than extend the network of fraud to include them (Pontell and Calavita 1998) . . .
Although the government has mounted a relatively strong response to the
unprecedented fraud in financial institutions in the United States, the success
of this effort has been severely limited. Most enforcement officials recognize
that a reactive approach, taken long after the complex and numerous frauds
were committed, limits their effectiveness as social control agents. Although
criminal justice and regulatory agencies now are coupled more tightly, major
structural and organizational obstacles remain. More generally, this study
highlights the limitations inherent in reactive state policies designed to con-
trol white-collar and corporate crime. . . .

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An Evolving Compliance Model for Tax Enforcement

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Decades of research on regulatory rule enforcement prompted a battle of
sorts between those who favor a deterrence approach and those who promote
compliance approaches, between punishment and persuasion (Reiss, 1984;
Hawkins, 1984; Pearce and Tombs, 1990; Snider, 1990). In some areas, evi-
dence suggests that deterrence works, if only modestly, as in the area of occu-
positional health and safety (Solnit, 1991; Braithwaite, 1985). In nuclear safety
and other realms, a shift away from a rule enforcement approach toward a
more communitarian style of self-regulation improves compliance (Rees,
1994). In other domains, however, it is unclear whether the effect of increased
deterrence is positive or negative (Malik and Braithwaite, 1994).

PANEL 20 Critics Beware

In 1998, Beverly Enterprises, one of America’s largest nursing home
operators, filed a defamation suit against Kate Bronfenbrenner, a Cor-
nell University labor researcher. Months before the suit was filed, at the
request of several congressmen, Dr. Bronfenbrenner spoke at a town
hall meeting in Pittsburgh, Pennsylvania, on unfair labor practices by
employers to curb organizing efforts by employees. She called Beverly
Enterprises “one of the nation’s most notorious labor law violators.” In
May 1998, Beverly’s suit was dismissed by a U.S. District Court judge,
who ruled that Bronfenbrenner’s statements were protected by legisla-
tive immunity under Pennsylvania state law.

The problem of corporate tax compliance is exacerbated by a cultural shift in the global elite of the accounting profession. In the United States, the Big Five accounting firms seem to have been able to increase their profits substantially through shifts towards more aggressive tactics. Individual staffers can secure bonuses up to $US400,000 for landing deals such as those pursued by Deloitte & Touche in the following letter to two middle-sized U.S. firms in 1998:

Dear...

As we discussed, set forth below are the details of our proposal to recommend and implement our tax strategy to eliminate the Federal and State Income taxes associated with [the company’s] income for up to five (5) years (“the Strategy”).

Ernst & Young and Deloitte & Touche reported a 29% jump in revenues from tax services in the United States in 1997 (Novack and Saunders, 1998). Since 1993, tax revenues for the Big Five have grown at twice the pace of audit revenues. The worry is that when elite firms play the game in this way, lesser players will increasingly assume that promotion of aggressive avoidance is the only way to stay competitive. In turn, management and directors of firms who receive letters such as the above, begin to worry that they will come under fire from shareholders if they pay some tax in circumstances where a Big Five accounting firm is telling them that they do not have to. The culture change is well grasped by the fact that tax departments today are viewed as profit centers in some large corporations.

What is true for the largest corporations is also true for the wealthiest individuals. Throughout the world, paying tax for them is increasingly optional. Again, the reason is not primarily tax evasion but the fact that the most sophisticated advisers can engineer a way around the need to pay any tax. This works until the tax authority discovers it, and, if it responds competently and decisively, new legislation will ban the new path around the law. At this point, the adviser forges a new financial product that will successfully put the wealthy client back in a gray area until it is made black by adjustment to the law. The game is much more destructive of the integrity of the law than outright evasion.

The “cash economy” refers to economic transactions that are conducted via cash payments without payment of applicable taxes. In nations like Nigeria, Thailand, Egypt, the Phillipines, and Mexico, this shadow economy predominates, and it is estimated to be near that in Russia and other transition economies (Schneider and Enste, 1999). Best estimates suggest that Australia has less of a problem than developing economies; in common with other Anglo-Saxon countries, Australia’s shadow economy seems to be somewhat below the average of all developed countries, around 14% of the economy (Schneider and Enste, 1999).
THEORETICAL BACKGROUND

In *Punish or Persuade*, Braithwaite (1985) first argues that compliance is most likely when an agency displays and employs an explicit enforcement pyramid. An example of an enforcement pyramid appears in Figure 1. Most regulatory action occurs at the base of the pyramid, where attempts are initially made to coax compliance by persuasion. The next phase of enforcement escalation is a warning letter; if this fails to secure compliance, imposition of civil monetary penalties; if this fails, criminal prosecution; if this fails, plant shutdown or temporary suspension of a license to operate; if this fails, permanent revocation of license. This particular enforcement pyramid might be applicable to occupational health and safety, environment or nursing home regulation, but inapplicable to banking or affirmative action regulation. It is not the content of the enforcement pyramid but its form. Different kinds of sanctioning are appropriate to different regulatory arenas.

Defection from cooperation is likely to be a less attractive proposition for business when it faces a regulator with an enforcement pyramid that when confronted with a regulator having only one deterrence option. This is true even when the deterrence option available to the regulator is a powerful, even cataclysmic, one. It is not uncommon for regulatory agencies to have the power to withdraw or suspend licenses as the only effective power at their disposal. The problem is that the sanction is such a drastic one (e.g., putting a television station off the air) that it is politically impossible and morally unacceptable to use it with any but the most extraordinary offenses. Hence, such "or else" has little credibility. This is one case of the paradox of extremely stringent regulatory laws causing underregulation. Regulatory agencies have maximum capacity to lever cooperation when they can escalate deterrence in a way that is responsive to the degree of uncooperativeness of the firm, and to moral and political acceptability of the response. It is the same point as in strategic deterrence in international affairs; a country with a nuclear deterrent but no conventional forces may be more vulnerable than one that can bargain with a limited range of conventional escalation. And it is the same point that has been demonstrated empirically in the domain of criminal justice: if death is the sentence for rape, juries that think this excessive will not convict rapists; if mandatory imprisonment is provided for drunk drivers, many police officers will decline to arrest them (Ayres and Braithwaite, 1992).

The logic and the use of regulatory pyramids are compatible with several theoretical perspectives. From a rational-actor point of view, the expectation of increased regulatory sanctions with repeated failure to cooperate provides an incentive for all players to economize on time and effort and settle differences sooner rather than later. For the tax officer working from a rational actor perspective, implementing the strategy involves three objectives: (1) to ensure that the full range of credible sanctions are known to the taxpayer, (2) to clearly signal a willingness to cooperate initially with the taxpayer, and (3) to make clear the intention to escalate in the event that cooperation is not forthcoming.

Social theories that understand compliance from the perspective of institutional legitimacy and procedural fairness are also given effect in the formulation of a regulatory pyramid. The argument is that taxpayers will regard tough enforcement action as more procedurally fair when persuasion has been tried first. Citizen perceptions of procedural fairness are more than just a political asset to an embattled tax authority; they are likely actually to increase voluntary compliance (Tyler, 1990; Makkai and Braithwaite, 1996). Moreover, when regulated actors believe they are treated as someone who is trusted, compliance increases (Braithwaite and Makkai, 1994).

According to the responsive regulatory strategy, trust works even better when verification–distrust–enforcement lurk in the background. One way of framing the responsive regulatory aspiration is to have most taxpayers be-

![Figure 1: A pyramid of enforcement responses.](Source: Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*. New York: Oxford University Press, 1996, page 35.)
lieve that tax officers trust them at a personal level, but to want tax officers to keep distrustful enforcement strategies at the ready because others cannot always be trusted. Knowing that the institutional mechanisms are in place to deal with those who cheat builds community confidence and the legitimacy of the tax system. Regulatory pyramids provide tax officers a set of tools that can be applied without regard to reasons for noncompliance. One starts with the expectation of cooperation, and escalation on the pyramid occurs only when one or other becomes noncooperative or defaults.

This analysis, however, denies something that is at the core of every regulatory encounter: whether it is personal or impersonal, tax focused or not tax focused, and that is the human quality of attributions about why others behave as they do. Attributions about other's behavior is at the heart of communication and social relationships (Heider, 1955), and in the area of regulation, the type of attribution that looms large is the underlying motive (Kaplan and Schutz, 1984). The advantage of the regulatory pyramid is that its use is not dependent on a correct diagnosis of the motives of the taxpayer. All one needs to do is to look for cooperation in correcting the problem at hand.

Yet the reality is that tax officers, like other regulators, are human and "think" motives.

Understanding the motives of another is difficult at the best of times. In the case of regulation, problems are created not only by the inaccessibility of the motives, but also by the demands of the social situation, specifically, the imperitive of hidden from the view of how we want to be at the heart of the social interactions. We publicly expose to defend our position with others (Schwartz, 1992). We all approach regulators with our own world view, which will influence the way we look to engage with the regulatory process. These orientations are generally knowable because they are freely expressed.

The individual is capable of adopting any of the four motivational postures to be described; they can be held simultaneously, and can be brushed into play in a relatively short space of time, depending on the nature of the social interaction. Postures are not fixed characteristics or a person, but are the result of the dynamic interplay between persons or groups and those who want to influence their behavior.

In the taxation context, the motivational posture of resistance would describe a confrontational approach to tax officers and the tax system. From this perspective, the tax system is likely to be seen as oppressive and burdensome, and officers are likely to be construed as unhelpful, incompetent, mistrustful, and unwilling to consult with taxpayers.

The posture of disengagement incorporates a spirit of hopelessness on top of resistance. The state of disengagement is accompanied by nonresponsiveness. The system is viewed as one that should be avoided at all cost, and any demands for compliance should be dealt with in a minimalist fashion. Cynicism about the tax system is likely to be matched by cynicism about the power of government. From the disengaged perspective, there is little tax officers can do to harm citizens who do not comply. According to this world view, there is nothing that anyone can do to make a noncomplier comply.

Both postures have been linked with noncompliant behaviors, but with one important difference. Whereas the posture of resistance is associated with a desire to be respected by the authorities, disengagement is not. Research on nursing home compliance has shown that those who adopt a resistance posture are more likely to comply at a future state. Those who have disengaged, however, remain noncompliant (V. Braithwaite et al., 1994).

The noncompliant motivational postures are balanced by two compliant postures, accommodation and capture. Accommodation describes an explicit commitment to doing the right thing, supporting the system, accepting responsibility for compliance, and managing compliance demands conscientiously and effectively. From the perspective of this motivational posture, the tax system would be seen to have power that is legitimate, and that will be used against those who do the wrong thing. At the same time, tax officers would be seen as respectful of taxpayers, treating them as trustworthy, and consulting them when appropriate.

While the posture of accommodation involves deliberate and conscious commitment to satisfying the demands that are being made, the posture of capture is more laissez faire. The tax system is likely to be seen as something of which one is part, and tax officers are not to be feared, nor their approval cultivated. The posture of capture would be associated with the expectation that trust and cooperation will prevail, and that nothing too terrible would happen if one owns up to mistakes and remedies them.

Compliance these postures is social distancing or the manufacturing of social rift, a phenomenon that, as it increases, makes voluntary compliance less achievable. Capture and accommodation are postures of minimal social distance in that they signal belonging to the regulatory community. Resistance is the posture of those who want to be respected by the community, but feel apart. The social distance is greater; but can be reversed. Disengagement, on the other hand, represents psychological separation without feelings of loss: A wall has been constructed between the regulated and the regulator.

The significance of social rift is best understood through theories of shame and identity (Braithwaite, 1988; Lewis, 1971; Tajfel, 1978). As regulators expose behavior that is noncompliant, those being regulated protect themselves from disapproval by placing more social distance between themselves and their accusers. Through construing the situation in terms of "us" and "them," the noncompliers are able to hide in the safety of an identity that is at odds with the "demonic" other. To sustain this protective mechanism, the social rift must be allowed to continue and grow. When noncompliers pursue this path, cooperative resolution of the problem is difficult. The challenge for the regulator then becomes one of changing the motivational posture.
According to the responsive regulatory strategy, trying cooperation remains the best first choice for achieving this goal. To the extent that social rift is manufactured through feelings of shame, offering cooperation displays the elements of social reintegration that are a necessary part of eliciting compliance in the future. Offering cooperation to resistant and disengaged noncompliers, however, may not always be the response that regulators feel like making. If regulators respond to resistance and disengagement in a like manner, they may exacerbate the social rift already in existence. In such circumstances, the risk is that regulatory activity will spiral up the pyramid, driven more by emotional volatility than reasoned action. The responsive regulatory strategy cautions against emotional reactivity. The reasoned response is to try cooperation first, regardless of the posturing of the noncompliers.

The ATO Compliance Model

In 1996, the Australian Commissioner for Taxation created and appointed members of a Cash Economy Task Force. Research presented to the Task Force showed that there was widespread acceptance in the community that not paying tax on cash income was acceptable and that there was no certainty in the community that the ATO could detect tax evasion through the cash economy (Cash Economy Task Force, 1997). In 1997, Valerie Breathwaite was invited to join the Task Force as an academic advisor on compliance issues and community values. In preparing for its second report, the committee examined and assessed strategies that would enable the ATO to (1) better understand the dynamics of the cash economy, (2) build partnerships with the community, (3) introduce incentives to improve compliance, and (4) enforce compliance through a greater variety of, and more flexible, sanctions tailored to particular industries and cash practices, and to individual circumstances. In 1998, the Task Force recommended that these objectives be achieved through the development of a model of compliance behavior that would complement the existing Taxpayers’ Charter (Cash Economy Task Force, 1998). The Charter assures citizens of their right to be treated fairly and reasonably, having their privacy respected, and receiving timely and helpful advice and information.

The Australian Taxation Office Compliance Model has three key features, each feature represented on a side of the pyramid (Fig. 2). The front side contains the “menu of options” for dealing with noncompliance. They range from top to bottom: 

1. **Self-regulation**
2. **Motivational postures**
3. **Regulatory styles**

At the top of the pyramid, the compliance model can be characterized as self-regulatory. At the base of the pyramid, interaction with regulatory authorities is more confrontational. The style of engagement varies and depends on the situation and the policy objective. The model suggests that the establishment of a menu of options, ranging from encouragement to enforcement, provides a framework for handling noncompliance in a constructive manner.

ATO staff. Different groups dealt with problems at different levels, and each group had its own culture and set of beliefs as to the “correct” regulatory style. Recognizing a range of regulatory styles, while reinforcing the importance of taxpayers having an opportunity to cooperate initially, communicated an important message to ATO staff. Each subculture contributed to overall tax compliance; the “soft approach” of persuasion and dialogue being as important as the “tough talk” of the court room. One context for these efforts is the Taxpayers’ Charter ensuring protection of the rights of citizens.

The model of the regulatory pyramid suggests regulatory strategies, while the social rift model describes the posturing of those subject to regulation. The ATO Compliance Model brings these different sides of the regulatory relationship together to summarize the process of conflict escalation, not with the intention of avoiding conflict so much as managing it. As one goes up the regulatory pyramid, sanctioning mechanisms increase in severity.
sanctioning strategies communicate increasing disapproval to the taxpayer, the social rift between noncompliers and the regulatory culture likely increases, and the entrenchment of noncompliant regulatory postures is more likely to follow. The ATO Compliance Model thereby reflects the ways in which the costs associated with enforcing sanctions are magnified by the antagonisms unleashed by resistant and disengaged taxpayers.

On the left face of the pyramid are the motivational postures of taxpayers and/or their agents from accommodation at the bottom through capture, reflection, business, industry, ecologically, economic, and psychological signs (BIEPS) that might explain why taxpayers present themselves to tax officials to investigate regulatory encounters. Furthermore, systematic attention to the BIEPS over an extended period of time is believed to enhance ATO understanding of the structural underpinnings of noncompliance and provide the necessary intelligence for its early prevention.

According to the responsive regulatory model, ever-increasing sanctions may have to be used to gain compliance. At the same time, dialogue and persuasion must be pursued to draw out a more cooperative regulatory posture so that negotiations can be resumed as soon as possible at the bottom of the pyramid. For a taxpayer showing disengagement, a strategy that results in a move to resistance would improve the tax officer’s prospects for gaining compliance. A further move in the right direction would be achieved through a strategy that harnessed the motivational postures of capture or accommodation. Accommodation implies a deeper level of commitment than capture, and would be regarded as the motivational posture that is most conducive to processes of thoughtful persuasion and rich dialogue, both of which are desirable at the bottom level of the regulatory pyramid.

The effectiveness of strategies of dialogue and persuasion rest heavily on a strong and cohesive regulatory culture. The ATO compliance Model captures the importance of investing heavily in building a broad base to the pyramid, a base where there is considerable consensus on what compliance means, strong commitment to doing the right thing, and communication networks that reinforce the importance of law-abiding behavior. Such bases cannot be taken for granted. Nowhere is this more apparent than in relation to the cash economy (Cash Economy Task Force, 1998).

**RESPONSIVE REGULATION AND TAX COMPLIANCE**

**Large Corporations**

John Braithwaite has been working with the ATO in adapting the cash economy compliance model to large corporate compliance. The Compliance Model objective of understanding taxpayer behavior has involved the ATO’s Large Business and International Business line in a variety of sophisticated exercises in risk assessment. As mentioned earlier, this had led them to the position that the main risks to compliance with the intent of tax laws comes not in the form of tax evasion but in tax avoidance. It has established a Business Systems Development Project (Bruce-Smith and Pegler, 1998) to build the hard and soft networks for knowledge coaches to mobilize the mentoring needed to advance contextual understanding of taxpayer behavior.

A Strategic Intelligence Network has been put in place. An example of how it has transformed the understanding of taxpayer behavior is through the insight that there are only a handful of tax advisers who have the capability and aggressiveness to promote the tax shelters that are most damaging to the revenue. It follows that it may be more strategic to target this handful of advisers than to target taxpayers with a high risk profile. Strategic Intelligence Analysis developed an “AAA list” strategy. For a major aggressive adviser, an AAA list of the adviser’s key clients would be discovered. When these were revealed to be repeat users of tax planning schemes, they would remain on the AAA list for special-purpose audits until they changed to a more conservative approach to tax compliance. In some cases, targeted clients actually called the ATO to advise that they were switching tax advisers and to please take them off the AAA list.

Risk leveraging is a creative activity. It is a bad idea to provide a formula for how to do it because advisers will soon learn that formula. Continuous reinvention of risk leveraging is what will keep would-be avoiders guessing and therefore, complying. A culture of continuous reinvention of risk leveraging requires taking storytelling seriously. The ATO has decisively moved away from being a business run according to a Procedures Manual. At the level of informal staff interaction, ATO culture is no longer a rulebook, it is a storybook (Sheering and Ericson, 1991). A storybook orientation helps with another objective of the Compliance Model: increased flexibility in operations to support compliance. Best Practice Workshops to share success stories is an important part of the staff morale game in revenue authorities who feel embattled in their dealings with powerful corporate taxpayers. So too is recognition in performance reviews for the heroes of risk leveraging success stories.

Strategic Intelligence Analysis (SIA) seeks to build community partnerships, among other initiatives, through a 250 Financial Planners Project to create an informal soft network to open communication channels between SIA and 250 of the largest financial planning institutions. Another SIA initiative is for a soft network with a group of 15 large corporate tax managers who represent a slice of corporate Australia.

A growing source of flexibility in the ATO’s approach to compliance is to

*Since this paper went to press, decisions in the Australian courts have obstructed the ATO’s access to client lists of tax advisers that the strategy required. Consequently, this particular way of targeting advisers has been abandoned.*
take problems to international forums. The Advance Pricing Arrangement (APA) is one approach to locking in higher tax receipts from transnational corporations that has been enabled by cooperation through the OECD (Kilby, 1986). APAs are negotiated agreements between the ATO and corporations on a transfer pricing methodology that will result in an appropriate allocation of income and expenses between related parties that are selling goods or services between different countries. Negotiating APAs is painstaking work. Because they lock in higher returns much more than audits do and because they shift the rules of the game to more cooperative ones with business, the investment may be well justified. On the other hand, the ATO needs to monitor the cost of keeping APAs up to date in the face of company-, product-, and time-specific changes that make the parameters of the APA obsolete. In addition, there is a worry that only “squeaky clean” companies will ask for APAs, hence skewing ATO activity to areas of low risk. Often companies are reluctant to enter into APA negotiations because they fear this may reveal tax liabilities going back over many years. The kind of flexibility of ATO response required here is for the ATO to be willing to grant an amnesty or tax liabilities going back more than two years as part of the incentive for entering into negotiations. International tax competition can cause compliance problems that can only be addressed through international cooperation. The practice of enlisting cooperative strategies to solve competitive problems is not only relevant to APAs. The approach extend to tax havens and e-commerce as just two examples.

In effect, amnesty fees on back taxes use reward as a compliance strategy at the base of an enforcement pyramid. The Canadian Audit Protocols (Revenue Canada, 1986) that the ATO is piloting also reward cooperative relationships between the ATO and its clients with negotiated audit protocols that reduce compliance costs for business and increase compliance effectiveness for the ATO. This may include scheduling visits by different areas of the ATO so that disruption to business is minimized, doing concurrent audits, discussing in advance the form that efficient record keeping might take, and the like. The key idea is that Revenue Canada and participating corporations jointly produce a written framework that established guidelines for the relationship and the audit process. The ATO is also increasing the number of escalation options in its enforcement pyramid by innovating with a variety of audit products short of full-scale audits (e.g., special-purpose audits, real-time enquiries). Above audit, it has the capacity to submit cases to the superior investigative powers and criminal punishment orientation of the National Crime Authority.

High-Wealth Individuals

The High Wealth Individuals (HWI) Taskforce commenced work in 1996 simultaneously with the work to develop the ATO compliance model. The objective was an enhanced compliance management strategy for HWIs. In the first year of operation, 180 HWIs received a questionnaire about the group of entities they control or from which they receive income. These were formalized in subsequent years into expanded tax returns. This was an important innovation to enhance flexibility of response. The inflexibility problem being responded to was that previously either a single individual or a single corporation was a case. The HWI Taskforce made a single case of one of the highest-wealth individuals in the country and all the entities (trusts, corporations) under that individual’s control. To stay on the program, HWIs also had to be paying very little tax. The Task Force therefore enabled a more holistic view of tax planning by the rich. One HWI adviser explained why this strategy might be effective with this kind of taxpayer: “The more information he’s [the Commissioner] got, the less aggressive they will be in their tax planning.” This adviser explained that notifying X in 1999 reduces the taxpayer’s degrees of freedom to reconfigure his 2000 affairs in such a way that not-X appears to be the case in 1999. “Changes each year will be noticed.” So HWIs must keep their affairs consistent with the underlying truths of earlier declarations. Moreover the holistic surveillance of the HWI’s diaspora of entities means that it is harder to pretend X in the return of one trust and not-X in the return of another. The Task Force may have had modest success in this kind of way. Private companies controlled by individuals in the HWI program paid 17% less tax than non-HWI companies in 1994,12% less in 1995, 23% more in 1996, and 20% more in 1997. In other words, companies controlled by high-wealth individuals in the project changed from being below-average to above-average taxpayers.

Cash Economy

To date, the impact of the Compliance Model as a response to the cash economy has been in building a stronger community base. Partnerships have been built with industry associations to improve the flow of information and to find ways of making compliance easier. A theme common to many of the industry-based projects is better record keeping. The ATO, for instance, has designed and published a restaurant record keeping booklet, freely available and successfully marketed not only as a tax aid but also as an aid to better business practice. Industry benchmarking has also been important for educating tax agents and the public as to ATO expectations of taxable income from different industry groups. Real-time reviews have been introduced as well in certain industry segments to improve knowledge of and practices in keeping track of cash transactions. The activity at this level is providing the ATO with valuable feedback concerning appropriate incentives for recording cash transactions, intelligence regarding tax evasion schemes, and strategies that may discourage some kinds of evasion in the future.

CONCLUSION

A holistic understanding of taxpaying behavior is necessary to improve compliance. It will not be accomplished by considering individual or corporate
taxpayers one at a time as value-maximizing unitary actors. We can learn from the insight of evidence-based tax administration that industry associations, families, advisers, tax managers, tax agents, and international organizations like the OECD, among others, are loci of influence over tax compliance. The drivers of compliance at these different loci are plural. By seeing and managing compliance appeals in pyramidal fashion so that reward and trust are favored strategies at the base and tough enforcement at the peak, we can move responsively to improve tax compliance by mobilizing appropriate drivers at propitious moments.

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