

# Do Penalties and Enforcement Measures Make Taxpayers More Compliant?—The View of Australian Tax Evaders'

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**Abstract:** The tax compliance literature indicates that many factors, including, economic, social, psychological and demographic, impact upon the compliance behaviour of individual taxpayers. This study explores the relationship, if any, that exists between selected tax compliance and demographic variables and the compliance behaviour of Australian individual tax evaders. The study employed a mixed method research approach comprising both a survey and interviews. The findings revealed that tax law enforcement measures and to a lesser degree penalties and detection, did impact upon the compliance behaviour of tax evaders. The study's results provide useful information for tax authorities and have implications for tax policy development.

Key words: tax penalties; tax enforcement; tax compliance; tax evaders

JEL code: K34

# 1. Introduction

An important issue for any government and revenue collecting authority is to obtain knowledge and understanding of the reasons for taxpayer non-compliance in order to maximize voluntary compliance in a self-assessment environment. However, measurement of the magnitude of intentional and unintentional non-compliance can be difficult as it involves estimating levels of uncollected tax, which by its nature is not detected by the revenue authority. The amount of tax lost through evasion is potentially enormous. (The Internal Revenue Service estimated it to be \$US345 billion in 2006 (Slemrod, 2007) which amounted to 16.3 percent of estimated actual paid plus unpaid tax liability.) In Australia an estimate of the underground economy was 10 billion or 1.2% of the level of GDP in 2002-03. Consequently in order to manage risk and improve the efficiency of government collections, further research is required into understanding taxpayer behaviour and attitudes.

The dominant view in research and practice of tax administration is that tax compliance is largely a function of taxpayers' rational pursuits of their self-interests. From this perspective, taxes are costs that taxpayers try to avoid or reduce. Consequently, taxpayers are likely to evade taxes unless the probability of detection and the severity of penalties render tax evasion an unattractive option. Therefore it is assumed deterrence is the only means of generating compliance (Allingham & Sandmo, 1972; Cowell, 1985; Andreoni, Erard & Feinstein, 1998).

On the other hand, given the actual low rates of audit and rather mild penalties it is argued that deterrence cannot account for the generally high levels of compliance (Alm, McClelland & Schulze, 1992). Rather, taxpayer

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behaviour, social norms, perceptions of fairness and legitimacy are said to largely determine tax compliance (James, Hasseldine, Hite & Toumi, 2001; Tyler, 1990).

Given this background, the focus of this study is to investigate taxpayers' perceptions of three compliance variables derived from the economic deterrence model including; the likelihood of being caught, the range of penalties applied to those who are caught and other enforcement measures and two demographic variables, age and gender. It should be noted that there is a current trend to integrate both economic and psychological approaches in tax compliance research (Kirchler et al., 2008) and while the emphasis herein may have been upon economic variables other psychological factors are also evidenced. Specifically, this research expands upon prior studies into taxpayer compliance in Australia conducted by (Wallschutzky, 1984) over twenty years ago which investigated the behaviours and attitudes of tax evaders. Uniquely however, this study has obtained original data of non-compliant individual taxpayers sourced via the Australian Taxation Office (ATO).

The remainder of this article is structured in the following manner. Section two outlines the development of the research questions to be addressed and the hypotheses to be tested in the study. This is followed by a description of the research methodology in section three. A discussion and analysis of the research findings, both quantitative and qualitative are provided in section four. Finally, section five summarizes and concludes the study by providing some tax policy considerations identifies limitations and makes suggestions for future research.

## 2. Penalties, Enforcement and Compliance

Tax compliance is defined here as compliance with reporting requirements, meaning that the taxpayer files all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the internal revenue code, regulations and court decisions applicable at the time the return is filed (Roth, Scholz & Witte, 1989, see also Jackson & Milliron, 1986; Richardson & Sawyer, 2001).

The overall objective of the study is to examine if a relationship exists between selected tax compliance variables (i.e., penalties, enforcement and detection) and the attitudes and behaviour of non-compliant individual taxpayers (referred to herein as tax evaders). Consequently, the purpose of this research is also to further elicit the reasons for taxpayer non-compliance and reveal some of the motives of tax evaders (e.g., Were tax evaders' actions based on, willingness to pay, legal contestation or aggression against the tax authority?)

Admittedly in conducting research into taxpayer compliance, there are clearly many factors at play. Consequently, it should be initially acknowledged that other factors, such as, complexity of the tax legislation, audit rates, tax rates and the opportunities for evasion, also impact upon compliance levels but are outside the scope of this study. Nevertheless, some indirect evidence of these other compliance factors has been discovered throughout the study.

In particular the research will focus on the impact of penalties and sanctions as a key determinant upon taxpayer behaviour. The link between taxpayers' attitudes towards penalties and their consequential attitude towards evasion/non-compliant behaviour is one which has been subject to considerable research in the past (Grasmick & Scott, 1982; Hasseldine & Kaplan, 1992; Kinsey, 1986). The study of penalties is important given that it is also one of the factors which are within the control of tax authorities. An emphasis in the study was placed on how taxpayers' felt penalties impacted as a deterrent measure and the appropriate use of penalties by the revenue authorities. Allowing for some expected inbuilt bias given the cohort of taxpayers being investigated, the study will nevertheless shed some light on the views of tax evaders regarding penalties and enforcement measures by analyzing original tax evader data.

Some researchers have found that taxpayers are more sensitive to the magnitude of the penalty than to the probability of detection when the probability is very low (i.e., 4% or less) (Jackson & Jones, 1985).<sup>1</sup> This could have implications for countries that have moved to a self-assessment environment.<sup>2</sup> A particular study observed that there was a significant relationship between the severity of the criminal sanctions and compliance by one group of taxpayers-high-income self-employed individuals (Witte & Woodbury, 1985). Within each of the groups this study covered, legal sanctions were most effective for the higher class and the better educated (not the best). This study did indicate however, that the threat of guilt feelings was a greater deterrent to tax evasion than the threats or stigma of legal sanctions. This finding has been supported by similar work on sanctions and penalties (Schwartz & Orleans, 1967; See Devos, 2002 and 2004).

However, the positive effect of increased sanction levels on taxpayer compliance has been found even where relatively low (and realistic) penalty levels are used (Carnes & Eglebrecht, 1995). What is of major concern though has been that taxpayers' perceptions of penalty levels are higher than the actual penalty levels (Jackson & Jones 1985). This has tended to skew some research findings.

Other research evidence suggested that a tax system that combines both penalties and rewards is more effective in maximizing compliance than a system that focuses solely on sanctions (Falkinger & Walther, 1991). Consequently, positive inducements to encourage compliance may also have a key role to play. However, other studies evidence the unwanted effects of rewards such as crowding out (Feld, Fry & Torgler, 2006), all-or-nothing behaviour (Kastlunger et al., 2011) and the overall inconclusive effects of rewards (Fischer, Wartick & Mark, 1992).

Given the past research with regards to the influence of penalties upon taxpayer compliance behaviour is mixed, what are the views of those who have actually been fined? This is addressed by the following:

• PRQ1: Is there a relationship between tax evaders' perceptions of tax penalties and sanctions and their tax compliance attitudes/behaviour?

H1: There is a relationship between tax evaders' perceptions of tax penalties and sanctions and their tax compliance attitudes/behaviour.

In contrast, studies of criminal behaviour in general have found that the probability of apprehension is more important than the sanctions actually imposed (Tittle & Logan, 1973). Alternatively, another influence may just be the precision of information regarding the probability that punishment will be imposed. Consequently, vague information about the relatively low probability of detection and punishment enhances a low deterrent value (Friedland, 1982). There is also evidence that suggests that taxpayers consider the probability of detection to be higher than it actually is (Richards & Title, 1981).

Overall the economic deterrence model proposes that increasing punishment by expanding criminal sanctions decreases non-compliance and this principle supports sentencing theory and the courts' right to consider the maximum penalty for an offence in order to achieve general deterrence (Jackson & Milliron, 1986). However, the research is also mixed with regards to the influence of enforcement measures and detection upon compliance behaviour in general. Are the views of those who were caught any different? This is addressed by the following research questions/hypothesis:

• PRQ2: Is there a relationship between tax evaders' perceptions of tax law enforcement by the revenue authorities and their tax compliance attitudes/behaviour?

<sup>&</sup>lt;sup>1</sup> This research also added credence to congressional efforts to raise the magnitude of legal penalties a taxpayer faces for non-compliance. Code Section 6661.

<sup>&</sup>lt;sup>2</sup> In a self-assessment environment tax returns are accepted on face value and then subject to potential audit.

H2: There is a relationship between tax evaders' perceptions of tax law enforcement by the revenue authorities and their tax compliance attitudes/behaviour.

• PRQ3 Is there a relationship between tax evaders' perceptions of the probability of detection by the revenue authorities and their tax compliance attitudes/behaviour?

H3: There is a relationship between tax evaders' perceptions of the probability of Detection by the revenue authorities and their tax compliance attitudes/behaviour

# 3. Research Methodology

In addressing the research questions/hypothesis, a survey instrument was developed to gather tax evaders' responses. Australian individual tax evaders derived from the data bases of the ATO were randomly sampled. In conjunction with this quantitative research component was also a smaller qualitative research component where interviews of a sample of those taxpayers surveyed were conducted to provide further support of the survey findings. Due to the sensitive nature of the topic and in order to maintain privacy, semi-structured interviews were conducted over the telephone and posed questions around the major themes which were also explored in the survey instrument. This procedure would assist in confirming or denying issues which were raised initially in the surveys.

# 3.1 The Population and Survey Sample

A mail survey (comprising 30 questions) was conducted for a selection of individual taxpayers labelled the "evader group". The sample frame was to be those individual taxpayers that, according to ATO records, had lodged tax returns for three previous income tax years, 2004, 2005 and 2006 and had been audited and subjected to a penalty of \$5,000 or greater (Appendix-Extraction of Evader Sample). In accordance with the researcher's specifications, tax evaders were selected randomly based on the following criteria: age, gender, marital status, agent prepared or not, location (which Australian state/territory), occupation (PAYG and non-PAYG)<sup>3</sup> and the level of income, all of which could be determined from their tax returns.

To maximize confidence, the sample frame needs to be known and accessible. The only organization which had knowledge and access to the evader group was the ATO. Consequently, the ATO was approached and their support was confirmed before proceeding.<sup>4</sup> It was also recognized that the sample frame will change over time and will only include "known" taxpayers. That is, individual taxpayers who have lodged returns, found to have evaded tax as discovered on audit and who had been penalized at the time of the sample being drawn<sup>5</sup> (See Appendix-Extraction of Evader Sample). Thus, persons who have operated outside the tax system may be "unknown" and, therefore, have no likelihood of being included in the sample. This is not considered to be a significant weakness in the design as, by and large, individual taxpayers are "known" to the ATO due to the extensive range of reporting systems in place (McKerchar, 2003).<sup>6</sup>

<sup>&</sup>lt;sup>3</sup> A few evaders were non-Pay As You Go (PAYG) taxpayers, including self-employed individuals who conducted business through various structures However, as the number were few and the focus of the research study was on the individual's behaviour, it was envisaged that the use of these structures would not impact upon the overall findings.

<sup>&</sup>lt;sup>4</sup> The past Commissioner of Taxation, Michael D'Ascenzo, had indicated in April 2000 that the ATO would consider making available taxpayer data to academic researchers providing that taxpayers' privacy was not compromised. ATO support for this study was confirmed in October 2006.

<sup>&</sup>lt;sup>5</sup> With the assistance of Assistant Commissioner Chris Mobbs, a sample of tax evaders based on specific selection criteria was drawn from the broader adjusted evader population in June 2007.

<sup>&</sup>lt;sup>6</sup> For example, the requirement to quote a tax file number (TFN) to a bank, or to provide an employment declaration (including your TFN) to an employer, in order to minimize the amount of Pay-As-You-Go (PAYG) tax that must be withheld from payments of interest or wages. However, it is noted that those taxpayers who operate in the cash economy may arguably be significant in number.

The demographic profile of the evader sample (n = 174) was not totally representative of the Australian population as expected, nevertheless, it produced useful data which could be analyzed in addressing the research questions posed. One significant characteristic of this evader sample was revealed in Q26 of the survey regarding education level, which indicated that a large number of those surveyed had obtained an advanced diploma 25 (15%) or had completed a bachelor degree 76 (45%). This is higher than the average educational level of the Australian population which is around the year 12 level.<sup>7</sup> Another important characteristic was highlighted in Q27 which categorized occupational groupings according to figures derived from the Australian Bureau of Statistics (ABS). The figures reveal that 24 (14%) fell into the clerical, sales and service industry. Interestingly, a further 48 (28%) indicated they were in the professional category, which would include occupations such as doctors, lawyers and accountants. The sub-group of associate professionals/education at 21 (12%) included for example, teachers, academics and social workers. Surprisingly, white collar workers rather than blue collar workers were predominant.

Consequently, as indicated in Q28, the majority of respondents 106 (62%) earned \$80,000 or more per annum with a large number (25, or 14%) earning more than \$140,000 a year. This salary range is unrepresentative of the majority of the Australian population<sup>8</sup> and clearly indicated that evaders tended to be in the higher income bracket. Given the sample incorporated high-income taxpayers selected for certain audit activity, there was likely to be some indirect bias. The other interesting demographic was the age of evaders. Question 24 revealed that the majority (147, or 86%) of respondents fell between the 20-59 year old age-bracket, with most in the 40-59 year old group. The majority (67%) were males (See Appendix-Table 2).

The sample population was 700 records for this evader group. Given an expected response rate of 25-30 percent, this resulted in a sample size of at least 150-200 respondents which would be sufficient in terms of the credibility of the results and providing a 95% confidence level in performing statistical tests. Names and addresses of those selected were only known to the ATO. Understandably due to the privacy provisions, the ATO was not willing to allow the researcher direct access to taxpayers' details. To satisfy this condition the surveys were supplied by the researcher to the ATO who conducted the distribution of the surveys to the evader sample. Then survey responses were received by the researcher directly at the University. Such an approach maintained taxpayers' privacy in that neither the researcher, nor the ATO, could match taxpayers' details to completed surveys. As the study was conducted in conjunction with the ATO, it was considered that this approach would also improve response rates. It should be noted that funding support for this phase of the research was provided by the Australian Tax Research Foundation (ATRF), which assisted the researcher in gaining the co-operation of the ATO.

## 3.2 Response Rates

Response rates in respect of mail surveys are varied. As a guide, a mail survey in Australia on taxpayer attitudes/compliance achieved an overall response rate of around 35 percent (Niemirowski, Wearing, & Baldwin, 2001). Therefore based on the necessity to have somewhere between 150-300 usable responses in order to generate a reasonable degree of accuracy, and given estimated response rate in the range of 25-30 percent, the sample size selected needed to be 700 individual taxpayers in terms of this evader group. The actual response rate received for this study was (174/636 effective distributions = 27.4%). Considering the good response rate obtained

<sup>&</sup>lt;sup>7</sup> See: http://www.abs.gov.au/AUSSTATS/abs@nsf.

<sup>&</sup>lt;sup>8</sup> The majority of the Australian population earned between \$30,000 and \$80,000 per annum in 2006, see http://www.abs.gov.au/AUSSTATS/abs@nsf.

and the results of preliminary statistical tests,<sup>9</sup> it was concluded that there was no direct evidence of any non-response bias

## 3.3 Reliability

Two frequently used indicators of a scale's reliability are test-retest reliability and internal consistency (De Villis, 1991). Test-retest reliability regarding a sensitive issue such as tax compliance is not likely to remain stable and is likely to be low. More relevant for this type of research is assessment through internal consistency. This study adopted Cronbach's coefficient alpha for measuring reliability. Where Cronbach's alpha is < 0.7 the scale is not necessarily unreliable but must be considered in combination with other factors (See Appendix—Tests of Reliability in Survey Instrument).

# 3.4 Validity

In terms of construct validity, both convergent and discriminate constructs were observed in this study which is supported by the literature (Dibbern & Chin, 2005). In this study, factor analysis or simple factor structure was employed as a test of internal consistency to demonstrate that, for a valid scale, indicator items for a given construct load unambiguously on their own factor. Likewise, discriminate validity as opposed to convergent validity was also carried out statistically testing whether two constructs differ. External validity was always going to be an issue with the sample drawn in this study. As the evader sample was drawn from the databases of the ATO and even though participants were selected at random, it was directed by the investigator's criteria and performed conveniently.

However, importantly content validity was achieved in this study with the items measuring what was implied by their labels. This was confirmed via the feedback of a pilot study amongst tax law students which tested the survey instrument, as well as from subject experts in the field. As it was not proposed that an actual cause and effect relationship between the dependent and independent variables was to be discovered, internal validity was not such a vital issue. Certainly, the strength of the relationships between variables was important without determining any direct correlations.

Finally, statistical validity required that statistical assumptions were not violated and that other standards were met, such as reliability. It also required that not all the emphasis is put on statistically significant relationships of  $p \le 0.05$  only, but that p-values between 0.05 and 0.15 are considered for marginally significant results, such as in the Chi-Square tests. Also, statistical power needs to be considered where it is difficult to place a lot of weight on the findings, given the level of testing that was possible via Chi-Square tests and regressions and the sample sizes achieved. Despite these limitations and qualifications, it is suggested that the tests employed in the study were robust. Also, the selection of tax evaders meant that their penalty-specific knowledge and knowledge of the audit process provided a degree of reliability to the data collected, albeit that there may have been some inherent bias.

## 4. Data Analysis and Results

In Table 1A below, survey question 7 asked respondents whether they had been fined or penalized in some way by the ATO and admitted evasion (i.e., non-compliant) was confirmed in 150 cases (87%). For the majority of 42 cases, the main type of evasion was not surprisingly, understating income. This would include both intentional and unintentional non-compliance (McKerchar, 2003) comprising both deliberate evasion and inadvertent errors.

<sup>&</sup>lt;sup>9</sup> Paired sample t-tests comparing initial responses to the responses post follow-up, indicated there were no significant differences found in the responses between the two different time intervals.

Overstating deductions, rebates offsets was also high with 31 cases, however there were 57 cases in the "other" category which accounted for nearly one third of all cases. Interestingly, there were 8 cases of criminal offences of defrauding or deceiving the Commonwealth while in 24 cases (13%) of respondents denied that they were penalized by the ATO (i.e., stated compliant).

Respondents Reasons	Penalty imposed (Yes)	Penalty not imposed (No)
Q7 Have you ever been fined or penalized in some way by the ATO and if so, for what type of offence?	150 (87%)	24 (13%)
1 By overstating deductions, rebates, tax offsets etc	31	
2. By understating income	42	
3. Defrauding or deceiving the Commonwealth	8	
4. Failing to withhold and remit tax	13	
5. Other	57	

Table 1A	Q7 Penalty/Non-compliance Relationship within the I	Evader Sample
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However, the fact that there was evidence of admitted evasion by the majority of participants (87% in this case) supports the claim that evaders are prepared to reveal details of their non-compliance if they feel comfortable with the anonymity of the survey instrument (Kinsey, 1986). On the other hand, it may also be evidencing a degree of inherit bias within the evader sample. To counter this issue, a sample of taxpayers from the general population, drawn previously using the same survey instrument, was employed as a control group. The results indicate that 91% of respondents in the non-evader sample admitted to not being penalized (See Table 1B). This provided some benchmark in which to gauge the accuracy of the evaders' responses.

 Table 1B
 Q7 Personal Penalty/Offence Relationship within the Non-evader Sample

Respondents' Reasons	Penalty Imposed (Yes)	Penalty not Imposed (No)
Q7 Have you ever been fined or penalized in some way by the ATO and, if so, for what type of offence?	26 (9%)	274 (91%)
1 By over-stating deductions, rebates, tax offsets etc.	1	
2. By under-stating income	10	
3. Defrauding or deceiving the Commonwealth	3	
4. Failing to withhold and remit tax	0	
5. Other	12	

# 4.1 Chi-square Test Analysis

Specifically in terms of a preliminary analysis and giving a snapshot of the data gathered, it was considered that employing chi-square tests was appropriate to explore the relationship between various categorical variables. Chi-square, as a non-parametric technique is ideal for situations where data are measured on nominal (categorical) scales and also where sample sizes are relatively small, as is the case here.

For the purpose of the preliminary analysis the chi-square statistical test was chosen to investigate the relationship between selected compliance variables and the compliance behaviour of the evader group. The specific independent variables investigated; survey Q4 tax penalties, Q11 Probability of Detection, and Q12 tax law enforcement, were statistically analyzed against Q7 compliance behaviour (i.e., compliant/non-compliant). These questions represented the thrust of the study. The variables employed were tested for statistical significance at the 5 percent level (i.e., statistically significant at p < or = 0.05 two tailed).

Specifically in the case of question 4(b) (Appendix—Table 3), 164 of the 174 respondents felt that a prison sentence was inappropriate (response = No) for the level of tax fraud illustrated. Chi-square tests reveal that there was a statistically significant relationship between Q4(b) prison sentence and Q7 compliance behaviour ( $X^2$  = 47.071, df = 18, p = 0.000). In question 4(c) the impact of community service upon compliance showed that 142 cases considered this course of action inappropriate. Chi-square tests reveal that there was a statistically significant relationship between Q4(c) community service and Q7 compliance behaviour ( $X^2$  = 43.484, df = 18, p = 0.001). In Q4(d) the impact of an educational program upon compliance indicated that 79 cases considered this course of action program and Q7 compliance behaviour ( $X^2$  = 43.155, df = 30, p = 0.057). Overall statistical tests revealed that tax evaders did perceive some penalties and sanctions (e.g., education courses and prison sentences) as having a significant impact upon compliance. However, the majority of tax evaders viewed more severe penalties as appropriate in only certain cases of tax fraud.

In Q12 (a) (Appendix—Table 5), 84 cases strongly agreed with educating the public and improving taxpayer services. However, chi-square tests reveal that there was a statistically insignificant relationship between Q12 (a) educating the public and improving taxpayer services and Q7 compliance behaviour, ( $X^2 = 20.065$ , df =18, p= 0.329). In Q12(c) 62 cases strongly disagreed to increasing civil and criminal penalties. Chi-square tests reveal that there was a statistically marginally significant relationship between Q12(c) increasing civil and criminal penalties and Q7 compliance behaviour ( $X^2 = 24.794$ , df =18, p = 0.131). In Q12 (d) 117 cases strongly disagreed to exposing tax cheats. Chi-square tests reveal that there was a statistically significant relationship between Q12 (d) exposing tax cheats and Q7 compliance behaviour ( $X^2 = 38.167$ , df =18, p = 0.004). Statistical tests revealed that respondents did perceive enforcement measures as having some effect on compliance behaviour. However the issues were generally marginally significant although exposing tax cheats was interestingly significant, given the cohort of taxpayers in this sample.

In Q11(a) (Appendix—Table 4), 48 cases strongly disagreed with imposing tough penalties. Chi-square tests reveal that there was a statistically insignificant relationship between Q11(a) imposing tough penalties and Q7 compliance behaviour ( $X^2 = 21.759$ , df = 18, p = 0.243). In Q 11(b) 61 cases strongly agreed that the probability of detection is small. Chi-square tests reveal that there was not a statistically significant relationship between Q11(b) probability of detection is small, and Q7 compliance behaviour ( $X^2 = 19.375$ , df = 18, p = 0.369). Overall statistical tests revealed that tax evaders did not perceive tough penalties or the probability of detection as having an impact upon compliance behaviour. Both issues were not statistically significant.

The effects of age and gender have proven to be important demographic variables which impact upon tax compliance as evidenced in previous studies (Hite, 1997) also showed a relationship in this analysis. Based on the test statistics, a significant relationship was discovered between penalties such as prison sentences and educational programs particularly amongst the majority of males (comprising 67%) of the evader sample. Importantly, there was a significant relationship discovered between gender and compliance behavior (Q7), indicating that overall males were generally less compliant than females. This finding is consistent with previous studies (Richardson & Sawyer, 2001). With respect to the age variable, statistical results indicated that, in particular, middle-aged (between 40-59 years) evaders were unhappy with the overall level of taxation in Australia. As the majority of evaders (55%) were middle-aged, a possible reason for the link between age and tax fairness might have been due to the financial burdens and family pressures commonly experienced during that time of life which ultimately impacted upon compliance behaviour.

## 4.2 Regression Analysis

The parametric statistical techniques of factor analysis and logistic regressions were also employed to explore the significance and strength of the relationships, if any, amongst the compliance variables in conjunction with the previous non-parametric technique of chi square tests. This enhanced the rigor of the statistical analysis and provided further support in the validation of results.



Figure 1 Level of Tax Law Enforcement and Non-Compliance Type

# Coding: Question 7 -compliance:

If the survey response was "Yes" then it fell into one of following five categories:

(1) Survey Response (1) = overstating deductions, rebates and tax offsets

- (2) Survey Response (2) = understating income
- (3) Survey Response (3) = defrauding or deceiving the Commonwealth

(4) Survey Response (4) = failing to withhold and remit tax

(5) Survey Response (5) = other type of non-compliance

Otherwise survey response was "No penalty"

In Figure 1, positive tax law enforcement questions 12(a) (educating the public and improving taxpayer services) and 12(e), (providing incentives for paying the correct amount of tax), was tested for its impact upon compliance behaviour—question 7.

The significant results from Figure 1 indicate that the higher evaders' view of the importance of positive enforcement, the less chance there was that they were penalized for failing to withhold and remit tax. (i.e., non-compliant—Probability 4 above). Alternatively, the higher the evaders' view of the importance of positive enforcement the more chance there was that they were penalized for overstating deductions and offsets. (i.e., non-compliant-Probability 1 above). Likewise a higher view of positive enforcement was also found in taxpayers who indicated that they were not subject to penalty (i.e., Probability of "No" above). However, an insignificant result was discovered for the effect of positive enforcement upon evaders' who were penalized for understating their income (i.e., non-compliant—Probability 2 above).

In terms of the research question RQ2 regarding the effectiveness of ATO enforcement upon taxpayer compliance, it is concluded that positive enforcement impacted mostly upon the compliance attitudes and behaviour of taxpayers who had overstated deductions and offsets. That is, those taxpayers who engaged in some form of deliberate/conscience tax minimization/evasion were sensitive to enforcement levels. There was less evidence of the effectiveness of positive enforcement amongst the other categories of non-compliant taxpayers. Overall, positive tax law enforcement did influence the compliance behaviour of tax evaders in this sample.



Figure 2 Probability of Detection and Non-Compliance Type

Figure 2 above which involved the probability of detection Q11(b) (the likelihood of being caught for tax evasion is small) was tested for its impact upon compliance behavior—question 7. The significant results from Figure 2 indicate that the higher evaders' view of the probability of detection the less chance there was that they were penalized for overstating deductions, rebates and tax offsets (i.e., non-compliant—Probability 1 above). Likewise, the higher the evaders' view of the probability of detection, the less chance there was that they were penalized for failing to withhold and remit tax (i.e., non-compliant—Probability 4 above).

On the other hand, where evaders' viewed the probability of detection as high it was more likely that they were either not penalized at all (i.e., probability of "No" above) or penalized for another type of non-compliance (i.e., Probability of 5 above). No significant results were discovered for the effect of the probability of detection upon evaders' who were penalized for understating their income (i.e., non-compliant—Probability 2 above).

Overall in terms of the research question RQ3 regarding the probability of detection by the tax authority influencing taxpayer compliance, it is concluded that a high probability of detection impacted upon the compliance attitudes and behaviour of taxpayers who had either not been penalized or had been penalized for another unspecified type of non-compliance. Consequently, a high probability of detection was influential upon the compliance behaviour of only a minority of tax evaders in this sample.

## 4.3 Interview Findings

While, generally, the views of a small sample tax evaders (6) concerning tax law enforcement were mixed, the tax evaders provided some clear messages for the revenue authority as to what problems existed. In particular,

low detection rates, collection rates, a weak authority, procedural justice issues, unsophisticated systems and narrowly focused audit activity, were high on the list. Some of these issues are within the control of the tax authority but others which involve greater resources may be out of their reach.

Certainly, the issue of procedural justice and unfair treatment of taxpayers must not be tolerated and is within the Taxpayer's Charter and the ATO's capacity to control (See the 2009-10 ATO Annual Report—Improving the Ease of Compliance, p. 189). Despite penalties being raised by a couple of tax evaders as a method of improving compliance, it was noted that the preference was to use penalties in conjunction with other methods. That is, the tax evaders did not see penalties as effective when operating in isolation. In terms of the cash economy, it was indicated that audit strategies need to focus more on those operating outside the system however this is more difficult due to their very nature. Likewise, the need to target particular taxpayer groups such as high wealth individuals and those that channel money offshore was mentioned as a concern. Typical of the strong comments received included the following:

"What the ATO should be doing is chasing the larger accountants and solicitors who push the boundaries. These people are the educators of tax compliance, in particular, the targeting of tax evaders who push money offshore."

This issue is being addressed to some extent through the operation of project Wickenby (Tax Fraud Investigation, launched in 2004, involving the joint resources of ACCC, ATO, AFP, which are investigating tax fraud totaling \$300 million). It is suggested that the deflection of audit activities away from ordinary taxpayers may also have been a reaction to the evaders' own actions.

The majority of the tax evaders interviewed who still considered penalties as a valid deterrent did so with some qualifications. These tax evaders suggested that penalties had varying degrees of effectiveness depending on the type of taxpayer (i.e., those who operate inside or outside the tax system), and whether the penalty is used in combination with other measures. Typical of the comments was the following:

"They keep the honest people, honest."

This, therefore, has implications for both general and specific deterrence.

Importantly, the reasons the tax evaders provided for why people evade appear to revolve around self-interest, compensation and tax minimization. The lack of exchange equity was also highlighted. This had implications for the overall fairness of the tax system and the legitimacy of paying taxes when it appeared that tax evaders felt they were not receiving adequate goods and services in return for their tax dollar.

While the tax evaders indicated that the penalties themselves were very severe, unfair and at times poorly communicated, they were reluctant to elaborate. Consequently, it was difficult to gauge whether the penalty had been imposed appropriately. Likewise, for those tax evaders who indicated that they would be very cautious about their future compliance actions, having been flagged by the ATO, could be interpreted as both a positive and negative effect of enforcement.

What was evident from the interviews regarding penalties and deterrence generally, was that penalties may be more effective when used in conjunction with other deterrent measures, such as educational programs, community service and weekend detention. Particularly given that doubts were raised concerning the effectiveness of a jail terms given the lack of incarcerations for tax fraud (Marriot, 2012), tax evaders viewed these additional measures as having an impact upon compliance behaviour. In developing a compliance strategy based more on prevention rather than cure, this appears appropriate.

# 5. Summary and Conclusions

#### 5.1 Summary of Findings

The main objective of the study was to examine if a relationship exists between selected tax -compliance variables and the attitudes and behaviour of Australian tax evaders. In particular, this study focused on the relationship between tax evaders' awareness of tax penalties and the affect of penalties upon their tax compliance decisions. As indicated previously, the thrust of the study in terms of statistical analysis and evidence from interviews centred on how tax evaders felt penalties impacted as a deterrent measure, the probability of detection, and tax evaders' attitudes towards tax law enforcement.

With regards to enforcement, overall the results indicated that it was influential upon the behaviour of tax evaders. In particular, ineffective enforcement by the ATO to tackle the cash economy and offshore evasion was found to be a factor upon voluntary compliance. Other studies have reported similar findings (Mason & Calvin, 1984; Johnson, 2003). However, another indirect result stemming from the issue of enforcement was that of procedural justice. The ATO's treatment of taxpayers has been investigated in previous studies (Feld & Fry, 2003) and although not directly examined here, it was evident that it impacted upon compliance behaviour as a sub-issue of enforcement. The interviews supported to some degree that enforcement was effective in other ways. Overall, a relationship between tax evaders' perceptions of tax law enforcement and their tax compliance attitudes/behaviour was confirmed and H2 was accepted.

Following on from the issue of enforcement is the probability of detection. Results were mixed overall, however, it appeared that tax evaders generally felt there to be a low probability of detection. This will be of a concern to the ATO who perceive the audit function as a vital component of the self-assessment system. Indeed prior studies (Tittle & Login, 1973) have also supported this notion. Consequently, a relationship between tax evaders' perceptions of the probability of detection and their tax compliance attitudes/behaviour was discovered to some extent and H3 was accepted in part.

With a focus of this study upon the penalties for non-compliance, it was evident from the findings that penalties per se were generally viewed as being limited in influencing compliance behaviour. On the other hand, penalties were found to be effective in curbing the future actions of those fined. Evaders indicated that they found penalties to be severe and were likely to be more cautious in undertaking future compliance obligations. It should be noted that although a specific deterrent may have been achieved for these tax evaders, the general deterrent effect of penalties was inconclusive (Mason, and Calvin, 1984). Other studies have shown that the majority of taxpayers who are compliant have been influenced by penalties, see for example, Nagin (1978), Witte and Woodbury (1985) and Grasmick and Scott (1982).

The results also suggest that penalties should be used in combination with other measures such as taxpayer education and services, (as a preferred option) in order to achieve greater compliance. Other studies such as (Zimring & Hawkins, 1973) support the notion that informal or personal sanctions by way of social stigma can be a more effective deterrent than penalties. This result may have implications for compliance generally as previous studies (Pilkington, 1988) have found that when penalties are employed in combination with high detection rates, greater deterrence can be achieved. Certainly, when penalties are low, higher detection rates are preferred, whereas when detection rates are low a higher penalty may be more appropriate. The trade-off or balance between both measures continues to be an issue in maximising taxpayer compliance (Collins & Plumlee, 1991; Beck, Davis & Jung, 1992; Alm, Cronshaw & McKee, 1993). Overall a relationship between tax evaders' perceptions of penalties

and their tax compliance attitudes/behaviour was evident to a certain degree and H1 was accepted in part.

# **5.2 Tax Policy Implications**

Therefore of the three research questions and hypotheses posed in the study, statistically significant relationships were discovered between tax law enforcement RQ2/H2, and the compliance attitudes and behaviours of tax evaders. These findings were generally also supported by interview evidence. While the findings for penalties per se RQ1/H1 and the probability of detection RQ3/H3 were not found to be significant, the results still contribute some important tax policy implications.

In particular, this study revealed that the issue of self-assessment gave taxpayers the right to take liberties with respect to "pushing the boundaries" and exploiting the loopholes in the tax law which otherwise would not be the case. Consequently, this finding challenges the self-assessment system as it currently stands and suggests that at least the effectiveness of audits needs to be addressed, in the absence of returning to full assessment. Many studies have indicated that it is tax audits that drive the compliance behaviour of taxpayers (for example, Wickerson, 1994; Jackson & Jaouen, 1989). Improving deterrence measures by increasing the probability of apprehension rather than imposing necessarily heavier sanctions was also found to be significant as evidenced in (Tittle & Login's, 1973) study.

Following on from the issue of audits is that of ATO enforcement generally. As tax evaders viewed audit rates and collection rates as low the general deterrent impact was minimal. Reviewing direct strategies such as for example, cash economy benchmarks, raising default assessments and conducting more BAS refund checks would arguably improve this perception. However, this should perhaps be balanced with more taxpayer education, media advertising and visibility within the community. Other studies have found the latter course of action by revenue authorities to be very effective (Hite, 1997).

This study's results also indicated that the impact of penalties as a form of deterrent on its own was found wanting. If these non-compliant taxpayers are classified as intrinsic taxpayers who are sensitive to institutional factors such as penalties, this was certainly not evident other than for a small number of those interviewed. For most tax evaders in this study, penalties was not a major consideration in their compliance decision, but rather the focus was more on how to reduce the actual payment of tax.

While penalties per se were viewed as having a minimal impact upon the compliance behaviour of tax evaders there was also a clear message that the penalties should be supported by other preventative measures such as, educational programs and advertising. Therefore it is suggested that the actual levels of penalty may be made more transparent on public literature and in the tax return itself. This would assist in providing a general deterrent for potential tax offenders. It is also acknowledged that this action may have the negative effect of increasing non-compliance if penalties are not perceived to be severe. That is tax evaders' general perception of penalties being severe needs to be matched with strong penalties in reality.

Also while tax evaders' awareness of the different types of penalties was poor, it was evident that there was a strong preference for community service, weekend detention, and the naming and shaming of offenders as having a greater deterrent impact upon compliance attitudes, as opposed to penalties. In this regard it may well be worthwhile reconsidering the listing of tax evaders by name and offence, in the Commissioners Annual Report. Achieving deterrence through education and voluntary means as evidenced in other studies (James & Alley, 1999; Noble, 2002) emphasizes the notion of developing a compliance strategy based on prevention rather than cure.

#### 5.3 Limitations of the Study

This study, like all research, possesses both strengths and weaknesses that must be acknowledged. While the

study revealed many interesting and important insights into how penalties and enforcement measures influence compliance behaviour, appropriate qualification must be made with respect to its methodology and findings.

The first limitation of this study was that the sample of taxpayers' surveyed was not representative of the Australian population which makes it difficult to extrapolate the results to the wider Australian population. For example, certain occupational groups, those of a lower educational standard and annual income and the age spread, given that Australia is an aging population was not evident. Nevertheless, the ATO had confirmed that the sample was representative of the broader adjusted population (i.e., evader/non-complier) in the years chosen, 2004-06.

Second, as only six interviews were conducted which was less than 10% of the number surveyed, it somewhat limited this component of the study and made it difficult to draw any solid conclusions there from. However, the fact that a very reasonable response rate of 27.4% was achieved from the surveys, maintained the validity of the results and the interview findings were used mainly for comparison and cross validation.

Third, problems of honesty and misinterpretation in tax surveys are always present and hard to erase. Particularly as self reports were used to obtain information from tax evaders on a sensitive issue originating from the tax authority, meant that any comments made would need to be appropriately qualified. In this case actual taxpayer behaviour was being measured by hypothetical compliance behaviour. However prior research by (Hite 1988; Roberts, 1994) indicates that hypothetical tax compliance behaviour are reliable measures for actual compliance behaviour. Information provided by subjects on actual compliance behaviour tends to be sensitive, incriminating and likely to be misinterpreted (Hessing et al., 1988). Consequently, in the case of tax evaders it could be reasonably assumed that there was some inherent bias which needs to be taken into consideration when viewing the results.

As mentioned previously, clearly the non-response bias due to low response rates can result in reducing the quality of the data. In particular, low response rates make it difficult to distinguish respondents from non-respondents and also to generalize the sample to the population. However, Czaja and Blair (1996), caution that response rates should not be taken as the only consideration in evaluating the quality of data from a survey and that data can still be meaningful if the sample is properly designed.

Finally, as the study only focused on a few selected tax compliance and demographic variables, other variables were not employed, thereby limiting overall results.

#### **5.4 Future Research**

Nevertheless, it is proposed that this survey data will be subjected to further analysis in subsequent research which will incorporate further mediating factors such as other demographic variables and examine the influence of tax practitioners and the tax authority upon compliance behaviour. In particular, it is suggested that the results of the compliance behaviour and attitudes of non-evaders could be further compared to the evader group, with more statistical testing undertaken to assist in identifying any trends or patterns between the two groups. As further data is analyzed, hopefully the reasons for taxpayers' responses and attitudinal changes can be more closely explored. This should in turn result in improving the revenue authority's tax compliance strategies and targeting of non-complying taxpayers in order to bridge the tax gap.

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Q S1 What was the highest level of education completed?	Frequency	Percentage
Year 10 (or below)	12	7%
Year 11	6	3%
Year 12	12	7%
Certificate	16	9%
Advanced Diploma/Diploma	25	15%
Bachelor Degree	76	45%
Post Graduate Degree	24	14%
Total	n = 171	100%
Q S2 What is your Occupational group?	Frequency	Percentage
Manager	31	18%
Professional	48	28%
Assoc Professional /Educational	21	12%
Tradesperson	10	6%
Clerical, Sales and Service	24	14%
Product and transport	16	9%
Labourer	13	8%
Not working	8	5%
Total	n = 171	100%
QS3 Status- if not working	Frequency	Percentage
Unemployed	1	12%
Retired from paid work	5	64%
Full –time student	1	12%
Home duties	1	12%
Other	0	0%
Total	n = 8	100%
Q S4 Your Gender	Frequency	Percentage
Male	116	67%
Female	57	33%
Total	n = 173	100%
Q S5 Where do you live?	Frequency	Percentage
NSW	56	32%
VIC	49	28%
QLD	33	19%
SA	14	8%
WA	15	9%
TAS	3	2%
NT	0	0%
ACT	3	2%
Total	n = 173	100%

Appendix Table 2 Summary of Demographic Data Questions 23-26

Table 2 continued

# Do Penalties and Enforcement Measures Make Taxpayers More Compliant?—The View of Australian Tax Evaders'

Q23 Age	Frequency	Percentage
18-19	4	2%
20-29	23	13%
30-39	31	18%
40-49	43	26%
50-59	50	29%
60 and over	20	12%
Total	n = 171	100%
Q 24. Ethnicity	Frequency	Percentage
European Origin	34	20%
British Origin	24	14%
Asian Origin	18	10%
Australian	86	49%
Other	12	7%
Total	n = 174	100%
Q 25 Personal Income	Frequency	Percentage
Less than \$10,000	2	1%
\$10,000	0	0%
\$20,000	8	5%
\$30,000	5	3%
\$40,000	13	7%
\$50,000	14	8%
\$60,000	13	7%
\$70,000	13	7%
\$80,000	14	8%
\$90,000	17	10%
\$100,000	16	9%
\$110,000	16	9%
\$120,000	15	8%
\$130,000	3	4%
\$140,000+	25	14%
Total	n = 174	100%
Q26 Last Tax Returned Lodged	Frequency	Percentage
2005/06 year	162	96%
2004/05 year	6	4%
2003/04 year	0	0%
2002/03 year	0	0%
2001/02 year	0	0.%
Not lodged in last 5 years	0	0%
Total	n = 168	100%

Respondent Opinion	(1)	(2)	(3)	(4)	(5)	(6)	(7) Pen Not App	Total	Mean	Std. Dev.
Q4 A business owner, (X), provided "discounts" for customers in return for being paid in cash. What would you consider an appropriate penalty for the fraud?										
4a) Monetary Fine	< \$5,000	\$5,000	\$10,000	\$15,000	\$20,000	>\$20,000			4.20	1.698
	12 (7%)	24 (14%)	39 (22%)	16 (8%)	10 (6%)	2 (1%)	71 (42%)	174 100%		
b) A Prison Sentence	< 1 week	1 week	2 weeks	3 weeks	4 weeks	>4 weeks			4.66	1.634
	0	4 (2%)	0 (0%)	2 (1%)	2 (1%)	2 (1%)	164 (94.5%)	174 100%		
c) Community Service	<1 week	1 week	2 weeks	3 weeks	4 weeks	>4 weeks			5.39	1.504
	1 (0.5%)	6 (4%)	11 (6%)	3 (1.5%)	5 (2.5%)	4 (2%)	144 (83.5%)	174 100%		
d) Education Program	<3 days	3 days	6 days	9 days	12 days	>12 days			5.09	1.256
	12 (7%)	20 (11%)	16 (9%)	17 (10%)	13 (8%)	20 (11%)	76 (44%)	174 100%		

## Table 3 Q4 Penalties Scenario

## Table 4Q11 Probability of Detection

Respondents' Opinion	Strongly Disagree (1-2)	Neither Agree or Disagree (3-5)	Strongly Agree (6-7)	Total Reponses	Mean	Std. Dev.
Q11 In the following, there are some more general positions concerning the issue of law enforcement a. The prospect of tough penalties would deter people from evading tax	48 (28%)	93 (53%)	33 (19%)	174 (100%)	3.92	1.688
b. The likelihood of being caught for tax evasion is small	20 (12%)	93 (52%)	61 (36%)	174 (100%)	4.68	1.658

## Table 5 Q12 Tax Law Enforcement

Respondents'Opinion	Not very Important (1-2)	Neutral (3-5)	Very Important (6-7)	Total Reponses	Mean	Std. Dev.
Q12Please indicate how important each of the following strategies are to improve taxpayer compliance. a. By educating the public and improving taxpayer services	9 (5%)	81 (47%)	84 (48%)	174 (100%)	5.33	1.428
b. By increasing the number of audits	37 (21%)	120 (69%)	16 (10%)	174 (100%)	3.66	1.468
c. By increasing both civil and criminal penalties	62 (36%)	95 (55%)	15 (9%)	172 (100%)	3.24	1.595
d. Through exposing people who cheat the tax system (e.g., publishing names of tax evaders in the ATO annual report or increasing the number of taxpayers charged with criminal offences)	117 (68%)	43 (25%)	13 (7%)	173 (100%)	2.36	1.663
e. Through providing incentives for paying the correct amount of tax (e.g., provide free tax services)	11 (6%)	39 (22%)	123 (72%)	173 (100%)	5.77	1.526

# Tests of Reliability in Survey Instrument

The following tables present the Cronbach's Alpha coefficient for the tax compliance variables examined in the three selected survey questions (where Cronbach's Alpha of 0.7 is the minimum level for reliability).

## Cronbach's Alpha coefficient-Q12 Tax Law Enforcement

Reliability Statistics Scores for Tax law enforcement was only slightly below 0.7 and noted

Cronbach's Alpha	N of Items
0.640	5

## Cronbach's Alpha coefficient-Q11 Probability of Detection

**Reliability Statistics** 

Cronbach's Alpha	N of Items
0.817	2

# Cronbach's Alpha coefficient-Q4 Penalties

# **Reliability Statistics**

Cronbach'sAlpha <sup>a</sup>	N of Items
0.653	4

Scores for Tax Penalties were also only slightly below 0.7 and noted