

POLICY ESSAY

SERIOUS TAX FRAUD AND NONCOMPLIANCE

Criminal prosecution within responsive regulatory practice

Valerie Braithwaite

Australian National University

In his article, Levi (2010, this issue) makes an argument for why serious tax fraud and non-compliance should be addressed through criminal as opposed to noncriminal proceedings. But will it deter the noncompliant? Context, as he acknowledges, is a central determinant in how sanctions affect subsequent tax noncompliance. Context includes the norms and attitudes of the community to tax evasion. It is also the case, as Levi notes, that a more “criminalizing” orientation has implications for “staffing levels and expertise of tax agencies, prosecution departments, and the already heavily occupied criminal and civil courts.” Such factors are bound to intervene between a more aggressive policy that applies criminal sanctions in response to serious tax evasion and the ultimate goal of deterring tax fraud and delivering to the taxpaying public just outcomes in response to serious tax noncompliance. That is not to say that Levi’s appeal should fall on deaf ears, just that it needs to be interspersed with a suite of other sanctioning mechanisms that have political support and that are embedded in the public’s understanding of how justice can be delivered in the domain of tax noncompliance.

Levi (2010) suggests that an analysis of cases—in particular, analogous cases—is the appropriate methodology for gathering evidence on causes and consequences. In the absence of such data, the policy question is how to progress the argument, begin a systematic scrutiny of cases, and maintain scope for correcting the strategy as evidence accumulates. Research supports Levi’s position that serious tax noncompliance needs to be a more costly exercise for taxpayers who intentionally engage in fraud, who drift into such activity through poor business acumen or financial desperation, or who act as opinion leaders and experts, convincingly discounting the risks of prosecution as they market financial products to an unsuspecting public. This policy essay considers how tax authorities might increase the costs of serious tax noncompliance through a

Direct correspondence to Valerie Braithwaite, Regulatory Institutions Network, Coombs Extension Building 8, The Australian National University, Canberra, Australian Capital Territory, Australia 0200 (e-mail: Valerie.Braithwaite@anu.edu.au).

suite of mechanisms that support rather than detract from criminal prosecution while preserving efficiencies in tax authority budgets and reassuring compliant taxpayers.

Community Norms and Expectations on Serious Tax Noncompliance

Arguably, the time is ripe for seeing serious tax noncompliance as a criminal activity that warrants a response that uses the full force of the law. Although tax evasion, at times, has been dismissed as the sort of thing that everyone would do given half a chance, the evidence suggests a stronger sense of law abidingness around the issue of paying taxes in the broader community. The public are well aware that the benefits offered by governments are dependent on the tax that everyone pays, and although acceptance is widespread that not everyone pays their fair share of tax (in particular, those in positions of privilege and power) and that governments are not immune from wasting taxpayers' money, community support is strong for the principle that it is everyone's responsibility to pay taxes (V. Braithwaite, 2009; Kirchler, 2007).

More recently, the case for governments taking a firm stand against serious tax evasion has been mounting. Few can argue with the costs that serious tax noncompliance places on the public purse. It is now common knowledge that the tax gap of countries in the developed world amounts to billions, if not trillions, of dollars. Any argument that tax defiance on this scale is justified because wealthy individuals do not approve of how the government spends their money or because economic prosperity would falter if corporations paid the tax they truly owed seems trite, if not insincere. If the tax gap could be closed, then money would be available for governments to pay the debts incurred as a consequence of the global financial crisis, and money would be available to spend on quality health care and education as well as on promoting environmental sustainability. Making the argument that tax monies are best placed in the hands of government rather than in private individuals or corporations is probably easier today than it has been for many decades.

Serious tax noncompliance also has assumed greater importance as a crime warranting investigation and for criminal prosecution because of the link that Levi (2010) points to between tax noncompliance and other serious financial crimes. This connection has been reinforced in public consciousness in the last decade with exposure of "secret havens" for purposes of money laundering post-September 11 and with revelations of the array of complex financial arrangements for reducing tax liability in the wake of the global financial crisis. Recent events strengthen arguments that tax noncompliance should not be given special status or be viewed as distinctively different in quality from other financial crimes of wealthy elites and corporations.

Although it seems unlikely that much public sympathy would persist for anyone making the case that serious tax noncompliance deserves the leniency described by Levi (2010), strengthening the government's arm to rein in serious tax noncompliance is not without pitfalls. Three policy challenges raised by Levi will be discussed. The first is putting sufficient resources into the investigation and collection of evidence for criminal prosecution. The second is differentiating between forms of serious noncompliance, bearing in mind that intentionality is not always readily identified in this domain. The third challenge is to manage the financial planning

industry that has burgeoned and embraced a range of forms of tax minimization and avoidance without clarity as to which forms are legitimate and which are not.

Resources for Investigation and Prosecution

Levi (2010) makes the point that serious noncompliance is “a behavioral and administrative label, not a legal one.” Included are major frauds that are prosecuted and what Levi describes as “serious” evasion cases that might meet *prima facie* criteria for fraud but are dealt with by negotiation and by administrative law and civil penalties. His argument is for pushing more cases through to criminal prosecution, presumably with better guidelines for doing so to enhance accountability and transparency. Levi puts forward the view that serious tax noncompliance will not be reined in through negotiating settlements or by imposing civil penalties “away from the gaze of the media and the public.”

In an important sense, Levi’s (2010) point is sound. When the government sanctions certain activities and labels them criminal, a message is sent to the community that says, “if you are an honest taxpayer and do not want to join the criminal ranks, then do not venture down this path because we will prosecute you.” Messaging about unacceptable conduct strengthens the self-regulatory moral pathway and is a relatively cost-effective way of improving compliance (V. Braithwaite, 2009). Being able to label serious tax noncompliance as a criminal act as opposed to dabbling naïvely on the margins of illegality might be expected to add to the salience of the message for those who value being law abiding. The message harnesses even more regulatory effectiveness if accompanied by steps that should be taken to avoid trouble (e.g., seeking advice from an honest tax adviser; V. Braithwaite, 2009). Tax authorities commonly issue guidance notes to tax practitioners to help them stay on the right side of the tax law and keep their clients out of trouble. This cost-effective strategy is commonly used for building a shared understanding in the tax community for what is expected and what kinds of actions risk prosecution.

Although all of these policies can be implemented without too great a cost to tax authorities, Levi’s (2010) point is that messaging is not credible if nothing much is done about noncompliance or, more importantly, if nothing much is observed to be done by authorities to control serious cases of noncompliance. And by and large, nothing much is observed as being done. Public skepticism about law-enforcement efforts has been captured through survey research (Braithwaite, Reinhart, Mearns, and Graham, 2001). Collecting taxes from high-wealth individuals and corporations, for instance, is regarded as a higher priority by Australians than reducing taxes (Braithwaite et al., 2001). It is in this kind of social context that Levi’s proposal for more public prosecutions and criminal sanctioning has merit. Otherwise, the cheaper option of messaging about honesty in taxpaying cannot be expected to hold sway. Honest taxpayers, those we might call the converted, might lie awake worrying about doing the right thing—as they always have done—but those engaged in serious tax noncompliance will dismiss the message as nattering or as a bluff because they see no action being taken to increase the risks of being caught. What is worse, no action suggests a covert message—that the authority lacks resources or is hamstrung in some other way and cannot take action. Stern messaging without

following through with firm action, in some quarters, will be an invitation to game play—to challenge and compete with the system and beat it through exploiting perceived weaknesses (V. Braithwaite, 2009).

So what is involved in reinforcing messages by increasing public prosecutions, particularly criminal prosecutions? Preparing cases for prosecution invariably will require greater resources. Realistically speaking, it is unlikely that tax authorities in the United States, Europe, Britain, Australia, or New Zealand in the foreseeable future will receive significant boosts in funding to pursue tax prosecutions more aggressively (unless it is part of a special project or task force to address a particular risk to revenue). Most tax authorities have been gearing up to do more to improve compliance with fewer resources, thus the emphasis throughout the Organisation for Economic Cooperation and Development (OECD) on improving voluntary or quasi-voluntary compliance. Where Levi's (2010) analysis, however, has real bite is in the assertion that, as the pendulum has swung in the direction of persuading and educating the public to do the right thing, attention has strayed from effectively dealing with those who were never going to comply voluntarily. Bureaucracies become caught in their own one-size-fits-all policies; the public are uniformly consistent tax cheats, who need to be sanctioned into submission or into uniformly law-abiding citizens waiting for education and persuasion. Policy needs to be more versatile with recognition that good governance means dealing with both groups of taxpayers as well as those Levi identifies as in transition, and staff need to be adept at using such policy to elicit the best outcome given the form of noncompliance they are confronting.

Regulatory pyramids, or as Levi (2010) describes them, “graduated sanction models,” ideally are suited to achieve both objectives of recognizing virtue and holding vice to account through criminal sanctioning if need be. The central principle is to give taxpayers the option of recognizing their noncompliance and making amends in the knowledge that if they do not, then the costs of noncompliance will escalate, right up to the point of corporate capital punishment if necessary. As Levi notes, the efficiency of regulatory pyramids is in the fact that not everyone requires maximum escalation. Different amounts of pressure are required in different cases to achieve compliance, and in most cases, this process will be far less than the full force of the law. The full force of the law and associated resources then can be saved for those cases in which it is the last option available to the authorities.

Levi's (2010) objection to graduated sanctions is that the authorities never get to the point of criminal prosecution or that the process is too slow and labored to be effective in preventing more fraud. A negotiated settlement is reached or civil penalties are applied behind closed doors, and fraudsters go back to their fraudulent practices without incurring costs of any significant kind. Levi's point is well taken, but the problem is not with regulatory pyramids; rather it is with the ways in which tax authorities have tried to script particular responses in the form of preprogrammed stages of regulatory intervention. This “game-like” approach of do X if the errant taxpayer does Y and settle as soon as is practicable is not an adequate way of operationalizing the intent of regulatory pyramids, and it certainly does not reflect the ways in which talented investigators use the principles of regulatory pyramids in practice.

Psychologically and socially, regulatory pyramids do three things. In focusing on education and persuasion, regulators are trying to draw out a moral self, with the assumption being that law abidingness, at some level, is part of every person's socialization experience. Evidence shows this concept to be one of the major pathways for reining in tax defiance (V. Braithwaite, 2009). Second, the regulator is trying to connect the errant taxpayer with the norms and standards of his or her community that neither approves of nor benefits from one of their own facing prospects of prosecution, which is why restorative justice conferencing is recommended for use at any, if not all, stages of escalation up the pyramid (Braithwaite, 2002). Third, the regulator is impressing upon the taxpayer that follow-through will occur, right up to criminal prosecution if necessary. Regulatory pyramids have to have tops in practice and in theory if they are to be used to deal with noncompliance (Ayres and Braithwaite, 1992).

The fact that many authorities use regulatory pyramids without tops lies at the heart of Levi's (2010) concerns about the effectiveness of "graduated sanction models." The question of "why no tops" is indeed one for policy makers. Does the law permit the use of the top? Does the authority have political support to use the top? Does the authority have the resources to pursue the case to the top? Do the risks to revenue justify pursuit of the case to the top? For regulatory pyramids to work, tax authorities must follow through on cases in which the answer to all these questions is "yes."

Follow-through would do much to lift the integrity of tax authorities in the eyes of the public. If the problem is that capacity to follow through is too often thwarted, then would the routine use of criminal sanctions guard against administrative complacency in settling cases of tax fraud behind closed doors? Possibly, but if the objective is to use criminal sanctions to deter others, then it is important that the public sees that the most egregious cases are taken to court and that convictions follow in fair and reasonable circumstances.

Roche (2006) looked into patterns of prosecution for tax evasion in Australia in 2005 after the tax commissioner announced a crackdown on cases of tax fraud. Australia has the kind of arrangement that Levi (2010) suggests might be advantageous in ensuring that different kinds of fraud against the government (e.g., welfare and tax) are dealt with in a comparable fashion. The Australian Tax Office refers cases to the Office of the Commonwealth Director of Public Prosecutions (DPP); the tax authority does not have authority to prosecute except for minor cases. The tax office set up a Serious Non-Compliance Unit in 2003, and 600 officers were assigned to work on "active compliance" soon after. Roche (2006: 3) described it as follows: "This new enthusiasm for punishment is borne out by figures showing a steady increase in DPP prosecutions of tax offences, from 121 in 2001–02 (60 of which resulted in prison sentences) to 172 in 2003–04 (81 of which resulted in prison sentences)." With this change came a flood of press releases announcing successful prosecution and jail sentences. The press reported the following: "These sentences, of up to six-and-a-half years, are finally burying a widely held myth that the worst that can happen for tax offences is a heavy fine" (Roche, 2006: 4).

The effectiveness of a tougher prosecution policy in making the public think more seriously about the consequences of tax fraud was not subject to rigorous evaluation, although as noted

by Roche (2006, citing Braithwaite, 2005: 29), during this period, corporate tax collections increased at a rate that was greater than growth in the economy. This phenomenon occurred at a time when corporate tax collection rates in OECD countries—already low—continued to fall. But Roche's interviews with a sample of those who had been prosecuted suggest that some undesirable consequences were incurred for tax office credibility during this period. Most importantly, the targets for prosecution were biased toward lower to middle classes (some cases involved welfare as well as tax fraud) and did not include wealthy elites and corporations—a fact that did not escape the notice of those who were prosecuted. It is likely that the DPP did not have the specialist knowledge necessary for prosecuting anything more than the more open-and-shut cases of tax evasion. Second, delays in prosecution were inordinately long. In the most extreme case, 5 years had elapsed between admitting the offense to an Australian Taxation Office officer and receiving a formal summons to attend court. As Roche (2006: 11) noted, “from a legal perspective, delay undermines the right to a fair trial” and breaches the spirit of the Taxpayers' Charter that promises procedural justice to all taxpayers.

Five years later, the Australian Taxation Office is working in partnership with five agencies with support from another two to investigate tax fraud at the top end of town. Project Wickenby has a budget of \$A305 million for 7 years. As of February 2010, Project Wickenby investigations have resulted in 57 people charged on indictable offenses, 26 criminal investigations, 1,167 audits with 665 under way, more than \$A573 million raised in tax liabilities, more than \$A174 million in tax collected, and almost \$A76 million in assets restrained (crimecommission.gov.au/media/faq/wickenby.htm.) The success of the project will be evaluated undoubtedly after its completion. In the meantime, these figures provide an indication of how resource-intensive criminal prosecution of serious tax fraud is, although it also should be noted that the taxes owing in the wake of the project are significant.

The purpose of this section is to concur with Levi (2010) that criminal prosecution is an important part of the sanctioning tool kit of tax authorities, but also to make the point that its feasibility is dependent on having policies that encourage the deployment of a suite of strategies to lessen the need for prosecution and to make sure that when it is used, the resources are available to optimize its effectiveness. The suite of strategies that have their own psychological, social, or economic deterrence value to a greater or lesser degree include queries directed to taxpayers and their advisers, desk audits, full audits with the intention of detecting fraud, skilled questioning to unpack the story of offenders, conversation to canvass future scenarios, conferencing to identify harms, and civil penalties to nudge people toward compliance—right up to criminal sanctions, seizing of assets, and reputational losses to prevent more fraudulent activities.

Differentiating Forms of Serious Noncompliance

Levi (2010) differentiates forms of serious noncompliance not only in terms of the size of lost revenue but also in terms of intentionality. Levi makes much of the planful fraudster, who sets out purposefully to defraud tax revenues—the “amoral calculator” or the “commercial socio-path.” This “type” is differentiated from “intermediate fraudsters,” who start out honestly but

turn to intentional fraud later, and “slippery-slope fraudsters,” who commit offenses of deception (and insolvency fraud) in an attempt to carry on their businesses and hopefully trade their way out of difficulty. Levi expects that criminal prosecution will affect fraudsters differently, depending on their intentionality, and he is attracted to a distinction between “theft from the public” and a more sympathetic version that might be described as “decisions not to meet all their legal and social obligations.”

Regulatory pyramids give investigators options for taking account of intentionality as they learn more about the case. Differences in intentionality as well as differences in the willingness to accept responsibility are important factors in determining how tax authorities respond to instances of tax fraud. When tax authorities select a case for closer scrutiny, establishing the degree of planning and purposefulness is part of the investigative process. As Waller (2007) reported after having interviewed car dealers subjected to visits from the tax office, people expect the tax authority to act on the knowledge that they have and to not waste time pretending to collect information that is already in its database. Waller’s study showed that it made no sense for scripts to be prepared for using regulatory pyramids, starting at the bottom, regardless of circumstance. If investigators have evidence of intentional and well-planned fraud, then they might adopt a highly intrusive approach, fairly high up on the regulatory pyramid, compared with how they might begin an investigation in which tax fraud is intertwined with incompetence and business failure. The practical utility of regulatory pyramids, however, is not so much where one begins but where one ends. The objective is always to keep the door open for cooperation of a genuine kind and to save resources for the cases in which tougher enforcement is necessary to elicit compliance.

Intention is an aspect of fraud relating to the past that investigators try to uncover. However, willingness to cooperate with the tax authority and to accept responsibility for fraudulent activity is a more dynamic quality, shaped by how the investigating officers conduct themselves, both in terms of their skill and competence and their adherence to principles of procedural justice. Regulatory pyramids allow tax officials to differentiate noncompliers in terms of their willingness to cooperate. Where fraud has been committed, and where the offender is prepared to acknowledge and accept responsibility for the crime, a case can be made for streamlining the process so that a person can pay their dues there and then, as opposed to waiting, sometimes for years among Roche’s (2006) sample, for a court date to air the same information. Obviously, the seriousness of the offense will frame what can and cannot be done procedurally. Given this constraint, however, merit exists in rewarding the moral self when it surfaces and strengthening its influence on future behavior. By contrast, little can be gained through prolonging punishment unfairly and, in the process, sowing seeds for resentment and defiance.

Managing Tax Avoidance

Adopting tougher enforcement policies on serious tax noncompliance requires support not only from the population at large but also from those involved in the tax and financial planning industries. As serious noncompliance is dealt with through criminal sanctions, it is necessary to keep open channels of communication with the financial planning industry as to where the line is being drawn between unacceptable and acceptable tax behavior. As Levi (2010) and others acknowledge, it is not always clear when tax minimization strategies serve legitimate business purposes and when they have no other purpose than to avoid tax. Tax authorities use the courts to test the law and to clarify interpretation, but this process invariably lags behind the development of new financial products for reducing tax liabilities. At the high end of the market, the beneficiaries of such products are wealthy elites and corporations who can stay ahead of the law. It is when the more complex and elaborate schemes are packaged for mass consumption that the holes emerge, and tax authorities swoop to close them down (Braithwaite, 2005).

The danger of an overreliance on criminal sanctioning in such cases is a delay in authorities taking action to reduce risk to revenue and minimize harm. As tax minimization schemes of dubious legitimacy are rolled out and marketed aggressively to the public, tax authorities need to issue warnings quickly and turn the stampede of investors around quickly. Having the capacity to prosecute scheme promoters and use criminal sanctions strengthens the hand of tax authorities considerably. By the same token, having such power is not much use if authorities are cut off and fail to gather intelligence of newly emerging schemes and how they are being marketed. For this reason, tax authorities need respectful, cooperative relationships with the financial sector along with a clear understanding of the kinds of activities that will be prosecuted with the full force of the law if necessary.

Within this environment, where the power of the tax authority can be matched by the power of the financial sector, Levi (2010) is critical of the way in which the fraudulent activities of large accounting firms can be swept under the carpet for fear of the collateral damage that might follow from public exposure. The timidity of regulators and their reluctance to ask questions and demand explanations played no small part in the unravelling of the financial system and the global financial crisis. But the policy lesson here is that regulators did not have to choose between looking the other way or preparing for a high-profile court case (see J. Braithwaite, 2009). Many steps could have been taken in between and been set in motion before problems were out of control, which involve investigative diligence and the opportunity for such firms to acknowledge misconduct and take steps to put their own house in order. In Levi's terms, would criminal prosecution be relevant in such a scenario? Most definitely. Criminal prosecution is the default. With this certainty in mind, the opportunity to acknowledge mistakes and to learn from them is the rational way forward for the accounting firm and for the regulator.

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Valerie Braithwaite is a professor in the Regulatory Institutions Network at the Australian National University and, formerly, director of the ANU's Centre for Tax System Integrity. Her research focuses on the micro-processes of governance and regulation, seeking answers to questions such as what makes people comply or defy, under what circumstances can government authorities expect cooperation, and what must these authorities do to earn respect in the eyes of citizens? She is the author of *Defiance in Taxation and Governance*, co-author of *Regulating Aged Care* and *Shame through Reintegration*, editor of *Taxing Democracy: Understanding Tax Avoidance and Evasion* and *Responsive Regulation and Taxation* (special issue, *Law & Policy*), and co-editor of *Trust and Governance*.