves, to their families and social groups, to the community at large? 2) Does the public see justice in the tax system? Are they paying their fair share, are others paying their fair share, are ATO decisions made fairly, are processes fair? 3) Does the public hold a moral obligation to pay tax? Do they accept that the law should be obeyed? Do they consider sanctioning by the tax office a serious offence? When public perceptions are predominantly yes – we do receive benefits from paying our tax, we do think the system is just overall, and we do carry a moral obligation to pay the tax we are said to owe, we have social alignment with the tax system. That is, the outer and second outer band are locked together, and the Wheel can move forward with efficient revenue collection, thanks to cooperative taxpaying and good tax administration. Tensions and conflicts are unavoidable and need to be resolved on the way to ensure that the Wheel keeps moving forward. For the Wheel to stop is to risk major disruption to the tax system. We have seen consequences of this. Tax agents and practitioners protesting against ATO demands, computer systems failing, internal fraud accusations, mass marketed schemes for tax avoidance getting out of control, and public government inquiries into ATO operations.

At the centre of the Wheel is a circle called “other”, which captures the alternative authorities that gain credibility when the tax system falters. The other takes the form of tax agents and tax practitioners who intervene to resolve problems between their clients and the tax authority. This

happens on a regular basis. At difficult times, taxpayers are inclined to place their trust in their tax agent, not the tax authority (Tan and Braithwaite 2016). Tax authority in the form of tax competence is questioned. If this occurs at the level of individual taxpayers, it becomes an annoyance, but it does not seriously threaten the tax system. A more serious threat to the integrity of the tax system occurs when the “other” represents a wave of aggressive tax planners or multinationals’ tax departments systematically exploiting loopholes in the tax system (J Braithwaite 2005). Law loses its potency for establishing what is and is not acceptable, and the tax authority loses power to enforce taxpaying behaviour. Tax authorities at this point usually rally (belatedly) with new laws and legal interpretations. Prevalent schemes for tax avoidance are closed down: Until a new loophole is found and another surge of avoidance contagion begins.

Disruption caused by false facts

The tax code is complex, beyond the comprehension of most Australians and probably a substantial proportion of tax administrators inside and outside government. This is the hunting ground for those skilled in aggressive tax planning and tax minimization, as well as the domain of those who offer cautious, no-fuss advice on meeting one’s tax obligations. Tax advisors fitting all three descriptions offer services to those who are opposed to paying tax, unsure of the tax they should be paying, time poor, or utterly confused by the tax system.

Whatever the reason for seeking an advisor, that advisor is expected to protect their clients against system error. Outdated information, errors in data entry, coding schemes that do not match contemporary business and economic conditions, and fast moving work-arounds to minimise tax mean that there are always going to be a substantial number of cases in the too hard basket for algorithmic rationality to produce the right answers. In other words, prefills on the tax lodgement form may be incorrect and risk assessments may unfairly and unreasonably target individuals and businesses. Taxpayers use tax advisors to protect their interests in this regard, though it is of note that Australia has a two tiered system in that around 30% do not have someone to check the ATO’s accuracy. At the very least, the ATO should be providing a user-friendly digital interface with additional support from a tax advocate if necessary to encourage and allow taxpayers to check that the data they have about them is accurate and complete. Lack of due diligence in managing the ATO-taxpayer relationship can turn a previously cooperative taxpayer into a highly uncooperative one.

Regulatory philosophy as a check on abuse of power

The ATO has enormous powers, including issuing garnishee notices to collect debt. Use of such powers can instil fear in honest taxpayers, resistance in those who feel victimised by taxation, and be ‘a red flag to a bull’ if the objective is to challenge tax authority and win (Braithwaite 2009b). The message the ATO sends is not uniformly received. Which message dominates is unknowable in an era where mass and social media saturate consciousness. For a democracy to survive, government needs citizen cooperation, certainly against the backdrop of legitimate coercive powers, but with full public confidence that such coercive powers are only used when more democratically acceptable means of achieving cooperation fail. This is how a democratic government keeps resistance at bay and prevents mass support for full scale taxpayer revolt. Use of power requires public transparency and accountability around the measures taken by the

revenue authority to resolve the dispute and the reasons why coercive measures like a garnishee order were used. This transparency and accountability speaks to the ATO's regulatory philosophy, that is, the methods and practices used to collect revenue and make decisions on transactions between the taxpayer and the ATO.

Taxpayers' Charter and Compliance Model: actioning a regulatory philosophy

Research conducted by staff in the Centre for Tax System Integrity at the ANU between 1999 and 2006 and beyond (see <http://ctsi.org.au>) focused on the drivers of cooperative taxpaying by citizens as well as the obstacles to the ATO nurturing such a culture. The ATO instrument that was most important in driving cooperation between taxpayers and the ATO was the Taxpayers' Charter because it aligned very well with taxpayers' notions of procedural fairness. Procedural fairness as understood by taxpayers means being treated in a respectful manner, being assisted to comply and be given a fair hearing, having an explanation for decisions so that one does not feel discriminated against or that one does not feel treated in an arbitrary or incompetent manner. At the time of introducing the GST, procedural justice through the Taxpayers' Charter was actioned in the ATO's GST roll-out plan. Every effort was made by the ATO to be responsive to businesses and taxpayers as they learnt about the GST system. The introduction of the GST under Commissioner Michael Carmody was widely hailed as a huge success for the ATO.

Procedural fairness proved to be particularly important in two other cases studied by CTSI. Tina Murphy found that the crackdown on 'tax avoidance' mass marketed schemes in the early nineties was a disaster for the ATO both in a public relations sense and in terms of revenue collected because of a failure to keep procedural justice matters at the centre of their dealings with so called "tax avoiders" (see publications by Kristina Murphy at <http://ctsi.org.au/publications/WP/WPlist.html>). In taking enforcement action the ATO was unable to simultaneously enforce law and keep faith with its Charter obligations (in admittedly a very fraught situation). The situation was made worse by the fact that the law failed both the ATO and taxpayers. The schemes had become popular without the ATO checking their growth, and the advisers peddling the schemes could not be held to account.

The second context in which procedural justice undermined taxpayer cooperation was seen in Eliza Ahmed's study of HECS (The Higher Education Contribution Scheme) (see Eliza Ahmed at <http://ctsi.org.au/publications/WP/WPlist.html>). Here the perpetrator of procedural injustice was not the ATO but rather the government of the day. University graduates who thought that HECS was unfair were more likely to cheat on their tax either through not declaring all their income or overclaiming deductions.

This second case study shows that the ATO is not immune to the political controversies of the day. Nor is it immune to the community's continuing loss of trust in government and loss of respect for institutions, both public and private, including legal institutions. For this reason, it is not reasonable to think that if the ATO behaves in accordance with the Taxpayers' Charter all will be well. If the ATO flagrantly disregards the Taxpayers' Charter problems are sure to follow, but the Taxpayers' Charter is not sufficient in and of itself to elicit cooperation.

It is in this context that the ATO's Compliance Model is an important complement to the Taxpayers' Charter. The Compliance Model conveyed a regulatory philosophy that reinforced the Taxpayers' Charter but openly explained to taxpayers that the ATO would enforce the law and not turn a blind eye to abuses of the tax system. In accordance with the Charter, taxpayers who were considered non-compliant by the ATO were identified and given an opportunity to explain themselves and comply. In circumstances where cooperation was not forthcoming, the Compliance Model articulated a set of actions that the ATO would take in order to ensure compliance. The actions increased in intrusiveness, with actions being expedited in cases where there was no reasonable explanation for non-compliance and no attempt to sort things out. The Compliance Model signalled to the community that "yes, the ATO will use its powers to elicit compliance, but it will do so justly, considering the taxpayer's circumstances and giving the taxpayer opportunity to cooperatively meet their obligations."

Since its inception, the Compliance Model has become confused with risk. The Compliance Model is an approach for dealing with non-compliance – how you manage non-compliance while honouring the Taxpayer's Charter. Risk management is the practice for determining where revenue is most likely to be lost. Even when a particular group or individual is identified as "high risk", best practice would mean that they would still be dealt with in a respectful and accountable fashion, as outlined in the Taxpayers' Charter and the Compliance Model. For instance, when the ATO issues priority areas for checking work related expenses, they are saying "we see high risk here, we are watching closely". They are not saying anyone with higher than average expenses is cheating the tax system – at least they should not be saying or acting on this presumption. The ATO should be saying "we expect you to have an explanation because we have no reason to assume you are dishonest, and we are committed to being fair and reasonable by listening to your explanation and understanding where you are coming from". This is consistent with the Charter and does not stigmatise a high risk taxpayer just because an algorithm identified them as an outlier. If no satisfactory explanation is forthcoming, the Compliance Model takes over with a further message: "If you cannot help us resolve this matter, we will pursue the case because you have broken the law - if you do not pay your tax we will impose penalties and prosecute if necessary."

Distortions in the ATO-taxpayer relationship with dismissive defiance

The Taxpayers' Charter and the Compliance Model have both come under pressure in the past decade as aggressive tax planning has become more widespread and with it, dismissive defiance. The relationship or the social contract that exists between taxpayers and the ATO is not universally held. The Taxpayers' Charter assumes most taxpayers want a relationship of cooperation with the ATO and the Compliance Model assumes that the ATO has power to elicit compliance while offering fair and reasonable treatment. Disputes over tax law and its grey areas, which are at the heart of aggressive tax planning, create contests between alternative authorities, where possibly one side does not care about showing respect to the authority of the other. In other words, the ATO faces the prospect of some taxpayers refusing to defer to its authority. This is dismissive defiance rather than resistant defiance. Resistant defiance is about justice and being treated fairly: The ATO's authority is not in dispute. Dismissive defiance is about winning against the ATO and undermining its authority and power.

In the games of bluff and counterbluff that may occur in the transactions that a revenue authority has with taxpayers, it is easy to misread resistant defiance for dismissive defiance, or assume the worst and act as if every case is one of dismissive defiance. This means that a revenue authority becomes oppressive and refuses to be accountable for its actions and decisions. It is a defensive posture designed to protect its authority and power. While it is understandable how and why this might happen, it is a dangerous path for the ATO to follow.

Most obviously, tax authorities around the world negotiate taxpaying with big business and high wealth individuals. Both have substantial resources for challenges in court so negotiation is a sensible strategy. If this is the gold standard for nurturing the taxpayer-ATO relationship, ordinary taxpayers may resent feeling that they have less access for sorting out their tax disputes with the ATO. Reducing taxpaying to virtually a non-negotiable financial transaction on a par with paying road tolls, parking fees and public transport fees risks damage in other ways. First it robs Australians of one of the two ways they buy into the governance of the country – voting and paying taxes. Contesting tax is as important a way to engage democratically as supporting a candidate in an election. All indications are that democracies are struggling to preserve their previously unquestioned status as the best form of government. It seems reckless in current circumstances to add to the public's sense of disempowerment and unimportance through constraining tax contestation for the ordinary taxpayer. Second, once a moral obligation to buy into governance is removed (or becomes irrelevant to taxpaying), the path is open to defying the ATO in whatever way one can. Moral obligation is the break on gaming systems. Without it, alternative authorities promoting tax avoidance and minimization become the shining lights to follow. The major asset that tax authorities in Australia and elsewhere have had to make a self-assessment system work is moral obligation.

All that we know about compliance in democratic societies tells us that conversations about what we must do and why we must do it matter. Digitisation cannot replace conversations that help us understand what is expected of us, and give us opportunity to explain why we can't or won't do what government wants. Conversation is at the heart of responsive regulation: Regulation that is respectful of people and communities and their needs because there has been a concerted effort to listen and take account of those needs (J Braithwaite 2011). When government agencies say in response to the busy-ness of their working day "we have no time for conversations", publics move in the direction of saying "we have no time for moral obligation to obey government." Law abidingness is not innate in humans. Lawfulness needs to be learnt, contested in an orderly fashion, understood as a social responsibility, internalised and respected. The ATO, like other government agencies, needs to play a part in earning the public's respect for their authority so that they operate not just with legally constituted legitimacy, but social legitimacy as well.

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