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Responsive Regulation and the Uncertainty of Tax Law – Time to Reconsider the Commissioner's Model of Cooperative Compliance?

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Abstract

Over the last decade the Australian Taxation Office has adapted the model of 'responsive regulation' in developing its cooperative compliance model. This model seeks to promote voluntary compliance with Australia's taxation laws by tailoring the administrative treatment of taxpayers in accordance with the individual taxpayer's tax compliance posture. The fulcrum of this model of tax administration is the proposition that taxation law is determinate, such that 'complying' and 'non-

the expansion of the public scrutiny of government, arising from the open government reforms of the 1980s, including freedom of information laws and the creation of additional avenues for public sector review;[3]

compliance. Regulators need to be able to identify non-compliance so that they can adopt an appropriate regulatory response. However, even when proponents of responsive regulation acknowledge that the law is indeterminate, they do not consider the implications of legal indeterminacy for the responsive regulation paradigm. If the law is indeterminate, and in section 3 I argue that there are good reasons for accepting that at least some tax law is of indeterminate meaning, then the operation of the responsive regulation model in the domain of taxation law is open to question. If a significant challenge confronting tax administ

model, in terms of tax administration efficiency, is open to question given that the cost of raising each $100 of tax revenue has increased over the past decade.[15]

One purpose of this paper is to explore the implications for the responsive regulation paradigm if one accepts, as I argue we must, that at least some tax law is of indeterminate meaning. The second purpose of this paper is to suggest future directions for quantitative and qualitative research with a view to quantifying the significance of these implications for the cooperative compliance model in its day to day operation.

2. WHAT IS RESPONSIVE REGULATION?

2.1 A definition

The concept of 'responsive regulation' entails administration of determinate law by officials who tailor their regulatory behaviour according to the compliance posture adopted by individuals subjected to the relevant law.[16] The hallmark of responsive regulation is the pursuit of cooperation by the regulatee with the regulator:

> Regulatory pyramids offer the advantage of handing tax officers a set of tools that can be applied without having to have a detailed understanding of why non-compliance has occurred. One starts with the expectation of co-operation; escalation on the pyramid occurs only when one sees the other defaulting and becoming non-co-operative.[17]

The compliance pyramid depicted by the Commissioner in his *Compliance Strategy*[18] reflects his interpretation of responsive regulation in the taxation domain.[19] For taxpayers who adopt a posture of 'voluntary compliance',[20] responsive regulation entails the provision of assistance in enabling taxpayers to understand and comply with the law. However, for taxpayers who adopt a posture of 'resistance', the tax administrator will consider deploying an escalating range of enforcement measures in achieving compliance. As taxpayers exhibit increasing resistance to 'cooperation', under the 'tit for tat' principle[21] the Commissioner responds with escalating enforcement powers.

2.2 Voluntary Compliance and Legitimacy

Promoting voluntary compliance generates public sector efficiency gains because the governed become voluntarily complying self-governors, thereby enabling the

[15] Commonwealth of Australia, *The Commissioner of Taxation Annual Report 2004-05*, Australian Taxation Office, Canberra, 2006, 11 (Fig 1.9). Of course, there is an infinite array of v0003 Tcof0.8(20w[(Proolecr46

regulatory agency to devote its limited enforcement resources to those exhibiting resistant postures. Tyler's work suggests that voluntary compliance is enhanced by legitimacy, and in turn that legitimacy is enhanced if procedural fairness is adopted by regulatory agencies.[22]

There are various factors which might induce compliance with the law: the perceived risk of sanctions, peer/social pressure to comply, normative motivation founded upon a sense of obligation to comply with laws which accord with a person's sense of morality and/or a belief that the law/government is legitimate such that the law must be obeyed.[23] Tyler notes that reliance upon sanctions alone will be ineffective in achieving effective and efficient regulation of compliance. Further, Tyler notes that moral norms offer an unreliable basis for governments seeking to achieve compliance with the law – moral heterogeneity within any community makes it virtually impossible that most will agree with the morality of all law. Similarly, peer/social pressure are unreliable. By contrast, Tyler argues that legitimacy offers governments the promise of discretionary authority – people will obey the law, even if they disagree with the law, simply because they believe that the law must be obeyed.[24]

Accepting that individuals continue their membership of social groups for self-interested reasons, Tyler observes that individuals use their perceptions of procedural fairness as a proxy for substantive fairness:

> The model that has been developed rests on an assumption that people ultimately care about issues of self-interfairn03 459.h l h1.8c7 ( )-5.8(o)-6.6h(es of).5(a)-5.o(e)-5.5(r)-1.x(c)-
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areas of tax compliance risk. Trusting the tax administration not to impose penalties arbitrarily, such taxpayers would seek the a

who, apparently routinely, would argue for an untenable interpretation of the relevant law.[43]

3. WHAT IS COMPLIANCE? LIBERAL L

holds that the state must be neutral as to competing conceptions of the good life, because favouring one conception over another would be oppressive and hence be an illegitimate exercise of state power.[52] There are competing understandings of how this principle of state neutrality should be adopted in practice, with some accepting it entails state compliance with formal procedures laid down in a 'rule of recognition'[53] while others hold that state legitimacy hinges upon compliance with some substantive principle of neutrality (ie promoting efficient private markets). Nevertheless, it is clear that the norm of state neutrality dictates that 'the law' is applied uniformly across all legal subjects because the imperfect administration of a 'neutral' law is as evil as a non-neutral law.

This requirement that the law be administered neutrally means that a community must be able to define compliance by reference to an objective standard which is independent of the behaviour of the participants in the process. That is, the meaning of the law must be clear such that state oppression through wrongful exercise of state

the definition of compliance suggested by James and Alley is adopted. This definition holds that compliance entails 'the willingness of individuals and other taxable entities to act … within the spirit as well as the letter of tax law and administration, without the application of enforcement activity';[56]

the Australian Taxation Office adopted what John Braithwaite labeled a literalist approach[57] to defining compliance, quite possibly drawing upon the definition adopted by Roth, Scholz and Witte;[58]

on occasion the Australian Taxation Office adopts a 'purposive' approach to the interpretation of taxation law;[59]

the Australian Taxation Office appears to adopt a theory of legislative meaning which incorporates both pragmatic and purposive elements;[60] and

the Commissioner ofsj/TTaxatifmsn

noted that if the 'right' interpretation is governed by the regulator's interpretation of the law, it is difficult to see how the rule of law is definitional of responsive regulation, because this would make regulators judges in their own cause and lay the way for autocratic power, which Ayres and Braithwaite expressly disavow.[67]

However, for present purposes it is clear that determinate meaning of authorized legislative texts, as determined by one means or another, is central to the operation of responsive regulation. There is little point in revisiting the substantial literature regarding the limitations of this liberal legalism.[68] However there are two salient aspects of liberal legalism which are particularly relevant to the ensuing discussion of responsive regulation:

1. a central aspect of liberal legalism is the proposition that a legislative text, created in accordance with the appropriate 'rule of recognition', constitutes law and is the focus of any interpretive inquiry. The interpretation of the text is not an open-ended inquiry into what is 'right' – it is the quest for the one 'right' legislative meaning. Finding the one right meaning of the text means that the consideration of the moral aspects of competing interpretations is just as irrelevant as perceptions of the various pragmatic consequences of differing interpretations.

   Under the paradigm of responsive regulation, then, a person is not a 'cheat' if they 'buy' a legislated tax favour through 'lobbying' and/or clandestine political deals.[69] From this perspective, such legislated deals are legitimate because they are 'the law' and are therefore apparently assumed to express the 'democratic will'.[70] The opacity of the legislative process and the myopia of 'the people' are ignored.[71] By contrast, a person who does not procure such legislative favours is a 'cheat' if they do not 'cooperate' with what they perceive to be a defective law which has emerged from a defective process driven by the machinations of powerful interest groups.

   Liberal legalism therefore dictates that we ignore the prospect that people might be cynical about the origins of a law and hence be cynical about the justice and fairness of a law. By adopting this legal formalism, Tyler and others within the responsive regulation fold have focused our attention upon the legitimation of the tax administration, rather than upon the legitimacy of the government's taxation institutions and the substantive law more generally.[72] However, if the law is indeterminate, it is possible that taxpayers look beyond administrative procedural fairness; and
2. legal formalism lends itself to a top-down, command and control theory of state power. Under this paradigm, state power is concentrated in state institutions

[67] Ayres and Braithwaite, above n 21, 53.
[68] For discussion of the concept of legal formalism, and its limitations, see Duncan Kennedy, 'Legal Formality' (1976) *Journal of Legal Studies* 351; J. Shklar, *Legalism*, Cambridge Mass 1964.
[69] Dan Roberts, 'GE surges as tax breaks cut in', *The Australian*, 24 January 2005, 28.
[70] Ayres and Braithwaite, above n 21, 82.
[71] The limitations of the legislative process in Australia were considered, albeit in the limited context of small business tax concessions, in: Mark Burton, 'The Australian small business tax concessions – public choice, public interest or public folly' (2006) 21 *Australian Tax Forum* 91. See also Mark Burton, 'Chaos, Rhetoric and the Legitimisation of 'Democratic' Government – A Critical Review of the Australian Tax Legislative Process" (2007) *Sydney Law Review* (forthcoming).
[72] Tom Tyler, *Why People Obey the Law*, Princeton University Press, Princeton, 2006, 262.

Apparently in recognition of this threat to responsive regulation, John Braithwaite has argued that the tax law can be made 'more certain' by adopting a combination of legislative principles and legislative rules. This legislative framework, Braithwaite suggests, would promote a purposive approach to legislation.[80] Under this approach,

> and who is driving a fully laden old car which has outmoded brakes and suspension. It is possible Braithwaite's interpretive model means that the law is no more certain than under any of the existing interpretive approaches adopted by the courts.

4.2 No consensus regarding interpretive standpoint

The second source of legal indeterminacy is that there is no consensus regarding the appropriate interpretive standpoint.

In view of the various approaches to defining the context of legislation for the purposes of ascertaining its meaning, it would be possible for a community to (somehow) agree that ambiguity should be resolved by recourse to one interpretive standpoint such as 'adopt the meaning which is most efficient in an economic sense'. Thus, Ayres and Braithwaite describe their concept of 'regulatory republicanism' in which an 'enlightened' private sector and an informed public sector engage constructively in deliberative dialogue.[86] This draws upon the communicative theories of Habermas[87] and Sunstein[88] which posit that rational conversations will tend to produce determinate meaning. However, there is good reason to question whether consensus can be reached when the participants in a shared conversation hold incommensurable standpoints.[89] Ayres and Braithwaite seem to acknowledge this issue, without adequately addressing it, when they express a preference for small group decision making upon the basis that it would 'maximise the prospects of genuine dialogue around the table leading to a discovery of win-win solutions, instead of a babble of many conflicting voices talking past each other.'[90]

Such standpoint incommensurability may be seen in the literature regarding taxation law. Within this literature there are diametrically opposed standpoints regarding the interaction of the concept of private property with the nature of taxation:

> for those who adopt a communitarian perspective, all property belongs to the state and so 'tax' is not an imposition upon individuals but merely the portion of the

rules, poorly framed tax concessions and tax loopholes continue to cloud any putative purpose, if one exists at all.

The Commissioner compounds the problematic identification of the underlying purpose of the law by sanctioning some arrangements which appear, at least to many tax practitioners, to have all of the hallmarks of 'aggressive tax avoidance'. For example, in his Media Release[118] regarding superannuation recontribution

The favourable treatment of superannuation by the Commissioner may be explicable on public policy grounds, but this favourable treatment has no clear legislative basis. By sanctioning a formalist approach in the case of superannuation recontribution arrangements, the Commissioner is signaling that, in circumstances of his choosing, he will vary his usual approach to the general anti-avoidance rules. This apparently arbitrary application of the general anti-avoidance rules may foster cynicism among tax advisors. Indeed, anecdotal evidence indicates that at least some tax advisors had advised clients against superannuation recontribution arrangements before the Commissioner's press release upon the basis that such arrangements were too aggressive. One point which the research literature does not explore is whether such arbitrary administration of the taxation law causes tax advisors to lose confidence in the integrity of the taxation system and/or whether they take courage to explore other opportunities for minimizing tax on behalf of their clients.

5. PARTNERSHIP OR STRATEGIC ALLIANCE? LEGAL INDETERMINACY AND WHAT IT MEANS TO BE "COOPERATIVE" UNDER THE COOPERATIVE COMPLIANCE MODEL

voluntary compliance. This link is fundamental to the cooperative compliance model. However, it is possible that Tyler's findings are inapplicable in the context of taxation law because of differing public perceptions of criminal law and taxation law respectively. Although Tyler noted the limitations of his study, and in particular the absence of literature demonstrating the applicability of his findings in other legal contexts,[128] little has been done to address this shortcoming with specific reference to taxation law.

An integral aspect of Tyler's study was the accuracy with which it was assumed that survey participants would self-report their compliance with the laws in question.[129] Tyler perhaps too readily accepts that the public are in a position to judge whether they have complied with such rules. Nevertheless, it might be that these rules of criminal law have assumed a relatively determinate meaning in Tyler's subject population. However, there is reason to doubt the relevance of Tyler's work to taxation law, given that 52% of the respondents in one recent survey agreed that they felt 'very confused about taxation matters'icipants would

Given that many Australians seem to view taxation law differently to the way in

5.4 Partnership and the problem of incommensurability

The indeterminacy of law also problematises the implementation of the compliance pyramid because of the fact that the Commissioner and taxpayers might have quite different understandings of what it means to comply with the tax law in specific contexts. By contrast to the adversarialism discussed in the preceding paragraph, such conflicting interpretations might be genuinely held in the sense that both parties genuinely believe that they have arrived at the 'correct' amount of tax to pay. This was acknowledged, for example, by the Senate Economics References Committee in its consideration of the mass marketed tax minimization arrangements of the 1990's.[144]

If 'cooperation' with the Commissioner is central to the concept of compliance, taxpayers who are not in a financial position to challenge the Commissioner's interpretation will feel coerced into complying with what they consider to be an incorrect interpretation of the law. Here, the Commissioner's adherence to the proposition of determinate law can cause real damage to the perceived legitimacy of the tax system at an individual level because the Commissioner fails to acknowledge that incommensurable interpretive standpoints may lead to different, plausible interpretations. By enforcing what he considers to be the correct interpretation of the law, it is possible that taxpayers will submit to the Commissioner's coercive power but move to a different compliance posture in the future. Again, such an outcome would be destructive of any partnership with the taxpayer.

5.5 Indeterminacy and the diffusion of social power – the genesis of strategic alliances

The third implication of legal indeterminacy for the concept of partnership is that officers within the Australian Taxation Office might be less secure about what compliance means in a particular case. Meaning will be contingent upon the interpretive stance adopted by the particular tax officer in the specific case and having regard to other contextual factors. Thus the neat dichotomous categorization of taxpayers depicted in the compliance pyramid, between compliers and non-compliers, will be problematic. Instead of black and white, there will be many shades of grey. As different tax officials interpret the law and taxpayers' circumstances differently, there is the possibility that the Australian Tax Office will speak with multiple dissonant voices as its officers grapple with the indeterminacy of the rules they are meant to enforce.[145]

5.5.1 Strategic alliances and diffuse social power

If there is no mutual understanding upon which a partnership between the taxation

> paying no tax who therefore have no interest in trading off higher compliance for lower company tax rates. However, floating the possibility of a *compliance-tax-rate-spiral* as something that might work in future could encourage public-regarding business taxpayers to see that in the long run there is much that Australian business could gain from a more cooperative compliance culture.[152]

Presumably public regarding businesses are already voluntarily complying with the law, so it is not clear how this compliance tax rate spiral would induce non-taxpaying taxpayers to pay tax. It is possible that lower tax rates will induce non-taxpayers to pay some tax because the perceived costs of minimizing tax are greater than

clients prefer low risk tax returns, it may be that in the context of ambiguous law advisors and clients have differing understandings of the meaning of 'low risk.'[162]

Therefore a number of questions are worthy of further investigation:

1. in selecting a tax advisor and seeking advice, do taxpayers clearly express their tax risk preference, such that the significance of tax advisors' influence is diminished? This is important because the personal opinions of tax advisors regarding the tax system might be outweighed by market forces – tax advisors would have to meet the tax advice market rather than tax advisors shaping that market;
2. whether the Commissioner's cooperative compliance program has induced a communitarian ethic on the part of tax advisors, such that ambiguous law is interpreted less 'aggressively'. Alternatively, have tax advisors adopted/maintained a self-interest ethic, under which they selectively negotiate strategic alliances with the ATO when in their clients' respective interests, while adopting 'aggressive' stances when this is perceived to be in their clients' respective interests; and
3. if such an ethical shift has arisen, what were the drivers and inhibitors of this shift and if such an ethical shift has not arisen, what might prompt such a shift? In particular, what is the significance of Taxation Office actions such as the publication of more inform

However, given the preceding discussion regarding the indeterminacy of the compliance concept, it is clear that there are shades of grey which the survey data does not tease out. After all, it should be remembered that many of those who participated in 'aggressive tax minimization arrangements' claimed to have taken appropriate steps in ensuring that their arrangements were 'within the law' and were not 'aggressive'.[165]

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obtain assurance that they are within the law has been supported by a number of studies in several jurisdictions.[173] However, the literature in this field indicates that clients and tax advisors often talk at cross purposes when discussing relative levels of audit risk with respect to particular items on a tax return.[174]

Third, the Braithwaite/Sakurai study does not indicate whether taxpayers would adopt a 'minimum fuss' approach where to do so created a higher perceived tax burden than would apply if some tax minimizing advice were followed. As Braithwaite notes, survey responses are context dependent.[175] With this in mind, it would be useful to know whether those who opted for a 'minimum fuss' approach would have responded similarly if told that this approach would effectively cost them $10,000 by comparison to a 'legitimate' restructuring of their affairs akin to the formalism of a superannuation recontribution arrangement. Braithwaite's conclusions as to taxpayer attitudes to compliance must be read cautiously, owing to the significant prospect that taxpayer attitudes towards compliance may vary with the context in which those attitudes are formed.

5.5.4 Coooperative compliance and tax advisors – the need for further research

Assuming that tax agents do play a significant role in shaping their client's risk profiles, responsive regulation posits that tax agents will adopt the cooperative, communitarian ethic of the responileraolatio9.1(ar)TJ18.8888 0 TD0.0007 Tc0.102 T3w[(to arnd)(thd, u)ce

lifting the veil of secrecy. Indeed, Braithwaite speculates that such action may be appropriate in the case of large corporate taxpayers,[183] although he does not explain why restricting tax system transparency to this demographic group would be appropriate. The most obvious benefit of such an approach would be that the Commissioner would not need to devote as many resources to integrity assurance measures designed to promote community confidence in the tax administration. Further research needs to be undertaken with a view to identifying the relative merits of a relaxation of the Commissioner's secrecy obligations.

6. CONCLUSION

There can be little doubt that the cooperative compliance model represents a quantum shift in the taxpayer/tax administration relationship, and it is doubtful that many would argue for a return to the adversarial approach of the past. Nevertheless, the cooperative compliance model is still under developmen

importantly, adherence to the legal determinacy thesis enables the Commissioner to adopt a 'don't shoot the messenger' discourse – 'I am only applying the law'- when confronted with allegations of partial tax administration or when subjected to political pressure.[185] More cynically, endorsing the proposition that 'the law is the law' means that the Commissioner is able to promote his interpretation of law, which he most probably knows to be contingent, as the 'right' interpretation. By doing so, he maintains the faith in impartial administration while in fact adopting contingent interpretations of ambiguous law. Further, by adopting this message, the Commissioner hopes to reassure the general public that all really are equal before the tax law, despite the evidence of regulatory capture which suggests the contrary.

Significant parts of the tax law are indeterminate and the implications of this indeterminacy for the cooperative compliance model must be the subject of further quantitative and qualitative research. In the absence of such research, it is possible that responsive regulation is not fulfilling its promise. It is possible, for example, that tax administration does not entail a partnership. Instead, Commissioner and taxpayer alike might pursue their respective interests as they best see them in specific contexts. In specific contexts, the interests of taxpayer(s) and tax Commissioner might overlap and so a strategic alliance will be formed. In other contexts, the interests of taxpayer(s) and Commissioner might diverge and any former strategic alliance will dissolve. It is possible, therefore, that effective tax administration is undermined by the failure to acknowledge the significance of law's indeterminacy for the cooperative compliance model. The limited evidence available suggests that these possibilities cannot be discounted. It is time to reconsider this model by undertaking further research.

[185] Michael Carmody, 'Administering Australia's Tax System' Monash University, Law School Foundation Lecture, 30 July 1998; see also George Megalogenis, 'Cheats lobbying politicians to pressure the ATO' *The Australian*, 31 July 1998, 5.