

# Rewarding Taxpayers: A Possible Method to Improve Tax Compliance in New Zealand?

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A thesis submitted in partial fulfilment of the requirements for the Degree of Master of Commerce in Taxation and Accounting

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**University of Canterbury  
2015**

## **Acknowledgments**

First, I would like to thank my supervisors Professor Adrian Sawyer and Associate Professor Andrew Maples for their support and assistance in the process of preparing this thesis. In addition, I would like to thank all of the interviewees for giving up their time to speak with me. Finally, I wish to thank my mother, Cheryl, for her support throughout the course of my studies.

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## **Abstract**

Traditional tax compliance policy is based on a deterrence approach, whereby compliance is achieved through a tax authority's threats of penalties and audits. This policy is based on Allingham & Sandmo's (1972) standard model of tax evasion, which posits that an increase in the probability of detection and punishment will, *ceteris paribus*, lead to an increase in compliance. However, this model has been criticised for lacking explanatory power for the majority of observed tax compliance behaviour. Consequently, a body of research has developed which attempts to identify the factors which influence compliance behaviour in addition to deterrence measures. This research has focused upon the concept of tax morale; a concept which broadly refers to the attitudes and beliefs of taxpayers which can influence their compliance behaviour. The concept of tax morale has developed into a growing area of research which investigates the potential for utilising the 'carrot' to encourage voluntary compliance, and reducing the reliance on the 'stick' to coerce compliance (Kornhauser, 2007; Torgler, 2007).

One carrot which has been identified as having the potential to improve tax compliance is the use of rewards for compliant taxpayers. Several theoretical and experimental studies have been undertaken which have investigated the impact of rewards on participants' tax compliance behaviour, and have indicated that the use of rewards is potentially an effective means of improving compliance behaviour. However, there is an absence of research focused on gaining an understanding of the views and opinions of tax practitioners and taxpayers regarding the potential introduction of a reward system. As such, a qualitative research approach utilising semi-structured interviews was adopted, in which interviews were conducted with five tax practitioners and two small business owners. These interviews covered issues such as the potential effectiveness of using rewards to encourage compliance, the features which should be included in a reward system, and the feasibility of implementing such a system.

The findings from the interviews indicate that the use of rewards could be a more effective means of improving the compliance behaviour of non-compliant taxpayers, as opposed to the sole use of deterrence measures. In addition, it was thought that the use of rewards could also

be an effective way of maintaining the compliance of honest taxpayers and reducing the risk of such taxpayers acting opportunistically in the future. Furthermore, it was found that the use of rewards for compliant taxpayers could also reduce the risk of the ‘bomb-crater’ effect occurring.

In regard to the features of a potential reward system, it was found that there was a strong preference for the use of financial rewards, which would be administered in the form of a percentage rebate. However, it was also noted that certain types of non-financial rewards could also be effective, particularly for maintaining the compliance of honest taxpayers. A key finding arising from the research is that in order for a reward system to successfully induce non-compliant taxpayers to become compliant, it is very likely that the reward system would need to be introduced in conjunction with a tax amnesty.

In regard to the feasibility of introducing a reward system in New Zealand, the findings indicated some doubts as to the ability of Inland Revenue’s Information Technology (IT) system to adequately implement a reward system. However, these concerns were tempered by the fact that Inland Revenue is due to receive a \$1.5b upgrade of its IT system over the next ten years, which the practitioners expected would be able to competently handle the implementation of a reward system. Furthermore, the findings indicated that it should be relatively straightforward for Inland Revenue to operate such a system. Finally, the findings highlighted several issues and challenges which Inland Revenue would need to overcome in order to successfully implement a reward system, which could impact upon Inland Revenue’s amenability to adopt such an approach.



# Chapter 1: Introduction

## 1.1 Background and research questions

The issue of tax non-compliance is a long-standing problem which has plagued revenue authorities around the world. The concept of tax compliance is rather difficult to define in a precise manner, with various definitions having been put forward which attempt to capture its elements. Roth, Scholz & Witte (1989, p. 21) provide that:

Compliance with reporting requirements means 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.

James & Alley (2002, p. 32) define tax compliance as “the willingness of individuals and other taxable entities to act in accordance within the spirit as well as the letter of tax law and administration, without the application of enforcement activity.” This particular definition is useful as it emphasises that tax non-compliance can arise not only from tax evasion, but from tax avoidance as well. Wallschutzky (1988, as cited in McIntosh & Veal, 2001, p. 80) provides that “tax evasion is paying less tax than would otherwise be the case and it is achieved by means which are outside the law.” In contrast to tax evasion, tax avoidance occurs where taxpayers attempt to save tax through actions which, whilst being within the letter of the law, are not within the spirit of the law. As many aspects of taxation law are ambiguous, considerable scope exists for taxpayers to exploit grey areas of the law in order to reduce their tax liability. Whilst at first glance non-compliance in the form of tax avoidance may not appear as serious as evasion, Tan & Braithwaite (2011, p. 270) note that “this type of ‘creative compliance’, if undetected, is considered to be even more destructive of the integrity of the law and, therefore, poses a much larger problem than outright evasion.”

Tax evasion has developed into a serious issue in New Zealand. The most recent available figures highlighted that in 1994, it was estimated that New Zealand’s hidden economy amounted to \$9.6 billion (Caragata, 1998, as cited in McIntosh & Veal, 2001). This included transactions which are of a criminal nature, as well as those of a legal nature which are

hidden from the tax authorities, which are categorised as reluctant sector evasion (McIntosh & Veal, 2001). Of this \$9.2 billion, tax evasion was estimated at \$3.2 billion, of which one third was due to criminal activity, with the remainder being caused by the reluctant sector (Caragata, 1998, as cited in McIntosh & Veal, 2001). McIntosh & Veal (2001) note that whilst there is often a public perception that it is large companies who are behind the majority of tax evasion, it is in fact small businesses and the self-employed who are responsible for most of the tax evasion committed in New Zealand. This is perhaps not surprising in light of the various studies which have indicated that the opportunity to evade is the most relevant determinant of non-compliance (Kirchler, 2007). As such, it can be expected that small business and self-employed taxpayers would pose a non-compliance threat to Inland Revenue, as opportunities to evade exist for this group of taxpayers, such as the potential for doing cash jobs which are not declared for income tax, or taking cash out of the till and not declaring it. Furthermore, Inland Revenue has acknowledged that this group of taxpayers poses a significant threat to the tax base, stating in its 1998-2001 strategic business plan (as cited in McIntosh & Veal, 2001, p. 93) that “we know that tax evasion is more prevalent in small to medium size business than large corporations, because of the greater internal controls operated within widely held businesses”. As such, this research thesis focuses on one particular approach which may potentially have a positive impact upon the compliance of small businesses owners (SBOs).

Although a tax authority may be well aware of the tax evasion threat posed by small businesses and the self-employed, curtailing such behaviour is extremely difficult. This is reflected by a comment by Hasseldine (1999, p. 228), who notes that “although tax administration agencies generally possess wide powers to sanction taxpayers for non-compliant acts, tax evasion remains a large social problem.” As alluded to in this comment by Hasseldine (1999), the most common approach adopted by tax authorities to combat tax non-compliance is the deterrence model, which utilises coercive measures in an attempt to achieve compliance, such as the threat of penalties and audit. This deterrence approach is based on Allingham & Sandmo’s (1972) economic deterrence model of tax evasion, which provides that “the extent of deterrence, as the product of the probability of being detected and the size of the fine imposed, determines the amount of income tax evaded” (Feld & Frey, 2007, p. 102). However, the ability of this deterrence model to explain the majority of tax compliance behaviour has been questioned by various researchers on the basis that this model predicts that levels of tax evasion around the world should be higher than they are in practice. This is

due to the fact that the deterrence measures applied in most countries are quite low and, therefore, taxpayers would be expected to evade more tax than they do in practice (Alm McClelland & Schulze, 1992a; Feld & Frey, 2002). Therefore, whilst the level of tax evasion around the world is worryingly high, it is not as high as would be expected under the deterrence model of tax evasion. As such, whilst deterrence measures such as penalties are an important aspect of improving tax compliance, it is clear that other factors have a significant influence upon the compliance behaviour of taxpayers.

As a result of the deterrence model's lack of explanatory power, a body of research has developed which attempts to identify the factors which influence compliance behaviour in addition to deterrence measures. This research has focused upon the concept of tax morale; a concept which broadly refers to the attitudes and beliefs of taxpayers which can influence their compliance behaviour, and is one potential explanation as to the discrepancy between observed levels of compliance and the deterrence model's predicted levels of compliance (Kornhauser, 2007). A key element of tax morale is the idea that tax authorities should reduce their reliance on the use of deterrence measures, and increase the use of more positive measures which can potentially encourage voluntary compliance from taxpayers. In this sense, tax morale favours the use of the 'carrot' (positive incentives) to encourage compliance instead of using the 'stick' (punishment) to coerce compliance (McKerchar & Pope, 2011). However this is not to say that there is no place for the use of deterrence measures. As Kornhauser (2007, p. 604) notes, "...sticks as well as carrots are needed to ensure compliance..." Whilst one component of tax morale relates to intrinsic factors, such as individual traits which motivate a taxpayer to be compliant, tax morale also consists of external factors which can be influenced by a tax authority in an attempt to improve tax compliance, such as taxpayers' perceptions of fairness, procedural justice and taxpayers' trust in government (Alm & Torgler, 2006; Kornhauser, 2007).

This thesis focuses on one particular external factor identified in prior research which could potentially improve taxpayers' tax morale and tax compliance, namely the use of rewards for compliant taxpayers as a means of encouraging tax compliance. Several theoretical and experimental studies have been undertaken which have investigated the impact of rewards on participants' tax compliance behaviour, and have indicated that the use of rewards is potentially an effective means of improving compliance behaviour (Alm, Jackson & McKee, 1992b; Bazart & Pickhardt, 2011; Torgler, 2003). However, there is an absence of research

focused on gaining an understanding of how tax practitioners and SBO/self-employed taxpayers would view the introduction of a reward system. Therefore, the aim of this thesis is to supplement the theoretical and experimental research in this area by approaching the issue from a different perspective; namely, through seeking to gain an understanding of SBOs' and practitioners' perceptions regarding how effective the use of rewards may be for improving compliance.

In particular, the broad research questions which this thesis seeks to answer are as follows:

*RQ1 - How effective would the use of a reward system be for improving tax compliance, and how should such a system be designed?*

Prior research has put forward various types of rewards which could be applied, such as different types of financial and non-financial rewards, as well as various ways and circumstances in which rewards could be administered. However, it is still unclear how a reward system should be designed so as to maximise its potential for improving tax compliance. Therefore, this thesis sought the views and opinions of tax practitioners and SBOs in regard to what they believe would be the most appropriate features of a reward system. This led to the following sub questions.

*RQ1(a) - How feasible would the implementation of a reward system be in New Zealand?*

*RQ1(b) - How amenable would Inland Revenue be to using such a system, and what are some potential difficulties which Inland Revenue would need to overcome in order to successfully implement such a system?*

As the majority of prior research on rewarding compliant taxpayers has been experimental in nature, the questions of whether implementing a reward system would be feasible, and whether a tax authority would be amenable to the use of rewards, have largely been unexplained. As such, this research project investigated these issues in the New Zealand context.

## 1.2 Importance of the research

In regard to the importance of this research, Tan (1999) notes that “tax non-compliance is an area of concern for the government as it not only affects their ability to raise revenue, but also other fiscal aims such as economic stabilization and income distribution” (p. 433). As such, considerable enforcement resources are required to be utilised by the tax authorities in order to combat non-compliance. For example, Tan and Braithwaite (2011) note that in 2009-10, Inland Revenue utilised approximately 1,075,000 hours in tax audits. This highlights the cost of non-compliance, not only in the lost government revenue, but also in regard to enforcing compliance. Furthermore, this emphasises the importance of investigating potential means of improving tax compliance, such as through a reward system being implemented to complement the traditional penalty system, as a method of encouraging compliance.

Slemrod (1992) notes that research focusing on providing an alternative means to deterrence in order to increase tax compliance, particularly research emphasising “the carrot for compliance rather than the stick for non-compliance” (p. 7) is important:

“... because, from the tax collection standpoint, it is extraordinarily expensive to arrange an enforcement regime so that, from a strict cost-benefit calculus, non-compliance does not appear attractive to many citizens. It follows that methods that reinforce and encourage taxpayer’s devotion to their responsibilities as citizens play an important role in the tax collection process” (Slemrod, 1992, p. 7)

Echoing the sentiments of Slemrod, Torgler (2007) states that “the analysis of positive rewards in tax compliance research is an important topic and just in its infancy” (p. 94).

The motivation for this research project stems from an interest to understand whether the implementation of a reward system is a feasible and desirable method of improving tax compliance in New Zealand. In addition, there is the motivation to supplement the relatively small body of research pertaining to tax reward systems, and to contribute to redressing the identified absence of studies regarding the views and opinions of taxpayers and practitioners regarding the concept of a taxation reward system.

### **1.3 Overview of the thesis**

The remainder of this thesis is structured in the following manner. Chapter 2 reviews the relevant literature regarding the topic of this thesis. Chapter 3 outlines the research approach and methodological position underlying this thesis, and provides details in regard to the methods utilised in this research. The research findings are presented in Chapters 4 and 5, and are analysed in Chapter 6. Finally, the conclusions, contributions, limitations, key assumptions and areas for future research are discussed in Chapter 7.

## **Chapter 2: Literature review**

### **2.1 Traditional deterrence approach**

Traditional tax compliance policy is based on a deterrence approach, whereby compliance is achieved through the tax authority's threats of penalties and audits. This policy is based on Allingham & Sandmo's (1972) standard model of tax evasion, which posits that an increase in the probability of detection and punishment will, *ceteris paribus*, lead to an increase in compliance. However, this model has been criticised on the basis that deterrence factors do not explain the majority of compliance behaviour. Specifically, due to the low level of deterrence measures applied in most countries, the model predicts too much evasion and too little compliance (Alm et al., 1992a; Feld & Frey, 2002). In other words, the level of actual observed compliance around the world is far higher than that predicted by deterrence models. As Alm et al. (1992a, p. 22) note, "a purely economic analysis of the evasion gamble implies that most individuals would evade if they are 'rational', because it is unlikely that cheaters will be caught and penalized." Therefore, it is argued that there are other factors in addition to deterrence measures that compel taxpayers to comply.

### **2.2 Tax morale**

Due to the traditional deterrence model's lack of explanatory power for the majority of taxpayers' compliance behaviour, researchers have sought to determine the various factors, in addition to the threat of deterrence measures, which influence the compliance behaviour of taxpayers. One concept which has developed in research focused on seeking to explain the unexpected gap between expected and actual levels of tax compliance is that of tax morale; a very broad, general term which relates to all of the non-rational factors, motivations, and non-deterrence aspects which can impact upon a taxpayers' voluntary tax compliance, whereby higher tax morale correlates with higher tax compliance (Kornhauser, 2007). According to McKerchar & Pope (2011, p. 3), tax morale research signifies "...a shift away from deterring non-compliance towards instead encouraging voluntary compliance (i.e. with both the letter and the spirit of the law) – that is, more emphasis on the 'carrot' rather than the 'stick'." However, tax morale is a rather imprecise term, and the concept has been described as a

phenomenon which “...is somewhat elusive in many significant respects including its meaning and relevance in the context of taxpayer compliance; how it may be influenced and, of course, its effects” (McKerchar & Pope, 2011). Due to tax morale being a rather imprecise term, there is no all encompassing definition of the concept. Some researchers have defined tax morale as being taxpayers’ intrinsic motivation to pay taxes (Frey, 1997; Feld & Frey, 2002; Torgler & Murphy, 2005, as cited in McKerchar & Pope, 2011). Schnellenbach (2006, p. 118) defines tax morale:

...as the phenomenon that taxpayers (i) on average evade less taxes than an optimisation calculus incorporating only expected judicial punishment and reasonable levels of risk aversion would predict and (ii) systematically adjust their evasion levels according to how satisfied they are with public policy, processes of collective decision-making and the quality of their relationship to authorities.

Whilst the concept of tax morale has often been treated as an “undifferentiated black box” (Kornhauser, 2007), research has sought to identify its various components. Torgler (2007) argued that tax morale consists of three main factors, namely moral rules and sentiments, such as norms and guilt; fairness; and the relationship between taxpayer and government. Kornhauser (2007) proposed that the norms influencing tax morale include procedural justice, trust and belief in the legitimacy of the government, reciprocity and altruism, which echoes the sentiments of Alm & Torgler (2006, p. 228), who argued that “tax morale is likely to be influenced by such factors as perceptions of fairness, trust in the institutions of government... and a range of individual characteristics.” These various components highlight that tax morale incorporates factors which are internal to taxpayers, as well as external factors which can be influenced by a tax authority.

### **2.2.1 Framing and Prospect Theory**

The concept of cognitive and affective processes is a growing area of research in the tax morale field. Kornhauser (2007, p. 607) defines cognitive and affective processes as “...unconscious mechanisms that influence a person’s perception and response to information, people, and the environment.” One cognitive process of importance in regard to tax



compliance is ‘framing’, which refers to the idea that the manner in which situations are presented can affect how a person reacts to it. One of the most important elements of framing for tax compliance research is Prospect Theory, which investigates how people evaluate and react to risk (Kahneman & Tversky, 1981). A series of experiments conducted by Kahneman & Tversky (1981) indicated that subjects consistently exhibited patterns of risk averse behaviour in situations involving gains, and risk seeking behaviour in situations involving losses. In other words, when a person was in a position to make a sure gain they were less willing to take risks, whilst people were more willing to take risks when they are in a position to make a sure loss. On the basis of these results, researchers have argued the relevance of Prospect Theory for understanding and curtailing evasion behaviour by considering the decision frames of two taxpayers who face, respectively, the prospect of a tax refund or a tax bill after withholding. For example, as Robben et al. (1990) explain, a taxpayer who knows that they are due to receive a tax refund may view themselves as being in a gain situation. Therefore, whilst they could elect to falsify their tax return and engage in tax evasion in order to receive a larger refund, Prospect Theory suggests that the taxpayer would tend to avoid the risks associated with evasion because they are already assured of a refund if they pay the correct amount of tax. In contrast, a taxpayer expecting to owe money may view themselves as being in a loss situation and, therefore, will be more likely to engage in tax evasion in order to reduce the anticipated loss.

Robben et al. (1990) highlight that there is some existing evidence which supports Prospect Theory’s predictions, and make reference to analyses released by the United States Internal Revenue Service (IRS) on the voluntary compliance rates for a sample of 50 000 tax returns, which indicated that income tax compliance varied as a function of the size of taxpayers’ refund of balance owed (Cox & Plumbley, 1988, as cited in Robben et al., 1990). For example, in regard to wage and salary earners, the compliance rate for taxpayers who claimed a refund of more than \$1000 was 96 percent, compared to 89 percent for taxpayers who faced a balance due of over \$1000. Similarly, for taxpayers earning business income, the compliance rate for individuals expecting a refund over \$1000 was 95 percent, compared to only 70 percent for taxpayers with a balance due of over \$1000.

Results such as those obtained from the IRS analyses have prompted researchers to test Prospect Theory’s predictions in the tax compliance context, with various studies providing support for its relevance to tax evasion behaviour. For example, Robben et al. (1990)

conducted an experiment in which the participants simulated the tasks involved in running a small business for a two 'year' period, including the completion of tax returns. Half of the participants were assigned to the condition that they could expect a significant tax refund during each of the two 'years' in which they managed the business, whilst the other half were assigned to the condition that they could expect that a considerable tax payment would be due on top of the taxes already withheld. Results indicated that compliance was higher among the participants who were due a refund compared to those who faced a balance due.

Schepanski & Kelsey (1990) found that taxpayers are less likely to claim a dubious deduction when in a position to receive a tax refund than when they are in a tax due condition. White, Harrison & Harrell (1993) experimentally investigated the effects of taxpayers' prepayment position (payment due or refund available) on evasion behaviour, and found that subjects who were due a tax refund chose less aggressive filing positions than those with a balance due. Similarly, Dusenbury (1994) examined the influence of prepayment position on taxpayers' preferences for risky filing options. The results indicated that taxpayers were more willing to take a risky position when they owed tax as opposed to being owed a refund, with taxpayers being owed a refund declaring 20 percent more of their uncertain taxable income. Anderson (1996) conducted a replication and extension of Dusenbury's (1994) study in the New Zealand context, in which Dusenbury's (1994) findings, and Prospect Theory's predictions regarding tax compliance, were supported.

Results such as those outlined above have led researchers to conclude that Prospect Theory's predictions could potentially be used to inform the compliance policies of tax authorities. In particular, Prospect Theory suggests that tax authorities could seek to reduce the amount of risk that taxpayers take when making compliance decisions by ensuring that taxpayers are in a position to receive a refund (Dusenbury, 1994; Hasseldine, 1998a). Hasseldine (1998a) provides that one way to achieve this is for a tax authority to intentionally over withhold income so as to put taxpayers in a position to receive a refund. This raises the question of whether another viable option of achieving this is through the use of financial rewards, whereby compliant taxpayers receive a refund which is, for example, proportional to the amount of tax paid; an issue which is examined in this thesis. However, Dusenbury (1994) cautions that such an approach is unlikely to be a panacea, noting that habitual tax evaders will not necessarily become compliant when they are in a position to receive a refund. There

is, however, the potential to reduce taxpayers' willingness to take the risk of evasion or avoidance if a refund is available.

### **2.2.2 Reciprocity**

The concept of reciprocity has been identified as a component which can increase tax morale, and is an aspect which could potentially be influenced by rewards. The general principle underlying the norm of reciprocity is that an individual will respond to another's act in the same manner in which that person treated them (Kornhauser, 2007). In the tax compliance context, the concept consists of two distinct dimensions. The first dimension, known as vertical reciprocity, relates to the relationship between taxpayers and the government/tax authority, whilst the second dimension, known as horizontal reciprocity, relates to the relationship between taxpayers (Schnellenbach, 2010). In regard to vertical reciprocity, a taxpayer's willingness to be compliant can depend on how they perceive their relationship with the tax authority, in regard to factors such as whether they feel the relationship between them and the tax authority is fair, as well as whether they perceive the tax system in general as fair (Luttmer & Singhal, 2014). Smith (1992) notes that a compelling reason for believing that a positive action by a tax authority towards taxpayers will increase the likelihood of compliance is that people have a tendency to try and reciprocate actions directed toward them. Smith (1992) also highlights that there is evidence that the norm of reciprocity holds in regard to concessions, whereby people feel an obligation to make a concession to someone who has made a concession to them. As such, he argues that "cycles of antagonism might begin to be broken by a positive concession by the administrator" (p. 226).

In regard to horizontal reciprocity, a taxpayer's willingness to be compliant can be influenced by their beliefs about the compliance behaviour of other taxpayers (Schnellenbach, 2010). For example, a taxpayer's perception that others are evading or avoiding tax may lead that taxpayer to act in a reciprocal manner, justifying their behaviour on the basis that they are behaving the same as others (Kornhauser, 2007). Conversely, taxpayers who perceive that most taxpayers are meeting their obligations may be more likely to act in a reciprocal manner and also meet their obligations. Therefore, Kornhauser (2007, p. 616) states that reciprocity

theory implies that an effective method of increasing cooperative, compliant behaviour is to “...promote... the shared belief that others can in fact be counted on to contribute their fair share to public goods...”

### **2.2.3 The role of rewards in tax morale: The psychological tax contract**

Feld & Frey (2007) have conceptualised tax morale as being a psychological tax contract between taxpayers and tax authorities. The psychological tax contract, as broadly defined by the authors, is a concept which goes beyond the traditional deterrence model’s reliance on fear as a means of achieving tax compliance, and explains tax morale “...as a complicated interaction between taxpayers and the government establishing a fair, reciprocal exchange that involves the giving and taking of both parties” (p. 104). The operation of this psychological tax contract as a means of achieving tax compliance is built on two main pillars. First, the authors argue that taxpayers are more likely to be voluntarily compliant when they perceive that the tax authority has treated them in a fair, respectful manner during the course of their interactions. Such interactions could occur, for example, during the course of a tax audit. This highlights that the concept of procedural justice, which “...concerns the perceived fairness of the procedures involved in decision-making and the perceived treatment one receives from the decision maker” (Murphy, 2003, p. 380), plays an important role in improving tax morale.

Second, the authors argue that for the psychological tax contract to be upheld, incentives must be provided. These incentives include both positive incentives, such as rewards for compliance, and negative incentives, such as penalties for non-compliance. The literature in regard to the use of rewards as a potential means of improving tax compliance will be discussed further below. Prior to this, however, the following subsection outlines how elements of tax morale and the psychological tax contract have been incorporated into the compliance strategies of Inland Revenue, and highlights where the use of rewards could be incorporated into Inland Revenue’s compliance strategies.

## **2.2.4 Elements of tax morale in practice: The Inland Revenue Compliance Model**

Kornhauser (2007, p. 622) notes that several tax authorities around the world have “switched their approach to tax administration from a one-size-fits-all enforcement model to a model that builds on the lessons of tax morale research.” Such an enforcement model is commonly referred to as a responsive regulation model. One of the key features of this model is that it adopts the use of ‘carrots’ as well as ‘sticks’ as a means of achieving tax compliance. The development and implementation of the responsive regulation model largely stems from research investigating the role that the concept of motivational postures has in the tax compliance context. Murphy (2004, p. 315) states that “motivational postures represent the ways in which individuals position themselves in relation to a regulatory authority, and are predispositions to compliant or non-compliant conduct.” Braithwaite, Murphy & Reinhart (2007, p. 138) defines motivational postures as being “...conglomerates of beliefs, attitudes, preferences, interests, and feelings that together communicate the degree to which an individual accepts the agenda of the regulator, in principle, and endorses the way in which the regulator functions and carries out duties on a daily basis.”

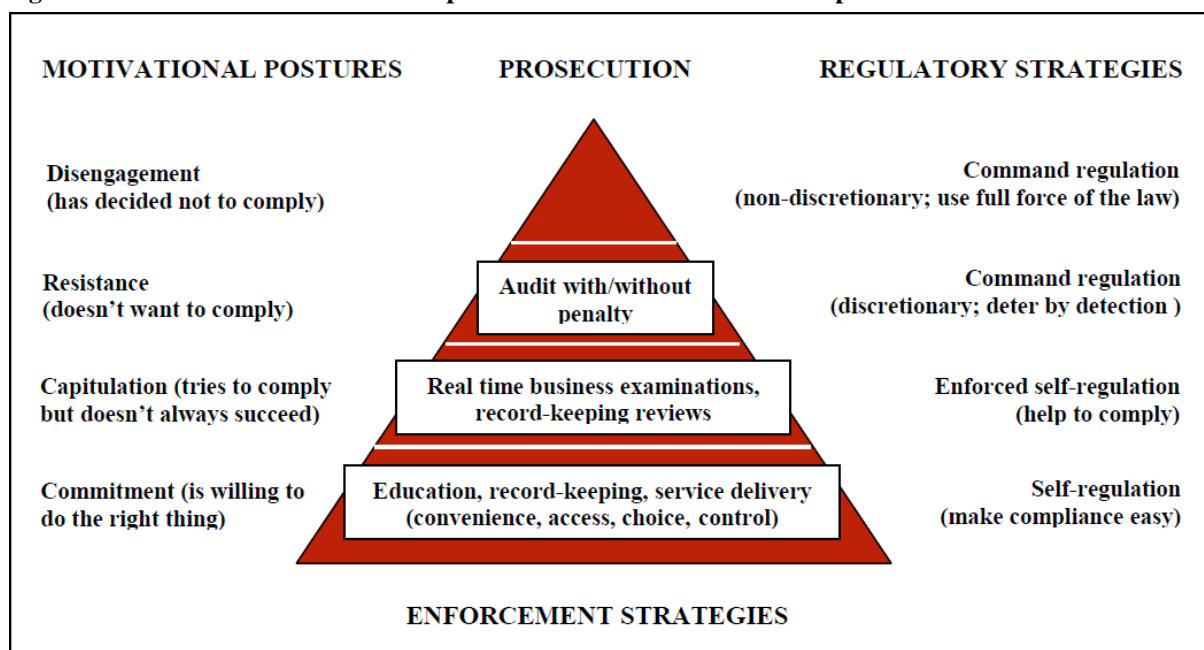
In regard to the tax compliance context, motivational postures reflect the manner in which taxpayers view the tax authority and tax system, and in turn indicate taxpayers’ degree of acceptance or rejection of the tax authority (Leviner, 2009). Braithwaite (2003) has identified five motivational postures which are of importance in the tax compliance context. At one end of the spectrum are two postures of deference, known as commitment and capitulation postures, which reflect an overall positive orientation toward the tax authority. A taxpayer with a commitment posture perceives the tax system as being desirable and fair, and feels an intrinsic, moral obligation to meet their tax compliance obligations. A taxpayer with a capitulation posture accepts the tax authority as holding legitimate power, and perceives it as a benign authority, provided one meets their obligations and defers to its authority.

At the opposite end of the spectrum are three postures of defiance, known as resistance, disengagement and game playing. A resistance posture represents a negative orientation towards the tax authority, whereby taxpayers may doubt the authority of tax officers and may perceive the actions of the tax authority as being dominating and controlling, as opposed to

supportive. A taxpayer with a posture of disengagement has cut themselves off from the tax system and seeks to hide from the view of the tax authority. Braithwaite (2003) notes that taxpayers who possess this posture are likely to become uncooperative with the tax authority if they feel the tax authority has got ‘tough’ with them. The final motivational posture is that of game playing, which represents a taxpayer who enjoys the game of finding ambiguities and grey areas of tax law, and the challenge of trying to beat the tax authority in order to minimise their tax liability (Murphy, 2004). Braithwaite, Schneider, Reinhart & Murphy (2003) note that game playing relates to the tax avoidance aspect of non-compliance, as opposed to the evasion aspect, as it encompasses “...finding ways of legally using the law against the tax authority and sidestepping the obligation to pay tax” (p. 91). In contrast, Leviner (2009) posits that under the postures of resistance and disengagement, non-compliance can take the form of both avoidance and evasion.

The underlying rationale for seeking to categorise taxpayers according to their motivational posture is that the effectiveness of compliance strategies is likely to vary depending on which motivational posture a taxpayer holds (Leviner, 2009). This has led to the development of the Australian Tax Office Compliance Model (Figure 2.1), which has since been adopted in New Zealand in the form of the Inland Revenue Compliance Model, as provided in Figure 2.2.

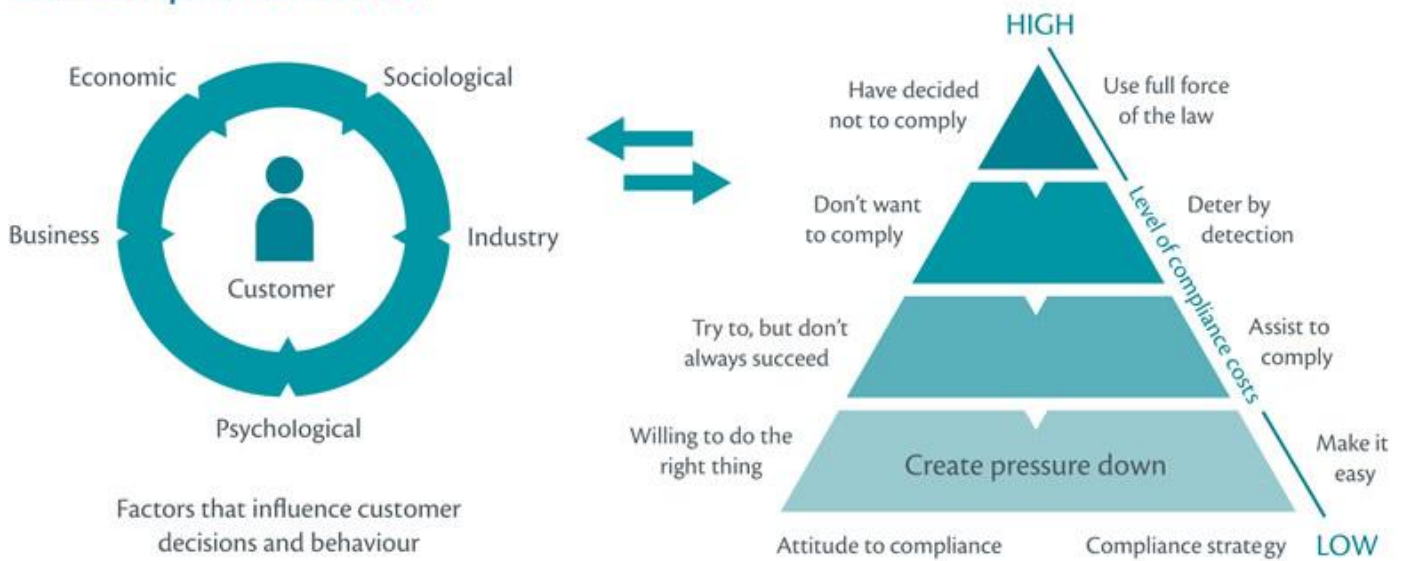
**Figure 2.1: Australian Tax Office Compliance Model which has been adopted in New Zealand**



Source: Batrancea, Nichita & Batrancea (2012, p. 206)

**Figure 2.2: Inland Revenue Compliance Model**

### Our compliance model



Source: Inland Revenue (2012)

As indicated above by Kornhauser (2007), these compliance models incorporate elements of tax morale, as they reduce the reliance on compliance strategies which are solely based on the use of threats and penalties (Leviner, 2009). Instead, the model emphasises the importance of ensuring that a tax authority engages in appropriate interactions with taxpayers, with the underlying principle being that a tax authority “...will tailor its enforcement actions to match the underlying attitude of a taxpayer towards compliance” (Alley et al., 2012).

As can be seen in Figure 2.1, four of the five motivational postures identified by Braithwaite (2003) are explicitly incorporated into the compliance models, where each motivational posture corresponds with a different enforcement strategy, the severity of which increases with the level of a taxpayer’s defiance. In addition, the fifth motivational posture of game playing can sit anywhere along the left axis of the compliance models (Hodson, 2011).

As such, it is evident that the Inland Revenue Compliance Model has incorporated several elements of Feld & Frey’s (2007) psychological tax contract. First, Inland Revenue starts at the bottom of the compliance pyramid by seeking to encourage compliance through building positive relationships with taxpayers and having respectful interactions with them (Leviner,

2009; Morris & Lonsdale, 2004). This is consistent with the first element of the psychological tax contract, which emphasises the importance of procedural justice. Second, where taxpayers are more defiant and less willing to meet their tax obligations, the compliance model instructs Inland Revenue to increase the severity of its enforcement actions and introduce the threat and utilisation of audit and penalties. This is consistent with the second element of the psychological tax contract, which advocates the use of negative incentives, such as penalties for non-compliance. However, Kornhauser (2007) notes that Feld & Frey's psychological tax contract extends beyond the sole use of negative incentives, and has proposed the use of positive incentives, such as rewards for compliance. As such, this raises the issue of whether there is a place for rewards to be introduced into the Inland Revenue Compliance Model which would operate alongside the use of the traditional deterrence measures. Consequently, the literature regarding the potential use of rewards as a means of improving tax compliance is now discussed.

### **2.3 The use of rewards to improve compliance**

Feld, Frey & Torgler (2006a) note that investigating the potential impact that rewards could have on tax compliance is a relatively novel approach. The authors highlight that instead of seeking to improve tax compliance by offering rewards to encourage compliance, governments and tax authorities are increasingly using tax amnesties as a 'carrot' for encouraging non-compliant taxpayers to improve their compliance behaviour. Richardson & Sawyer (2001, p. 218) explain that "a tax amnesty generally involves providing previously non-compliant taxpayers with the opportunity to pay back-taxes on undisclosed income, without fear of penalties or prosecution." Tax amnesties have previously been utilised in New Zealand, most notably with a relatively successful general tax amnesty being run by Inland Revenue for a two month period in 1988, which resulted in 24 685 amnesty returns being lodged, and \$26.6 million of tax being assessed (Hasseldine, 1989).

The use of tax amnesties as a means of improving tax compliance is largely based on the same rationale underlying the research putting forward the possibility of introducing rewards, namely that there are doubts as to the efficiency and effectiveness of relying on legal



sanctions as a means of increasing tax compliance levels (Hasseldine, 1998b). However, it is unclear whether tax amnesties are an effective method for improving tax compliance in the long-term (Hasseldine, 1989; Richardson & Sawyer, 2001). Furthermore, the success of tax amnesties can often be impaired due to the unintended negative consequences that can arise from their use. For example, honest and compliant taxpayers may perceive the use of tax amnesties as being unfair and view them as a signal that tax evasion is a forgivable and insignificant action, which can lead to a reduction in their motivation to comply in the future (Feld et al., 2006a; Hasseldine, 1989; Richardson & Sawyer, 2001; Torgler, 2007). As such, this has led to various researchers proposing that the use of rewards could be a more effective carrot for encouraging the desired behaviour of tax compliance, as opposed to relying on punishments or allowing non-compliers to come clean through a tax amnesty (Feld et al., 2006a).

### **2.3.1 Psychological effects of rewards and Crowding Theory**

Kirchler (2007) posits that tax compliance behaviour could follow rules put forward in Operant Conditioning Theory; a learning principle popularised by Skinner (1938). Psychologists' studies concerning learning processes have proved that the likelihood of an individual displaying a specific behaviour can be influenced through reinforcement of that behaviour (Kirchler, 2007). Influence is exerted through manipulating the consequences of the behaviour. Such manipulation can take the form of positive reinforcement to encourage desired behaviour, or punishment to deter undesired behaviour. Kirchler (2007) notes that whilst positive reinforcement has consistently proved to be effective, the effectiveness of punishments is mixed, as punishment tends to only suppress the undesired behaviour, as opposed to eliminating it. Furthermore, "...punishment may result in hatred towards the particular institution and in revenge-seeking actions" (Kirchler, 2007, p.127). This highlights the point that a sole reliance on the use of tax penalties may not be effective in achieving compliance, and that taxpayers who are penalised may seek to engage in further non-compliance as a form of revenge-seeking behaviour. Instead, the addition of rewards may be more effective in achieving the desired behaviour of compliance.

A further rationale underlying the argument for the use of rewards stems from the concept of Crowding Theory, which relates to the effect that external interventions can have on peoples' motivation to perform a certain activity or behaviour (Frey & Jegen, 2001). Feld et al. (2006a) explain that according to Crowding Theory, external interventions that are perceived as being controlling in nature, such as deterrence measures, tend to crowd-out, or reduce, people's motivation to perform the desired activity. For example, in the tax compliance context, the application of deterrence measures for a non-compliant taxpayer is seen as being controlling and may further reduce the taxpayer's willingness to be compliant. Feld & Frey (2007) highlight that the empirical evidence on the effect of deterrence on tax compliance is ambiguous, with some results indicating that non-compliance increases when the level of penalties and control increase. The authors argue that this ambiguity can possibly be explained with Crowding Theory, stating that "higher control intensities increase deterrence, and thus tax compliance, on the one hand, but may be perceived as intrusive by taxpayers, and thus reduce tax compliance, on the other hand" (p. 108).

Conversely, external interventions which are perceived as being supportive in nature can maintain and increase peoples' motivation to perform a desired behaviour. In this sense, intrinsic motivation is crowded in (Frey & Jegen, 2001). Feld et al. (2006b) state that the provision of certain types of rewards for compliant taxpayers is likely to be perceived as being a supportive external intervention, and would therefore increase the intrinsic motivation of taxpayers, leading to increased compliance. As such, Feld et al. (2006b, p.4) conclude that "rewards could be more effective than punishments for eliminating undesired behaviour or for motivating desired behaviour because it is perceived as supporting." Furthermore, the authors note that if taxpayers' intrinsic motivation to be compliant is not recognised or acknowledged, their intrinsic motivation may decrease and their willingness to act opportunistically may increase. Thus, there is a potential risk that 'good', compliant taxpayers may become non-compliant over time if their good behaviour is not acknowledged by the revenue authority. The introduction of a reward system could, therefore, be an effective mechanism for increasing tax compliance, as well as maintaining it.

Despite the growing research investigating the potential for rewards to improve tax compliance, Torgler (2007) notes that this area of research is still in its infancy. There are, therefore, areas of uncertainty in which research can seek to investigate. For example, there is uncertainty as to the potential negative effect that rewards may have on taxpayers' motivation

to be compliant, and the effect that rewards may have on different subgroups of taxpayers. These issues relate to the different possible features that a reward system could have and the different ways such a system would operate. The literature regarding these issues is discussed in the following subsections.

### **2.3.2 Features and operation of a reward system**

An important issue to consider is the design and operation of a potential reward system, in regard to the type of rewards which would be provided, and the circumstances in which they would apply. Tax authorities would be faced with a trade off between the costs and benefits of providing rewards, and the costs and benefits of using other incentives, such as punishments. Therefore, in order to justify the use of rewards, such an approach must raise net tax revenues after deducting the cost of rewards (Feld et al., 2006a). One of the aims of using rewards as a compliance strategy is to design the reward system in a way so as to change the relative prices in favour of compliance and against tax evasion, such as through influencing taxpayers' risk preferences (Feld et al., 2006a). However, Feld et al. (2006a) caution that rewards may induce strategic behaviour from taxpayers. The authors provide the example of a reward which is provided due to the reduction of evasive behaviour, in which case a taxpayer may strategically "...increase tax evasion as a first step in order to reduce it in a second step in order to generate higher benefits from the rewards" (p. 51). The authors propose that one way to reduce this risk is to make the provision of rewards dependent on a taxpayer being completely honest.

The literature has identified various types of rewards which could potentially be provided to taxpayers, ranging from different types of financial rewards to different types of non-financial rewards. In regard to financial rewards, Feld et al. (2006b) note that such a payment could be proportional to the amount of tax paid by a taxpayer, so the reward would be analogous to a percentage rebate. Alternatively, the payment could be administered at a single, set amount for all 'good taxpayers.' However, some doubts have been raised in the literature in regard to the potential effectiveness of financial rewards. For example, Kornhauser (2007) is critical of the idea of using financial rewards, stating that "monetary rewards, such as rebates of a percentage of the tax, can be counterproductive. They may

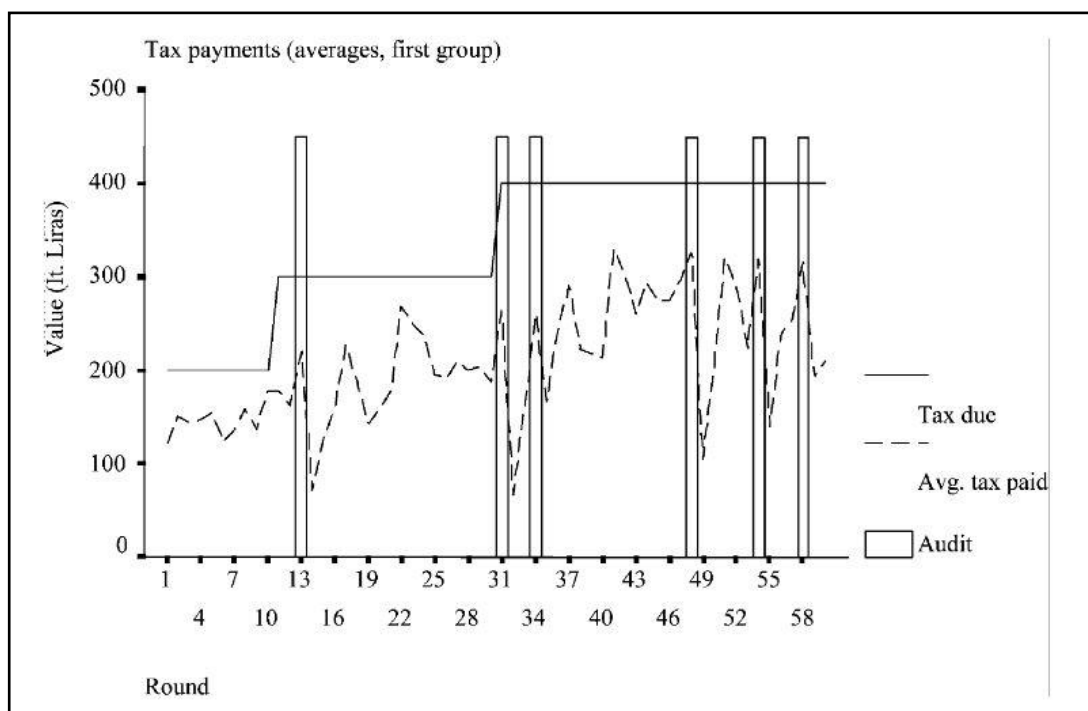
decrease internal motivations to comply because the taxpayer may consider them discounts, like rebates in a commercial setting, and thus ones to which s/he is entitled” (p. 639). This uncertainty as to the efficacy of financial rewards has led some researchers to propose that non-financial rewards may potentially be more effective (Feld & Frey 2007; Kornhauser, 2007). Such researchers note that where the reward is clearly distinguished from the tax payment, it may be more likely to be perceived as a sign of acknowledgment, and therefore is more likely to maintain or increase intrinsic motivation, as the sign of appreciation from the revenue authority is arguably stronger than a mere reduction in tax liability. This highlights the fact that the use of non-monetary rewards may be preferable. Such non-monetary rewards could include improved and cheaper access to public services, such as transport and cultural activities (Feld & Frey, 2007; Feld et al., 2006b; Kornhauser, 2007). Feld et al. (2006b) note that there is some anecdotal evidence regarding the use of non-monetary rewards as a means of enhancing tax compliance. For example, taxpayers found to be compliant in Japan are offered the opportunity to have their photograph taken with the Emperor, and South Korea provides access to airport VIP rooms, as well as issuing certificates and awards.

A further related area of uncertainty relates to the issue of how rewards may affect the compliance behaviour of different subgroups of taxpayers, such as the various motivational posture categories of taxpayers, and whether different types of rewards may be more affective for different categories of taxpayers. For example, Torgler (2002, p. 667) emphasises that “future efforts could, for example, examine whether some taxpayer subgroups, e.g. honest taxpayers, crowd out their intrinsic motivation when positive inducements are introduced.”

A final identified issue in the literature relates to determining the circumstances in which the rewards would apply. This stems from the question of what criteria should a tax authority set for a taxpayer to be deemed compliant and therefore eligible to receive a reward? As Feld et al. (2006b) note, there are different levels of tax compliance, such as a taxpayer declaring all of their income, not overstating deductions, filing tax returns on time, and paying the taxes due. As will be noted in the following section, an example of the circumstances in which rewards could apply is where a taxpayer is found to be fully or largely compliant after an audit. One advantage of applying rewards in this manner is the potential for reducing the bomb-crater effect; a term that is derived from World War I, where it is said that soldiers believed that the safest place to take cover from enemy fire was the crater of the most recent bomb, due to the belief that it was highly improbable that another bomb would strike in the

same place again (Kastlunger, Kirchler, Mittone & Pitters, 2009). Evidence of a similar phenomenon has also been identified in a tax compliance context, as several experiments have illustrated that immediately after a taxpayer is audited, the level of compliance decreases in consecutive periods (Guala & Mittone, 2005). It is posited that the most likely mechanism causing this decrease in compliance is misperception of chance, whereby taxpayers mistakenly believe that the probability of being audited again in the subsequent period is low (Guala & Mittone, 2005). Figure 2.3 illustrates the bomb-crater effect on tax compliance, based on experimental evidence.

**Figure 2.3: Bomb-crater effect as represented by the decrease in compliance after an audit**



Source: Guala & Mittone (2005, p. 505)

As it is apparent that the level of taxpayers' non-compliance may increase as a result of being audited, an interesting issue to consider is whether the introduction of rewards into the tax system could reduce, or eliminate, the bomb-crater effect. This possibility was identified by Kastlunger et al (2011), where experimental evidence indicated that subjects' compliance levels subsequent to an audit were higher when the reward was introduced as compared to the control condition.

Another possibility is for a reward to apply for the early filing of tax returns and making payments on time, whereby a tax discount could be granted. Such a reward is analogous to

the use of discounts by a number of New Zealand power companies, such as Meridian (2015), Mercury Energy (2014) and Genesis Energy (2014). Discounts are also utilised in a tax context. Cornia, McCluskey & Walters (2012) highlight the use of discounts for early payment of property tax as an incentive for encouraging compliance. In a New Zealand context, an early payment income tax discount applies to SBOs, as a means of encouraging them to voluntarily pay tax in the year before they are required to pay provisional tax (Income Tax Act 2007, s RC 37-40). Inland Revenue, therefore, has some limited experience in administering income tax discounts. Whilst no direct evidence regarding Inland Revenue's experience of implementing the discount is available, the fact that the scheme has been in place for a rather considerable length of time (since 2005) may suggest that the discount has been successful in achieving the desired behaviour of taxpayers.

## **2.4 Theoretical and experimental studies**

Despite the fact that tax compliance research investigating the potential for using rewards is a relatively new and undeveloped field, there are several theoretical and experimental studies which have examined the potential effectiveness of using rewards to improve tax compliance.

Falkinger & Walther (1991) provided the first detailed theoretical study in economics analysing the potential for incorporating a system of pecuniary rewards as an incentive for taxpayers to comply with their tax obligations. The authors proposed a mixed penalties-rewards model, whereby taxpayers must pay a penalty on tax evaded, whilst they receive a reward for the tax paid. According to the authors' analysis, the combination of penalties and rewards would lead to a welfare improvement, as taxpayers are in a better position, and the tax revenue collected will increase, provided that the level of penalties for non-compliance are increased so as to compensate for the expense of providing the rewards. According to the authors, in addition to being an incentive to comply, the rewards can also be seen as compensation to the taxpayer for the burden of being audited. Although not explicitly stated, the authors appear to be highlighting the positive effect that rewards can have on the intrinsic motivation and tax morale of taxpayers.

In addition to Falkinger and Walther's theoretical analysis, several experimental studies on the use of rewards for tax compliance have been undertaken. Alm et al. (1992b) conducted a

laboratory experiment in which the effects of three different types of rewards were examined, namely entry into a lottery scheme, a fixed reward, and a reduction in the probability of future audit. For each reward session, a subject audited and found to be fully compliant received the respective reward. In comparison to the control session with no reward, each type of reward had a significant positive effect on compliance, with the lottery session having the largest effect on compliance.

Torgler (2003) conducted an experiment with 'real' taxpayers, as opposed to students, in Costa Rica, with the aim of determining the effect that fiscal exchange, moral suasion and positive rewards have on tax compliance, holding traditional deterrence factors constant. In regard to the reward session, a subject audited and found to be fully compliant received a fixed monetary reward. As expected, the use of rewards increased the compliance of subjects compared to the control group. Furthermore, the highest compliance rate was achieved through the use of rewards, where a 100 percent compliance rate was observed. However, Kastlunger, Muehlbacher, Kirchler & Mittone (2011) highlights that it must be noted that the sample size in the reward group is quite small, with thirteen participants, and the experiment only consisted of one round.

Bazart & Pickhardt (2011) conducted experiments in Germany and France, whereby subjects who were audited and found to be fully compliant were entered into a lottery scheme, where they had the chance to receive individual lottery winnings. Again, the results indicated that the introduction of the reward system had a positive impact on compliance compared to the rounds without the reward system.

Kastlunger et al. (2011) provide insight in to the effect that rewards have on the decision strategies of taxpayers. The authors assumed that taxpayers can be categorised as being either completely honest, completely dishonest, or a mild evader. It was hypothesised that, although the first and second group's strategy was unlikely to be altered by the introduction of a reward, the mild evaders may be encouraged to become fully compliant so as to receive the reward. There would, therefore, be an all-or-nothing approach observed. Results indicated that whilst the number of total evaders was almost identical between the reward and control sessions, there were a higher number of completely honest subjects in the reward session, suggesting that mild evaders were persuaded in to becoming fully compliant due to the reward.

## **2.5 Overseas experience**

### **2.5.1 China**

Whilst the traditional approach to tax compliance is based on the application of deterrence measures, certain overseas jurisdictions, predominately in Asia, have in fact utilised rewards to provide an incentive for taxpayers to meet their tax obligations. China, for example, introduced a lottery receipt system in 1998, which operates simultaneously with the traditional punishment system in the context of indirect tax compliance, such as sales and value added taxes, and is almost identical to the lottery receipt system which has been operating in Taiwan since the 1950s (Wan, 2010). Wan (2010) notes that China, like many countries, faces the issue of tax evasion regarding sales taxes, due to the substantial costs which must be incurred by the government in order to monitor transactions between a firm and its consumers. Consequently, the costs involved in enforcing the tax provide an incentive for taxpayers to underreport the amount of tax due, as it is unlikely that such underreporting will be detected. Therefore, consistent with the sentiments of Slemrod (1992), rather than incurring more costs in an attempt to make non-compliance appear unattractive from a cost-benefit perspective, China has instead adopted an approach based on providing an incentive for taxpayers to be compliant, in the form of lottery winnings.

The lottery receipt system is facilitated by the use of a lottery receipt machine which issues an official receipt to consumers when a purchase is made. When the receipt is issued, the transaction value is simultaneously reported to the tax authority, consumer and firm. The issued lottery receipt contains a special number which enters the consumer into the lottery and, therefore, provides an incentive for consumers to demand a receipt from the seller. As a result, it becomes difficult for sellers to underreport tax due, thereby increasing the level of tax compliance (Wan, 2010). A 2002 report issued by the China Taxation Bureau (as cited in Wan, 2010) demonstrates the success that this reward system has had regarding increasing the level of tax compliance. The report noted that, as at July 2002, the total amount of lottery winnings paid amounted to 30 million yuan (approximately \$6.4 million NZD), whilst the additional tax revenues received totalled 900 million yuan (approximately \$192 million NZD) (Wan, 2010). In addition, a study conducted by Wan (2010) indicated that sales tax revenue was 17.1 percent higher in the areas in which the lottery receipt system had been



implemented, compared to the areas in which it had not, which further illustrates the positive impact the use of rewards has had in China.

### **2.5.2 Republic of Korea**

The Republic of Korea introduced a similar lottery system in the 1990s, which has since been revised into a ‘credit card tax deduction system’ (Wan, 2010). Kim (2005) indicates that tax evasion by the self-employed had become a serious tax administration problem in Korea, due largely to the significant volume of cash transactions which had led to a lack of transparency in business income. To combat this, the Korean Government implemented the aforementioned credit card tax deduction scheme in 1999, as a means of providing an incentive for buyers to use credit cards instead of cash, as the use of credit cards increases the transparency of business income through the records of credit card transactions being sent electronically to the tax authorities, thus making it more difficult for businesses to underreport their income (Kim, 2005). The incentive comes in the form of an income tax deduction for consumers who spend a certain level of their income using credit cards. As of 2005, a taxpayer was entitled to a 20 percent deduction of their credit card expenditure when that expenditure amounted to at least 15 percent of their gross income, with a 5 million won (approximately \$6 thousand NZD) deduction limit (Jun, 2009). As of 2014, the level of incentive has since been scaled down, with a taxpayer entitled to a 15 percent deduction of their credit card expenditure when that expenditure amounts to at least 25 percent of their gross income, up to the lesser amount of 20 percent of the taxpayer’s income and 3 million won (approximately \$3.6 thousand NZD) (KPMG, 2014).

The implementation of this deduction reward scheme has proven to be an effective method of increasing the proportion of expenditure conducted using credit cards since its inception in 1999, as illustrated in Figure 2.4. As such, the level of transparency of business income has increased, thus leading to improved tax compliance.

**Figure 2.4: Private consumption expenditure attributable to credit card usage**

*(Trillions of won, %)*

|      | <b>Credit card usage<br/>(A)</b> | <b>Private<br/>consumption<br/>expenditures (B)</b> | <b>(A)/(B)</b> |
|------|----------------------------------|---|----------------|
| 1990 | 5.3                              | 93.5  | 5.7            |
| 1994 | 18.9                             | 176.0   | 10.7           |
| 1998 | 30.8                             | 250.3   | 12.3           |
| 1999 | 42.6                             | 274.9   | 15.5           |
| 2000 | 79.5                             | 312.3   | 25.5           |
| 2001 | 135.3                            | 343.4   | 39.4           |
| 2002 | 174.0                            | 381.1   | 45.6           |
| 2003 | 170.5                            | 389.1   | 43.8           |
| 2004 | 167.0                            | 401.5   | 41.6           |

Source: Jun (2009, p. 34)

In addition to the credit card tax deduction system, a secondary reward system, known as the ‘credit card slip lottery programme’, was implemented in 2001. Jeon (2013) notes that the rationale behind the introduction of this lottery system was due to concerns that the credit card spending threshold may discourage low income earners from participating in the credit card tax deduction scheme. Furthermore, the fact that the level of allowable deduction under the scheme was, at that time, restricted to 3 million won may also have reduced the incentive of participating in the scheme. As such, the lottery scheme, offering a prize of up to 100 million won (approximately \$121 thousand NZD), was introduced to provide extra motivation for consumers to use credit cards. According to Jeon (2013), the lottery programme proved successful, and the resultant growth in credit card use led to the lottery programme being discontinued in January 2006, as its initial objectives had been met.

## **2.6 Conclusions from the literature**

As the preceding discussion has highlighted, the traditional deterrence model’s lack of explanatory power regarding compliance levels has given rise to the concept of tax morale, which emphasises the importance of encouraging voluntary compliance through the use of the ‘carrot’. One ‘carrot’ which has been identified as having the potential to improve tax compliance is the use of rewards for compliant taxpayers.

As highlighted above, the majority of studies investigating this topic have been theoretical and experimental in nature. Thus, there is an absence of research focused on gaining an understanding of the views and opinions of the tax profession and taxpayers regarding issues such as how effective a reward system could be in practice, the type of rewards which should be utilised, and the feasibility of introducing such a system. Through researching this topic from a different perspective, this study seeks to further enhance our understanding regarding the potential use of rewards as a means of improving tax compliance.

## **Chapter 3: Research approach, methodology and methods**

### **3.1 Ontology and epistemology**

Bryman and Bell (2011) note that ontology is “concerned with the nature of social entities” (p. 20), and the question of whether social entities are considered to be objective and external to social actors, or whether they are social constructions which are established from the perceptions and actions of social actors. The ontological position underlying the proposed research is constructivism. The constructivist ontological position holds that social objects are socially constructed by social actors. Creswell (2003, as cited in McKerchar, 2010, p.76) notes that constructivism “is used to describe the activity of the individual from which meaning is made by using inductive reasoning.” This reflects the inductive nature of the proposed research, whereby meaning will be constructed from interpreting the views and perceptions of the research’s respondents.

Epistemology concerns the issue of what should be regarded as acceptable knowledge (Bryman & Bell, 2011). The epistemological position of the proposed research is interpretivism; an approach in which the researcher interprets the subjective meaning of social action. McKerchar (2010) notes that interpretivism builds knowledge through inductive reasoning, as opposed to identifying causal relationships or making predictions. This aligns with the purpose of the proposed research, which is not to make ‘hard and fast’ predictions as to the effects that the use of rewards will have on compliance behaviour; rather, the purpose is to gain an understanding of taxpayers’ and practitioners’ perceptions.

### **3.2 Methodology**

The methodology underlying this thesis is qualitative. Bryman and Bell (2011) describe a qualitative methodology as one which emphasises an inductive approach to the relationship between theory and research. Qualitative research also emphasises elucidating the perspectives of those being studied, in order to understand what they see as important and significant. This approach lends itself to allowing the researcher to be closely involved with those being studied, “so that he or she can genuinely understand the world through their eyes”

(Bryman & Bell, 2011, p. 410). Therefore, this methodological approach is appropriate for the current research, as the focus is on gaining an understanding of how SBOs and tax practitioners view the concept of a reward system through their eyes.

Bryman and Bell (2011) note that one of the predominant methods utilised in research underpinned by a qualitative methodology is the semi-structured interview, as discussed in the following subsection.

### **3.3 Method**

As this research is underpinned by a qualitative methodological position, the research project involved the use of semi-structured interviews, which is a predominant qualitative method. Thus no quantitative methods were employed and thus no statistical analysis has been included. Bryman and Bell (2011) describe a semi-structured interview as one in which the “the researcher has a list of questions on fairly specific topics to be covered ... but the interviewee has a great deal of leeway in how to reply” (p. 467). The authors suggest the use of semi-structured interviews is appropriate in circumstances where “the researcher is beginning the investigation with a fairly clear focus ... so that the more specific issues can be addressed” (Bryman & Bell, 2011, p. 473).

The semi-structured interviews were conducted with two categories of participants, namely tax practitioners and SBOs who are required to file a tax return. As the researcher wished to give the participants considerable freedom in their responses, as well as allowing himself the opportunity to follow up on interesting points that they raised, the flexibility of semi-structured interviews was appropriate. Furthermore, as the researcher had a fairly clear focus on several issues that he wished to cover in the interviews, the semi-structured interview was more appropriate than the unstructured interview. In regard to determining the appropriate number of interviews to conduct in qualitative research, the literature suggests that saturation often occurs at twelve interviews, although six interviews can be enough to develop meaningful themes and interpretations (Guest, Bunce & Johnson, 2006). In total, seven interviews were conducted, although it must be noted that these interviews were spread between both categories of participants. As such, the sample size for each category of

participant can be considered as being small. However, as this research is exploratory in nature, its aim is not to draw generalisable conclusions. Rather, the aim of the research is to gain an initial in-depth understanding of the views of the participants, which can lay the foundation for future research.

As this research project involved interviews, approval from the University of Canterbury Human Ethics Committee was sought and received.

### **3.3.1 Interviews with the tax practitioners**

The purpose of the semi-structured interviews conducted with the tax practitioners was to gain an understanding of how the tax profession perceived the potential use of a reward system, in regard to issues such as its feasibility, potential design, and potential effectiveness. In total, five interviews were conducted with tax practitioners, with each interview being between 40 to 60 minutes in duration. All five of the interviews were recorded with the consent of the practitioner, and were later transcribed by the researcher. Four of the interviews were conducted in person at the practitioner's premises, and one interview was conducted over the telephone. In regard to the sample of tax practitioners interviewed, four practitioners worked for mid-tier accounting firms, three of whom were based in their respective firm's Christchurch office, and one in their firm's Dunedin office. Of these four practitioners, three were tax partners in their respective firms, whilst the other practitioner had approximately four years of experience working in tax. The fifth tax practitioner interviewed was a sole practitioner based in Christchurch, who had previously been a partner in a large accounting firm.

As alluded to above, the sample of tax practitioners was drawn from both mid-tier accounting firms and sole practitioners. The rationale for selecting the sample from this particular subset of accountants was due to the fact that practitioners in this subset were likely to have more experience in dealing with the taxation affairs of SBOs and self-employed persons, who are the taxpayers of interest for the purposes of this thesis. In contrast, practitioners from larger firms would potentially have more experience in dealing with the taxation affairs of larger businesses, which are not the focus of this project. As such, it was thought that limiting the sample of practitioners to this particular subset was appropriate for meeting the needs of this

project. This form of sampling is known as purposive sampling, whereby the researcher samples participants in a strategic manner, with the goal of selecting participants who “...are relevant to the research questions being posed” (Bryman & Bell, 2011, p. 442).

All five of the practitioners were initially contacted by telephone, whereby a brief overview of the project was provided, and an interview was arranged for a time which was convenient for the practitioner. In order to locate and select the practitioners, the researcher initially used the websites of various mid-tier accounting firms in an attempt to identify suitable candidates with experience in dealing with the tax affairs of small businesses. As a result of this process, three practitioners were selected and contacted directly via their contact information that was provided on their respective firm’s website. However, one of the firms’ websites did not provide information regarding its tax practitioners. As such, the researcher phoned the firm and, after explaining the purpose of the call, asked to speak with a member of the firm’s tax team. Finally, the sole practitioner was identified through a personal contact who engages the services of the practitioner, and who notified the researcher that the practitioner would potentially be interested in participating in the research.

After the initial contact had been made via telephone, information sheets were emailed to the practitioners. These information sheets provided details regarding the objectives of the project and informed the practitioners about the type of questions that would be discussed during the interview, as well as assurances that the practitioner’s identity would be kept confidential. This document also informed the practitioners of their right to withdraw their participation from the research within a period of two weeks from conducting the interview. In addition to the information sheet, a consent form was also provided to the practitioners immediately prior to the commencement of the interview.

Once transcribed, the researcher analysed each interview in an attempt to identify common themes arising from the interviews, as well as areas of conflicting opinions and views between the practitioners. Once this initial analysis was conducted, the researcher interpreted these findings in light of the prior research and theoretical bases in order to analyse the extent to which the findings were consistent, or inconsistent, with the prior research, as well as identifying findings which shed light on areas of uncertainty. It should also be noted that no software was used to assist the researcher’s analysis.

### **3.3.2 Interviews with the small business owner taxpayers**

The purpose of the semi-structured interviews conducted with the SBOs was to gain an understanding of such taxpayers' perspectives regarding the potential use of rewards to improve the tax compliance of SBOs. The general questions and topics covered in these interviews were largely the same as those covered in the tax practitioner interviews, which enabled the researcher to obtain an understanding of how both categories of participants perceived the various issues regarding the use of rewards. Initially, three interviews with SBOs were scheduled. However, one participant was unable to attend the interview on the date originally agreed. Several attempts were made by the researcher to reschedule the interview, but unfortunately this was not possible. As a result, two interviews were conducted with SBOs at their place of business in Christchurch, with each interview being recorded with the participant's consent and later transcribed by the researcher. Both interviews were approximately 50 minutes in duration.

The participants were involved in very different areas of businesses, with one owning a small electronic publishing business, and the other owning a small clothing business. Both participants were clients of one of the interviewed practitioners, who provided the researcher with their contact information after confirming that they were willing to be interviewed. This form of sampling is known as snowball sampling, and involves the initial participants of a study recruiting further participants from their acquaintances and contacts (Bryman & Bell, 2011). As was the case regarding the tax practitioners, information sheets were emailed to the SBOs after the initial contact via telephone, with a consent form being offered immediately prior to the commencement of the interview.

Once transcribed, the interviews were analysed in the same manner as identified above in regard to the practitioner interviews, with the additional aspect of identifying the consistencies and inconsistencies between the practitioners' and SBOs' views.



## Chapter 4: Findings from the tax practitioner interviews

### 4.1 The effectiveness of penalties

One of the underlying arguments in the tax morale literature is that tax authorities should look to implement compliance strategies which emphasise the ‘carrot’ over the ‘stick’. Therefore, as a starting point, the researcher sought the tax practitioners’ opinions as to how effective they believed the use of deterrence measures, or the stick, such as penalties, are in regard to achieving tax compliance from taxpayers. A general point which was raised in several of the tax practitioner interviews was that, whilst the majority of taxpayers have at least a general awareness of the existence of penalties for non-compliance, they lack any in depth knowledge about them:

I think they’re aware that there are penalties. A lot view the interest being charged as a penalty even though technically it’s not. They don’t know much detail about penalties. For example, most probably couldn’t tell the difference between avoidance and evasion, and would never have heard of the term ‘shortfall penalties.’ (Practitioner A)

I think people have a different awareness of the penalties. I think people at a general level mostly understand that there’ll be interest on amounts not paid in time and potentially late payment penalties and non filing penalties. Whether there’s a greater appreciation for the level of shortfall penalties for not taking proper care... there’s probably less knowledge of those. (Practitioner B)

Whilst the above comments indicate that perhaps raising taxpayers’ awareness of the penalties for non-compliance may improve compliance, the perception of the practitioners was that, in general, the effectiveness of penalties is relatively limited, and can even be detrimental to compliance in some cases:

I don’t think penalties are a huge deterrent, or at least, they don’t seem to be... (Practitioner C)

Sometimes I deal with people who are already deeply in trouble with the IRD. They know they have an obligation but no idea how much the obligation is because they're not opening envelopes [of letters sent to them from Inland Revenue], they have a mental block... It's an example of why these penalties make absolutely no difference to compliance, because whilst people know the penalties are there, they simply don't know how much, and if they do, it just causes them to run away from the problem... (Practitioner A)

Practitioner B, in his experience of dealing with taxpayers, felt that taxpayers can generally be categorised into three types, and that the effectiveness of penalties is likely dependent on which type a particular taxpayer is categorised as:

I break taxpayers down into three types: Those who are quite active in wanting to comply, so are very conscious of their filing deadlines and getting things done correctly, and do not look for ways to avoid tax; ones which need a little nudge across the line; and ones who just blatantly do not want to comply and seem very blasé about things... for the middle group, it [the threat of penalties] might shift things a bit and might motivate them enough to get across the line, but I think that, for the latter group, you're always going to have those people who can't be bothered, who don't care and who are against the system, regardless of the level of penalties, and if the IRD imposed a penalty on them then they might actually take a bit of offence by it, and that sometimes makes them a bit defiant with the IRD, and they don't want to pay tax because they want to cause the IRD a headache... (Practitioner B).

Rather than seeking to increase taxpayers' awareness of deterrence measures or the severity thereof, the practitioners believed it would be more beneficial for tax compliance if Inland Revenue sought to increase taxpayers' awareness and understanding of the tax system in general:

...first and foremost, I think it's more important to raise taxpayers' awareness of the actual taxes themselves, and how the tax system actually operates. For example, people need to understand that GST collected is not their money; PAYE withheld is withheld on behalf of another person and it's not their money, and it's effectively moving

towards theft [if they do not pay the tax to Inland Revenue]. People just don't really see it. I've seen a lot of people fall off the cliff and then have to ask us [tax practitioners] to help... so awareness is possibly an issue. (Practitioner C)

... I think that, rather than the IRD looking to use scare tactics so to speak, like telling taxpayers "this is the penalty if you do this, and this is the penalty if you do that", I think taxpayers would respond better if the IRD actually spent more time educating taxpayers about the tax system, so they understand how taxes work. (Practitioner B)

Although there are people out there who purposefully evade tax, like some small business people because it's quite easy to do, I also see a lot of people get into trouble not because they intentionally meant to be non-compliant, but they're just ignorant. They have no idea about tax or what they were meant to do. For people like them, penalties are not the solution. Raising their understanding of the system is the solution. (Practitioner E)

## **4.2 Procedural justice**

As the above results indicated that the tax practitioners felt that penalties are perhaps not the most effective means of ensuring tax compliance, the researcher sought their views as to whether they felt there was a place for Inland Revenue to utilise more positive approaches to encourage tax compliance. The responses obtained generally indicated a belief that tax compliance could be improved through Inland Revenue seeking to ensure that it has positive interactions with taxpayers, which can help to create a positive perception of the department in the eyes of taxpayers:

It's not hard to see the image of the IRD in the minds of the public shifting if they had more positive interactions with them, like for example the IRD contacting compliant taxpayers and saying "it's good to see you paying your tax on time, and filing your returns." It's similar to what the police can do. Whilst the police have to deal with unpleasant criminals, they still get a lot of public support simply by being a presence and being polite and helping people, and all the positive things the police do gives them

a positive image that outweighs the occasional negative image you have of them when they break up a student party for example ...their negative interactions are balanced by having a lot of positive interactions as well. (Practitioner A)

I think it's very important to ensure that taxpayers have a positive perception of the IRD, but I think that more comes down to the interactions that people have with Inland Revenue. I think also that just having a tax system that is seen as being fair overall... will probably have more effect on what peoples' behaviour is going to be as opposed to the effect that incentives might have. (Practitioner D)

I think that, generally speaking, peoples' attitudes about paying tax and attitudes towards the IRD are based more on peoples' day to day experiences with the IRD, and there are a large number of interactions that small business owners have with the IRD which can impact on their attitude towards the IRD and compliance. (Practitioner C)

However, Practitioner A expressed the opinion that he felt Inland Revenue's current interactions with taxpayers are not always of an acceptable standard. For example, in regard to the use of penalties, Practitioner A, whilst acknowledging that penalties are a necessary and important aspect in achieving tax compliance, expressed concern with the manner in which Inland Revenue conducts itself when imposing penalties, which can potentially further reduce their effectiveness:

The big stick will eventually whip them in to doing something through making demands or imposing penalties, but I think more success would come through the IRD ringing them personally and asking them what's going on. That would have a much better effect than just sending letters with increased penalties rolling up. It's dehumanising, highhanded, arrogant, bullying and it's abusive in some situations. So, whilst of course there is a role for penalties, the way they are currently administered is just appalling.

Practitioner E expressed the opinion that for some taxpayers, particularly those who are more defiant and willing to evade their taxes, positive interactions and perceptions regarding Inland

Revenue are not particularly important factors influencing their compliance behaviour. In regard to the question of whether he believed it was likely that some non-compliant taxpayers may alter their compliance behaviour in response to Inland Revenue improving its interactions and image, he stated:

No, not really. There will always be people who try and hide things, whether it is cash jobs or whatever, and I think those people always will, and I don't necessarily think that it matters whether they have a positive perception of the IRD or not, because it's just in their nature to try and evade tax. I think it would take more than just the IRD treating them nicely for them to become more compliant.

### **4.3 Rewards**

The above section highlighted that the practitioners were generally of the opinion that utilising more positive compliance approaches could be an effective means of improving overall tax compliance, which nicely leads onto the primary focus of this research, namely whether the use of rewards is potentially one positive approach which could improve tax compliance. As such, the researcher sought the opinions of the tax practitioners in regard to whether they believed the use of rewards could potentially be an effective method of improving tax compliance. The responses in general were supportive of the idea of introducing a reward system to operate alongside the traditional deterrence system. Some general comments are provided first.

.... It's a whole different mindset. It's a huge contrast to the idea that "we'll just beat you with an ever larger stick until you roll over into submission and you whimper appropriately." (Practitioner A)

It's hard to think of giving rewards for paying tax where historically it's been a penalty based system.... It's a complete and utter different mindset, and one which I think has a lot of merit. (Practitioner B)

If it helps them [Inland Revenue] maximise their tax revenue then they should absolutely go for it. The one difficulty I have with it is that we're rewarding people for doing what is already expected of them. That's the problem I have with it. (Practitioner C)

I think it's a good idea [the potential use of a reward system]. Any way to encourage people to pay their taxes is useful, and something like this could be a good system because it has the potential to encourage people to pay their taxes... It's a bit different because it's coming from a completely different angle. Instead of trying to use the old sledge hammer approach with penalties to try and get people to comply, this approach is doing it from a different angle, and I think it's a good approach to look at. (Practitioner E)

Various rationales for using rewards were provided by the practitioners, and the potential effect they could have on different subgroups of taxpayers was discussed. Practitioner E provided a general rationale he felt was applicable to all subgroups of taxpayers, noting that rewarding taxpayers for compliance could help to create a more reciprocal relationship between Inland Revenue and taxpayers, and lessen the feeling that the relationship between the parties is one which is dominated by Inland Revenue. In response to the question of whether he felt the introduction of a reward system could help to improve compliance, he replied that:

I think it could. I think it would help to break that stigma of the IRD if people got something in return for adhering to their taxes and paying on time. It may be important to change the perception of the IRD as being a taking organisation, you know, just take, take, take, and penalties, penalties, penalties, because that's a major gripe I see that taxpayers and clients have... changing that by using rewards I think would encourage taxpayers to be more honest, and it might even help to put a face to the IRD if they were seen to be giving a bit more back to the good taxpayers.

Practitioner A felt that the use of rewards would help Inland Revenue to create a more friendly tax environment which builds positive relationships with taxpayers:

I'm not sure whether they [Inland Revenue] would consider that they have a tax morale issue, or an image issue, but they just seem to have a negative aura. If they're looking for a way to improve tax morale and their image... then they need a change of attitude themselves, just as much as they need to change taxpayers' attitudes. They need to change their attitude towards taxpayers, from being one of 'we're out to look for the bad guys, and everyone is a potential bad guy.' If they had a reward focus... then the ones who receive the rewards are going to like them, and the interaction with the rewards group will be a lot more pleasant, and this could help to ensure that people keep complying in the future because there is a tangible incentive in place for them to do so.

Several tax practitioners expressed opinions regarding the potential effect that the use of rewards could have on different subgroups, or motivational postures, of taxpayers. In regard to taxpayers who could be classified as resistant or disengaged, the responses generally indicated the view that rewards could be very effective for encouraging these groups of taxpayers to improve their compliance:

I think rewards would be effective in bringing up to speed the fringe taxpayers by encouraging them to be fully compliant because they know that they are getting a gain by being compliant and they're not having to take any risks anymore. Also, if someone has had a penalty, it can make some taxpayers a bit more resistant and sometimes they can even get a bit of a vendetta behind them against the IRD, which can lead to negative compliance behaviour in the future... but the IRD might have some more scope if they had a reward system in place to mend some bridges with disgruntled taxpayers and ones who have sort of tried to shut themselves out of the system, so it gives the IRD another tool to engage with taxpayers and get them onside which would hopefully build up their compliance levels. (Practitioner B)

... I definitely think introducing rewards could improve the compliance of those taxpayers whose compliance is a bit iffy, like they're paying some of the tax they should but are also purposefully evading some as well, and it gives another point of contact from IRD to resolve an issue or come to an agreement on something. It's something in the taxpayers' favour and something that IRD can offer to entice

compliance. Because it is a positive strategy rather than another threat of audit or penalties, I think people might be more willing to accept a route that involves rewards if they're compliant rather than continuing to take the risk of cheating. (Practitioner E)

However, despite the positives, some doubts were expressed as to the potential ability of rewards to significantly alter and improve non-compliant taxpayers' behaviour:

I'm not entirely sure [whether rewards would significantly impact the compliance behaviour of non-compliant taxpayers]... the benefits they see from evading, such as taking the odd cash job, is something which is a hard habit to change. They'd still want the reward for the tax they do pay. They'd still file their tax on time. The prospect of receiving a reward for paying tax may make them evade less tax than before, but whether they'd include all their tax in it, I don't know whether that would necessarily change. (Practitioner A)

The big issue is that with cash businesses, it's so easy for them to hide it [income], and I'm not sure if a reward system would necessarily stop that. (Practitioner C)

Speaking in regard to taxpayers who could be classified as disengaged, Practitioner A was of the opinion that the introduction of a reward system would do little to change this group's compliance behaviour:

No, they're way outside the system. They're the ones who need to be penalised.

In contrast, Practitioner B, as indicated above, was of the opinion that the use of rewards may give Inland Revenue the opportunity to engage more with this group of taxpayers, and noted that maybe the aim of using rewards should not necessarily be to try and get every non-compliant taxpayer to become 100 percent compliant. Instead, the aim of using rewards should be to increase the compliance levels of as many taxpayers with the least amount of cost:

There will always be people who just through their personality or previous experiences have some negative view of the IRD. They don't like paying tax, they don't appreciate



the moral obligations that come with a welfare society and they don't want to cooperate with the IRD.... it's very hard to change those peoples' views but I think that something like this [using a reward system] is a value for money game. It's not about getting everyone being fully compliant; it's about encouraging as many people as possible to increase their compliance above what it was prior [to using rewards] with the least amount of cost. I don't believe you can change everyone, but I would think that the IRD would engage with more people if they introduced rewards than they otherwise would have been able to.

Practitioner C made reference to taxpayers who could be classified as game players, noting that whilst rewards may be able to encourage disengaged taxpayers to become more compliant, they would be unlikely to affect the compliance behaviour of game players:

I think rewards could possibly have a positive effect on taxpayers who have become quite non-compliant over time, because they would view the introduction of rewards as being something positive and something that would actually benefit them from paying their tax, so they may decide that it's not worth their while to take the risk of cheating anymore, but then people are different and some people like to play games and try to win, and it's competitive for them and they don't care what kind of incentive is being offered, they're still going to try and save as much as possible by not declaring all of their income.

Practitioner B also made further reference to game playing taxpayers, commenting that he felt the introduction of rewards would make it easier for practitioners to dissuade such taxpayers from looking to exploit the tax law in order to save tax.

Anything the IRD can do to improve tax compliance, like introducing rewards, would also make our jobs easier because we can say to clients, "hey look, I know you might not want to pay all of your tax and you'd like us to try and find some ways around it, but if you suck it up and just pay what you owe then you'll get a benefit out of it anyway without taking any risk." That would be a lot more effective than saying to them "look, this is the tax you need to pay because that's what's required, and if you look to exploit the law then you risk getting penalised." The use of rewards would

make it a lot easier to get difficult clients to comply because we can explain to them that “look, if you get on board with this then you will get something out of it, so we don’t need to bend the law because you already have an incentive to just pay your tax.” It would give us the chance to do a bit of a sales pitch to get difficult taxpayers across the line, which is obviously what the IRD would want.

#### **4.3.1 Using rewards to maintain the compliance of deferent taxpayers**

Whilst the above section largely focused on the effect that rewards would potentially have on improving the compliance of defiant, non-compliant taxpayers, a discussion was also had in regard to the role that rewards could play in maintaining the compliance of deferent, compliant taxpayers. A concern was initially raised by Practitioner A in regard to the lack of acknowledgement given to ‘good’ taxpayers from Inland Revenue:

...what I know is that the IRD only has two baskets. In basket one are the good taxpayers and in basket two are the bad guys. Most of the good taxpayers are just ignored... the IRD give you no credit for the fact that you’ve filed tax returns for so many years and you’ve done it correctly and paid all your tax. Instead, you’re treated no better or worse than the lowest scum ball out there.

This raises the question of whether the lack of acknowledgement of good taxpayers could potentially lead to such taxpayers becoming non-compliant in the future, perhaps due to a reduction in their motivation to be a good taxpayer. Mixed responses were put forward on this issue by the practitioners. For example, Practitioner D did not foresee good taxpayers becoming non-compliant over time due to a lack of acknowledgment from Inland Revenue:

...I think 90 percent of people are good people who are going to do the right thing and do it regardless, so if they get a letter of acknowledgment from the IRD, most people would say, “I was just going to do it anyway...”

Whilst on the other hand, when asked whether there was a risk of good taxpayers becoming non-compliant due to a lack of acknowledgment, Practitioner E noted:

Yes, and I suppose that happens now, because good taxpayers don't really get acknowledged for what they do, so I know that for some clients, if a cash job came along they would just take it because they don't hear from the IRD in a lot of cases, good or bad, so they just think "I might as well just do this cash job [and not declare it for income tax purposes] and if I get caught, well, I get caught."

This leads on to the issue of whether the use of rewards for compliant taxpayers could act as a potential means of reducing any risk that may exist in regard to good taxpayers becoming non-compliant due to a lack of acknowledgement from Inland Revenue. The general view from the practitioners was that rewards would potentially act to reduce such a risk. For example, Practitioner E stated:

I think some kind of reward would help to maintain or increase compliance, because most people like to be patted on the back....

Practitioner B was also supportive of the role that rewards could possibly play in this regard, stating that:

Yes, those taxpayers who are already compliant would remain compliant, because they feel like their good behaviour is being acknowledged... without some type of a reward system, there's just no positive reinforcement. There's no acknowledgment of taxpayers' intrinsic motivation to comply. If you're only ever after people to get something out of them, I can't imagine that people would think too nicely of you.

He further commented that:

The only time that the IRD contacts you is when tax payments are due or amounts are outstanding, and you're only getting negative news from them... From a taxpayer's view, they're only in contact with me if something's wrong. I don't hear anything from them when things are going ok and I'm doing the right thing. In that sense, the reason why people may develop such a negative view towards the IRD is because they're only

bearers of bad news. So, giving some kind of reward to compliant taxpayers would reduce this risk and keep them happy to comply.

Practitioner C was somewhat supportive, recognising that:

It could be effective for some people. I know that in regard to human psychology, some people are motivated by praise, and some people are motivated by other things.

It is important to note that whilst the above discussion has highlighted that good taxpayers do not generally receive acknowledgement from Inland Revenue, taxpayers with a good compliance history can receive favourable treatment in circumstances where they have incurred a penalty regarding a compliance issue. This raises the question of whether this actually already constitutes a reward for good taxpayers who have been compliant in the past; a question in which opposite views were elicited from the tax practitioners. Practitioner A was of the view that the penalty relief provided to taxpayers with a clean compliance history does not amount to a reward:

The only time it [a clean tax history] comes in to play is when they are looking at penalties and see you haven't had one before and say "we'll decrease it by 50%," and if you'd made a disclosure you'd get a decrease as well, but that doesn't feel like a reward.

In contrast, Practitioner B thought such relief might be viewed by Inland Revenue as being analogous to a reward for compliant taxpayers, which may reduce their willingness to offer further rewards:

...we could have a system that's set up where if you're continually compliant then you get the rewards, which is similar to kind of what we have at the moment, where if you have got a clean tax history, you might not get the full amount of penalties applied if you did happen to get into some kind of compliance problem. So, in that sense, whilst it's not labelled a reward, taxpayers who have been compliant over time are in effect

getting some reward, so the IRD might think that they're already offering enough of a reward for being compliant.

### **4.3.2 Customer versus Taxpayer and the role of rewards**

When discussing the role that rewards could play in improving tax compliance, the practice of Inland Revenue calling taxpayers 'customers', as opposed to taxpayers, and the impact this practice has on taxpayers' perceptions of Inland Revenue, arose. The tax practitioners expressed a negative view about this practice, as in their view, the practice of calling taxpayers customers has a negative impact upon taxpayers and their views regarding Inland Revenue:

... unless they actually treat people like a customer, it's a falsity [to call them a customer]. Most people scoff at the IRD using the term customer because they don't treat people as customers. (Practitioner A).

The IRD calling taxpayers customers is just like Work and Income calling people 'clients' ... I think it makes people take a negative view of the IRD... (Practitioner D).

These responses indicate that the main reason behind the practitioners' negative view of Inland Revenue's practice of calling taxpayers customers is that Inland Revenue does not attempt to actually treat taxpayers as customers. As such, this led to some of the practitioners expressing the view that the use of a reward system would help to reduce taxpayers' negativity associated with being called a customer, as it would increase the legitimacy and genuineness of Inland Revenue using such a term:

That's the only way they can do it [reduce the negativity associated with calling taxpayers customers], because using names like 'customer' is easy but without taking any action [such as introducing rewards] it's just cheap lip service... These are things which real service organisations do for their real customers [the use of rewards such as discounts]; otherwise the IRD using the word customers is just rather a joke.

(Practitioner A)

Using rewards to try and form a proper customer relationship with taxpayers is a pretty novel concept. It's bringing commerciality into the tax world. People like receiving benefits when they're a customer of a commercial organisation and organisations reward customers to try and build relationships, so I think a similar thing could work in the tax context. (Practitioner C)

If they're serious about it [having a proper customer relationship] they have to look at organisations that actually have customers and say "what do they do?" The IRD has been very anonymous, and most customer driven organisations hate anonymity; they actually like to form relationships, and they look to form them by offering rewards and incentives to people to build loyalty, but the IRD avoids forming relationships at all costs. (Practitioner E)

#### **4.4 Possible features and operation of a reward system**

An important issue to consider in regard to the potential use of a reward system is the type of rewards which would likely be the most effective in having a positive influence upon taxpayers' compliance behaviour. Prior literature on this point has largely categorised possible rewards as being either financial or non-financial in nature. The researcher sought the views of the tax practitioners in regard to the types of rewards which they believed would be the most effective for motivating taxpayers to become, or continue being, compliant.

##### **4.4.1 Financial rewards**

The general consensus from the interviews with the tax practitioners was that the use of financial rewards, as opposed to non-financial rewards, would be the most effective approach for motivating taxpayers who could be classified as belonging to one of the defiant motivational posture categories:

...those people who do the cash jobs and things like that, they'll always continue to do a cash job and not put it in the books, and I don't think any amount of reward would change that, unless it was monetary. It would have to be monetary for someone like

that. A non-financial reward, such as a letter acknowledging that they have been a good taxpayer, wouldn't be enough to motivate them to become a more compliant taxpayer. (Practitioner E)

It would have to be a good monetary incentive and probably a continual one, which they could receive year after year. (Practitioner D)

Getting a cheque back in the mail could be quite powerful, because they can see their bank account going up and it's more tangible, and they'll feel like they're getting a real gain from meeting their compliance obligations. (Practitioner C)

This next issue to consider is the type of financial reward that would be most likely to improve the compliance behaviour of defiant taxpayers. The general view of the practitioners was that the financial reward should take the form of a rebate calculated as a percentage of the tax paid by the taxpayer:

I think the most effective reward would be a rebate which is volume driven, so the more tax paid, the bigger the reward. That should incentivise them to declare more of their income so they get a bigger reward, and they feel like they're getting a real benefit from paying tax. (Practitioner A)

...practically it does seem that an approach based on the idea that the more you pay the more you save might be the only way to make people more compliant. I think the taxpayers who are on the threshold of 'shall I declare it all or should I run the gauntlet?' would likely go for the refund and say "I might as well just pay my full tax and get the refund so I can sleep easy and not take the risk of getting caught evading." (Practitioner C)

Despite the potential positive impact that a percentage rebate would have in reducing taxpayers' willingness to take the risk of evading, the point was also raised that some non-compliant taxpayers would still engage in tax evasion despite the prospect of getting a bigger rebate if they declared more of their income:

If, for example, someone was saving three thousand dollars tax by not declaring all their income, and then a percentage rebate was introduced which would give them a refund amounting to, say, one thousand dollars if they declared all of their income, the risk/reward profile has changed, so absolutely it's going to change people's behaviour. However, some people will still think, "well, I can still save an extra two thousand dollars if I keep evading the tax. Getting a larger refund wouldn't encourage every taxpayer to declare their extra income. (Practitioner B)

It's got to be a big enough incentive to stop them from doing the bigger cash jobs, and that could get quite costly, but an incentive like that [a percentage rebate] could be very effective in making them think that it's not worth their while to do it ... People might think "alright, if I don't do that cash job I've got nothing to worry about and if I know I'm going to get a couple of hundred bucks back here and be in the good books, then I'll just declare the income." I think they'd jump at it, but I still think that some people would declare what they were going to declare anyway. I just have a fear that they wouldn't start to declare all of their cash jobs, just because of the type of people they are. (Practitioner E)

Two of the tax practitioners also raised the point that there was a risk that the effectiveness of financial rewards may decrease over time if taxpayers were to start viewing them as the norm:

It [a percentage rebate system] may have a positive impact on the taxpayers who are on the cusp but it's not going to save the world, and I think it would become the norm. It would start with a hiss and a roar, but then it might just become part of the process and people would start to weigh up the numbers, like "do I pay everything and get the rebate, or am I better off doing something else?" (Practitioner C)

Monetary rewards can often just become expected, so if you gave someone a monetary reward every year and something slips up one year, and they're expecting to get their reward, they could get angry. (Practitioner B)



#### 4.4.2 Non-financial rewards

Despite the strong support put forward for the use of financial rewards, some of the practitioners were of a view that non-financial rewards could also have a part to play. In particular, the general view from the practitioners appeared to be that non-financial rewards may be more effective for maintaining the compliance levels of deferent taxpayers who have a positive opinion of the tax system and are already consistently compliant. Practitioner A put forward the idea that Inland Revenue could give taxpayers who have been consistently compliant some preferred status with Inland Revenue:

It would be interesting to see if there'd be a behavioural response if people could have, for example, some higher status with IRD than just being a normal taxpayer. For example, most people like the recognition of being a frequent flyer and being a preferred customer, and being acknowledged by the organisation.

Once taxpayers have been elevated to this preferred status, they would receive special treatment from Inland Revenue. Practitioner A offered the following example:

... it's an interesting idea that if the IRD were to say, "we see that you have been a good taxpayer and we consider you as one of our good taxpayers, and you have this preferred status", then maybe when they rang the IRD they would get put through more quickly for support and help, such as a special phone number to call, and taxpayers are given a special customer number, and they're put to the front of the queue...

Practitioner E, whilst being somewhat supportive of this type of idea, recognised that perhaps its effectiveness would be limited, noting that:

Clients always do say that if they're ringing the IRD they can never get through. But, most of the time it's the accountants who ring. So, to a certain degree that would help, but you'd probably have to put a few more positives on that list.

Practitioner E went on to discuss some additional types of non-financial rewards which he thought might therefore be necessary, one of which was allowing habitually compliant taxpayers more flexibility and leniency with tax filing times:

Maybe something like extending filing times for some returns or in special circumstances, such as their accountant who does all their tax returns being sick... So maybe some kind of incentives like that which allows for a penalty to be waived and time limits extended if a staff member is sick and returns not filed on time, or payments not made on time due to unusual circumstances... A bit of flexibility would be just as good for taxpayers as a monetary reward. The IRD do that to an extent now, but I think that if you can be put on a special list due to demonstrating good previous compliance behaviour which could allow leniency to taxpayers in genuine circumstances, it would be effective...

Practitioner B also expressed the view that a reward in the form of flexibility of timeframes for taxpayers with a good compliance history could be effective:

Monetary rewards can often just become expected... But, if the reward is in the form of the department doing something to make your life easier, you appreciate it more and you feel like you're getting a little and giving a little. I think discounts or rebates based on the amount of tax paid are a good idea, but I also think that a lot of taxpayers would appreciate the chance to have an extension of filing and paying dates which gives them more time, and they can hold onto the money for longer and therefore they can earn more interest with it... At the end of the day, tax is tax to people, and the biggest obstacle we sometimes have with clients is timeframes and things like that, so if they could get some leniency with the department due to their good behaviour in the past, I know that a lot of taxpayers would view the IRD positively and would continue to be compliant.

In addition to the idea of giving compliant taxpayers some type of preferred status with Inland Revenue, Practitioner A also suggested that Inland Revenue could provide rewards which would have a direct influence on a taxpayer's business. An example given was that

Inland Revenue could make use of its bulk buying power to provide discounted accounting software to small businesses:

The IRD might be able to have volume discount arrangements where they give good taxpayers a voucher number, so if they want to upgrade their business systems to Xero or MYOB, they quote this number and they'll get a 30% discount for example. The IRD could use its size and buying power to effectively negotiate good deals for people to help their compliance. People will tell others "wow, I got a voucher from the IRD which knocked 30% off the cost of my Xero", and then the IRD would start getting some love.

The idea of emphasising positive reinforcement through the use of direct communications with taxpayers, such as sending letters or certificates to taxpayers thanking them for meeting their tax obligations, was briefly raised by several practitioners, which received mixed opinions. Practitioner E was in favour of such an approach:

Some clients would love to get a bit of paper at the end of the year saying "congratulations, we classify you as a good taxpayer for this year." They'd love it. I could see it on some clients' walls, and they'd probably use it as a marketing tool for their business.

However, Practitioner D was less convinced with the utility of such a reward:

It's hard to say [whether such a reward would be effective] because some people would say "oh that's really nice, I got a letter from the IRD, so it's all worthwhile", and other people would say "oh what a heap of rubbish."

#### **4.4.3 Tax audits and the bomb-crater effect**

A possible scenario in which a taxpayer could receive a reward is where a taxpayer is found to be largely compliant after a tax audit by Inland Revenue. One of the potential advantages

of providing rewards to compliant taxpayers in these circumstances is that it may reduce the likelihood of the bomb-crater effect occurring. As outlined above, the bomb-crater effect refers to the risk that a taxpayer's level of tax compliance may decrease in the period following a tax audit, due to the perception that they are unlikely to be audited again by the tax authority in the following period (Guala & Mittone, 2005). The researcher sought the views of the tax practitioners in regard to whether they perceived the bomb-crater effect as being a realistic risk in practice, in which mixed opinions were given. Practitioner A did not perceive this as posing a realistic threat to compliance, noting that:

The IRD are already aware of the risk that people may think, "well, they're not going to come around here anytime soon."... I've never come across a client that says "I'm going to misbehave now because the prefect's back is turned." An organisation either prides itself on being a compliant taxpayer or it doesn't, and IRD auditors usually sense which type it is.

On the other hand, when asked whether a risk exists that a taxpayer may seek to save tax through evasion in the period following a successful tax audit, Practitioner B stated that:

I believe it does. Some taxpayers will be relieved, others will be on edge because they are thinking that the IRD will be sniffing around continually, but some might think that they're off the hook and have got some wriggle room.

Practitioner C and D took more of a middle ground, both echoing Practitioner A's sentiments that they are not aware of any clients seeking to save tax through evasion in the period following a successful audit, whilst at the same time recognising that it is possible that such behaviour could occur. For example, Practitioner C noted that:

I can understand why people would do that, but personally I haven't seen somebody come out of a successful audit and say "right, we'll rort the system next year."

Whilst Practitioner E stated that:

People seem to have a perception that you only get audited once every seven years. I don't know where that came from, so if someone gets audited they think "it's not my turn for another one."

These findings suggest that there is at least some level of risk that the bomb-crater effect could pose a threat to compliance levels in New Zealand. As such, the next point to consider is whether the utilisation of rewards for taxpayers found to be compliant after an audit could potentially act to reduce this risk. In response to the question of whether the use of rewards would be effective in this regard, Practitioner E was supportive of the idea, saying:

I think it probably would, yes. If they'd been audited and come up clean, and got a rebate they're probably going to think "why should I rock the boat when I'm safely in it?" They would possibly feel guilty taking advantage of the IRD. They would think, "I've done everything expected of me, and the IRD have done everything that is expected of them", so I think they would have a bit of a guilt trip if they tried it on.

A related point that was raised by Practitioner D and Practitioner E was the potential for taxpayers to develop negative feelings towards Inland Revenue after an audit. Practitioner D explained that:

I think that the general view of an audit by a compliant taxpayer is that they begrudge the interruption to their business and the cost that arises if they need to involve an accountant, which is often the case.... This can definitely lead to a negative view of the audit process and the IRD.

A similar view was put forward by Practitioner E, who opined that:

There is a bit of negativity around the audit process, with taxpayers saying "why are you wasting my time doing this, this and that?"

These responses raise the question of whether the use of rewards for taxpayers found to be compliant after an audit could be framed as a type of compensation for the monetary and time costs incurred by taxpayers during an audit, as a means of seeking to prevent feelings of ill

will be developed by taxpayers towards Inland Revenue. Practitioner E thought this could be the case:

...if they come out clean, I think some kind of incentive would reduce the chance of a bad taste being left in the taxpayer's mouth.

Furthermore, Practitioner D was very supportive of the potential use of rewards in this scenario, preferring to restrict the use of rewards to this defined context:

I think that if you had a clean audit, rather than having a wholesale rebate, it would maybe go some way to improving peoples' perceptions of the IRD, like "we've done an audit and we know it's cost you guys money and time, but it's been really good, so what we'd like to do is to reward you for your good behaviour". I think that in this context, the use of rewards maybe has more merit [than operating a wholesale rebate system]

However, Practitioner A recognised the potential pitfall with limiting the provision of rewards to circumstances in which taxpayers have had a clean audit:

You wouldn't want people putting their hand up for an audit simply because they want the reward. The IRD has to focus resources on where there's risk, and a lot of taxpayers would not receive the rewards. But, having done an audit on somebody, if they were found to be compliant, the IRD auditors could probably say "we'll recommend you for 'gold status' because we can see you've got strong compliance processes and you've been very cooperative."

#### **4.5 Overcoming the difficulties with defiant taxpayers**

The tax practitioners raised certain concerns regarding the ability of a reward system to encourage non-compliant taxpayers to improve their compliance behaviour, which would necessitate consideration regarding how a reward system would be designed.

### **4.5.1 The need for a tax amnesty**

The first concern related to the problem that non-compliant taxpayers, particularly those who would be classified as disengaged, would be hesitant to come back into the tax system and declare their full income in fear that Inland Revenue would penalise them for their past non-compliance. As such, the practitioners proposed that the introduction of a reward system would need to be accompanied by an amnesty if it were to be successful:

The danger is, for the non-compliant taxpayers who have been non-compliant for forever and a day, if they suddenly turn around and file a tax return with a large amount of income, the IRD will be going “alright, what about the last four years? What about the omission of income? Let’s go back and look...” So is it [the introduction of a reward system] going to encourage people who are out of the tax system to come back into the tax system? Not without an amnesty. (Practitioner C)

I think that people who have largely removed themselves from the system are probably too far gone because I would think that if they try to get back into the system, they’d be worried that the IRD would go back and look at what they’ve done in previous years, so there’d be a fear there and they probably wouldn’t even consider it I don’t think. To get them to consider it, you would need an amnesty because otherwise you’ve got the fear of the IRD looking back over the last 10 years. (Practitioner E).

### **4.5.2 Using the ‘stick’ as well as the ‘carrot’**

A further concern, which has been alluded to in prior sections, arose in regard to the possibility that although the use of rewards may encourage non-compliant taxpayers to increase their compliance levels, some taxpayers, particularly resistant and disengaged taxpayers, may still look to evade some taxes whilst still receiving a reward for the tax they have paid, as would be the case if the reward system operated as a rebate system. A possible solution to this issue was proposed by the tax practitioners, who felt that a reward system should be designed in a manner in which there are severe consequences for taxpayers who are

found to be engaging in evasion/avoidance and have benefited from the receipt of a reward. As a general comment, Practitioner D stated that:

I think if we do that [introduce a rebate system], there needs to be some mega consequence for having taken the reward and then being found out that you haven't deserved it, or that you haven't been declaring all of your income.

One example of a consequence put forward by Practitioner A was that taxpayers who are caught evading tax can never be eligible to receive rewards in the future, which would hopefully act as a significant enough deterrent to discourage taxpayers from taking the risk of evading:

Maybe in that situation [taxpayers not declaring their full income], when we talk about a reward system, people who are caught evading tax can never have that status. If you lose it, you can never have it back. Whereas people who just might have done something incorrectly or carelessly may just have a stand down period of say, five years before they can get back their preferred status, but for the person who evades, it's the irredeemable sin. Maybe that could make them think "I don't want to take the risk of getting caught and losing my rewards."

Practitioner E echoed Practitioner A's sentiments, adding that an additional deterrent would be for Inland Revenue to require that taxpayers who have been caught evading or avoiding tax to pay back the total amount of rewards that they have received, with interest penalties added on:

I think something like that would be effective. I think it's a bit of a variation of the big stick approach, saying that "we think you're good at the moment, and we want to keep you good, so therefore we'll give you discounts, rebates, or whatever, but if we ever find out that you've been evading or avoiding tax then we will want all of those rebates back, we want interest on those amounts, plus you're on the bad people's list and you may not be able to get rewarded again, or you will have to prove that you deserve them again. I think something like that would be necessary because, dare I say, the type of people you're targeting need a big stick being waved at them as well. So, keep them on board with the reward to encourage them, but make it clear that if they're ever caught



evading tax, then they'll have to pay the rebates and interest penalties back, and they'll be on the IRD's watch list.

Whilst there was agreement from the practitioners regarding the idea of banning tax evaders and avoiders from receiving rewards in the future, Practitioner B emphasised the importance of Inland Revenue being cautious in this regard, to ensure that it is only the serious offenders who receive such high-handed treatment:

If rewards were to come in, I think the biggest thing to sort out would be the conditions on when you get the reward and what would prevent you from getting the reward, so taxpayers know how to get back on track to get it in the future... If you stumbled or faltered every now and then and the IRD said "no, look, you've made a mistake, you'll cease to get your rewards for a period of x", that might ruin the relationship you've built up, so if the IRD are going to give a reward, there can't be too many strings attached to it, because then it becomes a game of if you become offside with it, you might just decide that you'll get back that negative attitude again, as you would have towards penalties, but you've now got a negative attitude towards the IRD because you know that you no longer qualify for the rewards.

#### **4.6 Feasibility of a reward system**

When discussing the issue of potentially implementing a reward system into the tax system, it is necessary to consider the potential feasibility of implementing such a system in New Zealand. A common issue raised by the practitioners in regard to the feasibility of introducing a reward system in New Zealand was the potential inability of Inland Revenue's IT systems to cope with the implementation and administration of such a system. For example, Practitioner A stated that:

The current computer system is not capable of coping with a reward system. The IRD would say that they can barely function with the jobs that are demanded of them now.

In a similar vein, Practitioner B noted that:

I don't think the IRD's IT system is up to it. There are already flaws in the system... By the time you have income tax, GST, KiwiSaver, Working for Families... it's at a point now where the functionality is often lacking. If you were to superimpose a reward system in the existing IRD IT world, where they've got the existing penalty system, they've got the use of money interest... how you would actually logistically and technically go about adding in another layer of effectively a differential system for compliant taxpayers... and keeping track of what taxpayers have qualified for what things... it could all cause headaches... Logistically, you'd be doing one hell of a job to put it through.

However, Practitioner B went on to note that Inland Revenue are planning on undertaking a \$1.5 billion upgrade of its systems over the next ten years, which may provide a window of opportunity for a reward system to be introduced:

If the IRD do get their IT upgrade, and depending on if the reward system was thought of sooner rather than later in that upgrade process, there would probably be a better chance of getting it in while everything is being figured out, rather than after the fact when they'd have to add it in.

Practitioner C also highlighted that perhaps the implementation of such a system would need to be considered sooner rather than later, but did note that the added flexibility of the new IT systems should allow for the addition of a reward system:

I would say that they [Inland Revenue] would need to figure it out quickly so they can build it into their IT system, although the new system is supposed to be highly flexible and state of the art, so you would hope that there would be enough flexibility in the new system to deal with this, but I think that the discussion would still have to happen sooner rather than later.

As for the technical requirements that would likely be required to be implemented into Inland Revenue's systems, Practitioner A noted that:

A proper CRM [customer relationship management system] component in the IRD's system would be required. The CRM component would possibly be volume driven, so the more tax paid the bigger the discount.

A further issue to consider in regard to the feasibility of implementing a reward system is whether the practical administration of such a system would be viable for Inland Revenue to operate. On this point, the practitioners believed that a reward system would be straight forward for Inland Revenue to administer. Practitioner C, using the example of a tax rebate, stated that:

I think it would be easy [for Inland Revenue to administer]. This isn't putting a man on the moon. This is offering someone a rebate based on known parameters and known thresholds. It should be very easy to programme that into the IRD's systems. You've paid on time, and you've paid x amount of tax, and if this equals that then this is the outcome. I don't think administering a reward system should be hard at all. It is just an extra part in the overall system.

Practitioner D also thought that the administration of a reward system should be straight forward for Inland Revenue, and made reference to the early payment discount for first time provisional taxpayers which is already in operation in New Zealand, in accordance with sections RC 37-40 of the Income Tax Act 2007:

They [Inland Revenue] should be able to do it. I mean, there is already an early payment discount for first time provisional taxpayers, so they already have at least some experience in administering rewards, and this [a reward system] is just like that but on a larger scale, so they should be able to handle it.

A further aspect relating to the feasibility issue arose, with two practitioners drawing attention to the issue of how the implementation of a reward system would potentially impact upon accounting firms and practitioners. In particular, the practitioners were concerned with the possible adverse effects that a reward system may have on accounting firms and practitioners in regard to tax filing time frames. The circumstances in which this issue could

arise is if a reward took the form of extending tax filing times for compliant taxpayers, as discussed above in the non-financial rewards section:

The other thing to keep tabs on is how it would affect filing. With public accounting firms, we have a year to get through our work, and each taxpayer generally has similar timeframes for filing requirements, and if you created a distortion in that, in the sense that taxpayers who meet certain requirements have a different filing time horizon, it might negatively affect the practitioners business in terms of internal staff management and work flow management because there are already peaks and troughs in terms of compliance.... if you start changing time horizons based on a reward system, there is always the question of whether practitioners have the capacity and ability in their business to handle new time frame requirements or work bottlenecks. (Practitioner B)

A point to consider would be how changing filing times for some taxpayers would affect the other time horizons of events for practitioners. (Practitioner A)

These comments highlight another feasibility issue that would need to be considered when determining whether to introduce a reward system, this time not in regard to whether Inland Revenue could handle the administration of such a system, but whether accounting firms and practitioners themselves could successfully adapt to the changes incurred through the implementation of a reward system.

#### **4.7 Inland Revenue's potential amenability to using rewards**

A limitation of this research is that the views and opinions of Inland Revenue regarding the possibility of introducing a reward system have not been incorporated into this thesis. In an attempt to overcome this limitation, at least to a small extent, the researcher sought the opinions of the tax practitioners in regard to how they believed Inland Revenue might perceive the potential use of a reward system, and the difficulties which they would need to overcome. One concern raised by Practitioner A and Practitioner B was that Inland Revenue may be hesitant to implement a reward system as they are aware that taxpayers often view anything Inland Revenue does with suspicion:

The IRD knows that there's a certain cynicism towards anything they do. Any reward system introduced would probably be met with disbelief and a degree of cynicism. The IRD might have a mountain to climb there and they may say "what's the point?" (Practitioner A)

Some taxpayers might be sceptical if rewards were introduced... People are generally a bit sceptical of the government, so if there was a media release about a tax reward system, people might be a bit sceptical, so it would be very important how the system is released in the media. While the IRD may have good intentions in that they genuinely want to encourage and reward compliance, if it is launched in a way so as to give people a negative perception of it, they may end up with a result that people are sceptical, and think "I was paying my tax anyway". Perception is very critical for how people will accept it going forward. (Practitioner B)

Practitioner B and Practitioner C expressed the view that it could be rather difficult to convince Inland Revenue personnel of the potential benefits of rewarding compliance. However, Practitioner C noted that only several key personnel would need to be in favour of the idea:

Personally, I don't think it would fly with the IRD... I feel that there's an attitude of some people in the department that they are the law, the IRD is entitled to that tax, and if you were to try and convince IRD staff of this [the potential benefits of introducing a rewards system], there may be some pushback from them because in their mind, they have every right to go into peoples' businesses and extract the tax due, so why should they reward that when it's a duty that the taxpayer should have otherwise met... there could be a scepticism there. (Practitioner B)

I think there would be some hardened investigators out there who would think, "I've seen some horror stories out there and I don't think we should be helping these people." But, you only have to convince a few people... and if it can be theoretically proven that this [the introduction of a rewards system] would increase our revenues by x amount... then it should be OK. (Practitioner C)

Practitioner A drew attention to the political aspect which would affect Inland Revenue's ability to implement a reward system:

The IRD itself might want to be more like a customer facing business, and behave more that way, but politicians will probably say "if it's not going to do anything to give me more money to spend on my portfolios, then I'm not interested in the idea."

This point relates to the fact that in order for a reward system to be a viable compliance strategy, it must be shown that such a system would be likely to increase the net tax revenue collected over time:

There's quite an uncertain risk/reward aspect with will it actually increase the tax revenue collected over and above the costs involved of operating the system. It has to be remembered that the IRD are tasked with bringing in as much revenue as possible, so something like this [a reward system], whilst it might be a nice thing to have, it might actually cost revenue... (Practitioner A)

If it could be demonstrated that the cost of implementing and administering the rewards were less than the gains, then the IRD should be in favour of it. They will spend more money to make more money. It's just a question of economics. If there is a return on the investment... then logically they should be in favour of it, but it is a matter of demonstrating that putting incentives in place are going to drive behavioural changes that will result in increased collections... it's difficult because it's not just a matter of calculating the direct costs of the incentives, but it must also be determined whether there would be any indirect adverse effects... (Practitioner D)

The difficulty of conducting a cost/benefit analysis was noted by Practitioner E, who postulated that the potential complexity may lead Inland Revenue to determine that a better approach is to increase the level of deterrence measures:

They [Inland Revenue] would have to consider things like what percentage rate to use for a rebate and how much money they would be paying out to small business owners, and they'd of course need some kind of estimate regarding how much tax they think they lose each year so they can estimate how much money they think they can make,

and set a limit on how much they want to pay out in rewards. I think it would be quite complex. I'm sure they could do it, but the IRD might think that rather than spending money on rebates, they should just spend more money on more audits and catch people that way.

#### **4.7.1 Equity issues and PAYE taxpayers**

A potential difficulty with the implementation and use of a reward system in New Zealand was raised in regard to what could be perceived as its discriminatory effects against pay-as-you-earn (PAYE) taxpayers, and the inequity that could arise between this group of taxpayers and small business taxpayers. PAYE is a withholding tax which is applied to the income payments of employees, such as wage and salary earners, and is deducted from an employee's earnings by their employer on behalf of the tax authority. In New Zealand, employers can calculate the appropriate amount of tax to withhold on behalf of Inland Revenue through online resources provided by Inland Revenue. Due to the fact that wage and salary earners have their incomes taxed at source, they do not have any opportunity to evade their taxes, provided their wage or salary is their sole source of income. As such, this group of taxpayers does not pose a compliance risk to Inland Revenue and, therefore, any reward system that was implemented would not be applicable to this group of taxpayers. This position initially raised some concerns from Practitioner C, who stated that:

Something which I think needs to be thought about is that there seems to be a bit of a gulf between the self employed business owner and the PAYE earner. Why should the PAYE earner, who pays their tax on time every time, be discriminated against somebody who is self employed or a small business owner, who is being incentivised to actually do what the PAYE earner is doing in the first place. This is also coupled with the fact that if you're a self employed person, there is far more scope for deductions as well, so there's a game to be played there as well. So, I think that's probably one of the biggest hurdles, in that it wouldn't be fair... I think there's a real equity problem here.

Practitioner D also acknowledged the potential risk of PAYE taxpayers becoming upset in regard to a reward system applying to SBOs and the self employed, but excluding them from its scope:

PAYE earners are probably the people who begrudge the small business owners who can already take advantage of the opportunities to save tax through deductions, and these opportunities don't exist for wage and salary earners. Given how many they number, I think it's a real risk and is a very good point.

Similar sentiments to those of Practitioner D were expressed by Practitioner E, who noted that:

I think that there would be some resentment from PAYE earners because I think that PAYE earners think that self employed people are on the pigs back sort of thing, like "they claim a deduction for this and they claim a deduction for that, and they do cash jobs, so why should we be subsidising for the self employed people?" So, I think there would be some resentment and they would be saying "Well, where's our rebate?"

These responses highlight the fact that there is a clear risk that the implementation of a reward system to encourage tax compliance from small business owners and the self employed could cause considerable unrest amongst wage and salary taxpayers. However, it must also be considered that the very reason why this group of taxpayers would not be eligible for any rewards is also the reason why Inland Revenue may not be concerned with any unrest that may be caused, that reason being that as this group of taxpayers' income is taxed at source under the PAYE system, their opportunity to evade tax is severely limited. Therefore, any unrest caused will not adversely affect the level of tax collected from this group of taxpayers. As Practitioner E noted:

... at the end of the day, they [Inland Revenue] probably wouldn't mind if they upset the PAYE earners because they're still getting their full whack of tax from them, so there really is no difference as far as the IRD is concerned.



Furthermore, Practitioner D highlighted, rather pragmatically, that:

I think it would be very hard to get them [PAYE taxpayers] to accept it. But then again, you know, who cares, they can't do anything about it.

Despite the view that Inland Revenue may not be concerned with the potential negative reaction from PAYE earners, Practitioner C still harboured some reservations in this regard, stating that:

You don't want a revolt. There is a lot of money coming in from the PAYE earners and you don't want to annoy them.

Therefore, an important issue that arises is how Inland Revenue could implement a reward system without upsetting the PAYE earners. This highlights the question of how Inland Revenue would justify the implementation of such a system. Practitioner E stated that:

The only way to justify it would be to emphasise that it's for you [the PAYE taxpayers] at the end of the day.

Therefore, it appears that the most viable way of justifying the implementation of a reward system to the PAYE taxpayers would be for Inland Revenue to emphasise to them that the reward system is being used as a means of increasing the level of taxes collected from the small business sector and, therefore, it is ultimately in the best interests of society in general, as the government would be in a position to increase its level of public spending. However, whilst this justification appears reasonable in theory, the practitioners raised doubts as to whether such a justification would actually be effective in practice. For example, Practitioner C stated that:

I can see how you could attempt to justify it by saying it's for the good of all, but they'll [the PAYE earners] be going, "hang on a minute, they're [small business owners and the self employed] getting a double whammy then. They've got that and the benefit of the rewards, so it's not fair either".

Practitioner D was unsure whether the majority of PAYE earners would be accepting of a reward system even if it was justified on the basis of being for the benefit of society as a whole, posing the question of:

How many blue collar wage and salary earners would have that broad, accepting frame of mind?

#### **4.8 Summary of the tax practitioner interviews**

The findings from the tax practitioner interviews indicate that they held some doubts in regard to whether penalties are an effective tool for improving taxpayers' compliance in practice. Instead of Inland Revenue seeking to raise taxpayers' awareness of deterrence measures and increasing the severity of penalties, the practitioners were of the opinion that raising taxpayers' understanding of the tax system in general would have a more positive impact upon tax compliance. As the practitioners felt that penalties are perhaps not the most effective tool for improving tax compliance, it was believed that there is a place for more positive compliance strategies to be utilised by Inland Revenue. For example, the practitioners expressed the importance of ensuring that the interactions Inland Revenue has with taxpayers are conducted in a respectful and positive manner, which highlights the role that procedural justice has to play in improving tax compliance.

The findings indicate that the practitioners were largely supportive of the idea of utilising rewards as an additional compliance strategy, and highlight that rewards could potentially be more effective than penalties for encouraging defiant taxpayers to improve their compliance behaviour. In addition, the practitioners felt that the use of rewards could also be an effective means of maintaining the compliance of deferent taxpayers in the long-term, and could help to reduce the risk of the bomb-crater effect occurring.

In regard to the type of rewards which could be applied, the practitioners noted that a financial reward in the form of a percentage rebate would be the most likely type of reward to have a positive impact upon the compliance behaviour of defiant taxpayers. However, it was also noted that in order for a reward system to have a positive impact upon defiant taxpayers,

it is very likely that such a system would need to be introduced in conjunction with a tax amnesty, in addition to there being severe consequences for taxpayers who are found to be engaging in evasion/avoidance and have received the benefit of a reward. In regard to the potential effectiveness of non-financial rewards, the practitioners believed such rewards could have a role to play in maintaining the compliance levels of deferent taxpayers.

The findings highlight some concerns as to the feasibility of introducing a reward system in New Zealand, as Inland Revenue's IT system may struggle with its implementation. However, these concerns were tempered by the fact that Inland Revenue is due to receive a \$1.5 billion upgrade of its IT systems over the next ten years, which would enable the implementation of a reward system. As for the administration of such a system, it was believed that it should be straightforward for Inland Revenue to operate. It was also noted that any potential adverse effects that a reward system may have on accounting firms and practitioners must be considered.

Finally, the practitioners raised several difficulties that Inland Revenue would need to overcome in order to successfully implement a reward system. Such difficulties include minimising the risk that taxpayers may view the introduction of a reward system with scepticism; the challenge of gaining support from Inland Revenue staff for the use of rewards; and the complexity of determining whether the increased tax revenue that could be collected from the use of rewards would outweigh the costs involved. Equity concerns were also raised in regard to the potential discriminatory effects that a reward system could have against PAYE taxpayers.

The following chapter presents the findings from the SBO interviews.

## **Chapter 5: Findings from the small business owner interviews**

### **5.1 Rewards**

Both interviewees were of the opinion that the use of rewards could be an effective approach for improving the tax compliance of SBOs. SBO A indicated that there is a perception amongst SBOs that the tax system is unfair, as it is perceived as being more favourable toward larger businesses, and this perceived unfairness can be detrimental to the compliance of some SBOs. He went on to express that the introduction of rewards for compliant SBOs would likely have a positive impact upon how some SBOs view the tax system, which could improve their compliance:

One thing that's always disturbed me is that it's said that the majority of growth in this country comes from medium and small businesses, but the tax regime is actually set up for huge businesses, so there's a perception amongst small businesses that the tax system is unfair, so I think that can have a poor impact on compliance behaviour. If rewards were brought in, I think it would help to keep people on track because they would see that as them being treated fairly. (SBO A)

Furthermore, speaking in regard to Goods and Services Tax (GST), SBO A supported Practitioner E's proposition that many taxpayers view Inland Revenue as being a "taking organisation", noting that the fact that SBOs do not receive anything in return for collecting GST on behalf of Inland Revenue creates a disincentive for SBOs to be compliant; a problem which he believed would be redressed by the introduction of rewards:

Way, way back, when we used to have sales tax which was collected by customs, small business owners would do all that work collecting it, and it was acknowledged that you were doing that work on behalf of the customs department, so you got a little percentage of it, and it incentivised you to do the job. Now, we're still doing that work for GST and essentially doing someone else's job but we don't get anything for it. So there is a disincentive to comply because we don't get anything back from being

compliant. So yeah, I think that receiving a reward for being compliant would give an incentive to comply.

SBO B put forward the view that rewards could have a positive motivating effect for taxpayers to be compliant because receiving a reward would create a more positive relationship between taxpayers and Inland Revenue, as taxpayers would appreciate getting something back from Inland Revenue:

I think one of the things that would happen if the IRD were to offer rewards is that people would start to feel more willing to comply, not only because of the incentive aspect of getting the reward, but also because people would feel more, I guess, respected by the IRD... I guess you'd feel more valued by the IRD because you're getting something from them.

Similar to what was noted in the practitioner interviews, the SBOs indicated that whilst the use of rewards would be likely to have a positive impact upon the compliance of a significant number of taxpayers, certain taxpayers, such as those who have been habitually non-compliant, may be unresponsive to the introduction of rewards:

I definitely think it would work for some people, like especially those small business owners who are maybe thinking about having a go at evading some tax and are on the cusp of doing it, or those who are already maybe evading a bit. I think for that type, rewards would be a good incentive for them to just be honest and pay the proper tax. But people who are habitually evading a lot of tax, I'm not sure. A lot of them will probably always try and hide income. (SBO A)

### **5.1.1 Using rewards to maintain the compliance of deferent taxpayers**

During the course of the practitioner interviews, an issue was raised in regard to the lack of acknowledgment given by Inland Revenue to good, habitually compliant taxpayers. It was also suggested that the only time that Inland Revenue contacts taxpayers is when something

has gone wrong, so taxpayers are generally only having negative experiences with Inland Revenue. This was corroborated by SBO A:

The only experiences I generally have with the IRD are negative, like for example, if I do a GST return late and then I get banged with a penalty, but habitually I'm always on time and I pay the correct amount of tax, and you'd quite like that fact to be recognised. I know that sometimes they might rescind a penalty, but it still feels like they could do more to acknowledge compliant taxpayers.

In response to the question of whether there is a risk that this lack of acknowledgment could lead to some taxpayers becoming non-compliant in the future, he noted:

There could well be, yes. I would imagine that there are people out there who would think like that. (SBO A)

SBO B also believed there was a risk of this occurring, particularly with taxpayers who have a perception that tax evasion amongst small businesses is common. She believed that the introduction of rewards for compliant taxpayers would help to reduce this risk:

There probably is a risk of that happening. Some people probably think "well, I know a lot of people are doing cash jobs and stuff, but I pay my tax and don't really get any acknowledgment for doing the right thing, so maybe I should start [evading] too." So a reward for compliance would probably stop people from thinking like that.

Similarly, SBO A indicated that rewards would likely help to motivate honest taxpayers to maintain their compliance because they would appreciate the fact their good compliance behaviour is being recognised and acknowledged by Inland Revenue:

Yeah I think rewards probably would motivate me because it would signal to me that the IRD recognises and appreciates the fact that I'm a good taxpayer, so I think that would motivate me to keep being a good taxpayer. I think most people would appreciate that and react in a similar way.

## 5.2 Possible features and operation of a reward system

### 5.2.1 Financial rewards

In regard to the issue of what type of reward would be the most effective for motivating taxpayers to be compliant, both SBOs were strongly in favour of financial rewards:

Money. Money would be the most motivating for me to keep being compliant, and if we talk about taxpayers who are evading tax, then the reward would definitely need to be monetary. (SBO B)

SBO A expressed the view that a likely reason why a lot of people evade tax is because they perceive that they would otherwise be paying an unfair amount of tax, which would necessitate the use of financial rewards to motivate them to pay more tax, as opposed to non-financial rewards:

I think the most effective reward to incentivise a non-compliant person would be a monetary reward, like a refund. I would think that one of the reasons why people evade tax is that they don't see the tax system as being fair and they feel like they would be losing too much money if they paid all their taxes, so I would think that they would respond more to a financial reward rather than a non-financial reward.

The general view that arose in the practitioner interviews was that the use of non-financial rewards may potentially be more effective for maintaining the compliance of deferent, honest taxpayers. As both SBOs classified themselves as deferent taxpayers, the researcher sought their views regarding this matter. SBO B, whilst still favouring financial rewards, did note that certain types of non-financial rewards may be effective for this group of taxpayers. This is discussed in the following section. However, SBO A was adamant that deferent taxpayers would prefer financial rewards:

No, I still think that people who are good honest taxpayers would prefer to be incentivised financially. I certainly would. I think for all types of taxpayers, the best way to incentivise them to be compliant is through using monetary rewards.

Another point of difference between the practitioners and SBOs arose in regard to the issue of whether there is a risk that financial rewards may reduce the motivation for compliant taxpayers to continue being compliant; a concern which has been raised in prior literature and received some support in the practitioner interviews. However, both SBOs did not foresee this problem arising:

I don't think so. I can't see why that would be the case. Financial rewards certainly wouldn't demotivate me anyway. (SBO A)

I wouldn't imagine that people would react negatively to getting a monetary reward in return for paying taxes and being a good taxpayer. I think people would appreciate getting the reward and it would be another motivating factor to comply. I don't see a problem with using money to reward people. (SBO B)

In regard to the type of financial reward that would be the most likely to have the greatest effect on taxpayers' compliance, the SBOs, like the practitioners, were in favour of a percentage rebate. Interestingly, both SBOs made reference to taxpayers who could be categorised as game players, noting that a percentage rebate could be particularly effective for curbing avoidance behaviour:

I think a volume based rebate system could be particularly useful for incentivising people to stop engaging in avoidance... it might incentivise them to stop looking for things that are legal but dodgy. They'd probably think it's not worth their while to do it, nor worth the risk. (SBO A)

I have a few friends who are often going on about the different schemes they use to find ways to pay less tax, you know, they go out of their way to try and avoid as much tax as they can, but I think a rebate system could potentially help to stop people like them from doing things like that [finding ways to avoid tax]. If it was a percentage rebate, then the way to get the most benefit from it is to pay more tax isn't it? So I think you'd feel like you're getting a good benefit from paying the proper amount of tax, and there'd be less of an incentive to try and avoid tax, or evade it or whatever... Why take the risk when you could get money back from the IRD anyway? (SBO B)



## 5.2.2 Non-financial rewards

Whilst both the small business owners were of the view that financial rewards would be the preferred type of reward for most taxpayers, SBO B indicated that certain types of non-financial rewards could still have a role to play. In particular, SBO B raised the idea that the reward offered by Inland Revenue could be of a nature which would attempt to directly benefit taxpayers' businesses. According to SBO B, this type of reward could be designed in several ways. For example, Inland Revenue could organise free business seminars for compliant taxpayers to attend. Such seminars would be hosted by business experts, and would provide opportunities for small business owners to learn new skills, potentially enabling them to improve and expand the success of their businesses. Alternatively, Inland Revenue could provide free consultations with a business mentor. A second example of how such a reward could act to potentially improve the success of a taxpayer's business is for Inland Revenue to aid compliant taxpayers in the promotion of their businesses. This could involve Inland Revenue providing a small amount of funding for the business owner to increase the level of their business advertising. In regard to this type of reward, SBO B noted that:

“Something which would actually help my business to grow would be a very strong motivation [to meet my tax compliance obligations]. I think that [a reward which seeks to benefit small businesses] would be very motivating for many small business owners.... particularly because a lot of small businesses struggle to grow financially after they lose money to tax.”

As for non-financial rewards in the nature of gifts such as free admission to cultural events or free access to public and government services, SBO B was less supportive:

...the idea of being rewarded by receiving free public transport or access to cultural events doesn't really appeal to me so much. Sure, they are nice things but I think people would be more motivated by a reward which could help their business. That, or money.

### 5.2.3 Tax audits and the bomb-crater effect

The findings indicated that both SBOs were of the opinion that there is a risk that the bomb-crater effect can occur. SBO A, who had been the subject of a tax audit several years ago, noted that after the completion of the audit, he personally did not feel tempted to evade tax in the following period, but was sure that there are SBOs who would be:

Oh yeah obviously some people would see it as a chance to save some tax in following years. I had an audit done a few years ago and it didn't make me want to try anything stupid afterwards but some people would definitely try it on, so I think it's a definite risk.

SBO B, who has not been the subject of a tax audit, also noted that she believed a risk existed:

I've never really thought about that kind of situation, but yes, I suppose that it is possible that someone would look at it as an opportunity to save some tax because they probably wouldn't anticipate another audit anytime soon. (SBO B)

In regard to the issue of whether rewarding taxpayers found to be largely compliant after an audit would help to reduce the risk of the bomb-crater effect, both SBOs believed this would be the case. For example, SBO A noted:

Yes I think so. They would probably help due to a combination of things, like making people feel guilty evading after getting a reward, and making people have a positive perception of the IRD.

Interestingly, in addition to the use of rewards, both SBOs also highlighted that the manner in which the Inland Revenue auditors conduct themselves during the audit, and the overall nature of the interactions during the process, would be an important factor influencing a taxpayer's future compliance behaviour, highlighting the importance of procedural justice:

I came out of the audit feeling really good because the auditors were really good. They were pleasant the whole time and gave me feedback about the process, and one of the guys said that he would make a note on my file that my business was a good taxpayer, so they made it a rather positive experience which left me with a good perception of the IRD. (SBO A)

I think that getting some positive feedback after the audit, and just being able to get on well with the IRD employees during the audit would be a good motivation to keep being compliant in the future. (SBO B)

### **5.3 Overcoming the difficulties with defiant taxpayers**

#### **5.3.1 The need for a tax amnesty**

As was the case in the practitioner interviews, the SBOs raised concerns regarding the likely unwillingness of habitually non-compliant taxpayers to become fully compliant due to the fear of the consequences for their past evasion:

One problem I can see is that taxpayers who have been habitually evading will be worried about increasing the amount of tax they pay because it will draw attention to the fact that they've been evading in the past. (SBO A)

If I put myself in the shoes of someone who has been evading tax for an extended period of time, then if I wanted to take advantage of the rebate system and start paying my tax properly, I probably would be too scared to do it, even if I wanted to come clean so to speak. I would be worried that there would be consequences for my past evasion. (SBO B)

These findings further highlight that a reward system would need to be implemented in conjunction with a tax amnesty.

### 5.3.2 Using the stick as well as the carrot

Similar to the practitioner interviews, the SBOs raised the issue that, in the context of a rebate system, there would be a risk of some taxpayers continuing to evade their taxes whilst still receiving a rebate for the tax they do pay, which would necessitate the implementation of severe consequences for such actions:

I think that [a rebate system] could work but then you'd need the carrot and the stick, because if someone is saving money from evading their tax, they might look at it and say "well I'm getting some money back but I can still save more if I keep evading". They might think it's worth the risk of evading some tax and still receiving the rebate for the tax they do pay, so you'd have to make it so they think that it's not worth the risk of evading taxes anymore. (SBO B)

In regard to the type of consequences for being caught evading whilst receiving rewards, the SBOs believed that the ideas put forward by the tax practitioners, that is, never being eligible to receive rewards again in the future, and being required to pay back the rebates received with penalty interest, would be effective deterrents. For example, SBO A noted:

I think it would certainly go a long way to achieving that. You'd have to be a big risk taker to carry on evading if there were those types of consequences for getting caught. I think with a rebate system, these consequences would probably make the majority of taxpayers just declare their full income rather than looking to evade taxes and taking the risk of getting caught. They'd rather just get the reward with no risk, even if that reward is a bit less than what they'd save by evading tax. I think that would be an effective approach, you know, they're [Inland Revenue] offering rewards on the one hand but also ramping up the penalties on the other.

## 5.4 Equity issues and PAYE Taxpayers

The findings indicated that the SBOs did not believe that the introduction of rewards for SBOs would be perceived by PAYE taxpayers as being inequitable, provided Inland Revenue clearly explains to the public that the reason rewards are being used is to improve overall compliance levels, which would actually make the tax system more equitable:

I'm sure some people would find it unfair but you could rationalise it though. Their compliance process is very simple, someone else is reporting their income, and they don't really have to do anything. Personally I can't really see there being too many complaints about it if the IRD sells it the right way, and emphasises that it's going to help the overall tax take, so it might eventually reduce the amount of tax each individual will have to pay, then I think people would accept it. (SBO A)

There is a potential fairness issue I suppose. I imagine some PAYE people would wonder why they weren't getting a reward and could get upset that they weren't getting anything but small business people were. But then I guess it would be the IRD's responsibility to actually explain to the public why they're using the reward system, and explain that it's being used to try and improve overall compliance which will make the tax system fairer. I used to be a PAYE taxpayer and if it was explained to me like that, I think I would be accepting of it. (SBO B)

Furthermore, as indicated in section 5.1 above, SBO A indicated that there is a perception amongst small business owners that the tax system is unfair due to it being seen as favouring large businesses. As such, SBO A was of the opinion that the introduction of rewards for compliant SBOs would actually improve the fairness of the tax system, rather than leading to inequity.

## 5.5 Summary of the small business owner interviews

The findings indicate that both interviewees were of the view that the use of rewards could be an effective method for improving the tax compliance of SBOs. SBO A expressed the opinion that the introduction of a reward system would improve SBOs' perceptions of the fairness of the tax system, and would provide an incentive for SBOs to be compliant. SBO B noted that the introduction of rewards would likely create a more positive relationship between taxpayers and Inland Revenue. Both SBOs indicated that they believed there was a risk that a lack of acknowledgment for habitually compliant taxpayers could lead to some taxpayers becoming non-compliant in the future, and that the introduction of rewards for compliant taxpayers would reduce this risk. The SBOs also highlighted that the use of rewards could reduce the likelihood of the bomb-crater effect occurring.

In regard to the type of rewards that the interviewees believed would be the most effective for motivating taxpayers to be compliant, strong support was provided for financial rewards in the form of a percentage rebate, although SBO B did note that non-financial rewards of a nature which would benefit a taxpayer's business could also be effective. However, as was indicated in the tax practitioner interviews, the SBOs noted that in order for a reward system to be successful, it is likely that it would need to be introduced in conjunction with a tax amnesty, in addition to there being severe consequences for a taxpayer who receives the benefit of the rewards whilst evading/avoiding tax.

Finally, the SBOs did not believe that the use of a reward system would be perceived by PAYE taxpayers as being inequitable, provided Inland Revenue clearly explains that the rationale underlying the introduction of such a system is to make the tax system more equitable by improving overall compliance levels.

The following chapter provides an analysis of the research findings from both the tax practitioner and SBO interviews.

## Chapter 6: Analysis

### 6.1 The effectiveness of penalties

The responses from the practitioner interviews indicated that they held some doubts as to the effectiveness of penalties as a tool to improve taxpayers' compliance. Two practitioners were of the opinion that perhaps the penalty system is not particularly well understood by the majority of taxpayers. Whilst this might suggest one way in which Inland Revenue could attempt to improve compliance is by raising taxpayers' awareness of the penalties and consequences for non-compliance, the practitioners were of the opinion that such action would be unlikely to be beneficial, as the effectiveness of penalties is perceived as being limited. Practitioner C noted that in his experience, penalties do not appear to be an effective deterrent to prevent evasive or avoidance behaviour, whilst Practitioner A expressed the opinion that penalties can often cause taxpayers to "run away from the problem", which hinders the effect that the penalties have on the taxpayers' behaviour. Practitioner B highlighted that penalties can also have a detrimental effect on the future compliance of certain types of taxpayers. He noted that some taxpayers, particularly those who have a negative view of the tax system and are unwilling to be compliant, whom in the context of motivational postures would be categorised as a resistant or disengaged taxpayer, may increase their level of defiance regarding tax compliance in response to receiving a penalty, sometimes even getting a "vendetta behind them against the IRD", which can have a negative impact upon their future compliance behaviour. This is important in light of Braithwaite's (2008, as cited in Hodson, 2011) proposition that a grievance, such as "they've got a vendetta against me", can push a resistant taxpayer to become disengaged with the tax system, or to become a game playing taxpayer. According to Practitioner B, receiving a penalty could be perceived by some resistant taxpayers as Inland Revenue having a vendetta against them.

Whilst the practitioners acknowledged that deterrence measures such as penalties are a necessary component of Inland Revenue's compliance strategy, the findings highlight that the practitioners believe that instead of focusing on raising awareness of the penalty system, or increasing the severity of penalties, it may be more effective for Inland Revenue to raise taxpayers' understanding of the tax system in general. This is in light of the fact that the practitioners suggested that a lot of non-compliance is the result of ignorance on the part of

taxpayers in regard to the operation of different types of tax. This corroborates the findings of Webley (2004, as cited in Kirchler, 2007), in which it was found that self-reported non-compliant SBOs had less accurate knowledge about the tax system and believed that sales and withholding taxes were coming out of their own business funds. This is pertinent to a point raised by Practitioner C, who noted that Inland Revenue needs to emphasise to SBOs that tax collected on behalf of the government, such as GST, is not the business's money, but rather, is money which belongs to the government. This is important in light of the findings from Webley's (2004) study (as cited in Kirchler, 2007), which found that small business owners differ in how they perceive tax collected on behalf of the government, with some perceiving that money as belonging to their business, whilst others perceived it as belonging to the state. As Kirchler (2007) highlights, taxpayers who perceive that this money belongs to the government and mentally separate it from money generated from business turnover are likely to be more compliant. As such, the findings support the proposition by James & Alley (2002) that resources aimed at assisting taxpayers through educating them may yield greater revenue than if resources were spent on additional enforcement activities.

## **6.2 Procedural justice**

Feld & Frey (2007) have interpreted the concept of tax morale as encompassing a psychological tax contract between taxpayers and the tax authority which is built on two main pillars, the first of which is procedural justice. The authors propose that taxpayers are more likely to be voluntarily compliant when they perceive that the tax authority has treated them in a fair, respectful manner during the course of their interactions. The findings from both the practitioner and SBO interviews indicated support for the importance of this aspect of the psychological tax contract, emphasising the importance of ensuring that Inland Revenue is perceived in a positive light by taxpayers. The findings indicated that having positive interactions and relationships with taxpayers is a key way in which Inland Revenue can build a positive image, which can have a beneficial impact upon tax compliance. Practitioner C noted that as Inland Revenue has a large number of interactions with SBOs, it is imperative that Inland Revenue ensures that these interactions are conducted in a respectful and positive manner, as these interactions are largely what form the basis for SBOs' attitudes towards Inland Revenue, which can impact upon their attitudes towards tax compliance. Practitioner D stated that he felt the interactions that taxpayers have with Inland Revenue would be more



likely to have an impact upon taxpayers' perceptions of Inland Revenue compared to the effect that using rewards and incentives may have. Practitioner A drew an analogy between Inland Revenue and the New Zealand police force, noting that whilst it is inevitable that the police will sometimes be perceived in a negative light by the public, overall they are still largely perceived in a positive manner because they make an effort to ensure that their positive interactions with the public outweigh the negative ones. In a similar vein, Practitioner A noted that Inland Revenue can build a positive image by seeking to ensure that its positive interactions with taxpayers outweigh the negative ones.

The findings from the SBO interviews indicated the importance of procedural justice in the context of tax audits, with both SBOs indicating that the way in which Inland Revenue staff interact with taxpayers during this process will likely influence how the audited taxpayer perceives Inland Revenue. SBO A, who had experienced a tax audit in the past, noted that he came out of the audit with a positive perception of Inland Revenue because he felt that the audit had been a positive experience, as the Inland Revenue auditors provided feedback throughout the process and had treated him in a respectful manner. Similarly, SBO B indicated that she felt taxpayers would be more willing to be compliant after a tax audit if they had received positive feedback from the Inland Revenue auditors, and felt like they had a positive relationship throughout the process.

This procedural justice component of the psychological tax contract has been incorporated into the compliance strategy of Inland Revenue through the implementation of the Inland Revenue Compliance Model, which emphasises the importance of Inland Revenue encouraging taxpayers to adopt a deferent motivational posture through having positive interactions with them and encouraging voluntary compliance, whilst reserving the use of coercive deterrence measures for those taxpayers who have adopted a defiant motivational posture (Alley et al., 2012; Morris & Lonsdale, 2004). However, Practitioner A expressed concern with the "appalling" manner in which Inland Revenue sometimes imposes penalties, noting that he was aware of cases where taxpayers have been treated in an almost abusive fashion. The practitioner noted that whilst penalties are a necessary compliance tool, the way they are imposed can be improved so as to reduce the likelihood of creating hostility between the taxpayer and Inland Revenue, such as trying to understand the underlying reasons behind the taxpayer's non-compliance and ensuring that the taxpayer understands what is expected of them, as opposed to continually sending notifications of increased penalties. This

highlights that procedural justice has a role to play even in regard to the interactions between taxpayers and Inland Revenue in the context of the penalties process.

Despite the support for the importance of procedural justice, Practitioner E expressed that for some taxpayers, most notably those who could be categorised as belonging to a defiant motivational posture group, procedural justice and positive interactions with Inland Revenue would be unlikely to have a significant impact upon their compliance behaviour. As such, this leads on to the primary issue of whether the use of rewards for compliance would be likely to improve the compliance behaviour of defiant taxpayers, which is discussed in the following section.

### **6.3 Rewards**

The second aspect underlying Feld & Frey's (2007) psychological tax contract is that incentives, both negative and positive, should be utilised in a tax authority's compliance strategies. The findings from the practitioner and SBO interviews were largely supportive of the idea of using positive rewards as an additional compliance tool. Several responses indicated that the use of rewards could potentially improve tax compliance by having a positive impact upon the vertical reciprocity aspect of tax morale, thereby improving the relationship between taxpayers and Inland Revenue and incentivising taxpayers to improve their compliance. Practitioner E noted that he felt the use of rewards would encourage taxpayers to be more honest because rewards would change the dynamic of the taxpayer/Inland Revenue relationship, from one which is dominated by Inland Revenue due to them being perceived as a "taking organisation", to one which is perceived as being more reciprocal due to Inland Revenue giving something back to compliant taxpayers. This perception of Inland Revenue being a taking organisation was indicated by SBO A in the context of GST, who made reference to the fact that whilst small businesses collect GST on behalf of Inland Revenue, they do not receive anything in return for doing that work, which can create a disincentive to be compliant. In contrast, SBO A noted that in the past when businesses collected sales tax on behalf of the New Zealand Customs Service, they received a percentage of the tax as an acknowledgment that they were doing the work of collecting it, which provided an incentive for small business owners to be compliant because they were getting something back from the authority.

Furthermore, the results highlighted that the overall tax environment may be improved by Inland Revenue giving something back to compliant taxpayers in the form of a reward. For example, Practitioner A noted that taxpayers who receive a reward from Inland Revenue will be more likely to view Inland Revenue kindly, and therefore the interactions between Inland Revenue and this group of taxpayers would be more pleasant. Similar sentiments were expressed by SBO B, who felt that taxpayers would be more willing to comply if they received a reward because they would feel valued and respected due to getting something back from Inland Revenue in return for their good compliance behaviour, further illustrating the positive influence the use of rewards could have on the reciprocity of the taxpayer/Inland Revenue relationship.

The findings indicated a belief that the use of rewards for compliance could potentially be more effective than penalties for encouraging defiant taxpayers to improve their compliance behaviour. Practitioner B noted that, in his experience, taxpayers who have been penalised by Inland Revenue can sometimes become more defiant and unwilling to be compliant. As such, the practitioner felt that the introduction of a reward system could be an effective tool “to mend some bridges with disgruntled taxpayers” and get them back into the tax system. Similarly, Practitioner E expressed that defiant taxpayers may react more positively to the use of rewards because it would be perceived as being a positive initiative which is in their favour, and provides another avenue by which Inland Revenue can seek to encourage defiant taxpayers to improve their compliance. These findings are important in light of Smith’s (1992) proposition that “cycles of antagonism might begin to be broken by a positive concession by the administrator” (p. 226). In this sense, the practitioners’ responses indicate that the introduction of a reward system could be viewed as a positive concession by Inland Revenue which could reduce the level of defiance of non-compliant taxpayers and thus improve their compliance. Furthermore, these findings can also be interpreted in light of Crowding Theory’s assertion that external interventions which are perceived as being supportive in nature can increase peoples’ motivation to perform a desired behaviour (Frey & Jegen, 2001). This is because the findings indicate that rewards could have a positive impact upon taxpayers’ motivation to be compliant, as it is likely that taxpayers would view the use of rewards as being a positive intervention in their favour. As such, the findings support Feld et al’s. (2006b) proposition that rewards could be more effective than punishments for motivating compliance because rewards would be perceived by taxpayers as being a supportive, as opposed to a controlling, intervention from Inland Revenue.

The interviewees also provided insight into the potential effect that rewards could have on the compliance behaviour of taxpayers with a game playing motivational posture. Practitioner C was of the opinion that taxpayers who enjoy playing games with Inland Revenue in an attempt to minimise the amount of their tax liability would be unlikely to be responsive to the introduction of rewards because they enjoy the competitive aspect of trying to beat Inland Revenue. However, it is important to note that game playing taxpayers who seek to avoid tax through exploiting ambiguities in the law generally do not act alone. Instead, such taxpayers require the aid of tax practitioners who have a mastery of tax law (Braithwaite, Reinhart & McCrae, 2004; Hodson, 2011). As such, it is recognised that Inland Revenue needs to take steps to ensure that tax practitioners uphold the integrity of the tax system and do not exploit it for the benefit of clients (Morris & Lonsdale, 2004). According to Practitioner B, the introduction of a reward system would make it easier for practitioners to dissuade game playing taxpayers, or “difficult taxpayers”, from seeking to take an aggressive tax position, as practitioners can explain to them that they already stand to receive a benefit from paying their tax. In the practitioner’s view, this would be a more effective approach than seeking to deter the taxpayer from taking an aggressive tax position by highlighting the risk and threat of penalties if Inland Revenue deems the taxpayer guilty of tax avoidance. This corroborates the findings of Braithwaite et al. (2004), who found that taxpayers categorised as game players are less likely to acknowledge the effect of deterrence measures in regard to the likelihood of getting caught, the likelihood of sanctions being imposed, and the seriousness of the consequences of the sanctions. Practitioner B’s view, that rewards could improve the compliance of game players, was shared by the SBOs, who both indicated that the introduction of rewards would reduce the incentive for such taxpayers to seek out ways of avoiding their tax liability.

A common justification for the use of rewards that arose in the practitioner interviews was that the introduction of rewards could improve compliance by reducing taxpayers’ propensity to take the risks involved with evasion, as taxpayers would be aware that they stand to receive a benefit from paying their tax. This issue regarding the impact that rewards could have on taxpayers’ risk preferences is discussed in section 6.4.1.

Finally, the findings from both the practitioner and SBO interviews highlight that, whilst the use of rewards could have a positive effect on the compliance of some taxpayers, it is very likely that they would have minimal impact upon certain taxpayers, such as those who have

been habitually evading. This issue, and potential solutions to it, are addressed below in section 6.5.

### **6.3.1 Using rewards to maintain the compliance of deferent taxpayers**

A concern was raised in the tax practitioner interviews regarding the lack of acknowledgment that Inland Revenue gives to ‘good’ taxpayers for their compliance behaviour. This point was supported by SBO A, who noted that whilst he is an habitually compliant taxpayer, the only experiences he generally has had with Inland Revenue have been negative, such as when he has made an error on one of his tax returns, whilst on the other hand, there is no acknowledgment of the fact that he is an habitually compliant taxpayer. This corroborates the view of Practitioner B, who noted that the only time the majority of taxpayers hear from Inland Revenue is when something has gone wrong, so they are only having negative experiences with Inland Revenue, which can lead to people developing a negative view of Inland Revenue. These concerns raised the question of whether this lack of acknowledgment could potentially increase the likelihood of ‘good’, or deferent, taxpayers becoming non-compliant in the future, due to their motivation to be a compliant taxpayer decreasing. This issue arises in light of the proposition put forward by Feld et al. (2006b), who noted that if taxpayers’ intrinsic motivation to be a compliant taxpayer is not recognised or acknowledged, their intrinsic motivation may decrease and their willingness to act opportunistically may increase. As such, the authors conclude that the provision of certain types of rewards for good taxpayers can act to maintain the tax morale and intrinsic motivation of such taxpayers, thereby reducing the likelihood of these taxpayers becoming non-compliant in the future.

The results from the tax practitioner interviews provided mixed opinions regarding this issue. For example, Practitioner D felt that if a taxpayer is motivated to be a compliant taxpayer, their motivation will not diminish in light of a lack of acknowledgement from Inland Revenue, whereas Practitioner B and Practitioner E expressed the opinion that they believed there was a risk that good taxpayers could be more likely to become non-compliant in the future due to a lack of acknowledgment from Inland Revenue for their good compliance behaviour. The findings from the tax practitioner interviews, whilst not providing a consensus on this point, do provide some support for the first element of Feld et al. (2006b) proposition,

namely that a lack of acknowledgement of good taxpayers can increase the risk of them becoming non-compliant in the future. Further support was obtained from the SBOs, who were both of the opinion that there is a risk that the lack of acknowledgment can reduce the willingness of compliant taxpayers to continue being compliant, and increase the likelihood that they may be tempted to act opportunistically. For example, SBO B noted that some SBOs, particularly those who perceive tax evasion to be common amongst SBOs, might start to think that they should also start to evade some tax because they do not get any recognition from Inland Revenue for the fact that they are doing the right thing when others are not.

The second element of Feld et al's. (2006b) proposition is that the use of rewards for compliant taxpayers can act to maintain their compliance levels in the long-term through having a positive influence on taxpayers' tax morale and motivation to be a good taxpayer. The results obtained from the tax practitioner interviews indicated strong support for this view, with, for example, both Practitioner B and Practitioner E highlighting the important role that rewards could play in regard to increasing the level of positive reinforcement to encourage the continuance of the desired behaviour of tax compliance. It was noted that in the absence of some type of reward system, the presence of positive reinforcement is severely lacking, which can potentially be harmful for tax compliance in the long-term. The findings from the SBO interviews provide further support for the proposition that rewards would help to maintain the compliance levels of good taxpayers. SBO A expressed the view that receiving a reward from Inland Revenue would be a strong motivation to continue being compliant, as taxpayers would feel like their good behaviour is being appreciated by Inland Revenue. Similarly, SBO B was of the view that receiving a reward for being compliant would reduce the likelihood of taxpayers entertaining the thought of becoming an evader because they would appreciate the acknowledgment from Inland Revenue.

The findings generally provide support for Feld, et al's. (2006b) proposition that the introduction of a reward system could be an effective means of maintaining compliance from good taxpayers. However, it must be recognised that a degree of doubt exists as to whether Inland Revenue would view the use of rewards as being necessary in this regard. This is in light of the fact that taxpayers with a history of good behaviour are already eligible for favourable treatment from Inland Revenue in certain circumstances. For example, in accordance with section 141FB of the Tax Administration Act 1994, a taxpayer can have a shortfall penalty reduced by 50 percent if they have not, in the previous two years in regard to

GST, FBT, PAYE and RWT, and four years in regard to all other taxes, received a shortfall penalty. In light of this, Practitioner B highlighted that Inland Revenue may already view this as being a reward for good taxpayers, and thus Inland Revenue may not deem the introduction of a formal reward system necessary in this context. However, contrary to this view, both Practitioner A and SBO A did not view this penalty relief as constituting a reward, indicating that whilst they were aware that Inland Revenue could reduce penalties, it was their opinion that Inland Revenue could do more to acknowledge compliant taxpayers.

### **6.3.2 Customer versus Taxpayer and the role of rewards**

During the course of the tax practitioner interviews, the practice of Inland Revenue calling taxpayers ‘customers’ arose. The use of the term ‘customer’ appears to clearly signify that Inland Revenue recognises the importance of ensuring that taxpayers have a positive perception of Inland Revenue, and that Inland Revenue believes that the practice of calling taxpayers customers is a means through which they can form positive relationships with taxpayers, thereby improving the likelihood that taxpayers will be compliant. This is evident from comments made in the Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance (1998) document, in which Chapter 16 addressed the issue of Inland Revenue’s relationships with taxpayers. Paragraph 16.3 introduces the point that since 1995, Inland Revenue has been attempting to change and improve the way in which it interacts with taxpayers, and that “a core aspect of this change has been an instruction to refer to taxpayers as 'customers'.” Paragraph 16.4 states that:

The object is to improve the department's service to taxpayers and its relationship with taxpayers. It is hoped that the best-practice private-sector processes and standards that the term 'customer' implies will encourage staff to achieve this improvement. In turn, it is anticipated that improved levels of service to 'customers' will lead to better levels of voluntary taxpayer compliance.

These comments illustrate Inland Revenue’s attempt to bring an element of ‘commerciality’ into the tax context, in an attempt to improve how it is perceived by taxpayers.

The practice of tax authorities calling taxpayers ‘customers’ has received some limited attention in the tax morale literature, most notably from Kornhauser (2007), who takes a negative view of the potential effects that using such terminology can have on the compliance behaviour of taxpayers. Kornhauser’s criticism stems from the argument that this commercial element’s introduction into the tax context can reduce taxpayers’ tax morale and motivation to be compliant, as it “devalues the civic duty aspects of paying taxes...” (p. 637). Kornhauser (2007) further criticises this practice, on the basis that it may cause taxpayers to react negatively towards the tax authority because of the imbalance of the so called customer relationship, due to the tax authority having the power to impose penalties, stating that “if the taxpayer is merely a customer, then paying taxes is no different than paying off a car loan, except that the IRS may be viewed more hostilely than other creditors because it carries a bigger stick” (p. 638).

Like Kornhauser (2007), the results from the tax practitioner interviews also indicated a negative view of Inland Revenue’s practice of calling taxpayers ‘customers’. However, the reasons for holding this negative view differ to those of Kornhauser (2007). The findings highlighted that the practitioners’ negativity stems from the fact that Inland Revenue currently does not attempt to actually treat taxpayers as customers through seeking to improve relationships with them, and this consequently can lead to taxpayers viewing Inland Revenue negatively because they do not believe that Inland Revenue is making a genuine effort to improve its relationships with them. These sentiments reflect concerns that were raised by the Committee of Experts on Tax Compliance (1998), where it was noted that a potential pitfall of Inland Revenue’s attempt to create a customer-based relationship with taxpayers is that taxpayers may not perceive Inland Revenue as being genuine and sincere in this regard, due to the fact that taxpayers must pay their taxes without directly receiving benefits in return, and will be subject to penalties for failing to pay the correct amount of tax when it is due. Despite this, however, the Committee noted that this customer-based approach should not necessarily be discontinued, provided it is implemented in a manner which maximises its benefits.

The results from the tax practitioner interviews indicated that the introduction of a rewards system for compliant taxpayers is one way in which the benefits of this approach could potentially be maximised, as this is the type of action that proper customer serving organisations do, and would therefore signal to taxpayers that Inland Revenue is genuine in



its attempt to improve its relationships with taxpayers. It is apparent, therefore, that in the view of the tax practitioners, it would potentially be beneficial for Inland Revenue to attempt to increase and emphasise the commerciality aspect of its relationship with taxpayers. This is in contrast to the view put forward by Kornhauser (2007), who was of the opinion that attempting to incorporate commerciality into the tax realm is damaging to taxpayers' tax morale, and therefore poses the risk of decreasing taxpayers' compliance levels. However, the introduction of rewards may overcome one of the problems which Kornhauser (2007) identified regarding the incorporation of commerciality into the tax system, namely that taxpayers may develop hostility towards the tax authority if it tries to treat them as a customer due to the 'big stick' that it wields. The rationale behind the introduction of rewards, however, is that the reliance on the tax authority's big stick is reduced in favour of emphasising the 'carrot' to encourage compliance, and could therefore negate the risk of hostility arising. This in turn would increase the likelihood of Inland Revenue's objective underlying this customer based approach being achieved, namely that it will "...lead to better levels of voluntary taxpayer compliance" (Committee of Experts On Tax Compliance, 1998).

## **6.4 Possible features and operation of a reward system**

One of the main areas of uncertainty in prior literature is the question of how a reward system should be designed so as to maximise its potential positive influence on tax compliance. This uncertainty relates to the type of rewards which would be the most effective for motivating compliance, and the manner in which such rewards should be administered. A related issue to consider is the effect that rewards would likely have on different subgroups of taxpayers. The analysis below attempts to shed some light on these issues in the New Zealand context.

### **6.4.1 Financial rewards**

Financial rewards have been identified in prior literature as being one type of reward which could encourage compliance. The general consensus from the tax practitioner interviews was

that financial rewards would be the most likely type of reward to have a positive influence on the compliance behaviour of taxpayers belonging to the defiant motivational posture subgroups, such as resistant, disengaged and game playing taxpayers. For example, Practitioner C, Practitioner D and Practitioner E emphasised that money would be the only motivating factor for these groups of taxpayers, and that non-monetary rewards would be unlikely to have an impact on them. These sentiments were shared by the SBOs, who both agreed that financial rewards would be necessary to motivate defiant taxpayers to improve their compliance. SBO A noted that he felt one of the main reasons why taxpayers become defiant and evade or avoid tax is because they perceive that they would otherwise be paying an unfair amount of tax and, therefore, the only way to motivate them to improve their compliance is to provide a monetary incentive to do so.

Whilst consistent views were obtained from both the tax practitioner and SBO groups in regard to the necessity of using financial rewards to improve the compliance of defiant taxpayers, differing opinions were held between the two groups in regard to the type of reward which would be the most effective for maintaining the compliance levels from taxpayers in the deferent motivational posture subgroups. As will be discussed in more depth below, the tax practitioners generally felt that non-financial rewards could be more effective for taxpayers of this type, as opposed to financial rewards. However, the findings from the SBO interviews indicated that each SBO, who both categorised themselves as being deferent taxpayers, viewed money as being more motivating than non-financial rewards for both deferent and defiant taxpayers.

However, prior literature has voiced concerns as to the efficacy of financial rewards, on the basis that financial rewards may decrease taxpayers' intrinsic motivations to be compliant due to them treating the financial reward as a 'right' or 'claim' (Feld et al., 2006b; Feld & Frey, 2007; Kornhauser, 2007). These concerns regarding the potential negative impact of financial rewards appear to be directed more toward the deferent subgroups of taxpayers who are at least partially intrinsically motivated to be an honest taxpayer, as opposed to the defiant subgroups of taxpayers. This view is supported by Torgler's (2002) proposition that research should consider whether the introduction of financial inducements could reduce the intrinsic motivation of honest taxpayers to comply with their tax obligations. The findings from the SBO interviews do not support these concerns, as both SBOs indicated that they did not believe financial rewards would have a demotivating effect on deferent taxpayers. Rather,

they felt such rewards would be appreciated by deferent taxpayers and would be another motivating factor for them to remain compliant. The findings, therefore, suggest that from the perspective of taxpayers, financial rewards would be the most effective type of reward for improving the compliance of defiant taxpayers and maintaining the compliance of deferent taxpayers.

The next issue to consider is how the financial rewards should be administered in order to have the greatest effect on taxpayers' compliance behaviour, as Feld & Frey (2006) note that the way in which rewards are provided to taxpayers will be an important determinant of how effective they are. The prior literature has proposed that the financial reward could be proportional to the amount of tax paid by a taxpayer, so the reward system would operate in a manner which is analogous to a percentage rebate system. Conversely, the financial reward could be administered as a set amount, so the reward is the same size for all recipients (Feld et al., 2006b). The general consensus from both the tax practitioners and the SBOs was that administering the financial rewards as a percentage rebate would likely be the most effective approach to incentivise taxpayers to improve their compliance. A common theme that arose in support of using a percentage rebate system was that it could improve compliance by reducing taxpayers' willingness to take the risk of evading or avoiding tax by placing them in a position where they are guaranteed to receive a rebate. Practitioner C noted that he felt a lot of taxpayers would prefer to pay their proper amount of tax and receive a rebate so they can "sleep easy", rather than continuing to take the risks associated with evasion. Practitioner B noted that the introduction of a percentage rebate system would alter the risk/reward profile of evasion. Practitioner B illustrated this by using the hypothetical example, involving arbitrary amounts of money, of a taxpayer who is evading \$3000 of tax by underreporting their income prior to the introduction of a rebate system. However, subsequent to the introduction of a rebate system, the taxpayer would be owed a rebate amounting to \$1000 if they reported all of their income and paid the proper amount of tax. As the practitioner noted, the benefit the taxpayer now receives from evading is reduced from \$3000 to \$2000, which equates to the net gain of \$2000 after deducting the foregone \$1000 rebate the taxpayer would have received for being fully compliant and taking no risk, from the \$3000 the taxpayer receives from evading and taking the associated risks. Practitioner B was of the view that this altered risk/reward profile would lead to some taxpayers behaving in a more risk averse manner as they decide that the extra gains they could make through evading are not worth the risk, and instead they would prefer to receive the risk free rebate. Similarly,

Practitioner E expressed that he felt a percentage rebate would help to make taxpayers take the view that taking the risk of doing cash jobs and not reporting the income is not worthwhile.

Similar sentiments regarding risk preferences were expressed in the SBO interviews where, interestingly, both interviewees made reference to the fact that they believed a percentage rebate system would reduce the likelihood of game playing taxpayers seeking to look for legal, but “dodgy”, methods of avoiding tax as it would not be worth their while, nor worth the risk. These findings from the practitioner and SBO interviews are consistent with the prior research which has experimentally tested Prospect Theory’s risk preference predictions. For example, results from Anderson (1996), Dusenbury (1994), Robben et al. (1990), Schepanski & Kelsey (1990), and White, Harrison & Harrell (1993) indicated that taxpayers tend to be risk averse when in a position to receive a tax refund, which has prompted researchers to suggest that a potential way to improve tax compliance is for tax authorities to take action so as to put taxpayers in a position in which they will receive a guaranteed refund. The current findings tend to suggest that the use of a percentage rebate system could be one potentially effective means of achieving this.

Whilst the practitioners expressed support for the view that using a percentage rebate system could reduce the number of taxpayers willing to take the risk of avoiding or evading tax, it was also noted that such a system would not result in all non-compliant taxpayers becoming risk averse, which is consistent with Dusenbury’s (1994) caution that habitual tax evaders will not necessarily become risk averse when placed in a position to receive a refund. Practitioner E noted that he was concerned that some non-compliant taxpayers would continue to take the risk of evading because it is in their nature to do so. Practitioner B made reference to his hypothetical example of a taxpayer evading \$3000 of tax, who would be eligible to receive a \$1000 rebate if they declared all of their income. As noted above, whilst Practitioner B felt that some taxpayers would prefer to take the risk free option of receiving the \$1000 rebate, he also felt that some taxpayers would take the view that it is still worth the risk of evading in order to receive the extra \$2000 net benefit.

A further issue to consider in this regard is the fact that rewards can induce strategic behaviour from taxpayers, such as where taxpayers could exploit the rewards system by evading tax and yet still receive a reward (Feld et al., 2006a). The authors note that the way

to negate this threat is to make the receipt of a reward dependent on a taxpayer being found to be completely honest. However, requiring this standard of compliance would necessitate Inland Revenue conducting tax audits for all small businesses to confirm their compliance, which is not practicable. As such, the percentage rebate system proposed by the practitioners would not require a taxpayer to be found completely honest in order to receive a rebate. Instead, the receipt of the rebate would simply be based on the payment of tax, with the size of the rebate increasing as a function of the amount of tax paid. Therefore, there is a risk that a taxpayer may act strategically because on the one hand they could receive a benefit from evading a portion of their taxes, whilst on the other hand they still receive the benefit of the rebate based on the amount of tax they do pay. The risk of taxpayers acting in a strategic manner was raised by SBO B, who noted that some taxpayers may think it is worth the risk of evading some tax whilst still receiving the rebate for the tax they do pay. Practitioner C also stated that some taxpayers may start to “weigh up the numbers” and determine that it is worth the risk of not being 100 percent compliant.

This raises the issue that the way in which a non-compliant taxpayer frames the compliance decision could impact on the level of risk a taxpayer is willing to take when they are in a position to receive a rebate, and the likelihood that they will act strategically. The following hypothetical scenario outlines this issue:

A taxpayer earns a taxable income for the year of \$50,000. Based on the current income tax rates in New Zealand, the taxpayer’s income tax liability would be approximately \$8020. However, if we assume that this taxpayer has been evading tax, or is contemplating doing so, by underreporting their income by, for example, \$10,000, then the income tax which is owed on the \$40,000 of declared income amounts to only \$6020, resulting in a \$2000 tax shortfall for the government. If a percentage rebate of 5 percent was introduced, the taxpayer would be entitled to receive \$401 if they declared the full \$50,000 and paid the proper amount of tax (\$8020). On this basis, the net benefit that the taxpayer would receive from evading is reduced from \$2000 to \$1599. In this case, the taxpayer frames the decision as a trade-off between taking a risk free gain of \$401, or taking a risky gain of \$1599. This frame is consistent with that provided in Practitioner B’s hypothetical example above.

There is, however, an alternative way that a taxpayer may frame the decision, which would increase the chances of a taxpayer acting strategically. As the percentage rebate is based on

the amount of tax paid, a non-compliant taxpayer would still receive a reward based on the amount of tax they do pay. In the current scenario where the taxpayer is evading \$2000 tax, the taxpayer would still receive a rebate of \$301 based on the \$6020 tax they would pay, which would give them a gross benefit of \$2301 should they take the risk of evading, and a net benefit of \$1900 after deducting the \$401 rebate they would receive if the proper amount of tax was paid. In this case, the decision is framed as a trade-off between taking the risk free gain of \$401, or the risky gain which consists of both the amount of evaded tax and the reward that would be received for the level of taxes actually paid. As the net gain is greater when viewed from the second frame's perspective, there may be a higher likelihood that a taxpayer would be willing to take the risk of evasion if they frame the decision in this manner.

Therefore, whilst the results lend support to Prospect Theory's assertion that the prospect of receiving a guaranteed rebate may reduce some taxpayers' willingness to take the risks associated with evasion due to a gain already being assured (Robben et al. 1990), they also highlight that some taxpayers would be likely to act strategically and take the risk of evading tax in addition to receiving the rebate for the tax they do pay. As such, the practitioners and SBOs noted that the use of a percentage rebate system would necessitate the inclusion of deterrence measures in order to dissuade defiant taxpayers from doing so; an issue which is discussed in section 6.5.

Further support was expressed for the use of a percentage rebate on the basis that the size of the reward available to taxpayers under this approach increases as a function of the amount of tax paid, so in order for taxpayers to gain the maximum advantage from the rebate, it stands that they should declare all of their income for tax purposes. Practitioner A stated that he felt such a system would incentivise taxpayers to honestly declare their income because the more tax they pay, the bigger the reward they receive from Inland Revenue. In this sense, taxpayers may perceive that they are making a gain from paying their tax. Similarly, SBO B noted that the way to receive the maximum benefit from a percentage rebate is to pay a higher amount of tax, which they thought could lead to taxpayers perceiving that they are making a bigger gain the more tax they pay, which would reduce the incentives to avoid or evade tax. These findings are also consistent with Prospect Theory, as Kornhauser (2007) notes that according to Prospect Theory, tax compliance should increase if paying taxes is seen as a gain as opposed to a loss. According to the aforementioned responses, it is possible that the use of a

percentage rebate is one means of making taxpayers perceive paying taxes as a gain. This illustrates why the use of a percentage rebate would be more effective than a single set amount for all taxpayers, and is consistent with Feld & Frey's (2007) assertion that a percentage rebate has a greater impact on shifting the relative prices in favour of paying taxes than does a single set amount.

#### **6.4.2 Non-financial rewards**

It has been suggested in prior research that the use of non-financial rewards could potentially be more effective than financial rewards as a means of motivating taxpayers to increase or maintain their level of tax compliance. For example, Feld & Frey (2007), Feld et al. (2006b), and Kornhauser (2007) note that a reward which is received in the same monetary dimension as the tax payments is likely to be treated by taxpayers as a 'right', which consequently reduces its positive influence upon taxpayers' tax morale. In contrast, the aforementioned authors posit that a non-monetary reward which is distinguished from the tax payments is more likely to be perceived by taxpayers as a sign of acknowledgment from the tax authority for their good behaviour and, therefore, it will have a stronger influence upon taxpayers' tax morale. As highlighted above, the results indicated mixed views regarding this issue. Both SBOs expressed the view that financial rewards would be a more effective motivator than non-financial rewards, and would be perceived as a sign of acknowledgment by taxpayers. However, despite favouring financial rewards, SBO B did note that she felt certain types of non-financial rewards would be also be motivating for small business owners to be compliant.

The results from the practitioner interviews were more supportive of the aforementioned proposition regarding the use of non-financial rewards, in the sense that the general view was that, whilst financial rewards would be necessary to improve the compliance of defiant taxpayers, non-financial rewards may be more effective for maintaining the compliance of deferent taxpayers. Practitioner B and Practitioner C did voice concerns as to the possibility of taxpayers treating monetary rewards as a right, noting that there was a risk that monetary rewards could just become expected by taxpayers, which could reduce their positive impact. Furthermore, Practitioner B felt that a taxpayer would be more appreciative if the reward took

the form of something which benefited them or their business by “making their life easier.” To this end, he suggested that extending and allowing more flexibility regarding the filing and payment timeframes for taxpayers who have been consistently compliant would be greatly appreciated by taxpayers. This idea was also put forward by Practitioner E, who felt that many taxpayers would appreciate increased flexibility regarding filing and payment times as much as they would appreciate monetary rewards.

Practitioner A put forward the idea that taxpayers who have been consistently compliant in the past could be given preferred status with Inland Revenue which would give them certain benefits, such as providing access to a special phone number which reduces the wait time when taxpayers call Inland Revenue for assistance. This idea is consistent with that put forward by Kornhauser (2007, p. 639), who proposed that “taxpayers who have paid the correct amount of taxes in a timely fashion for a stated amount of time... might be given faster access to assistance such as special phone lines that have a shorter wait.” Due to the fact that tax authorities are often notorious for having long waiting times on phone calls, such a reward could be an effective way of maintaining taxpayers’ tax morale and reducing the risk of taxpayers developing a negative perception of Inland Revenue due to this issue. However, as Practitioner E points out, the effectiveness of this type of reward may be limited by the fact that it is often the taxpayer’s accountant, as opposed to the taxpayer themselves, who will phone Inland Revenue if a query has arisen. Therefore, whilst a reward in this form could potentially have a positive effect, it is likely that additional non-financial rewards would be required in order to have a significant impact on taxpayers’ compliance behaviour.

Further examples of non-financial rewards which could directly benefit a taxpayer’s business were proposed in both the tax practitioner and SBO interviews. For example, Practitioner A proposed that Inland Revenue could take advantage of its bulk purchasing power in order to provide discounted accounting software such as Xero and MYOB to small businesses that have been consistently compliant. This type of idea seems appealing, as there is a clear mutual benefit being received by both parties; on the one hand, taxpayers are rewarded for being compliant, whilst on the other hand, Inland Revenue benefits from the fact that more small businesses will have improved accounting software, which theoretically should lead to more accurate records being kept, which in turn increases the likelihood of the correct amount of tax being paid by these small businesses. Similarly, SBO B proposed the idea that Inland Revenue could reward compliant taxpayers by seeking to aid them to grow their



business, such as, for example, organising free business seminars or providing free consultations with a business mentor. In a similar vein to the idea put forward by Practitioner A, this idea can also be seen as providing a mutual benefit to both parties, as the taxpayers receive the opportunity to grow their businesses and revenues, which would consequently benefit Inland Revenue through the higher levels of tax revenue which would be collected if taxpayers' businesses were to increase their revenues.

Practitioner E proposed the idea that Inland Revenue could send letters or certificates to taxpayers who have been deemed to be compliant for the previous tax period. Speaking from the perspective of his clients, Practitioner E felt that taxpayers would appreciate receiving such a reward and would potentially use it as a marketing tool to promote their business. This type of reward is consistent with an idea put forward by Torgler (2010), who proposed that a useful form of reward would be a certificate issued by the tax authority to a business which acknowledges that, to the best knowledge of the tax authority, the business has declared and paid the correct amount of tax on time, and has acted in a cooperative manner with the tax authority. The author highlights that such a reward would be beneficial to a business as it indicates that the business is a 'good' taxpayer, which will enhance the business's image and reputation. This is consistent with Practitioner E's claim that taxpayers would use such a reward as a marketing tool to promote their business.

The use of this type of reward could also have additional benefits in regard to the effect they could have in improving taxpayers' attitudes towards tax compliance by drawing attention to the fact that a large number of small businesses are honest taxpayers. Kornhauser (2007) notes that taxpayers' compliance behaviour can be influenced by how they perceive other taxpayers to be behaving. For example, if a taxpayer has the perception that a large number of other taxpayers are cheating on their taxes, there is a risk that this perception can negatively influence the compliance behaviour of the taxpayer. The tax morale literature refers to this concept as horizontal reciprocity, which provides that taxpayers are likely to be more willing to comply with their tax obligations if they are aware that the majority of other taxpayers are compliant as well (Kornhauser, 2007). As such, it follows that an effective means of improving tax compliance from small businesses could be for Inland Revenue to emphasise and give attention to the small businesses who are being compliant, which may encourage other small businesses to follow suit (Kornhauser, 2007). This could be achieved through the

provision of some type of certificate or award to compliant businesses which would act to raise awareness of the importance of being a ‘good’ taxpayer.

Prior research has also suggested that the provision of non-financial rewards in the form of reduced public transport fees or free admission to cultural events could be an effective way of acknowledging the good behaviour of taxpayers in order to motivate them to be compliant (Feld & Frey, 2007; Feld et al., 2006b; Kornhauser, 2007). However, these types of rewards did not receive any support from the interviewees with, for example, SBO B noting that she did not believe such rewards would have the same level of effectiveness of motivating compliance compared to financial rewards, or non-financial rewards of a nature which can benefit taxpayers’ businesses.

The research findings presented in this subsection provide a degree of support for the general proposition that non-financial rewards could be useful for encouraging compliance, as they highlight that such rewards could be effective for maintaining compliance from deferent taxpayers, but less so for improving compliance from defiant taxpayers. Furthermore, the findings tend to suggest that in order for non-financial rewards to have a significant impact upon tax compliance, such rewards should take the form of something which benefits a taxpayer’s business, rather than the taxpayer on a personal level. There is, therefore, little support for the use of non-financial rewards in the form of reduced public transport or free admission to cultural events, as suggested in the prior research, such as Feld & Frey (2007), Feld et al. (2006b) and Kornhauser (2007).

### **6.4.3 Tax audits and the bomb-crater effect**

Whilst the preceding discussion has drawn attention to the fact that the proposed percentage rebate system would apply on a wholesale basis to SBO/self employed taxpayers without the requirement for a taxpayer to be found fully compliant, another circumstance identified in prior literature, in which rewards could apply, is where a taxpayer is found to be largely compliant and honest after a tax audit. Prior experimental studies investigating the effect that rewards have on the compliance behaviour of participants have all used this scenario as the

basis for testing the impact of rewards (Alm et al., 1992b; Bazart & Pickhardt, 2011; Kastlunger et al., 2011; Torgler, 2003). A potential additional advantage of utilising rewards in this scenario is that the use of rewards may act to reduce the likelihood of the bomb-crater effect arising. The findings from the tax practitioner interviews generally supported the view that the bomb-crater effect is a risk which does exist in practice, although this view was not unanimously held. For example, Practitioner A noted that he had never heard of a taxpayer seeking to save tax through evasion after a tax audit, and further noted that he believed Inland Revenue auditors would likely sense whether a taxpayer was of a nature to attempt such action, and would therefore put measures in place to prevent it from happening. In contrast, Practitioner B and Practitioner E were of the opinion that the bomb-crater effect does pose a threat to compliance, as some taxpayers do perceive the chances of being audited again in the future as being low, which is consistent with the explanation offered by Guala & Mittone (2005). These sentiments were also shared by the SBOs. Practitioner C and Practitioner D provided a degree of support for the view that the bomb-crater effect poses a compliance threat, noting that whilst they personally have not seen examples of such a phenomenon happening, they could understand why taxpayers may engage in such behaviour and could foresee it occurring.

As the general view arising from the tax practitioner and SBO interviews supports Guala & Mittone's (2005) proposition that the bomb-crater effect exists in the tax compliance context, the question arises as to whether the use of rewards can act to reduce the risk of the bomb-crater effect occurring. This issue was addressed by Kastlunger et al. (2011), who provided experimental evidence indicating that subjects' compliance levels subsequent to an audit were higher when the reward was introduced as compared to the control condition, which tends to suggest that the introduction of rewards tempers taxpayers' willingness to evade their taxes subsequent to an audit, thereby reducing the impact of the bomb-crater effect. Practitioner B and Practitioner E supported this view, indicating that in their opinion, the provision of a reward to a taxpayer found to be compliant after a tax audit would likely reduce their willingness to evade tax in the future, most likely due to the feelings of guilt that would arise after they had received a reward from Inland Revenue. Similarly, SBO A noted that he felt rewards could help to reduce the bomb-crater effect as taxpayers would likely feel guilty evading tax after having received a reward, as well as the fact that receiving a reward would give people a positive perception of Inland Revenue. Therefore, the findings tend to

suggest that the positive experimental results obtained by Kastlunger et al. (2011) would be replicated in practice. Furthermore, the findings highlight the important role that procedural justice has in ensuring that audited taxpayers continue being compliant in the future, with both SBOs raising the point that taxpayers would be more likely to be compliant in the future if they have had a positive experience during the course of the audit, and have felt respected by the Inland Revenue staff.

Whilst Practitioner D was also supportive of using rewards in the audit context, he viewed the issue from a slightly different perspective. Practitioner D, whose sentiments were shared by Practitioner E, expressed the view that taxpayers can develop negative feelings towards Inland Revenue after an audit, due to the financial and time burden that may be imposed upon the taxpayer. Consequently, there is a risk that such ill feelings toward Inland Revenue could be detrimental to compliance. Therefore, the use of rewards in this scenario could be framed as being compensatory in nature, so as to recognise the disruption to the taxpayer's business and the associated costs incurred, which would help to ensure that the any ill will held by taxpayers towards Inland Revenue is kept to a minimum.

This is consistent with the view put forward by Falkinger & Walther (1991), who conducted a theoretical study in economics which investigated the potential for introducing financial rewards as a means of improving compliance. The authors highlighted that in the audit context, the use of rewards could be framed in two distinct ways. First, "the reward can be seen as an incentive for declaring income accurately" (p. 72), or alternatively, "it may also be seen as a compensation... for the burden of investigation which the taxpayer has had to suffer" (p. 72). The results from the tax practitioner interviews, in conjunction with the view put forward by, Falkinger & Walther (1991), highlight the dual role that rewards can play in regard to improving compliance when applied in the audit context. First, the use of rewards seeks to improve compliance through acting as an incentive for taxpayers to be compliant, so as to be eligible to receive the reward should they be audited. Second, the use of rewards seeks to maintain the compliance of taxpayers after they have been audited by acting as compensation for the burden incurred by the compliant taxpayer, thereby maintaining a positive relationship between the taxpayer and Inland Revenue.

Practitioner D, in his assessment of the different circumstances in which rewards could apply, noted that he felt restricting their application to the audit scenario may be a more effective

approach to increase compliance through improving taxpayers' perceptions of Inland Revenue, as opposed to applying them in a wider context, such as implementing a wholesale rebate system. The advantage of this is that it significantly reduces the scope for taxpayers to act strategically as in the case where the percentage rebate applies on a wholesale basis without taxpayers being subject to an audit. However, Practitioner A cautioned against limiting the reward system to this narrow context. The rationale for this view was based on the fact that as Inland Revenue only has limited resources available to conduct audits, limiting the application of rewards to this context may inhibit their potential to improve compliance on the larger scale that could be achieved if a wholesale rebate system was implemented, as such a system would be applicable to a larger number of taxpayers, thereby increasing their scope for influencing compliance behaviour. Furthermore, limiting their application to the audit context would only partially solve the problem regarding the lack of acknowledgment for good taxpayers, as discussed above. These concerns are consistent with those raised by Feld et al. (2006a), who note that applying the rewards solely to taxpayers selected through a random audit can be problematic due to the fact that, as only a limited number of taxpayers would be rewarded each year, it is likely that many previously rewarded taxpayers would not be rewarded again in the future, which could have negative effects on their future compliance behaviour.

Therefore, whilst the application of rewards in the audit context is desirable as a means of reducing the compliance threat which stems from the bomb-crater effect, it is likely that a reward system would need to be applied in a broader context if it were to have a significant impact upon compliance levels. As such, it seems reasonable to conclude that in order to maximise the potential compliance benefits that could be obtained from a reward system, it is likely that such a system would need to be applied in multiple contexts. That is, a broad context in which the reward was applied, for example, as a wholesale rebate, which would act to encourage taxpayers to improve and maintain their compliance behaviour, and a narrow context, targeted at improving compliance levels through reducing the impact of the bomb-crater effect that arises in the audit context. This would also allow for different types of rewards to be provided in different contexts. For example, whilst a percentage rebate is well suited to apply on a wholesale basis, the provision of certain non-financial rewards, such as certifications of compliance, flexibility of timeframes, and accounting software are perhaps more suited to the narrow audit context in which Inland Revenue can verify that the taxpayer has been compliant for an extended period of time and is deserving of such rewards.

## **6.5 Overcoming the difficulties with defiant taxpayers**

The results obtained from the practitioner and SBO interviews highlight two particular difficulties regarding defiant taxpayers which would need to be considered when designing and implementing a reward system. The first difficulty would necessitate the use of a tax amnesty, whilst the second difficulty would necessitate the use of the ‘stick’ in addition to the ‘carrot’.

### **6.5.1 The need for a tax amnesty**

It was highlighted in both the tax practitioner and SBO interviews that in order for the introduction of a reward system to have the effect of motivating and inducing non-compliant taxpayers to become compliant, or at least more compliant than they were prior to the introduction of the reward system, it is very likely that the reward system would need to be introduced in conjunction with a tax amnesty. The rationale behind this requirement is that whilst a non-compliant taxpayer may wish to improve their compliance levels in response to the introduction of a reward system, they may be hesitant to do so due to the fear that Inland Revenue will conduct an investigation into their past non-compliance, which would subsequently result in penalties being imposed. As such, it is not difficult to envision the implementation of a reward system having only a limited impact on increasing compliance levels if it was not accompanied by a tax amnesty.

As noted in section 2.3, the use of tax amnesties as a means of improving tax compliance is largely based on the same rationale underlying the research putting forward the possibility of introducing rewards, namely that there are doubts as to the efficiency and effectiveness of relying on legal sanctions as a means of increasing tax compliance levels (Hasseldine, 1998b). As such, it seems appropriate that both the introduction of a reward system and use of a tax amnesty could be used together as a way of seeking to increase compliance. Furthermore, there are additional reasons why a tax amnesty and the introduction of a reward system could potentially complement each other as a compliance strategy. First, Hasseldine (1989) notes that there are doubts as to the ability of tax amnesties to ensure long-term compliance and, therefore, “taxpayers may need to... be encouraged via some other method to

comply” (Hasseldine, 1989, p. 522). Therefore, the concurrent introduction of a reward system could act as a method of encouraging taxpayers to become compliant in the long-term. A second reason is that after a tax amnesty is run, previously honest taxpayers may anticipate a future amnesty, and therefore their tax honesty may be reduced, thereby causing a detrimental impact on long-term compliance levels (Torgler, 2007). Furthermore, honest and compliant taxpayers may perceive the use of tax amnesties as being unfair and view them as a signal that tax evasion is a forgivable and insignificant action, which can lead to a reduction in their motivation to comply in the future (Feld et al., 2006a; Torgler, 2007). However, as the results of the current research have indicated, the introduction of a reward system would likely act to maintain the compliance levels of ‘good’ taxpayers who are currently compliant, therefore negating this potential pitfall of tax amnesties.

Therefore, whilst a tax amnesty would almost certainly be required for a reward system to be successfully implemented, it appears that the two strategies could complement each other as a means of ensuring a long-term improvement in tax compliance levels. A final point to note in regard to the use of an amnesty in this context is the ability for Inland Revenue to utilise a limited scope tax amnesty. Sawyer (2005) notes that in 2004, the New Zealand Government proposed the use of limited tax amnesties, which would have enabled Inland Revenue to offer tax amnesties to specific industries or groups in which tax evasion had become ingrained. As it currently stands, however, the limited scope tax amnesty programme has not been implemented. Nevertheless, the introduction of a reward system could provide an appropriate opportunity for Inland Revenue to utilise limited tax amnesties, as Inland Revenue could target industries which it believes contain many small businesses who are habitual tax evaders, and who would therefore be more unwilling to improve their compliance behaviour in response to the implementation of a reward system. Therefore, if the New Zealand Government was hesitant to run a general economy wide tax amnesty for the purpose of introducing a reward system, the use of limited scope tax amnesties may be an effective alternative.

### **6.5.2 Using the stick as well as the carrot**

As alluded to previously in the context of using a percentage rebate system, the findings from both the practitioner and SBO interviews raised concerns that, whilst the prospect of

receiving a guaranteed gain in the form of a rebate would encourage some taxpayers to act in a risk averse manner, some taxpayers would still seek to take the risk of evading or avoiding tax in order to make a larger gain, inducing strategic behaviour. As such, the interviewees proposed that to be effective, a reward system should be designed so as to include rather severe deterrence measures for non-compliance as a means of dissuading taxpayers from taking the risk of evasion or avoidance. Practitioner D noted that there would need to be “mega consequences” for a taxpayer found to have been receiving rebates whilst intentionally underreporting their income. Practitioner E put forward the idea that a taxpayer found to be evading or avoiding tax be required to repay the amount of refunds received, including an additional payment of penalty interest. In addition, both Practitioner E and Practitioner A proposed that a further appropriate consequence would entail the taxpayer being ineligible to ever receive a reward again in the future, or having to demonstrate to Inland Revenue that they are deserving of receiving them again, such as being fully compliant for a certain number of years.

Support for these types of consequences was provided by both SBOs. For example, SBO A expressed that a taxpayer would have to be “a big risk taker” to be willing to evade taxes if these were the consequences of getting caught, and that the majority of taxpayers would be content to receive the risk free rebate rather than take the risk of evading, even though the gains they make from the rebate are less than what they would make from evading. Therefore, there was support for an approach in which a reward system provides a ‘carrot’ on the one hand, but wields a ‘stick’ in the other. This approach is still consistent with a tax morale approach to tax compliance, as whilst tax morale emphasises adopting methods other than deterrence to improve compliance, it recognises that both sticks and carrots should work together to ensure compliance (Kornhauser, 2007).

Furthermore, the combination of using rewards and deterrence measures is consistent with Inland Revenue’s current compliance approach under the Inland Revenue Compliance Model, whereby Inland Revenue reserves the use of deterrence measures for taxpayers who have adopted a defiant motivational posture, and focuses on using positive interactions to encourage taxpayers to adopt a deferent motivational posture (Leviner, 2009; Morris & Lonsdale, 2004). Similarly, in the context of a reward system being introduced into the Compliance Model, the rewards would be utilised to encourage taxpayers to adopt a deferent motivational posture, whilst the increased deterrence measures proposed by the interviewees



would apply to those taxpayers who have adopted a defiant motivational posture and have chosen to receive the benefits of the rewards whilst still engaging in non-compliance.

## **6.6 Feasibility of a reward system**

The prior literature regarding the potential use of a reward system for compliant taxpayers has largely left the issue of the practical feasibility of implementing and administering a reward system untouched. It is, however, important to consider such an issue, as whilst the introduction of a reward system may potentially be an effective method of improving tax compliance from a theoretical perspective, if such a system is unfeasible to implement, its practical utility is severely impeded.

In regard to the feasibility of implementing a reward system in the New Zealand context, the general consensus of the tax practitioners was that Inland Revenue's IT system, in its current state, may struggle with the implementation of a reward system. The practitioners' rationale for harbouring these concerns was largely on the basis that Inland Revenue's IT system is potentially already stretched to its limits with the various aspects it must handle. This problem has arisen due to the fact that whilst Inland Revenue's IT system was originally established to solely carry out the function of income and company tax collection, over time the system's areas of responsibility have grown to include additional aspects, such as KiwiSaver, student loans, and Working for Families. As such, the practitioners felt that adding an additional area of responsibility in the form of a reward system may increase the complexity of the IT system to an unfeasible level.

However, despite the practitioners' concerns as to the feasibility of implementing such a system into Inland Revenue's current IT system, they did note that this is less of a concern in light of the planned \$1.5b upgrade of Inland Revenue's IT system over the next ten years, as this new and improved system should be able to competently handle the implementation of a reward system. This does, however, raise a further issue for consideration, namely whether any potential reward system would need to be implemented during the IT system upgrade process, or whether the reward system could still be introduced after the upgrade is completed. Uncertainty surrounds this issue, with Practitioner B feeling that it may be

necessary to implement the reward system during the upgrade process, whilst Practitioner C felt that the increased flexibility that the upgraded IT system will likely possess should allow for the addition of a reward system after the upgrade phase has been completed. At the very least, it seems the tentative conclusion that can be drawn on this aspect of the feasibility issue is that the implementation of a reward system is likely to be feasible, provided the IT upgrade is successfully implemented.

The second aspect in regard to the feasibility of introducing a reward system into the New Zealand tax system relates to the actual administration of such a system. Overall, the responses from the practitioners regarding the feasibility of administering a reward system indicated that it should be reasonably straight forward for Inland Revenue to operate such a system. In particular, Practitioner D made reference to the fact that Inland Revenue does have experience in the administration of rewards, albeit on a smaller scale than the type of reward system which is the subject of this project, in the form of an early payment discount for first time provisional taxpayers, in accordance with sections RC 37-40 of the Income Tax Act 2007. As such, it is reasonable to conclude that the administration of a reward system should be feasible for Inland Revenue to handle.

A final feasibility issue that arose from the interviews with tax practitioners related to the potential adverse effects the introduction of a reward system could have on accounting firms and practitioners. This particular concern was raised in regard to the effects that a reward system could have on tax filing timeframes and workflow issues if a reward took the form of an extension of tax filing time frames. Whilst these concerns were only raised by two of the five tax practitioners interviewed (Practitioner A and Practitioner B), it does highlight that the consequences of implementing a reward system will not only have to be considered in regard to Inland Revenue, but consideration would also need to be given to how the implementation of such a system would impact upon accounting firms and practitioners so as to ensure that they do not incur any unintended adverse effects.

## **6.7 Inland Revenue's potential amenability to using rewards**

As is the case concerning the feasibility of introducing a reward system, the question of how amenable a tax authority may be to the possibility of introducing a reward system has received little attention in prior research. In an attempt to shed some light on this critical issue in the New Zealand context, the researcher sought the opinions of the tax practitioners in regard to how they believed Inland Revenue might perceive the potential use of a reward system, and some of the potential difficulties which Inland Revenue would need to overcome in order to successfully implement such a system.

The responses from the tax practitioner interviews indicated several potential difficulties which would need to be overcome. First, Practitioner A and Practitioner B were of the view that taxpayers are generally sceptical of Inland Revenue and, therefore, there may be a significant level of scepticism surrounding the introduction of a reward system which could result in its implementation having a negative impact upon taxpayers. In Practitioner A's view, Inland Revenue may be deterred from attempting to introduce a rewards system due to this level of scepticism that would need to be overcome. In order to overcome this particular challenge, Practitioner B emphasised that a lot of attention would need to be focused on the manner in which the system was advertised and released in the media.

Whilst the first difficulty relates to the challenge of gaining support for a reward system from taxpayers, a second potential difficulty identified by the tax practitioners was the challenge of gaining support from Inland Revenue staff for the use of such a system. This difficulty arises from the fact that, in the opinion of Practitioner B and Practitioner C, some Inland Revenue investigators operate with the mindset that it is their job, and possibly their right, to take a sceptical view of taxpayers, and to employ high-handed techniques to extract tax from them. Such a mindset is not conducive to implementing and administering rewards to taxpayers. If this is the case, it would therefore be necessary for Inland Revenue as an organisation to have a shift in its mindset towards the way it views and treats taxpayers. This sentiment was expressed by Practitioner A, who felt that if Inland Revenue is serious about improving compliance and its image, it must not only focus on changing taxpayers attitudes towards it, but Inland Revenue itself must change the attitude it has towards taxpayers, from one which views all taxpayers as being potential tax evaders, to one which focuses on fostering positive

relationships with taxpayers. Inland Revenue does appear to have taken action in this regard through the implementation of its Compliance Model, which seeks to improve the interactions Inland Revenue has with taxpayers in order to encourage, rather than coerce, compliance (Morris & Lonsdale, 2004). As such, whilst the introduction of a reward system is a novel concept, Inland Revenue has shown that it is willing to implement compliance strategies which seek to reduce the reliance on deterrence measures.

A further difficulty for Inland Revenue identified by the tax practitioners relates to the challenge of establishing whether the increased tax revenue that could be collected from the introduction of a reward system would outweigh the costs of administering the rewards. As Feld et al. (2006a) note, in order to justify the use of rewards, such an approach must raise net tax revenues over time after deducting the cost of rewards. Practitioner D noted that whilst Inland Revenue would spend money on administering rewards in order to increase the level of taxes collected, the challenge lies in undertaking an analysis to determine whether the introduction of a reward system would lead to an overall behavioural change from taxpayers which would result in increased tax collections over and above the costs incurred. Practitioner A and Practitioner D highlighted that the question of whether the potential benefits outweigh the costs is very uncertain, with Practitioner D emphasising that it is necessary to not only consider the direct costs of paying out rewards, but to also determine whether there are any indirect costs that may arise if the introduction of a reward system were to incur a negative reaction from taxpayers. Such costs may be incurred, for example, from PAYE taxpayers taking umbrage with the introduction of a reward system; a potential risk discussed below. Practitioner E also commented on the potential complexity of undertaking a cost/benefit analysis, noting that such complexity may deter Inland Revenue from implementing a rewards based approach in favour of focusing on deterrence measures. This emphasises Feld et al's. (2006) point that a tax administration faces a trade-off between the costs and benefits of giving rewards, and the costs and benefits of utilising other approaches, such as penalties and audits.

This particular difficulty of establishing the net benefit of implementing a reward system highlights the underlying political aspect which may further complicate the issue of whether introducing such a system is viable. As Practitioner A noted, Inland Revenue itself may see the potential benefits that could be gained through improving the tax morale of taxpayers, and therefore it may wish to take steps to improve its interactions with taxpayers, such as seeking

to operate in a manner analogous to that of a customer facing organisation, but unless Inland Revenue can explicitly demonstrate to the government of the day that such action will lead to increased tax revenue, it is highly unlikely that Inland Revenue will be permitted to take such action. However, this raises the question of whether Inland Revenue would require the legislative backing of the New Zealand Government in order to implement a reward system or, alternatively, whether the Commissioner of Inland Revenue (CIR) already possesses the authority to implement such a system, in accordance with section 6A of the Tax Administration Act 1994. Under this section, the CIR is charged with the care and management of the taxes covered by the Inland Revenue Acts. It is the duty of the CIR to collect over time the highest net revenue that is practicable within the law. In discharging this duty, the CIR must have regard to the resources available, the importance of promoting voluntary compliance by taxpayers, and the compliance costs incurred by taxpayers. As such, it is arguable that the CIR may have the discretion to implement a reward system, on the basis that such a system would potentially aid Inland Revenue to collect over time the highest net revenue that is practicable within the law, whilst also promoting voluntary compliance by SBO taxpayers through providing a positive incentive to do so.

### **6.7.1 Equity issues and PAYE taxpayers**

A potential difficulty with the implementation and use of a reward system in New Zealand raised by the tax practitioners concerns its discriminatory effects against PAYE taxpayers, and the inequity that could arise between this group of taxpayers and small business taxpayers. The responses of the tax practitioners highlighted the fact that there is a clear risk that the implementation of a reward system to encourage tax compliance from small business owners and the self employed could cause considerable unrest amongst wage and salary taxpayers.

This issue can be viewed in light of Adam Smith's (1991) four canons of taxation, or principles of good taxation, "...which provide a framework within which a tax system or tax proposals can be considered and evaluated" (Alley et al., 2012, p. 31). One such principle of a good tax is that of equity. Alley et al. (2012) note that the concept of equity is comprised of two components, namely vertical equity and horizontal equity. Alley et al. (2012) explain that

vertical equity means that taxpayers in different situations should be treated differently. For example, taxpayers who earn a higher income should pay more tax than those who earn a lower income. Conversely, horizontal equity emphasises the importance of ensuring that taxpayers who are in similar situations receive similar tax treatment from the revenue authority (Alley et al., 2012). The component of relevance to the current discussion is horizontal equity, as the equity concerns raised by the practitioners relate to the fact that two groups of taxpayers (PAYE taxpayers and SBO taxpayers) in similar positions would be treated differently, as one group (SBO taxpayers) would receive the benefit of a reward system, whilst the other group (PAYE taxpayers) would not.

Equity plays an important role in the quest to improve tax compliance. As Alley et al., (2012, p. 32) note, “equity in the tax system, and taxpayers’ perceptions of it, affects tax compliance. However well designed and administered a tax system may be, a tax or tax system that is perceived by taxpayers as unfair may not enjoy widespread support and may result in taxpayers seeking to avoid or evade their tax liabilities.” Furthermore, the Victoria University of Wellington Tax Working Group (2010, p. 33) highlighted that “where taxpayers consider the system is unfair and confidence declines, voluntary compliance tends to reduce. This will undermine people’s trust in the tax system and put at risk the sustainability of the tax revenue base.”

These points are pertinent to the discussion of introducing a reward system, as they highlight the potential negative effect that such a system could have if it were to be perceived as being inequitable by PAYE taxpayers, due to them being ineligible to receive the benefits of the reward system. However, it is also important to consider the fact that that the very reason why this group of taxpayers would not be eligible to receive the benefits of the rewards is also the reason why Inland Revenue may not be concerned with any unrest that may be caused by the inequality of the reward system. For example, as the above quotes indicate, the non-compliance threat which can arise due to perceived inequality in the tax system is likely to be caused by taxpayers seeking to avoid or evade their taxes due to their discontent with what they perceive to be an unfairly designed tax system. However, as PAYE taxpayers’ income is taxed at source under the PAYE system, their opportunity to evade taxes is inherently limited. Therefore, any unrest caused by the implementation of a reward system will not adversely affect the level of tax collected from this group of taxpayers; a point which was noted in the tax practitioner interviews. As such, whilst there are clear equity concerns

which would arise from the introduction of a reward system, it would appear unlikely that these concerns would actually lead to non-compliance from this group of taxpayers.

In contrast to the views expressed in the practitioner interviews, SBO A was of the opinion that the introduction of a reward system would not be inequitable towards PAYE taxpayers. The rationale for SBO A's view was that the compliance process for PAYE taxpayers is very simple, as their employer is responsible for reporting their income. In contrast, the compliance process for small business owners and the self employed is much more onerous which, in SBO A's opinion, would be one reasonable justification for providing the benefit of rewards to this group of taxpayers. Furthermore, in chapter 5.1 above, SBO A noted that there is a perception amongst small business owners that the tax system is unfair due to it being seen as being set up to be more favourable for larger businesses which, in the SBOs opinion, can potentially have a negative impact upon the compliance behaviour of some small business owners. This finding confirms the fears expressed by Alley et al. (2012) and the Victoria University of Wellington Tax Working Group (2010) as to the detrimental effect that perceptions of inequality can have on compliance. SBO A suggested that the introduction of rewards for compliant small business owners may improve their perception as to the equity of the tax system, which in turn could improve their compliance. As such, it is arguable that the introduction of a reward system could actually improve the equitability of the tax system. However, Practitioner C still expressed concern regarding the potential for unrest to arise from PAYE taxpayers, noting that as there is a significant amount of tax being collected from this group, it may not be in Inland Revenue's best interests to be seen as introducing discriminatory policies against them. This highlights the importance of seeking to ensure that any proposed reward system is introduced in a manner which minimises the risk of PAYE taxpayers taking umbrage to it.

According to the views obtained from the tax practitioner and SBO interviews, the approach that would be the most likely to gain the support of PAYE taxpayers is to emphasise that the reward system is being introduced as a means to increase the level of taxes collected for the benefit of society as a whole. Both SBOs expressed that they believed the majority of PAYE taxpayers would be accepting of a reward system if Inland Revenue explained to the public that its underlying purpose is to improve the fairness of the tax system by increasing the compliance from the small business sector, which could consequently reduce the tax burden of PAYE taxpayers.

Despite the potential for justifying the reward system to the PAYE taxpayer group, Practitioner C and Practitioner D expressed some doubt as to whether PAYE taxpayers would accept such a justification. Therefore, the equity issue which arises in regard to the introduction of a reward system is analogous to that which arises in regard to the use of tax amnesties. In the tax amnesty context, the equity issue arises in regard to the risk that honest taxpayers may be upset by the use of an amnesty, which could result in previously honest taxpayers becoming non-compliant. The solution put forward by Hasseldine (1989) in the tax amnesty context was for the tax authority to make an evaluation of taxpayer sentiment before introducing the amnesty. If Inland Revenue were concerned about the potential for a negative reaction from PAYE taxpayers to the introduction of a reward system, then an approach similar to that put forward by Hasseldine (1989) would appear to be appropriate. However, as identified above, it is possible that Inland Revenue could choose to implement a reward system regardless of how it is perceived by PAYE taxpayers, due to their inability to reduce their compliance.



## Chapter 7: Conclusion, contributions, limitations and future research

### 7.1 Conclusion

In response to the traditional deterrence model's lack of explanatory power regarding observed compliance levels, the concept of tax morale has developed into a growing area of research which investigates the potential for utilising the 'carrot' to encourage voluntary compliance, and reducing the reliance on the 'stick' to coerce compliance. One carrot which has been identified as having the potential to improve tax compliance is the use of rewards for compliant taxpayers. The aim of this study was to supplement the theoretical and experimental research, which has investigated the potential use of rewards as a compliance tool, by gaining an understanding of how tax practitioners and SBOs perceive the potential effectiveness of utilising such an approach.

The broad research questions which this thesis sought to answer were as follows:

*RQ1 - How effective would the use of a reward system be for improving tax compliance, and how should such a system be designed?*

*RQ1(a) - How feasible would the implementation of a reward system be in New Zealand?*

*RQ1(b) - How amenable would Inland Revenue be to using such a system, and what are some potential difficulties which Inland Revenue would need to overcome in order to successfully implement such a system?*

In regard to the first question, the findings were generally supportive of the concept of utilising rewards as a compliance tool. Several responses indicated that introducing rewards could have a positive impact upon taxpayers' compliance behaviour due to improving the reciprocity between taxpayers and Inland Revenue, which is a component that has been identified as influencing taxpayers' tax morale (Kornhauser, 2007). This could occur as a result of the provision of rewards improving the perceived fairness of the relationship between taxpayers and Inland Revenue. This is due to the impact that rewards could have on

altering the dynamic of the relationship from one which is dominated by Inland Revenue due to them being perceived as a “taking organisation”, to one which is perceived as being more reciprocal if Inland Revenue were to give something back to compliant taxpayers. Furthermore, it was indicated that the use of rewards may be more likely than penalties to improve the compliance of defiant taxpayers, as they could be an effective tool to mend some bridges with disgruntled taxpayers and get them back into the tax system, and they would offer Inland Revenue another means by which to encourage defiant taxpayers to become deferent. This corroborates Smith’s (1992) proposition that “cycles of antagonism might begin to be broken by a positive concession by the administrator” (p. 226), and indicates the introduction of rewards for compliance could be one example of a positive concession by a tax authority. Similarly, in the context of Crowding Theory, the findings noted that rewards could have a positive impact upon taxpayers’ motivation to be compliant, as it is likely that taxpayers would view the use of rewards as being a positive intervention in their favour. As such, the findings supported Feld et al’s. (2006b) proposition that rewards could be more effective than punishments for motivating compliance because rewards would be perceived by taxpayers as being a supportive, as opposed to a controlling, intervention from Inland Revenue.

In regard to taxpayers who could be classified as game players, the findings noted that the use of rewards may potentially be effective in reducing this group of taxpayers’ willingness to engage in tax avoidance. Whilst Practitioner C was unsure whether the introduction of rewards would influence this group of taxpayers’ compliance behaviour, Practitioner B was of the opinion that the introduction of rewards would make it significantly easier for tax practitioners to dissuade taxpayers from taking aggressive tax positions, as practitioners would be able to explain to the taxpayer that they already stand to receive a benefit from paying their tax. Practitioner B’s sentiments were shared by both SBOs, who believed that the use of rewards could have a positive impact on the compliance of this group of taxpayers.

The findings also supported Feld et al’s. (2006b) proposition regarding deferent taxpayers, noting that there is a risk that if taxpayers’ intrinsic motivation to be a compliant taxpayer is not recognised or acknowledged, their intrinsic motivation may decrease and their willingness to act opportunistically may increase. Furthermore, the findings supported the authors’ view that the provision of rewards for compliant taxpayers can act to maintain their

compliance levels in the long-term through having a positive influence on taxpayers' tax morale and motivation to be a good taxpayer.

During the course of the interviews, several practitioners made reference to the practice of Inland Revenue calling taxpayers 'customers', and highlighted the potentially negative impact this practice can have on taxpayers' perceptions of Inland Revenue, due to Inland Revenue not actually attempting to foster a customer relationship. The findings indicated that introducing an element of commerciality into the tax system in the form of rewards could potentially be an effective way of signalling to taxpayers that Inland Revenue is genuine in its attempt to improve its relationships with taxpayers as it is the type of action that customer facing organisations implement, and could have positive flow on effects for tax compliance.

In regard to the type of reward that would be the most effective for motivating taxpayers to be compliant, the findings provided overwhelming support for financial rewards. Whilst prior research has expressed concern regarding the use of financial rewards in this context (particularly in regard to the effect they may have on the compliance of deferent taxpayers, on the basis that financial rewards may decrease taxpayers' intrinsic motivations to be compliant due to them treating the financial reward as a 'right' or 'claim') the findings from the SBO interviews indicated that this was unlikely to be the case. Rather, both SBOs noted that they believed financial rewards would be appreciated by deferent taxpayers and would be an effective means of motivating them to remain compliant. As for how the financial rewards should be administered, the findings were in favour of using a percentage rebate system, whereby the size of the reward increases as a function of the amount of tax paid.

One of the key rationales behind the support for this type of system was that it could potentially reduce taxpayers' willingness to take the risk of evading or avoiding tax by putting them in a position where they are guaranteed to receive a rebate. These findings suggest that a percentage rebate could be used as a tool to influence taxpayers' risk preferences in a manner consistent with that identified in research investigating Prospect Theory's predictions in the tax compliance context, whereby taxpayers who are in a position to receive a guaranteed gain in the form of a refund tend to be less willing to take the risk of avoiding or evading tax. However, consistent with Dusenbury's (1994) caution that habitual tax evaders will not necessarily become compliant when they are in a position to receive a refund, the findings indicated that such a system would not result in all non-compliant

taxpayers becoming risk averse. Further, consistent with Feld et al's. (2006a) proposition that the use of rewards may induce strategic behaviour from taxpayers, the findings highlighted the risk that certain taxpayers may exploit the percentage rebate system by evading a portion of their taxes whilst still receiving the rebate based on the amount of tax they do pay.

As such, it was noted that a reward system would need to be designed in a manner so as to include deterrence measures as a means of reducing the likelihood of taxpayers taking this risk. The findings indicated that measures such as requiring a taxpayer found to be intentionally underreporting income and receiving the benefit of the rewards to pay back the total amount of rebates received with penalty interest, and the threat of being ineligible to receive rewards in the future or for a specified period, could be effective deterrence measures in this regard.

Whilst financial rewards received the most support, the findings did highlight that certain types of non-financial rewards could also be utilised, particularly in regard to maintaining the compliance of deferent taxpayers. Whilst prior research has recommended the use of rewards such as improved and cheaper access to public services like transport and cultural activities (Feld et al., 2006b), the findings did not support this suggestion. Instead, the findings indicated that a non-financial reward in the form of something which is beneficial to a taxpayers business is a preferred option. Examples provided included the provision of discounted accounting software, a certificate from Inland Revenue stating that the taxpayer's business has been compliant for a specified number of years, and providing compliant taxpayers with preferred status with the Inland Revenue which would grant certain benefits, such as a special phone number for faster access to Inland Revenue.

The findings also illustrated that the introduction of a reward system could have a role to play in reducing the likelihood of the bomb-crater effect arising. The responses indicated that the provision of a reward to a taxpayer found to be largely compliant after a tax audit could reduce the risk of the taxpayer seeking to evade a portion of their taxes in the following period, which corroborates the experimental findings of (Kastlunger, 2011). This could occur, for example, due to a taxpayer feeling guilty should they attempt to evade tax after receiving a reward from Inland Revenue, as well as the fact that receiving a reward would give people a positive perception of Inland Revenue.

Furthermore, consistent with Falkinger and Walther (1991), it was also indicated that the rewards in this context could be framed as compensation for the disruption to the taxpayer's business and the associated costs incurred, which would help to ensure that any ill will held by taxpayers towards Inland Revenue is kept to a minimum. Practitioner D was of the opinion that it may be preferable to limit the provision of rewards to this narrower audit context, for taxpayers who have had a clean audit. The advantage of operating a reward system in this manner is that it reduces the risk of taxpayers acting in a strategic manner, as could be the case with a percentage rebate system which applies on a wholesale basis without taxpayers being subject to an audit. However, Practitioner A cautioned against this approach, observing that as Inland Revenue only has limited resources available to conduct audits, limiting the application of rewards to this context may inhibit their potential to improve compliance on the larger scale that could be achieved if a wholesale rebate system was implemented, as such a system would be applicable to a larger number of taxpayers.

Therefore, the findings suggest that in order to maximise the potential compliance benefits that could be obtained from a reward system, it is likely that such a system would need to be applied in multiple contexts, such as the narrower audit context, and the wider wholesale basis. This could also facilitate the provision of different types of rewards in different contexts, such as a percentage rebate applying on a wholesale basis, and the provision of certain non-financial rewards in the narrow audit context, whereby Inland Revenue can verify that the taxpayer has been compliant for an extended period of time and is deserving of such rewards.

A final important issue that arose regarding the first research question was the finding that in order for a reward system to successfully induce non-compliant taxpayers to become compliant, it is very likely that the reward system would need to be introduced in conjunction with a tax amnesty. This is due to the fact that, whilst a non-compliant taxpayer may wish to improve their compliance levels in response to the introduction of a reward system, they may be hesitant to do so due to the fear that Inland Revenue will conduct an investigation into their past non-compliance.

In regard to the second research question, the findings indicated some doubts as to the ability of Inland Revenue's IT system to adequately implement a reward system. However, these concerns were tempered by the fact that Inland Revenue is due to receive a \$1.5b upgrade of

its IT system over the next ten years, which the practitioners expected would be able to competently handle the implementation of a reward system. This does, however, raise the issue of whether any potential reward system would need to be implemented during the IT system upgrade process, or whether the reward system could still be introduced after the upgrade is completed. Whilst the practitioners felt that the added flexibility of the upgraded system would allow for a rewards system being introduced subsequent to its completion, the general feeling was that it would be beneficial for the idea of introducing a reward system to be considered sooner rather than later.

The tentative conclusion that can be drawn from the findings is that the introduction of a reward system would be feasible provided Inland Revenue successfully receives its IT system upgrade. Regarding the feasibility of administering a reward system, the findings indicated that it should be relatively straightforward for Inland Revenue to operate such a system, particularly in light of the fact that Inland Revenue has experience in administering rewards on a smaller scale in the form of an early payment discount for first time provisional taxpayers, in accordance with sections RC 37-40 of the Income Tax Act 2007.

A final aspect regarding the feasibility of operating a reward system arose in regard to the potential adverse effects that a reward system could have on the workflow of accounting firms and practitioners. Such an issue could arise if a non-financial reward took the form of an extension of tax filing time frames which could affect the time horizons of other events for accounting firms and practitioners.

In regard to the third research question, several difficulties were identified by the practitioners which could potentially reduce Inland Revenue's amenability to introducing rewards into the tax system. First, it was noted that Inland Revenue may be deterred from attempting to introduce a rewards system due to the level of scepticism which is often held by taxpayers regarding anything Inland Revenue does. As such, it was highlighted that the manner in which such a system was advertised in the media would be critical for its success.

Second, the practitioners raised some doubts as to whether Inland Revenue staff, particularly hardened and experienced investigators, would be open to the concept of rewarding taxpayers as it would be a vastly different and novel compliance approach to that which is utilised currently. However, Practitioner C highlighted that only several key personnel would need to

be open to the idea and, through the implementation of the Inland Revenue Compliance Model, Inland Revenue has indicated that it is willing to implement strategies which attempt to reduce the reliance on deterrence measures.

Third, it was highlighted that whilst the introduction of a reward system may increase the level of tax revenue collected, it is very uncertain whether this potential increase would outweigh the costs of providing the rewards, due to the likelihood that performing a cost/benefit analysis could be a considerably complex process. As such, whilst Inland Revenue itself may wish to take steps such as this to improve taxpayers' tax morale, it is highly unlikely that Inland Revenue will be permitted to take such action unless it can explicitly demonstrate to the government of the day that such action will lead to increased tax revenue. However, it must also be considered that, in accordance with section 6A of the Tax Administration Act 1994, the CIR may already possess the authority to implement a reward system without the requirement for legislative backing.

A final potential difficulty highlighted by the practitioners is that the introduction of a reward system may be perceived by PAYE taxpayers as being inequitable. However, it was also recognised that Inland Revenue may not be concerned by this risk, as there is very limited scope for PAYE taxpayers to reduce their tax compliance if this group of taxpayers were to become disgruntled. Furthermore, it was noted by SBO A that the introduction of a reward system may actually improve the fairness of the tax system in the eyes of small business owners, which could in turn have a positive impact upon the compliance of this group of taxpayers.

## **7.2 Contribution to the literature**

This study sought to make several contributions to the literature. First, whilst theoretical and experimental research has been conducted in regard to the potential benefits of utilising rewards to encourage tax compliance, there is an absence of research focused on understanding taxpayers' and tax practitioners' views as to the potential effectiveness and feasibility of introducing a tax reward system. This research has taken the first steps in regard to redressing this lacuna in the literature by approaching the topic from a different

perspective. Through approaching the topic in this manner, the research has provided insight into how the tax profession and taxpayers believe a reward system could be designed so as to maximise its effectiveness.

Secondly, as it currently stands, there has been no research conducted in relation to the possibility of utilising rewards to encourage tax compliance in a New Zealand context. This research has therefore provided a starting point for investigating the suitability of implementing a reward system in New Zealand. However, as will be noted in further detail in the following subsection, the research has largely examined the views of practitioners and SBOs in Christchurch and is therefore somewhat limited in that regard. Nevertheless, the research has provided a basis from which further research may be conducted on a wider scale.

Finally, this research will potentially be of interest to tax policy makers, as it has provided insight in to the potential effectiveness of introducing rewards into the New Zealand tax system. Such insights may be useful for policy makers to further investigate the potential benefits of introducing such a system.

### **7.3 Limitations and key assumptions**

In regard to the limitations and assumptions underlying the research, several issues must be identified. First, the research has not taken in to consideration the views and opinions of taxpayers and tax practitioners outside of Christchurch, with the exception of one interview which was conducted with a tax practitioner in Dunedin. In other words, the research is largely confined to the views and opinions of persons in only one city in New Zealand, as opposed to incorporating a nationwide approach, which may arguably limit the representativeness of the research findings. Further research would likely be required in order to confirm the consistency in the views and opinions of persons located in other areas of New Zealand. Second, it must be noted that due to practical reasons, this research has not incorporated the views of Inland Revenue. Therefore, any reference as to how the revenue authority may perceive the proposed reward system will be speculation only. The inclusion of tax practitioners in this research project is somewhat of an attempt to overcome this limitation, as these subjects were able to offer a certain degree of insight as to how Inland Revenue might perceive the proposed reward system. Third, the taxpayers who participated



in this research are, at least to the researcher's knowledge, largely compliant and could be classified as being 'good' taxpayers. As such, the research is limited to the extent that the views and opinions of taxpayers who have engaged in tax evasion or intentional non-compliance have not been sought. Such views and opinions would have been useful as a means of understanding how 'bad' taxpayers would perceive the potential implementation of a reward system, and how such a system would potentially influence their tax compliance behaviour. However, due to the sensitive nature of the topic of tax evasion, such taxpayers were not sought for the purposes of this research project. Finally, the sample size of SBOs was small, consisting of only two participants. However, as this research was of an exploratory nature, its aim was not to draw generalisable conclusions. Instead, the aim of the research was to gain an initial in-depth understanding of the views of the participants, which can lay the foundation for future research.

An assumption underlying this research is that the government and Inland Revenue have not already given consideration to the possibility of introducing a reward based scheme into the tax system, and have subsequently already deemed it inappropriate. This assumption is based on the fact that no public information has been released which would indicate that consideration has been given to the possibility of using rewards as a compliance strategy. Therefore, it is assumed that the government and revenue authority would at least be amenable to the potential implementation of such a system.

#### **7.4 Future research areas**

Several areas for future research can be outlined from this thesis. First, as identified in the previous subsection, a limitation of this research is that it has not included the views and opinions of taxpayers who have been intentionally non-compliant. Future research could seek to gain an understanding of this group of taxpayers' views as to how they would perceive the potential effectiveness of introducing rewards into the tax system. Furthermore, future research could expand the scope of the sample size to include participants from different cities in New Zealand, in order to provide greater representativeness to the research findings.

Similarly, the views and opinions of Inland Revenue have not been incorporated in this thesis. Further research could attempt to obtain input from Inland Revenue regarding how it views the potential for using rewards as a compliance strategy, and the potential difficulties and challenges it would face in implementing such an approach. Such research could attempt to discern whether the CIR possesses the authority under section 6A of the Tax Administration Act 1994 to implement a reward system, or whether legislative backing from the government would be required. Such research could also seek to obtain input from the government regarding this issue.

Finally, the findings in this thesis indicated that, in line with Prospect Theory, the use of a percentage rebate system could be an effective way of reducing taxpayers' willingness to take the risk of evading or avoiding their taxes. Future research could conduct experiments which test the impact that a percentage rebate has on the risk preferences of participants regarding their tax compliance behaviour, similar to those which have been conducted in previous tax compliance research investigating Prospect Theory's predictions. Such research could attempt to model the costs and benefits of utilising such a system.

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# Appendices

## Appendix 1: University of Canterbury Human Ethics Committee Approval Letter



HUMAN ETHICS COMMITTEE

Secretary, Lynda Griffioen  
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Ref: HEC 2014/78

13 August 2014

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Department of Accounting & Information Systems  
UNIVERSITY OF CANTERBURY

Dear Jonathan

The Human Ethics Committee advises that your research proposal "Rewarding taxpayers: a possible method to improve tax compliance in New Zealand" has been considered and approved.

Please note that this approval is subject to the incorporation of the amendments you have provided in your email of 13 August 2014.

Best wishes for your project.

Yours sincerely

A handwritten signature in black ink, appearing to read 'L. MacDonald'.

Lindsey MacDonald  
**Chair**  
*University of Canterbury Human Ethics Committee*

## **Appendix 2: Outline of the semi-structured interview questions**

### Interview questions for practitioners

- How effective do you believe the current deterrence approach is in regard to achieving tax compliance? For example, do you believe that the sole reliance on deterrence measures may reduce the intrinsic motivation of taxpayers to comply with their obligations, thereby inhibiting the effectiveness of such an approach?
- Do you believe there should be less focus on deterrence based approaches and more focus on positive approaches to encourage compliance? If yes, what type of positive approaches?
- How effective do you think the introduction of a reward system would be in regard to improving tax compliance? For example, could the use of rewards act as a motivating factor for non-compliant taxpayers to become compliant? Could the use of rewards for compliance act as a means to reduce the incentive of taxpayers, who are aware of the relatively low likelihood of being audited, to engage in tax noncompliance (e.g. tax avoidance or tax evasion)?
- Is there a risk that the lack of acknowledgment for compliant taxpayers could increase the likelihood of them becoming non-compliant in the future? If yes, could the provision of rewards help to maintain their compliance in the future?
- From your experience in dealing with clients, how do you think taxpayers would respond to a rewards system?
- Do you believe that there is a risk of some taxpayers evading tax in the period following a tax audit in which the taxpayer was found to be compliant? If yes, do you believe the provision of a reward would reduce this risk?
- What are the key features you believe should be included in the design of a reward system? For example, what type of rewards should apply, and how should they be administered?
- How feasible is the implementation of a reward system?
- How amenable do you believe Inland Revenue would be to the possibility of introducing a reward system, and what are some difficulties which would need to be overcome?

### Interview questions for small business owners

- How effective do you believe the current deterrence approach is in regard to achieving tax compliance? For example, do you believe that the sole reliance on deterrence measures may reduce the intrinsic motivation of taxpayers to comply with their obligations, thereby inhibiting the effectiveness of such an approach?
- Do you believe there should be less focus on deterrence based approaches and more focus on positive approaches to encourage compliance? If yes, what type of positive approaches?
- How effective do you think the introduction of a reward system would be in regard to improving tax compliance? For example, could the use of rewards act as a motivating factor for non-compliant taxpayers to become compliant? Could the use of rewards for compliance act as a means to reduce the incentive of taxpayers, who are aware of the relatively low likelihood of being audited, to engage in tax noncompliance (e.g. tax avoidance or tax evasion)?
- Would the use of a rewards system motivate you personally to comply?
- Is there a risk that the lack of acknowledgment for compliant taxpayers could increase the likelihood of them becoming non-compliant in the future? If yes, could the provision of rewards help to maintain their compliance in the future?
- What type of rewards would motivate taxpayers the most? For example, would financial rewards, such as tax discounts, lump sum payments, or lottery winnings be preferred to non-financial rewards, such as improved and cheaper access to public services?
- Is there a risk that financial rewards may actually reduce compliant taxpayers' motivation to continue being compliant?
- Do you believe that there is a risk of some taxpayers evading tax in the period following a tax audit in which the taxpayer was found to be compliant? If yes, do you believe the provision of a reward would reduce this risk?
- Is there a risk that PAYE earners may perceive the introduction of a reward system as being unfair? If yes, how do you believe Inland Revenue could address this issue?