CENTRE FOR TAX SYSTEM INTEGRITY

The role of trust in nurturing compliance: A study of accused tax avoiders

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THE CENTRE FOR TAX SYSTEM INTEGRITY WORKING PAPERS

The Centre for Tax System Integrity (CTSI) is a specialised research unit set up as a partnership between the Australian National University (ANU) and the Australian Taxation Office (Tax Office) to extend our understanding of how and why cooperation and contestation occur within the tax system.

This series of working papers is designed to bring the research of the Centre for Tax System Integrity to as wide an audience as possible and to promote discussion among researchers, academics and practitioners both nationally and internationally on taxation compliance.

The working papers are selected with three criteria in mind: (1) to share knowledge, experience and preliminary findings from research projects; (2) to provide an outlet for policy focused research and discussion papers; and (3) to give ready access to previews of papers destined for publication in academic journals, edited collections, or research monographs.

Abstract

Why an institution's rules and regulations are obeyed or disobeyed is an important question for regulatory agencies. This paper discusses the findings of an empirical study that shows that the use of threat and legal coercion as a regulatory tool—in addition to being more expensive to implement—can sometimes be ineffective in gaining compliance. Using survey data collected from 2292 taxpayers accused of tax avoidance, it will be demonstrated that variables such as trust need to be considered when managing non-compliance. If regulators are seen to be acting fairly, people will trust the motives of that authority, and will defer to their decisions voluntarily. This paper therefore argues that to shape desired behaviour, regulators will need to move beyond motivation linked purely to deterrence. Strategies directed at reducing levels of distrust between the two sides may prove particularly effective in gaining voluntary compliance with an organization's rules and regulations.

The role of trust in nurturing compliance: A study of accused tax avoiders

Kristina Murphy

Introduction

For many regulatory agencies, managing non-compliance has become increasingly difficult over the past few decades. With the advent of globalisation and the disturbing increase in individuals and corporate citizens exploiting loopholes in the law (McBarnet, 2003), the question of how regulators can best ensure voluntary compliance with the spirit of the law is important. Having an accurate understanding of why people are motivated to accept third party decisions and rules can go some way to answering this question.

Two quite different theories that attempt to explain compliance behaviour have been proposed. The rational choice model has previously dominated the formulation of public policy in areas as diverse as criminal justice, welfare policy, and tax. The model posits that people are motivated entirely by economic welfare. They assess opportunities and risks and disobey the law when the anticipated fine and probability of being caught are small in relation to the gains from non-compliance (for a discussion see Kagan & Scholz, 1984). In the taxation context, for example, a taxpayers' choice is between compliance and tax evasion. By complying, the taxpayer incurs a loss in the form of taxes paid, but by evading tax there is the chance of a relative gain if the evasion is undetected. Alternatively, there is the chance of an even greater loss if the evasion is detected and penalized. According to the rational choice model, taxpayers calculate these risks when deciding whether or not to comply. Advocates of the rational choice model therefore believe that individuals or firms will comply with an authority's rules and decisions only when confronted with harsh sanctions and penalties.

In recent times there has been a convergence toward questioning the adequacy of the rational choice model for understanding interaction in natural settings and as a basis for social policy (for example, Cook & Levi, 1990; Tyler, 1990). Contemporary regulatory scholars suggest that attitudes and moral obligations, in addition to purely economic calculations or fear of punishment, are important in explaining compliance behaviour and therefore need to be considered when managing non-compliance (for example, Braithwaite, 2002; Kagan & Scholz, 1984). According to advocates of this view, the rational choice model ignores the possibility that people may be just as concerned about social issues such as justice and fairness when deciding whether or not to comply (Kinsey, Grasmick & Smith, 1991; Murphy, 2002a; 2003; Wenzel, 2002), or that they may be concerned about damaging their social reputation if caught doing the wrong thing (Grasmick & Bursik, 1990). It is hypothesized, therefore, that the most productive way to achieve genuine acceptance of, and adherence to, regulations is not by an exclusive reliance upon sanctions and legal coercion but rather through strategies that appeal to a citizen's law abiding self (for example, Ayres & Braithwaite, 1992; Bardach & Kagan, 1982; Braithwaite & Makkai, 1994; Hawkins, 1990). Placing trust in the foreground of a regulatory encounter has been one such strategy that has been suggested in the literature (for example, Braithwaite & Makkai, 1994; Cherney, 1997).

Trust and compliance

Over the past decade, the specific importance of trust in organizational relations has been increasingly recognized (for example, Braithwaite & Levi, 1998; Kramer & Tyler, 1996; Putnam, 1993). So too has the role that trust plays in influencing compliance with an organization's decisions and regulations (for example, Braithwaite & Makkai, 1994; Shapiro, 1987, 1990). In fact, Braithwaite and Makkai (1994) go so far as to suggest that trust actually nurtures compliance. Support for their view comes from a handful of empirical studies that have explored the relationship between trust and compliance (for example, Braithwaite & Makkai, 1994; Kim & Mauborgne, 1993; Scholz & Lubell, 1998; Tyler, 1990; 1998; Tyler & Degoey, 1995; 1996). These studies show specifically that trust does play an important role in determining acceptance and compliance with an organization's rules and decisions.

For example, in a study of multinational corporations, Kim and Mauborgne (1993) were interested in determining what motivated top level executives of subsidiaries to comply with corporate strategic decisions. Using a longitudinal survey methodology, Kim and Mauborgne found that if the executives trusted head office management, there was an overall positive effect on their compliance with corporate strategic decisions. Tyler and

Degoey (1996) were also interested in exploring whether trust influenced voluntary acceptance of decisions. They interviewed citizens of San Francisco about their views of a regulatory agency charged with enacting water conservation policies during a water shortage. They found that the regulator's trustworthiness was the major factor shaping citizens' willingness to accept their decisions. Tyler and Degoey also showed that within a variety of contexts and groups, trust consistently influenced feelings of obligation to obey organizational rules and decisions. In another study, Scholz and Lubell (1998) tested the link between trust and tax compliance. Using data collected from a national survey of 299 taxpayers in America, Scholz and Lubell showed that taxpayers' trust in government and trust in other citizens significantly influenced their levels of tax compliance, with decreases in trust resulting in higher levels of self-reported non-compliance with tax obligations.

Perception that a regulatory agency is untrustworthy has also been shown to be a function of whether regulators distrust those from whom they are demanding cooperation and compliance. Braithwaite and Makkai (1994) argue that if those being regulated are treated as trustworthy, they will repay this respect with voluntary compliance (see also Feld & Frey, 2002; Fisse & Braithwaite, 1993; Frey, 1997). Braithwaite and Makkai (1994) attempted to examine this question empirically by studying compliance in the Australian nursing home industry. Over a 20-month period, 410 nursing homes were inspected with the aim of determining whether or not they complied with 31 nursing home standards. During an initial inspection, each nursing home was given a compliance rating against each of these 31 standards. Eighteen months later, a follow up inspection was conducted and the compliance score given at the second inspection was of interest. Braithwaite and Makkai found that if inspectors were initially seen to be treating nursing home managers with trust, compliance was more likely to improve in the two years following the initial inspection.

Previous research therefore suggests that trust does play an important role in nurturing compliance with an authority's rules and decisions. Not only does this appear to be the case among individuals, but it also appears to be the case in the corporate sector. A regulatory strategy that initially places trust in the foreground of any encounter may therefore prove to be particularly effective in gaining individual and corporate compliance. Before advocating such a view, however, one must first be able to understand and explain the drivers of trust. For example, what can a regulatory authority do to improve trust among those being regulated? And what type of factors can lead to a decrease in trust?

Procedural justice

Several researchers (for example, Folger & Konovsky, 1989; Levi, 1998; Tyler, 1997; Tyler & Degoey, 1996) argue that the key to creating trust is to act in ways that citizens will experience to be fair. This argument is the core conclusion of the literature on procedural justice. Procedural justice concerns the perceived fairness of the procedures involved in decision-making and the perceived treatment one receives from the decision maker. The procedural justice literature demonstrates that people's reactions to their personal experiences with authorities are rooted in their evaluations of the fairness of procedures those agencies use to exercise their authority (Lind & Tyler, 1988; Tyler, 2000, 2001; Tyler & Blader, 2000). In fact, there is evidence to show that people who feel they have been treated fairly by an organization will be more likely to trust that organization and be more inclined to accept its decisions and follow its directions (Lind & Tyler, 1988; Tyler & Degoey, 1996). It has also been found that people are most likely to challenge a situation collectively when they believe that the procedures are unfair (Tyler & Smith, 1998). According to Tyler, this does not mean that the favourability of decision outcomes is irrelevant. Tyler argues that outcomes do influence reactions to experiences with third parties, and they strongly influence satisfaction with outcomes. However, both the willingness to accept outcomes and feelings about the decision-maker are dominated by reactions to the process (for example, Casper, Tyler & Fisher, 1988; Lind, Kulik, Ambrose & de Vera Park, 1993).

The 'group value approach' in the procedural justice literature specifically highlights the importance of an authority's perceived fairness, interpersonal respect, and neutrality in its dealings with others (Tyler, 1989; 1994; 1997; Tyler & Smith, 1998; see also Murphy, 2003). If people believe that an authority is 'trying' to be fair and treats its citizens fairly, they trust the motives of that authority and develop a long-term commitment to accepting its decisions. Being treated politely, with dignity and respect, and having genuine respect shown for one's rights and social status, have also been shown to enhance feelings of fairness. Finally, people are influenced by judgments of the neutrality of decision-making procedures. Neutrality includes assessments of honesty, impartiality, and the use of fact, not personal opinions, in decision-making. People generally seek a level playing field in which no one is unfairly advantaged (Tyler & Degoey, 1996; Tyler & Lind, 1992). Hence, if individuals perceive an authority to be acting fairly and neutrally, and they feel treated with respect and dignity, they will be more willing to trust that authority and will voluntarily obey and defer to its decisions and rules.

The present study

The aim of the present study is to explore empirically whether trust plays a role in predicting compliance in the taxation context. Scholz and Lubell (1998) have already addressed this question and shown that trust does play a role in predicting tax compliance. It should be noted, however, that Scholz and Lubell tested an instrumental-based version of trust. Instrumental-based trust sees trust being linked to individual beliefs about the likelihood of receiving positive outcomes from interactions with authorities. In the taxation context, for example, instrumental-based trust is linked to judgments of financial risk. Here, citizens undertake some immediate costly effort like paying taxes, but face some risk that future collective benefits expected in return for compliance (for example, tax-supported public goods) may not materialize unless the government and other citizens maintain their side of the bargain. Scholz and Lubell therefore argue that the positive experience of receiving tax funded benefits goes on to enhance trust and hence the likelihood of complying with tax obligations, while the negative experience of not receiving those benefits reduces both trust and compliance.

While Scholz and Lubell (1998) found that instrumental-based trust played an important role in predicting tax compliance, the present study aims to extend their work by showing that social-based trust—trust which is based on social relationships and fair treatment—is just as important, if not more important, for determining a taxpayers' willingness to comply with a tax authority's rules and decisions. The present study tested this assumption by conducting a large-scale survey on a group of Australian taxpayers engaged in a long-standing dispute with the Australian Taxation Office (Tax Office).

Disputes between regulatory authorities and those being regulated offer unique opportunities for examining people's willingness to accept decisions and rules. Disputes between taxpayers and tax authorities are particularly interesting because of the widely held belief that economic self-interest factors dominate taxpayers' actions. Consider for example the situation where a taxpayer is accused of tax avoidance. The accompanying penalties and interest on their outstanding tax debts can be quite substantial. Given the presence of economic self-interest factors, advocates of the rational choice model would predict that a taxpayer would respond to this situation based on how much they stood to lose financially. Those who argue that attitudes play a role in compliance behaviour, in contrast, would predict that social factors—as well as financial factors—would affect how this taxpayer would respond to the tax authority's accusation. By examining in detail the situation surrounding a real life dispute that involves high financial stakes, the present study will be able to evaluate the validity of these two opposing theories. The examined dispute is also of theoretical interest in its own right because it has implications for how regulators in general should manage non-compliance.

The dispute

Throughout the 1990s tens of thousands of Australian taxpayers 'invested' in mass-marketed tax effective schemes (for an example of a scheme see Appendix A). Their investments provided them with combined tax deductions exceeding four billion Australian dollars (approximately $2.6 billion USD). The Tax Office maintained that investments in these arrangements were largely funded through tax deductions and little private capital was at risk. The Tax Office therefore came to the conclusion in 1998 that taxpayers who invested in these schemes did so for the 'dominant purpose' of obtaining a tax benefit, and, as a result, the anti-avoidance provisions of Part IVA of the *Australian Income Tax Assessment Act 1936* applied[1]. The Tax Office moved to disallow scheme related tax deductions claimed up to six years earlier and issued amended assessments to

[1] Under Australia's self-assessment system of taxation, the Tax Office initially accepts taxpayers' deductions at face value. Part IVA of the *Income Tax Assessment Act 1936* then empowers the Tax Office to deny or 'cancel' an investor's tax benefit up to six years after it has been made if they conclude that the sole or dominant purpose for making the deduction was to obtain a tax benefit.

approximately 42 000 investors[2]. Scheme investors were told that they had to immediately pay back taxes with interest and appropriate penalties or they would run the risk of facing the full extent of the law.

Investor reactions toward the Tax Office's decision to disallow previous years' scheme-related tax deductions came as somewhat of a surprise to the Tax Office. The majority of investors claimed that the schemes they invested in had been sold to them, in many cases by their accountants, as a way of legally minimizing tax. Many investors therefore believed that they had done nothing wrong by investing in these schemes and actively resisted the Tax Office's demands that they pay back tax. In fact, at the time of starting fieldwork for this study in January 2002—three and a half years after amended assessments had been issued—more than 50% of scheme investors had still refused to enter into settlement arrangements with the Tax Office to pay back their taxes (a 50% non-compliance rate is considered extremely high; Tax Office, personal communication). Of interest to the present study was why such a large number of investors chose to resist the Tax Office's subsequent decision to recover tax owing on disallowed scheme deductions. Was the resistance a result of decreased trust in the Tax Office (and if so, what led to this decrease in trust), or was it simply a result of economic rationalism? The answer to these questions will be addressed using survey data collected from 2292 scheme investors.

Method

Participants

The data used to test the predictions in this article came from The Australian Tax System Survey of Tax Scheme Investors (Murphy, 2002b). The survey was posted to a random sample of 6000 Australian tax scheme investors who had been selected from Tax Office case files. After repeated appeals for participation, 2292 useable surveys were received. When adjusted for out-of-scope taxpayers who had died, moved address, or who were

[2] Several court cases relating to various tax effective schemes have been conducted over the past few years. The two that have been decided upon (Howland-Rose & Ors vs. Federal Commissioner of Taxation (2002) FCA 246, (2002) 49 ATR 206, 2002 ATC 4200; Vincent vs. Federal Commissioner of Taxation (2002) FCA 656) have agreed with the Tax Office's interpretation of tax law (that is, scheme related tax deductions do exploit the spirit of the law and therefore are vehicles for tax avoidance).

incapable of completing a survey (N = 677), a response rate of 43% was obtained. While somewhat low, this response rate compares very well with experiences from other tax surveys conducted in Australia (Mearns & Braithwaite, 2001; Wallschutzky, 1984; 1996). Using the limited amount of demographic data available on the Tax Office's case files, it was found that the sample of scheme investors who completed the survey was representative of the overall scheme investor population (for detailed information on the survey's methodology see Murphy & Byng, 2002a).

The respondents in the final sample were between 24 and 81 years of age (M = 46.50, SD = 9.30), 82% were male and 17% were female (1% did not disclose their gender). Their average personal income level for the previous financial year was approximately $73 000 (currently about $44 000 USD) and their average family income was approximately $93 000 (currently about $56 000 USD).

Procedure

Survey data were collected over a seven-month period between January and July 2002. The initial survey package was posted to each taxpayer in the sample and included a cover letter, the questionnaire, and a reply-paid envelope. The covering letter explained the intent of the study, specifically that the researchers were interested in hearing from taxpayers whose tax assessments had been amended by the Tax Office. The letter also guaranteed participants strict confidentiality and referred potential respondents to a toll-free number should they have any questions.

The survey process was modelled on the Dillman Total Design Method (Dillman, 1978), which involves following up non-respondents over a period of time. The follow-up of non-respondents after the first mailing was accomplished using an identification number attached to each questionnaire, which was in turn linked to the sample name at the Tax Office. In order to protect investors' privacy, the Tax Office was responsible for all mailings of the survey and reminder letters. Investors who agreed to participate were asked to return their completed questionnaires in a reply-paid envelope to the Australian National University (ANU) for analysis. This procedure ensured that researchers at the ANU did not have access to the names or addresses of sampled investors. It also ensured that the Tax Office did not have access to any individual taxpayers' survey responses. A total of six mailings were made and by the end of July 2002, a total of 2292 useable surveys had been received.

Questionnaire

The survey consisted of a range of questions designed to measure respondents' views of the Tax Office and the Australian tax system. Also measured were the possible reasons why taxpayers invested in tax minimization schemes and why there was such widespread taxpayer resistance to the Tax Office's debt recovery procedures. The present article, however, only deals with those survey questions relevant to five categories of variables: procedural justice, trust, resistance, outcome favourability, and demographic control variables (for those interested in other findings from the survey see Murphy & Byng, 2002b).

Procedural justice. The procedural justice variables used in the present study were taken from previous research on the group value model (for example, Tyler, 1997), with its distinction between the sub-concepts respect, fairness, and neutrality. Two additional scales adapted from Braithwaite and Makkai (1994) were also used to measure sub-concepts of procedural justice: trustworthy treatment and consultation. Exact wording and formats of the items used to construct these scales are given in Appendix B.

Trust. Braithwaite's (1997) measure of institutional trust, modified for use in the taxation context, was used to measure taxpayers' level of trust in the Tax Office. Again, Appendix B details all items used in the scales. An additional survey question assessed whether or not taxpayers' trust had been detrimentally affected by their recent experience with the Tax Office.

Resistance. To measure taxpayer's level of resistance toward the Tax Office, respondents were presented with six statements asking them to rate how they viewed the Tax Office (Braithwaite, 1995). According to Braithwaite (2003), resistance reflects doubts about the intentions of the Tax Office to behave cooperatively and benignly towards those it dominates and provides a rhetoric for calling on taxpayers to be watchful, to fight for their rights, and to curb tax office power.

Outcome favourability. The outcome favourability scale used here was adapted from Tyler's (1997) instrumental judgment index. It should be noted that this measure refers to the perceived outcome favourability to oneself of the tax authority's decision processes rather than to the tax system in general; thus its inclusion in an analysis is designed to measure self-interest concerns[3].

Demographic variables. Survey respondents were asked to indicate their age, sex (1 = male, 2 = female), personal income, and family income (each on a scale from 0 to 250+ thousand dollars).

Questionnaire Pre-testing

It should be noted at this stage that prior to sending the Investors' Survey into the field, the questionnaire was not pre-tested in its entirety. There were three reasons for this decision. First, a large scale tax survey of the general population—which shared many questions in common with the Investors' Survey—had been conducted by researchers at the ANU just one year earlier. The response rate and reliability of scales used in that general population survey were found to be very good. Second, as indicated in the Procedure section above, privacy issues precluded ANU researchers from having access to the names and addresses of scheme investors (a Tax Office employee would have had to be assigned to help with the pre-testing—something which the Tax Office was reluctant to devote further resources to). Third, the mass-marketed tax scheme issue had received a lot of media attention. It was of concern that pre-testing the survey would have called attention to the aims of the research, thus possibly biasing responses in the survey proper. It was for these three reasons, therefore, that pre-testing of the survey in its entirety was not undertaken.

[3] Favourability in the taxation context can be reasonably assumed to refer to economic favourability.

Results

Factor analysis

A factor analysis was first conducted to test for the assumed conceptual differentiation between all four non-demographic categories of variables used in the present study (that is, procedural justice, trust, resistance, and outcome favourability). The analysis yielded a four-factor solution explaining 52% of the variance (see Table 1).

With this sample, it was found that 26 of the 28 items loaded clearly, and as anticipated, on their respective factors (three of these items, however, did not reach the desired cut-off level of 0.44). Only one item appeared to have substantial loadings on two factors. When considering its content the item conceptually seemed to fit Factor 1 better. The remaining two items that did not load onto their expected factor were deleted from any further analyses. Thus, Factor 1 comprised 11 items that measured facets of procedural justice, Factor 2 comprised seven items that measured trust, Factor 3 comprised six items that measured taxpayer resistance, and Factor 4 comprised two items that measured outcome favourability.

Table 1: Factor analysis differentiating categories of variables

Item	Factor 1	Factor 2	Factor 3	Factor 4
1. Procedural Justice				
ATO concerned about protecting rights	0.65			
ATO respects individual's rights	0.50			
ATO considers average citizens concerns	0.63			
ATO cares about position of taxpayers	0.63			
ATO tries to be fair in decision-making	0.53			
ATO gives equal consideration to all	0.48			
ATO gets the information it needs to make decisions	(0.35)			
ATO generally honest in way it deals with people	0.44	0.45		
ATO treats people as trustworthy	0.44			
ATO thinks people will do right only when forced to			0.48#	
The Tax Office more concerned about themselves			0.46#	
ATO consults widely about changes	0.58			
ATO goes to great lengths to consult	0.53			
2. Trust				
ATO has misled Australians		0.60		
ATO has acted in the interests of all		0.64		
ATO has turned its back on its responsibility		0.61		
ATO is trusted to administer the tax system fairly		0.44		
ATO takes advantage of the vulnerable		0.44		
ATO meets its obligations		0.59		
ATO is open and honest in its dealings		0.55		
3. Resistance				
It's impossible to satisfy ATO			-0.46	
ATO more interested in catching you			-0.50	
ATO pushes you around			(-0.33)	
ATO will get tough if don't cooperate			(-0.39)	
ATO never changes mind if non-compliant			-0.47	
We need to take a stand against ATO			-0.44	
4. Outcome favourability				
Agreement with decisions				0.62
Favourability of decisions				0.66
Eigenvalues (before rotation)	10.50	1.35	1.28	1.20
Explained variance after rotation (%)	38	5	5	4

Note. Principle-components analysis, varimax rotation. Only factor loadings $\geq$ 0.44 are displayed.
# denotes an item that loaded onto a different factor than that expected.

Trust in the Tax Office

Scheme investors' level of trust in the Tax Office was then analysed. Using Braithwaite's (1997) measure of institutional trust, it was found that scheme investors' level of trust had a mean slightly below the midpoint ($\underline{M}$ = 2.40, $\underline{SD}$ = 0.74) on the five point rating scale. This result indicates that scheme investors tended to be somewhat distrusting of the Tax Office.

In order to ascertain whether their trust in the Tax Office was unusually low, investors' level of trust was compared to taxpayers in the general population[4]. It was found that scheme investors' trust in the Tax Office ($\underline{M}$ = 2.40, $\underline{SD}$ = 0.74) was substantially lower than the trust exhibited by taxpayers from the general population ($\underline{M}$ = 3.03, $\underline{SD}$ = 0.74). The difference between the two groups was found to be statistically significant, $\underline{F}(1, 4266) = 1248.07$, $\underline{MSE} = 0.33$, $\underline{p}<0.001$ ($\underline{\omega}^2 = 0.23$). When further questioned about their trust in the Tax Office, 89% of the scheme investors indicated that their trust had been adversely affected because of the Tax Office's actions to amend their tax returns.

Predicting investor resistance

Was the resistance exhibited by the majority of tax scheme participants towards the Tax Office a result of their decreased trust in the Tax Office, or was it simply a result of economic self-interest? In order to answer this question, a hierarchical regression analysis was performed using 'outcome favourability' and 'trust' as predictors of 'resistance'.

In order to control for demographic differences between respondents, the background variables 'sex', 'age', 'personal income' and 'family income' were used as predictors of 'resistance' in the first step of the hierarchical regression analysis. As can be seen in

[4] A total of 2040 taxpayers from the general population were surveyed prior to the Investors' Survey by Dr Valerie Braithwaite (2000) from the Centre for Tax System Integrity, The Australian National University. Between June and December 2000, a random sample of 7003 Australian citizens was sent a taxation questionnaire. After repeated appeals for participation, 2040 respondents, or 29% of the sample, returned a useable survey (for procedural details, see Mearns & Braithwaite, 2001). The sample proved broadly representative of the Australian population, with the exception that people younger than 35 tended to be under represented, and people between the age of 40 and 65 years and those more educated were over represented. The general population survey shared many questions in common with the survey of scheme investors.

Table 2, the regression analysis failed to explain a significant portion of the variance in Step 1, indicating that the demographic variables did not have any effect on taxpayer resistance.

In order to identify the unique contribution offered by the two predictor variables of interest, 'outcome favourability' was entered separately into the regression model at Step 2, followed by 'trust' in Step 3. Table 2 presents the results for this analysis. First, it should be noted that 36% of the variation in taxpayers' resistance could be explained by all of the variables in the model.

Table 2: Hierarchical regression analysis showing antecedents of taxpayer 'resistance' towards the Tax Office

	Step		
Predictor	1	2	3
Age	0.02	0.06**	0.06***
Sex	-0.03	-0.01	-0.01
Personal income	-0.01	-0.01	-0.03
Family Income	-0.02	-0.03	-0.00
Outcome favourability		-0.36***	-0.14***
Trust in the ATO			-0.53***
R^2	0.00	0.13	0.36
Adjusted R^2	0.00	0.12	0.36
R^2 change	0.00	0.12	0.23
F change	1.11	297.93***	746.93***
df	4, 2092	1, 2091	1, 2090

Note. predictor entries are standardized regression coefficients (β).
**p < 0.01; ***p < 0.001.

From Table 2 it can be seen that when the self-interest variable 'outcome favourabilty' was entered into the model at Step 2, the measure was found to uniquely explain 12% of the variation in taxpayers' resistance. In fact, this variable was significantly negatively related to taxpayer resistance (β = -0.14, $p < 0.001$), indicating that those who were more likely to think that Tax Office decisions were favourable to them tended to be less resistant towards the Tax Office. In contrast to Step 1, the demographic variable 'age' now had a significant positive effect on taxpayer resistance (β = 0.06, $p < 0.01$). While it is unclear why age only had an effect on taxpayer resistance after outcome favourability was entered into the model at Step 2, the finding indicates that older investors were more likely to be resistant towards the Tax Office. No other variables predicted taxpayer resistance at Step 2.

'Trust' was entered into the regression model at Step 3. It had a significant negative effect on taxpayer resistance ($\underline{\beta}$ = -0.53, $\underline{p} < 0.001$) and uniquely explained 23% of the variation in taxpayers' resistance. This finding suggests that those who have lower levels of trust in the Tax Office are more likely to be resistant towards the Tax Office.

When considered together, the findings suggest that 'age', 'outcome favourabilty' and 'trust' predict taxpayer 'resistance'. However, before drawing any conclusions, it should first be noted that 'trust' was found to have a greater effect on taxpayer 'resistance' than 'outcome favourability' (or 'age'). Inspection of R^2 change values at both Steps 2 and 3 (0.12 versus 0.23, respectively) indicate that the entry of 'trust' as a predictor at Step 3 affected the model much more than did the entry of 'outcome favourability' at Step 2. While the findings do not deny self-interested action, they do indicate that the resistance exhibited by the majority of tax scheme participants towards the Tax Office was more likely to be a result of their decreased trust in the Tax Office.

An additional hierarchical regression analysis was run using investors' actual debt level (in dollars)—rather than 'outcome favourability'—as a more objective measure of economic self-interest. When using this item it was found that investors' 'debt level' and 'trust' still predicted taxpayers' 'resistance', with 'trust' still explaining more of the variance ('age' no longer had an effect). However, given that the measure of 'outcome favourability' has been commonly used in the literature to measure instrumental judgments (for example, Tyler & Degoey, 1996), the conclusions made in this paper will be based on the analyses presented in Table 2.

Predicting institutional trust

In the analysis performed earlier, it was found that scheme investors' trust in the Tax Office had been detrimentally affected as a result of their involvement in tax schemes. The regression analysis presented in Table 2 also showed that taxpayers' level of trust significantly predicted taxpayer resistance. In particular, it was found that those taxpayers who had lower levels of trust were more resistant towards the Tax Office. The specific reasons why investors' level of trust in the Tax Office was detrimentally affected by their involvement in tax schemes was therefore of interest.

In order to test Tyler's (1997) theory that perceptions of procedural unfairness decrease trust, another hierarchical regression analysis was conducted. In Step 1 of the regression analysis, the background variables 'sex', 'age', 'personal income' and 'family income' were used to predict 'trust'. As in the regression model above, these variables were included to control for demographic differences between survey respondents.

In Step 2 of the regression analysis, the instrumental measure of 'outcome favourability' was introduced as a predictor of 'trust'. The five relational facets of procedural justice were then introduced as a group of predictors in Step 3 of the regression analysis. 'Outcome favourability' was entered into the model before the procedural justice items because Tyler (1997) claims that perceptions of fair treatment affect trust more so than favourable economic outcomes. If Tyler (1997) is correct in his assumption, the R^2 change value should be greater between Steps 2 and 3 of the model than between Steps 1 and 2. The results from this regression analysis can be found in Table 3.

As can be seen in Table 3, the regression analysis failed to explain a significant portion of the variance in Step 1 (0%). This indicates that the demographic variables did not have an effect on trust. In contrast, Steps 2 and 3 both explained significant portions of the variance (17% and 42% respectively). Analysis of the regression results will therefore mainly focus on the more complete third step.

Table 3: Hierarchical regression analysis showing antecedents of 'trust in the Tax Office'

Predictor	Step 1	Step 2	Step 3
Age	0.05*	-0.01	0.01
Sex	0.02	-0.00	0.00
Personal income	-0.03	-0.03	0.01
Family Income	0.04	0.05	0.01
Outcome favourability		0.41***	0.08***
ATO is fair			0.36***
Neutrality			0.30***
Respect			0.04**
ATO consultation			0.10***
Trustworthy treatment from ATO			0.08***
R^2	0.00	0.17	0.59
Adjusted R^2	0.00	0.17	0.58
R^2 change	0.00	0.17	0.42
F change	1.58	414.02***	410.80***
df	4, 2061	1, 2060	5, 2055

Note. predictor entries are standardized regression coefficients (β).
*p < 0.05; **p < 0.01; ***p < 0.001.

Upon further inspection of Table 3, it can be seen that 58% of the variation in trust can be explained by the self-interest and procedural justice variables together, suggesting that these variables had a substantial effect on the final model. All of the procedural justice variables were found to have a positive effect on trust. For example, the procedural justice variable 'trustworthy treatment from the ATO' had a positive effect on trust ($\beta = 0.08$, $p < 0.001$), indicating that respondents who believed the Tax Office treated them as trustworthy were more likely to have higher levels of trust. Likewise, those who were more likely to think the 'ATO was fair' ($\beta = 0.36$, $p < 0.001$), those who believed the Tax Office was 'neutral' in its decision-making procedures ($\beta = 0.30$, $p < 0.001$), those who were more likely to feel the 'ATO respected them' ($\beta = 0.04$, $p < 0.01$), and those who felt that the 'ATO consults with the public' about various tax issues ($\beta = 0.10$, $p < 0.001$) were also more likely to have higher levels of trust in the Tax Office.

When it came to the self-interest variable 'outcome favourability', it was found that this item also had a significant positive effect on trust ($\beta = 0.08$, $p < 0.001$). This indicates that those who were more likely to think that Tax Office decisions were favourable to them were also more likely to have higher levels of trust in the Tax Office. Like the first regression analysis performed in this paper, this finding again suggests that self-interest does play a significant role. However, as can be seen by the magnitude of the change in R^2 between Steps 1 and 2 and between Steps 2 and 3 (0.17 and 0.42, respectively), the self-interest variable did not have the strongest effect on trust. In fact, in general, perceptions of fair treatment appear to have affected investors' trust more so than having received favourable outcomes.

An additional hierarchical regression analysis was again conducted, replacing 'outcome favourability' with investors' actual 'debt level'. Unlike the analysis presented above, this more objective measure of economic self-interest did not significantly predict taxpayers' trust in the Tax Office. All five procedural justice items still predicted taxpayers' trust.

Structural equation model

One of the limitations of the regression analyses presented above is that they do not permit the conclusion that perceived poor treatment led to a decrease in trust and that low trust was the causal factor that produced increased resistance. The most obvious alternative model that could be used to explain the results is that those who resisted the Tax Office's attempts to recover tax later rationalized their non-compliance with reports of decreased levels of trust brought on by poor treatment. Of course, a methodology that would yield clearer evidence for the causal relationship between trust and resistance would be one based on a longitudinal design (that is, either testing investors' trust levels prior to their dispute with the Tax Office, as well as after, or testing investors in a follow-up survey in which measurement of the same concepts at two different points in time could be assessed). For the purposes of the present study, however, these suggestions could not be tested.

Hence, in order to address the causal limitation in a more practical way, the variables used in the regression analyses were subjected to a structural equation model using Analysis of Moment Structures (AMOS). Prior to arriving at the model presented in Figure 1 a fully mediational model, with a non-recursive pathway between resistance and trust, was tested. The non-recursive pathway between trust and resistance was used to test whether trust was a mediator for taxpayer resistance (that is, as hypothesized) or whether taxpayer resistance was a mediator for trust (that is, that decreased trust was used as a rationalization for resisting authority)[5]. In constructing this non-recursive model, the pathway from resistance to trust was not statistically significant, $t = 1.07$, $p > 0.2$, and therefore had to be removed. This particular finding suggests that in the present context, resistance was not a mediator for trust. A number of other pathways were also removed, leading to the final model presented in Figure 1.

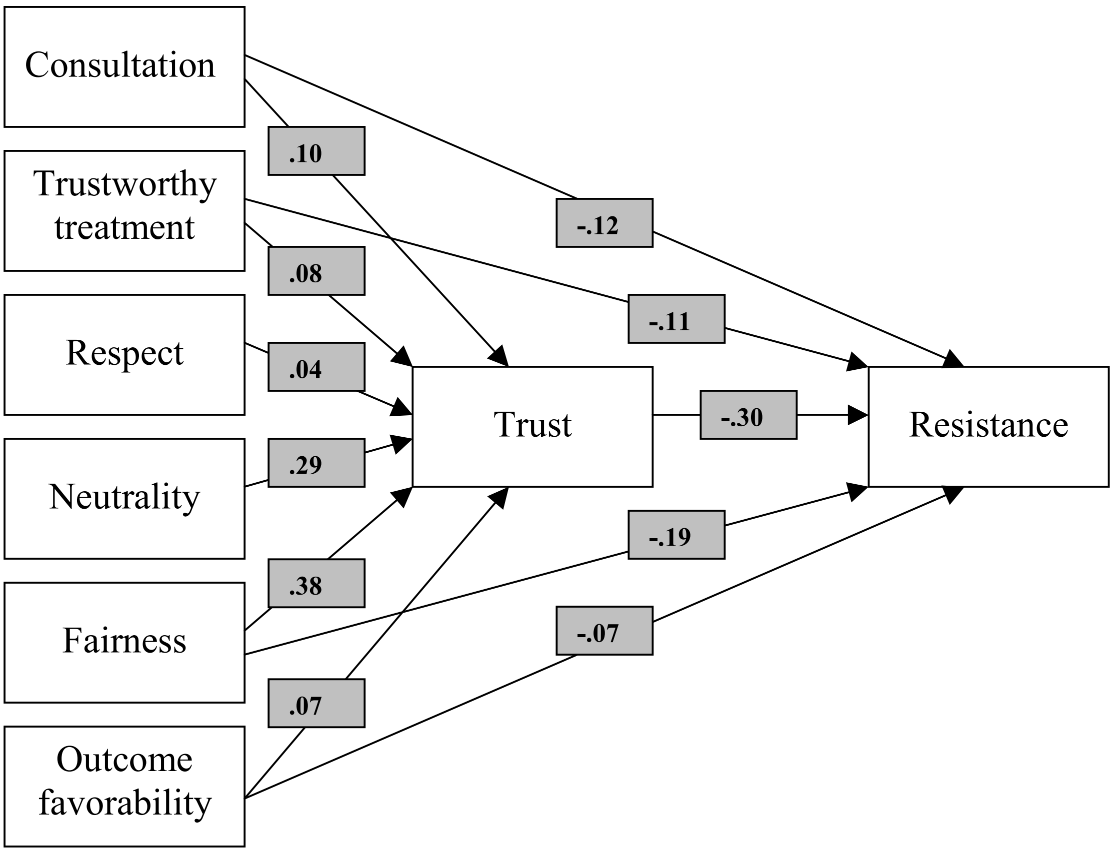

Figure 1: Structural equation model demonstrating the relationship between variables of interest.

[5] In order to ensure there were enough degrees of freedom in which to estimate a non-recursive model, a pathway between two variables first needed to be deleted. The choice of which path to delete was determined by analysing the bi-variate correlations between all variables in the model. It was found that the correlation between respect and resistance was the smallest, so the pathway between these two variables was first deleted before model estimation began.

In the final model, support was found for the idea that perceptions of procedural justice increase trust (as indicated by the positive standardized path coefficients between trust and consultation, trustworthy treatment, respect, fairness and neutrality[6]) and decrease levels of resistance (as indicated by the negative standardized path coefficients between resistance and consultation, trustworthy treatment, and fairness). Like the regression analyses presented earlier, outcome favourability was again found to have only a minor part to play in predicting trust and resistance (as indicated by the small path coefficients; 0.07 and –0.07, respectively). Finally, there was also a significant pathway from trust to resistance (-0.30), suggesting that those who had less trust in the Tax Office were also more likely to be resistant towards the Tax Office (as discussed in the previous paragraph, the pathway from resistance to trust was not significant). Overall, these findings support those of the regression analyses presented above: poor treatment by a regulatory authority can undermine trust in those being regulated, which in turn can lead to increased resistance toward decisions and rules. The goodness-of-fit indices for the structural equation model are presented in Table 4. According to the modification indices, addition or deletion of any further pathways could not improve the model.

Table 4: Chi-square statistics and goodness-of-fit indices for the structural equation model linking 'resistance' to level of 'trust in the Tax Office'

Goodness of fit statistics	Structural Equation Model
χ^2	3.10, p<0.22
df	2
Comparative fit index	1.00
Goodness of fit index	1.00
Adjusted goodness of fit index	0.99
Root mean square	0.02

[6] Although significant, the pathways between respect and trust (β = 0.04) and trustworthy treatment and trust (β = 0.08) were relatively small. In the present study, therefore, the procedural justice items of consultation, neutrality and fairness appeared to be the most important predictors of trust.

Summary of findings

The study reported in this paper examined why such a large number of tax scheme investors chose not to comply with the Tax Office's subsequent decision to recover tax owing on disallowed scheme deductions. Specifically, the study was interested in exploring whether trust played a role in this non-compliance. To summarize, it was found that scheme investors' level of trust in the Tax Office was substantially lower than that of the general population. It was also found in a regression analysis that trust did play a role in the resistance exhibited by tax scheme investors, and this factor outweighed the role played by economic self-interest. Further, when examining why investors' level of trust in the Tax Office was low, it was found in a second regression analysis that perceptions of unfair treatment appeared to have affected investors' trust more so than having received an unfavourable outcome. Finally, using a structural equation model, in which the relationship among all variables of interest could be examined, it was found that the pathway from trust to resistance was significant, suggesting that taxpayer resistance could be sufficiently predicted by decreased levels of trust. This particular finding is important as it rejects the claim that taxpayers may be looking to rationalize their resistance by using claims of decreased trust.

Discussion

While the law will always involve elements of coercion, the legal system has, at best, a limited ability to compel people to obey the law. Knowing what motivates people to obey and defer to decisions and rules is therefore important. As discussed in the introduction to this paper, the 'rational choice' model of the individual has previously dominated the formulation of public policy in many areas. This view suggests that people are motivated to maximize their personal gains and minimize their personal losses. Those advocating such a view therefore believe that non-compliance can only be dealt with by handing out harsh sanctions and penalties.

The situation surrounding the mass-marketed tax scheme issue demonstrates, however, that the use of threat and legal coercion as a regulatory enforcement tool—in addition to being more expensive to implement—can sometimes be counter-productive (see also Ayres &

Braithwaite, 1992; Bardach & Kagan, 1982; Hawkins, 1990). For example, the Tax Office's initial use of threat and legal coercion with 42 000 tax scheme investors did not appear to be as effective as desired in producing compliance. Instead of complying, the majority of tax scheme investors actively resisted the Tax Office's repeated attempts to recover tax owing on their scheme related tax debts.

When attempting to explain why investors did not comply with the Tax Office's directives to pay back tax, the present study showed that taxpayer trust in the Tax Office played a very important role in explaining their behaviour. Specifically, the findings suggested that trust, rather than economic self-interest, was the major predictor of investor resistance towards the Tax Office, with those who were less trusting of the Tax Office being more resistant. Further, perceptions of unfair treatment appeared to have affected investors' trust more so than having received an unfavourable outcome. These findings are interesting because they extend Scholz and Lubell's (1998) work by showing that social-based trust can also affect compliance in the taxation context. The results are also important as they question the appropriateness of the 'rational choice' model as a basis for effective regulation. Instead, the results argue that to effectively shape desired behaviour, regulators will need to move beyond an enforcement strategy linked purely to deterrence.

Moving towards a more effective model of regulation

Doubts about the effectiveness of a deterrence-based model of enforcement are not new. In fact, for the past decade, many contemporary regulatory theorists have been arguing that the most effective way in which to achieve genuine acceptance of regulations is not by an exclusive reliance upon legal coercion but rather through the use of strategies that attempt to bring the best out of those being regulated (for example, Ayres & Braithwaite, 1992; Braithwaite, 1993; Cherney, 1997; Sparrow, 2000). These theorists argue that regulatory agencies risk discouraging civic virtue if they engage in aggressive prosecution for relatively minor offences, because those being regulated are likely to feel that their past good faith efforts at compliance have not been acknowledged. Coupled with the findings of the present study, it is therefore proposed that a regulatory strategy that is directed at reducing levels of distrust between the two sides may prove particularly effective in gaining voluntary compliance with an authority's rules and decisions (see also Braithwaite & Makkai, 1994; Cherney, 1997).

As can be seen from the results of the present study, the perceived trustworthy treatment given by the Tax Office towards scheme investors was found to significantly predict investors' trust in the Tax Office. In other words, those investors who were less likely to feel that the Tax Office treated them as trustworthy were also less likely to trust the Tax Office in return. Findings such as these suggest that regulators may be able to use the responsive nature of trust to encourage relevant individuals or industries to enter into cooperative relationships, which in turn will ensure greater compliance with regulatory goals. Trust appears to be a resource like no other, as it is not depleted through use but rather through lack of use (Gambetta, 1988). Hence, the more that regulatory interactions are based on trust the more likely regulators will be able to nurture the development of reciprocal trust relationships.

The added advantage of adopting a regulatory strategy based on trust is that it would involve an efficient use of resources. Treating others as trustworthy in the first instance will elicit a more co-operative approach from the regulatee, more information is likely to be forthcoming about their practices and possibly about areas of non-compliance, and it will engage the regulatee in best practice decisions for securing compliance (Black, 2001). If such a strategy works, both sides avoid expensive enforcement and litigation procedures and more resources are left to expand regulatory coverage. In such a situation, society will gain the benefits of greater compliance at a low cost to the economy.

It would be naïve, however, to think that a strategy based purely on trust would be effective in all cases (see Ayres & Braithwaite, 1992, pp. 19-53). A strategy based purely on trust fails to recognize that there are some people who would take advantage of being presumed to be trustworthy. A regulatory strategy that combines a preference for trust with an ability to switch to a policy of distrust is therefore likely to be the most effective (see also Braithwaite & Makkai, 1994). This dynamic strategy could enable regulators to try trust first and escalate to more interventionist forms of regulation (for example, more severe sanctions) if abuse of trust occurs and persists. By having the threat of punishment in the background (see Ayres & Braithwaite, 1992), it reinforces to individuals that a regulator's attempts at cooperation should be listened to.

When escalating to more interventionist forms of regulation, however, it needs to be kept in mind that people are also strongly concerned about issues of fair treatment, neutrality, and respect when forming their opinions about the way a regulator handles their situation. As the findings of the present study demonstrate, if sanctions or punishments are perceived to be procedurally unjust, regulators also run the risk of undermining trust. Thus, in order to create and maintain trust, regulators will need to acknowledge the importance of procedural justice in their dealings with non-compliers, and make a commitment to implement and nurture the principles of justice and fairness. Regulators need to consider how they would want to be treated if their roles were suddenly reversed.

Conclusion

While this paper has not been the first to critique a regulatory strategy based on threat and legal coercion, it has been one of the first to provide empirical evidence to support a regulatory strategy based on trust. In particular, the findings from the present study have shown that if taxpayers feel poorly treated by a tax authority as a result of their infractions (innocent or otherwise), this can lead to a decrease in taxpayer trust. This decrease in trust can then go on to affect their willingness to comply, and might in fact lead to active resistance towards a regulatory authority. It has been proposed here that by using a strategy based on trust, regulators may be more likely to prevent widespread resistance towards their decisions, while at the same time nurturing the good will of those with a commitment to compliance.

In making these conclusions, however, it needs to be kept in mind that the survey data used to draw these conclusions were collected after the dispute between taxpayers and the Tax Office had commenced. While the structural equation model presented earlier went some way to addressing issues of causality, it still cannot be ruled out conclusively that an alternative model could be formulated to explain the results. Without knowing taxpayers' levels of trust before the Tax Office first took action against them, the conclusions drawn in the present paper should be considered in light of this limitation. To improve upon this study, therefore, it is proposed that future research in this area should attempt to examine how taxpayer attitudes change across time; specifically, do their attitudes and behaviours change dramatically after experiencing an event that they consider to be procedurally unfair?

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Appendix A

To date, three categories of mass marketed schemes operating in the Australia have been identified by the Tax Office (Commissioner of Taxation, 2000). These include, (1) round-robin schemes, including non-recourse financing, often in agriculture, afforestation and franchises; (2) certain film schemes, with guaranteed returns that are, in effect, a return of part of the invested funds; and (3) employee benefit arrangements that have tax benefits as their main purpose. It is only the first two types of scheme that are of relevance to the present study.

An example of a franchise scheme is 'Oracle'. Oracle offered investors the opportunity to invest in a business that promoted and presented personal development and educational workshops. By making an initial cash outlay of $10 000 and borrowing $30 000 from Oracle's financing company, investors could claim an immediate tax deduction of $40 000. This would therefore lead to some investors, depending on their original income level, to receive a tax refund from the Tax Office of up to $19 400 (Source: Oracle International Pty Ltd Prospectus, p. 3). From here, $10 000 of the $19 400 went into paying the initial $10 000 set up fee. In some cases, investors were therefore able to pocket the remaining $9400. Several aspects of the investment were of concern to the Tax Office. One major concern was that the loan of $30 000 was repayable only from the proceeds of the business. If the business made no profit, investors would not be required to repay the loan. Therefore, unlike many other investments (for example, negative gearing of property), there was no risk to the investor. In addition, some scheme investors made a profit from their tax return (in some cases the profit was as high as $9400). Another concern for the Tax Office related to the nature of the deduction made. Specifically, only a fraction of the $40 000 claimed as a tax deduction went into the underlying activity. For many scheme arrangements, the majority of the money raised went into financing the management fees.

Appendix B

Below is a complete list of the measures used in the analyses of the present paper. It also details the original scale formats, the recoding of the data if applicable, reliability coefficients of each scale, the mean score and standard deviation obtained on each scale.

Procedural justice

Measured through five multi-item scales representing procedural justice – three adapted from Tom Tyler (1997) (scales a-c below) and two adapted from John Braithwaite and Toni Makkai (1994) (scales d-e below). All responses given on a 1 to 5 scale (1 = strongly disagree, 2 = disagree, 3 = neither, 4 = agree, 5 = strongly agree).

(a) *Neutrality*. Cronbach's alpha = 0.60. (M = 2.49, SD = 0.75).

- The Tax Office gives equal consideration to the views of all Australians
- The Tax Office gets the kind of information it needs to make informed decisions
- The Tax Office is generally honest in the way it deals with people

(b) *Tax Office is fair*. Cronbach's alpha = 0.80. (M = 2.15, SD = 0.78).

- The Tax Office considers the concerns of average citizens when making decisions
- The Tax Office cares about the position of taxpayers
- The Tax Office tries to be fair when making their decisions

(c) *Respect*. Cronbach's alpha = 0.71. (M = 3.13, SD = 0.52).

- The Tax Office respects the individual's rights as a citizen
- The Tax Office is concerned about protecting the average citizen's rights

(d) *Trustworthy treatment from the Tax Office*. (M = 2.37, SD = 0.88).

- The Tax Office treats people as if they can be trusted to do the right thing

(e) *Consultation*. Cronbach's alpha = 0.68. (M = 2.05, SD = 0.79).

- The Tax Office consults widely about how they might change things to make it easier for taxpayers to meet their obligations
- The Tax Office goes to great lengths to consult with the community over changes to their system

Institutional trust

A measure of Valerie Braithwaite's (1997) measure of institutional trust, modified for use in the taxation context, was constructed by combining responses to all seven items. This particular scale measured investors' level of trust in the Tax Office and it was found to have a Chronbach's alpha reliability coefficient of 0.86. (M = 2.40, SD = 0.74). All responses given on a 1 to 5 scale (1 = strongly disagree, 2 = disagree, 3 = neither, 4 = agree, 5 = strongly agree).

Think of the Tax Office and what it has been doing over the past few years. To what extent do you agree or disagree with the following statements. The Tax Office …

- Has misled the Australian people (reverse coded)
- Acted in the interests of all Australians
- Turned its back on its responsibility to Australians (reverse coded)
- Is trusted by you to administer the tax system fairly
- Takes advantage of people who are vulnerable (reverse coded)
- Meets its obligations to Australians
- Is open and honest in its dealings with citizens

Resistance

Measured through a multi-item scale based on the work of Valerie Braithwaite (1995). All responses given on a 1 to 5 scale (1 = strongly disagree, 2 = disagree, 3 = neither, 4 = agree, 5 = strongly agree). Cronbach's alpha = 0.67. (M = 3.72, SD = 0.58).

- It's impossible to satisfy the requirements of the Tax Office completely
- The Tax Office is more interested in catching you for doing the wrong thing, than helping you do the right thing
- It's impossible not to let the Tax Office push you around
- If you don't cooperate with the Tax Office, they will get tough with you
- Once the Tax Office has you branded as a non-compliant taxpayer, they will never change their mind
- As a society we need more people willing to take a stand against the Tax Office

Outcome favourability

Measured through two items taken from Tom Tyler's (1997) instrumental judgment index. All responses given on a 1 to 5 scale (1 = almost never, 2 = on occasion, 3 = sometimes, 4 = mostly, 5 = almost always). Cronbach's alpha = 0.70. (M = 2.57, SD = 1.02).

- How often do you agree with the decisions made by the Tax Office?
- How often are the decisions of the Tax Office favourable to you)

Change in trust

Measured through one item developed by Murphy (2002b). (M = 1.43, SD = 0.69).

- As a result of your amended tax return, do you have more or less trust in the Tax Office? (1 = a lot less trust, 2 = less trust, 3 = no change, 4 = more trust, 5 = a lot more trust).

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