eJournal of Tax

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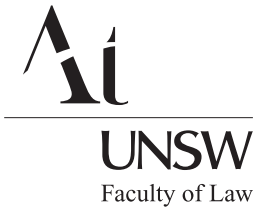
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eJournal of Tax Research (2008) vol. 6, no. 1, pp. 5-22

Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation

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Abstract

Taxation is a fundamental part of everyday life and it comes as no surprise that it attracts great interest from policymakers, academics, business and the wider community both in Australia and overseas. However, those interested in tax research come from very diverse discipline backgrounds including law, accounting, economics, political science, psychology and philosophy. The prior learning of many tax researchers does tend to be in the study and application of the law and typically they have little training in or exposure to the detail of the theory and practice of research design. This is a limitation for both

represent philosophical approaches that lie in the middle ground. A critical realist seeks to answer both the 'how' and 'why' questions. In terms of the underlying ontology, a critical realist sees greater complexity in the relationships under study, going beyond the depths of empirical realism. Researchers who subscribe to this paradigm would typically allow the research design to be driven by what was wanted to be learnt, rather than to be pre-ordained.[11] A pragmatist has a similar approach and freely chooses the methods, techniques and procedures that best meet the needs and

about change - after all, the rules are not set in concrete - it can be a perilous pathway if the researcher has not based the chosen research methodology on a solid and defensible foundation.

Irrespective of whether or not the researcher is embarking on a ground-breaking

seeking to address them until personally satisfied and confident in the appropriateness of the chosen methodology.

Apart from issues of appropriateness, it is fundamental that there is clear alignment between research problem and research design if the research is to have theoretical rigour.[17] It is advisable not to lock in prematurely to a particular design, particularly without considering the alternatives. To achieve the best alignment, it may mean that the researcher needs to develop new skills or else revise the purpose of the research and/or the research questions at the outset. Are they achievable? Time spent at the outset revising and refining all the design details is well worth the investment and can save a lot of headaches down the track. One important design detail is (are) the strategy(ies) of inquiry to be employed and

referred to as the demographics) findings in the tax compliance literature are noticeably mixed and on this basis it is reasonable to conclude that the demographics are mediating variables rather than the 'cause' of a particular type of behaviour. It may be possible to control the independent variable (for example, using a fixed tax rate or set tax brackets) to look more closely at the influence of the mediating variables. An alternate view is that it is difficult to control variables such as taxpayers' attitudes and this may be an inherent design weakness in this methodology.

Selecting populations and then getting access to their data are typically problematic in tax research. How does one identify the population of tax evaders if they are to be surveyed so as to understand what drives their behaviour or the extent of their evasion? Whilst the tax authority may have knowledge of the level of tax evasion, by its very nature it will be imperfect, and regardless, access to this type of data by external researchers is unlikely. What happens in practice in experimental tax research is that university students are typically used as subjects. This in itself may be an inherent weakness and a valid reason for interpreting and generalising experimental results with caution. However, Alm and Jacobson[18]

In the social sciences generally there is the danger to over-interpret, to ignore the other uncontrolled variables that occur in experiments. Stouffer[26] uses an example of comparing the attitudes of two groups of men from the armed services at the same point in time. One group is from the infantry and the other from the air corps. He points out that we cannot know assuredly how much of the difference in attitudes between the two groups can be attributed to the experience in the given branch of service and how much is a function of the attributes of the personnel. True, we can try to rule out various possibilities by matching, comparing men from the two groups on the basis of their age and education for example. But there is all too often a wide-open gate through which other uncontrolled variables can march. 'One lone study, however well designed, can be a very dangerous thing if it exploited beyond its immediate implications.'[27] Further, Stouffer expresses a 'central brooding hope that we will have the modesty to recognise the difference between a promising idea and proof.'[28] These cautionary comments are of course equally applicable to both experimental and survey designs.

Surveys are generally described as being structured, semi-structured or unstructured and can be conducted via various means including electronic, telephone, in person or by mail. Structured or semi-structured surveys are generally aligned with a quantitative methodology and they are the focus of the discussion in this part whilst unstructured surveys are discussed in more detail in the following part. A structured or semi-structured survey can be used for collecting both empirical and non-empirical data (usually by means of open-ended questions). It can be a useful tool for testing hypotheses and making statistical generalisations to broader populations. However, as a strategy of inquiry, a survey does have inherent weaknesses. Typically there is much attention given to the sample population, its size, sampling rate and means of selection, and to the issues of bias, response rates (i.e. the reliability of the findings) and external validity (i.e. ability to generalise more broadly) as reflections of the objectivity of the research.[29]

Possibly a more critical issue in survey design is not its objectivity, but the design of the instrument itself. Surveys presume that all the questions and possible answers are known prior to the questions being asked.[30] Further, as Axinn and Pearce note, whilst a key feature of surveys is standardized questions, respondents' interpretation of the questions is not standardised.[31] Further, they assert that this high level of structure makes it difficult to use a survey to uncover completely new hypotheses.

There are clearly means by which the design of survey instruments can be improved. Whilst pilot and cognitive laboratory testing can be used to some extent to identify and correct misunderstandings,[32] the importance of developing a survey instrument that has clear, unambiguous and useful questions is a critical first step towards improving

[26] See note 22, p.357.
[27] See note 22, p.358.
[28] See note 22, p.361.
[29] For more detailed discussion on these issues and the conduct of surveys see for example Fowler, F., 1993, S*urvey Research Methods*, 2nd edn, Sage, Thousand Oaks.
[30] See note 17, p.57.
[31] See note 13, p.4.
[32] See for example, McKerchar, M., 2003, *The Impact of Complexity Upon Tax Compliance: A Study of Australian Personal Taxpayers"*, Australian Tax Research Foundation, Sydney.

their text is generally written in the field of health, it is primarily social research and thereby of relevance to taxation.

Within the qualitative methodology, a number of theoretical frameworks exist including ethnography, case study, narrative, phenomenology and grounded theory and each of these (and their associated strategies of inquiry) is discussed herein in more detail.[37] Other theoretical frameworks do exist, such as symbolic interactionism, feminism, postmodernism and hermeneutics, and no doubt more will emerge over time. Given the transitional state of qualitative methodology, Liamputtong and Ezzy make the important point that a qualitative researcher should not assume that the particular theory and research method used in their project will be understood by all other qualitative researchers. That is, if a piece of research is to be meaningfully understood and assessed by other qualitative researchers, the researcher must explicitly state the theoretical tradition and methodological criteria employed.[38] This point is aptly illustrated by the use of 'case study' in the literature as both a theoretical framework and also as a strategy of inquiry in the tradition of Yin.[39]

An ethnography is the study of an intact cultural group in a natural setting over a prolonged period of time, primarily by collecting observation data, but can also include data collected by focus groups or in-depth interviews. An ethnography attempts to interpret and present its findings from a cultural perspective and is more so associated with anthropological research than with social research. Given its conditions of conduct, its application to tax research is limited.[40]

A case study framework explores in depth a program, an event, or one or more individuals. Creswell describes a case study as being bound by time and activity, with researchers collecting detailed information using a variety of data collections procedures over a sustained period of time.[41] An example of this type of framework being successfully used in the context of tax research in Australia is the study by Wallschutzky and Gibson on small business compliance costs wherein participating business owners diarised their compliance activities over a twelve month period and underwent in-depth interviews on a regular basis.[42]

Creswell describes narrative research as a theoretical framework in which the researcher studies the lives of individuals and asks one or more of them to provide

down the text into discrete parts or collecting information on observations at interview for subsequent analysis.[44]

appropriate in tax research, such as examining subjects' tax returns or record keeping procedures, or the level of stress they exhibit in solving a tax problem.[51]

Within this methodology, in-depth interviews can be semi-structured or unstructured and the interviewer can be passive, empathetic, probe or even provocative. It is essential that the interviewer be skilled and well able to build rapport with interviewees. In practice, this strategy is normally conducted by the individual researcher rather than by an assistant. Questions are not normally constructed or standardised in advance (as in the structured survey of the positivist paradigm), but instead the research has a theme list as a guide to establish the topic at interview. The interview is then shaped according to the

higher the value of the study so the issue is one that warrants further attention. Hence the temptation to overgeneralise and to make conclusions that cannot be substantiated.

Sarantakos does discuss strategies by which generalisability of qualitative findings can be improved, such as conducting multi-site research.[60] Yin's repeat application of a case study protocol and the study of consistency in emerging patterns is another means by which greater generalisability of findings may be achieved.[61] Drawing conclusions

interactionism, structuralism, postmodernism and methodological anarchism (in which there are no valid methodological rules, hence 'anything goes').[73]

While each strategy of inquiry or typology can be applied in its own right, there is increasing evidence of researchers drawing from more than one paradigm, or using more than one strategy of inquiry from within the same methodology. Each strategy has its strengths and weaknesses and the drive for mixed method research (i.e. using more than one strategy of inquiry to collect data) is to use one strategy to either inform, validate or compensate for the weaknesses of another. In terms of both research design and conduct, mixed method can offer real scope for researchers who are driven by the purpose of the question and not necessarily bound by any one paradigm. It can help fill in some of the gaps, but may not necessarily be superior than a single strategy of inquiry if it is not well designed and conducted.

Multiple methods of data collection require multiple methods of data analysis, and Creswell explains this makes it more important than ever that there is a rationale for the overall design that will purposively and systematically guide the processes.[74] There are key decisions to be made about the order of implementation of the strategies, the priority given to the various strategies, and the point of intersection of the strategies.

The implementation of strategies of inquiry may be sequential or concurrent and serve different purposes (such as to explore, to explain or to corroborate). Collecting data sequentially allows the findings from one strategy to inform another. For example, a focus group could be used to discover the key concerns of tax agents and this could then be used to develop a survey to be conducted with the total population of tax agents so that statistical generalisations could be made (i.e. qualitative methodology used to inform the design of a quantitative methodology). Further, in-depth interviews

of a problem) can be subsequently compared thereby perhaps achieving a triangulation of findings and improving the validity of the research.

It follows that different strategies may well receive different emphasis within the research, depending on their purpose in the overall design. This is not problematic provided that there is a sound rationale. Similarly, there is a point of intersection of data from the strategies. This can be at the collection phase (such as a survey that includes open-ended questions, or observational and textual data collected at interviews), or at the analysis stage (such as in the thematic approaches of matrix analysis or case study protocols), or in the forming of conclusions and recommendations. Creswell does explain that there does need to be a binding theoretical perspective to mixed method research, whether it be a participatory lens (e.g. small business taxpayer; private binding ruling applicants) or the advocacy lens (e.g. reform of anti-avoidance legislation), as this theoretical perspective helps guide the framework.[76] That is, the possible combinations for mixed method research are almost unlimited.

The key challenge in mixed method design is to develop and conduct the best and most appropriate combination of strategies. In theory it does offer potential to shed deeper light on perplexing problems, in particular, on the nature of causal relationships, but it still may not necessarily provide all the answers given the complexities of human behaviour.[77]

7. CONCLUSIONS

Throughout this paper there are a number of consistent messages. The overarching message is that there are many approaches to research and no one methodology is necessarily better than another. Each methodology and each strategy of inquiry has its strengths and weaknesses. However, different methodologies and different strategies are more suited to answering different types of research problems. Further, researchers will have personal preferences for different approaches depending on their ontology and epistemology, whether implicit or explicit.

A researcher must adopt a strong conceptual framework for a piece of work and be prepared to justify that framework to others. The process of justification is more straightforward where the research adopts a philosophical approach that is readily understood by others, and a known strategy of inquiry that fits under the paradigm umbrella. That is, it is an easier pathway if the research can be placed in an existing paradigm and to do this the researcher needs to be familiar with the relevant literature. This does not mean that a researcher cannot develop a new systematic and rigorous framework for the design and conduct of re

eJournal of Tax Research (2008) vol. 6, no. 1, pp. 23-44

Avoidance and *abus de droit*: The European Approach in Tax Law

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Abstract
Defining tax avoidance has been always a nearly impossible quest for tax lawyers. In Continental Europe, however, it could be said that the notion of "avoidance" is strongly embedded to the concept of "abuse" of a right, being an "abuse", according to the Roman law tradition, the exercise of a right inconsistently with the general principles of correctness, good faith or even with the basic rules of ethics. Therefore the definition of avoidance is not purely legal, but it depends also on other disciplines which influence it. In EU law qualifying avoidance is even more complex as the law of the Union is nearly deprived of any

between the legal form of the commercial operations and the substance of the aims pursued by the taxpayers.

The purpose of this contribution is therefore less far-reaching. The basic assumptions are that (1) the problems avoidance raises are not limited to tax law and (2) it is necessary to analyse avoidance of law in order to understand better the features and the characteristics of it when dealing with tax law. Another assumption is that (3) the EU tax harmonisation via regulations, directives, soft law and ECJ case law progressively compels the legal systems of the different member States to converge on specific characteristics necessarily found in all the tax planning schemes to be qualified as avoidant, even if these conditions might change from tax to tax. However this final result will be difficult to achieve as the fight against tax avoidance is intrinsically national in its roots, depending as it does on factors that do not necessarily belong to the tax systems; coming back in this way to (1).

Last but not least, the linguistic differences[3] across Europe also play an important role in the distinction between evasion, avoidance and "abuse of law".

Some of these barriers are easy to overcome, in so far as they depend only on the language and not on the meaning of the concepts used by the legislator or by the judges. To this extent, it is easy to consider the English "tax avoidance" as the French *évasion fiscale*, the German *Steuerumgehung* or the Italian *Elusione fiscale*. On the other hand, "tax evasion" can be compared to the French *fraude fiscale*, the German *Steuerhinterziehung* and the Italian *Evasione fiscale*, for instance.[4]

Some other differences, however, are of a theoretical nature, although strongly correlated to the different languages used: the concept of "abuse of law" is one of these.

In many cases, especially on the continent, the notion of "abuse" is used instead of that of "avoidance of a legal provision". In this sense the abuse of law could be

Some authors noted that a line should be drawn between avoidance considered as the outcome of loopholes in statutes and avoidance that is the result of different interpretations of statutory law or common law.

While the difference is theoretically correct, it must be remembered that this distinction is in any case based on interpretation of the rule of law, and that understanding the rule is an *a priori* condition to ascertain any loopholes or gaps in the system.

This requirement was well known in the continental (it could be said Roman) experience since the Middle Ages, when the debates on the notion of "abuse" of law and "avoidance" of statutory law arose for the first time, even if they did not immediately involve tax issues.

The historical approach is a good starting point even for current analysis: all in all, the

However, there's enough to understand the Roman reasoning in respect to interpretation, avoidance and abuse of law. That approach constituted the base on which the medieval commentators in Italy (and first of anywhere in the world, in Bologna) built up medieval law in the form of comments (*glossa*) to the *Corpus Iuris* in the 12th century.

Basically, all the doubtful cases submitted to the lawyers were answered according to one of two rules: "*in dubio contra fiscum*" or "*in dubio pro fisco*". According to the first one, all the cases where tax avoidance

The consequence, as is mentioned above, was that the problem of avoidance was solved in different ways, making the substance over form (or vice versa) prevail, depending (also) on the source of the law to be applied.

This basic rule suffered some exceptions, anyway. Perhaps the most relevant one is given by the same Bartolus (from Saxoferrato) in one of his *responses* (legal advices).

executio non habet iniuriam,"[18] which is not completely new to the UK legal tradition, where "*… if it was a lawful act, however ill the motive might be, he had a right to do it …*".[19]

The situation was clear, for instance, in the case of slavery. The owner of a slave had any right over him (or better, *it*, according to the Roman law) including the right to kill him at will (*ius vitae necisque*): a right that was accorded to the *pater familias* over all his family in the early stage of Roman law.

After centuries, however, during the later Empire era, this absolute right was somehow clarified without being explicitly limited. In other words, the property right had to be exercised over the slave according to some guidelines, so that the *pater familias* still had an absolute right "*… sed dominorum interest ne auxilium contra saevitiam vel famem vel intolerabilem iniuriam denegetur his qui iuste deprecantur*";[20] soon after the principle was extended by Gaius in the rule "*… male enim nostro iure uti non debemus …*" or also "*… expedit enim rei publicae ne qui re sua male utatur …*".

The turning point of the Roman legal approach towards the abuse is evident.

For the first time the Emperor clearly ruled that the exercise of an absolute right must meet specific conditions. The most important aspect of the *revirement* relies on the fact that neither Antoninus Pius nor Gaius seem to reduce the content of the property right, which still remains absolute, but rather they appear to introduce external and objective limits to its exercise, because a public interest may require it. This aspect is particularly evident in the passage quoted by the *Institutiones*, where the author clearly refers to the "common interest" as a limit to the improper exercise of rights. The step from "improper exercise" to "abuse" of right is particularly short.

It could be interesting to question what might have been the reason for such a drastic change (which, although adopted, at the same time respected the traditional content of the right).

Italian authors who faced this issue argued that a reason might have been the advent of the Christian religion[21] or, in the specific circumstances, the personality of the Emperor, who was particularly keen on these issues. In a Christian perspective, slavery was more than inconceivable and any legal rules that allowed it were unacceptable.

[18] Dig. 47, 10, 13, 1. "The one who exercises his own rights never damages others: indeed the exercise of a right is never an offence". To a certain extent, the step-transaction doctrine could be seen as grounded on this basic assumption: where every step of a more complex transaction is taken according to the law of contracts, no abuse is conceivable and therefore no avoidance occurs.

[19] Lord Halsbury in *Bradford v. Pickles* [1895 A.C. 587].

[20] Inst. 1, 8, 2; Dig. 1, 6, 2 "It is in the same interest of the owner not to refuse help in case a

So here began a sort of war of attrition between two sets of rules: legal on one side, moral or religious on the other, with the la

today take the place of what once was the morality of some religion or the general principles of the *ius commune*.

This historical journey has eventually come to an end.

It was not useless. The most important result of this brief research is that in this perspective, the notion of avoidance is not absolute but might vary through the centuries, and, most important of all, according to the legal framework of tax law (but also of constitutional and civil law), it has to be implemented within.

In other words, it could change from State to State.

The Rule of reason, therefore, should succeed where morality or religious or philosophical obligation failed in the past.

6. RULES AND BOUNDARIES: REASONABLENESS AND FUNDAMENTAL FREEDOMS

The fundamental freedoms enshrined in the EU Treaty are not different from the rights analyzed above, starting with Roman law. They are not introduced mainly for tax law purposes but have a relevant impact in this context.

When a national taxpayer adopts an approach to the national tax rule that leans towards tax avoidance, he could try and justify his behaviour under the aegis of a fundamental freedom.

It could be said, therefore, that the abuses of the Treaty rights (freedom of movement of the citizens of the Union, the free movement of goods, the free movement of workers, the right of establishment, the freedom to provide services and the free movement of capital[33]) raise the same problem discussed above while analysing the notion of abuse in different fields.

The solution differs: here it is the rule of reason[34] that distinguishes between proper exercise of the right and abuse (and therefore improper avoidance of tax).[35]

According to this approach, the national anti-avoidance provisions must pass several tests in order to qualify as consistent with EU law.

The first condition is that the specific circumstances of the case might fall into the exercise of one of the fundamental freedoms mentioned above, as far as the conflict (between national anti-avoidance rules and EU law) arises only where the second is theoretically applicable[36].

In this respect, it was noted that the real purpose of the taxpayer (namely the subjective approach to avoidance) is now absolutely irrelevant.[37] The ECJ always

At first glance, a provision like this could impair the freedom of establishment[40] because a resident company could be prevented from establishing a subsidiary abroad if this decision could then immediately and directly increase its taxable base.

The UK provision, considered alone, is reasonable because it is aimed at preventing the foreign allocation of profit where this decision is inspired mainly by tax

In tax cases, such as *Cadbury*, the distinction is not so straightforward, and the artificial nature of the subsidiary could constitute a reasonable limit to the fundamental freedoms of the Treaty.

Of course *Centros* and *Cadbury* have a significant common ground. In both cases the court ruled that the nationals of any Member States cannot use EU law to "improperly circumvent"[43] the national legislation or, in another point of the decision, that they are not allowed to "improperly or fraudulently"[44]

Freedom of establishment means that (1) the Treaty protects not every kind of business, but only those that are aimed at actually pursuing an economic goal through a fixed establishment for an indefinite period. Moreover, (2) the business must underpin a genuine economic activity: this means that it must reflect, as the Court says, a "real economic activity".

In other words, that there has been a *detournément*, that is, a deviation, of the *ratio* of the rule in question. The taxpayer invoked the freedom of establishment, but the operation he set out is not intended to establish anything in the other Member State.[57]

In this way the Court sought to strike a balance between the two abuses underlined before: on one hand, the abuse of the taxpayer exercising his freedoms and rights in a improper way (inconsistent with the duty to pay taxes and the solidarity principle that are introduced in almost every European Constitution, if any, or fundamental law of the State) and on the other hand of the State introducing an anti-tax avoidance that could constitute an overkill, in some cases, of the business operation.

A clear example of this were the British CFC regulations: unable to distinguish true tax avoidance from the exercise of the freedom of establishment.

The Court tried to reach the best solution available, considering that the playing field was all but level, in the circumstances of the case.

In other words, tax avoidance is perceived differently (and answered differently) in light of the general principle of any tax system[58]. If, like in many Member States, a duty of economic solidarity is present, then a certain answer is possible; if, as in EU law, this principle is not present (the Treaty is not a Constitution and arguably it will never become one), the Court can't but use overarching rules of reason in a desperate attempt to find an acceptable solution for all the parties involved.

This answer is, however, valid not for all EU law, but only for those aspects that are not harmonised and where the tax avoidance and the abuse of law can be tested only in the light of the fundamental freedoms enshrined in the Treaty.

Where the EU legislation is more detailed and contains principles and rules applicable to all the Member States it is possible for the Court to implement a notion of abuse and of tax avoidance that is more compatible with the system it has to work within, without any need to refer to anything but the rule of reason.

In the case of the VAT, the Court has a complete and detailed legislation built upon several directives, later consolidated into one text[59], and a principle, the neutrality of the tax, that must necessarily inspire the different legislations of the Member States without entering into any conflict with other issues at a constitutional level (such as solidarity or the ability to pay taxes…).

The notion of abuse (and of avoidance) shall, therefore, be flavoured differently.

Member State to demonstrate something more of the subjective element; that's why it could be argued that it is the burden of the Tax Administration to demonstrate that the business operation is not sound at all.

[56] See *Cadbury*, § 64.

[57] See *Cadbury*, § 64.

[58] P. Harris, *cit.*, p. 136.

[59] Directive 2006/112/EC.

9. ABUSING NEUTRALITY? PLAYING WITH THE VAT DEDUCTION IN *HALIFAX*

The most striking difference between *Cadbury* and *Halifax*[60] is clearly summarised by the court in §§ 57 and 62 of the latter judgement.

According to the first paragraph of the sentence, the notion of abuse (if any) in the VAT mechanism is not qualified by any subjective element.[61] In other words, the VAT application must be necessarily inspired by two general principles, facility in the application and certainty et(tac 6X3Tw 0 -ica5 0 0)-3(-188.139es, facili)6(ty i47 -1.14j r.00o)5(c244 0)]T the

assessment of the operation it is possible to say that the essential (not only the main) reason for the existence of the specific operation is to obtain a tax advantage.

All in all, the approach seems to recall the one analysed before, where the Court stressed the importance of the effective exercise of a fundamental right or freedom enshrined in the Treaty (freedom of establishment, of movement of capital, etc., …), but here the soundness of the business is the condition to be met and the neutrality of the tax the feature to be preserved as far as possible.

10. CONCLUDING REMARKS: WHERE DO WE GO FROM HERE?

The first part of this brief research began with a quotation from an author[70] indicating that the issue relative to tax evasion and, first of all, avoidance, is an eternal one. After ten years the same author implicitly confirmed his opinion some months ago at another academic meeting[71]. Moreover, other academics recently presented a different
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of a non-legal nature: of course this conflict depends on the national background and on the strength (real or perceived) of the non-legal rules[74].

When the ECJ tries to harmonise the different tax systems as far as this is allowed by the Treaty, it progressively has to solve the same problems faced by the different national States across the centuries. However, while in every Member State the abuse is always a judgement of comparison between an individual right (not necessarily of the taxpayer) and other principles enshrined in the legal system (ability to pay, solidarity, etc., …), in Europe these principles are missing, in so far as something more of a Treaty between States will not be implemented.

This is helpful towards explaining why the Court, in some cases, seems to wander in obscurity[75], recalling concepts such as "genuine business" or even "non-artificial business" that although sufficient to solve the problem from a theoretical point of view are of little use from a practical point of view. The practitioners need something more,

eJournal of Tax Research (2008) vol. 6, no. 1, pp. 45-66

The Economic Benefits of the Use of Guanxi and Business Networks in a Jurisdiction with Strong Formal Institutions: Minimisation of Taxation

Nolan Cormac Sharkey [*]

Abstract

Why rely on informal institutions when conducting business? Because it leads to a greater economic return

The current academic status quo on the use of guanxi and business networks by Chinese entrepreneurs in both China, South East Asia and beyond is that it is a response to the weak formal institutional environment[1]. It is argued that weak institutional environments create an economic rationale for the use of guanxi and business networks. From this base, it is further asserted that the use of guanxi and business networks will reduce and disappear with the strengthening of formal institutions in China and other jurisdictions. This paper will challenge this latter assertion by arguing that there are strong economic benefits to those that are able to operate through guanxi and business networks in a jurisdiction with strong formal institutions. The primary benefit that will be examined is the reduction or elimination of business taxation which is a very significant issue in most jurisdictions with strong institutional environments. This paper will demonstrate how guanxi and business networks can be used to avoid taxation in the strong formal institutional environment such as that represented by Australia.

THE USE OF GUANXI IN BUSINESS

The discussion of the use of networks and guanxi in Chinese business is not free from controversy. Most scholars do not question its existence (at least in part). That is, there is clear evidence to show the instrumental and extensive use of strong reciprocal informally constituted inter-personal bonds (guanxi) by Chinese entrepreneurs in the conduct of business in China and beyond. It has also been shown that people can be bound by these bonds into networks that are used to facilitate economic activity (guanxi networks). Thus the extensive use of guanxi and networks can be viewed as a Chinese business modality.

There is, however, critical debate as to the causes, rationale and therefore future of this business modality. Early work attributed the phenomenon to the fact that Chinese business people's economic activities were socially embedded[2] and Chinese social

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[1] Chan, K. B. (2002). Preface. Chinese Entrepreneurship and Asian Business Networks. T. Menkhoff, Solvay. London, RoutledgCurzon**:** xii - xiv.

[2] Fei, X. (1992). From the Soil: The Foundations of Chinese Society. Berkley, University of California Press.

values dictated that business be pursued through guanxi and networks. The behaviour was therefore not pursued with a rational objective but was simply the result of social embeddedness.

A conclusion that may be drawn from this is that network business activity leads to economic inefficiency. The argument here is quite clear. That is, that the most efficient economy is one where market forces and prices determine economic decisions and therefore allocation. Given that in the case of Chinese entrepreneurs, it is being asserted that economic decisions are being highly influenced by inter-personal relationships, economic inefficiency must accordingly result. Therefore, as long as Chinese business people hold "Chinese" social

of economic success[12]. In this case, however, the lack of opportunity has been caused by the inability of these people to sustain themselves through primary production rather than formal exclusion.

Trade and business activity involve shifts of wealth between individuals and groups. It is therefore a general prerequisite for the existence of such activities at any meaningful scale that institutions are available to protect rights to wealth and reinforce adjustments to them. At the very least formalized property rights should exist. Thus in a developed capitalist state property rights are upheld by the state and courts while trade is reinforced by contracts and the legal institutions that support these. Commerce is therefore supported by formal state institutions.

As has been shown above, formal institutional support has often not been available to Chinese entrepreneurs in China and the region. The answer as to how Chinese entrepreneurs have been able to engage in extensive commercial activities without strong formal institutional support is that institutional support has been obtained through informal or popular institutions[13]. Chinese entrepreneurs have relied upon the use of trust obtained through appropriate interpersonal relationships (guanxi) and networks to provide the institutional support for their business activities. The substitutability of these informal institutions for formal institutions is borne out by the general success of these entrepreneurs in not only getting business done but in often prospering.

The rationality of the use of guanxi and business networks in undeveloped or exclusionary formal institutional environments is therefore clear. Chinese business methods are highly suited to prospering in these environments due to their lack of reliance upon formal institutions to engage in economic activity. Chinese entrepreneurs have therefore been able to succeed without legal support and with extremely constrictive bureaucratic impediments.

The argument that Chinese business modalities are not the result of social embeddedness but a rational response to a particular environment is therefore a strong one attested to by historical circumstance. Further credence is added to the argument by studies that show that in China, South East Asia and other areas, when the formal institutional environment has provided entrepreneurs with the appropriate support, they have often made use of the formal institutions instead of informal institutions[14]. There are studies that show that large firms in China seek employees through the market and not through connections. In the case of Singapore[15], Hong Kong, Taiwan

[12] See generally: Gates, H. (1996). ChinaI2Twithout l 5.6rcJ03s0.000948(,)39 1
are n1MBT1eh,00948(,)38 0 7[(i)10(n)-28 p.15 Td[(Tj-0.0013 Tc 0.)-7(42 0 Eout5(ee g)-8(e-2(r)-5)63a0.)-of inM8(,)36 T009 Tc 9 15htr

and western countries, it may be argued that Chinese entrepreneurs base their decisions on market factors due to the strong institutional support[16]. Finally, reinforcing the argument in the other direction, there are studies that show that certain non-Chinese groups also make use of similar informal institutions when faced with a lack of formal institutional support[17].

Based on the above, it is becoming increasingly common to assert that Chinese business modalities that make use of networks and guanxi are not the product of Chinese culture and society at all. Rather they are simply a rational response to the formal institutional environment. The conclusion that is drawn from this is that as the formal institutional environment in China and the region improves, the use of informal institutions will disappear as reliance upon formal institutions replaces them[18]. Thus the demand for guanxi and network institutions disappears as formal institutions appear. This, after all, is why informal institutions are not a feature of modern developed economies.

There is little doubt that the use of guanxi and networks is a rational response to poor formal institutions. However, studies that see it as nothing more than such a response do not question whether there is a demand for these informal institutions even when there are fully developed formal institutions to support business. If such a demand can be shown to exist then it is unlikely that the use of guanxi and business networks will simply disappear with the strengthening of formal institutions. Rather it is likely tter Tcuc0r(d)7(nem)6(p8n)

formal institutional environments due to the lack of institutional support. This fact being something which is too often ignored by those that seek to show that Chinese culture is irrelevant by demonstrating that some other group uses similar informal institutions to overcome problematic formal institutions.

The fact that Chinese culture and society does not have a monopoly on guanxi/ network type institutions does not mean that these very institutions are not a particular characteristic of Chinese society. It simply means that some other societies or cultures have similar characteristics but not all of them and seemingly not modern western secular cultures with Christian roots.

This paper seeks to add strength to the type of argument put forward by Yang that the

NON-MARKET BASED TRANSACTIONS AND ARBITRAGE

Non-market based transactions are integral to tax arbitrage through planning and avoidance. They can be used to shift income from one taxpayer to another who is granted differential treatment. They can also be used to transfer value from one situation to another. Finally, non-market based transactions can be used to alter the actual nature of a taxpayer or situation.

Many well known tax arbitrage strategies ranging from income splitting by professionals and small business to international transfer pricing by multinationals rest upon essentially simple non-market based transactions that shift income from one taxpayer to another. It may be a self-employed doctor paying a 'wage' to their spouse in the case of the former or the payment of royalties and management fees to offshore associates in the latter. In terms of altering

focus on identifying tax evasion and collecting any available information that will allow the law to operate correctly.

IDENTIFYING NON-MARKET TRANSACTIONS – THE 'ASSOCIATE' CONNECTION

A key difficulty that arises in relation to nullifying or adjusting non-market transactions is identifying them. Without such identification, adjustment is impossible. Once they are positively identified, adjustment or nullification of non-market transactions may be readily achieved. In carrying out the task of identifying non-market transactions both the tax law and administration make use of the separate concept of an associate taxpayer or related party (hereafter associate).

The concept of the associate is essential to the identification of non-market transactions and arrangements. To this point the concept of a non-market or non-arm's length transaction is often used synonymously with the concept of an associate or related party transaction. The concepts are, however, quite distinct. A non-market or non-arm's length transaction is a transaction that is not priced through market interactions such as bargaining. An associate or related party transaction, on the other hand, is a transaction between taxpayers that are related to one another. The link between the two concepts is that it is presumed that non-market transactions will only occur between associates.

If the presumption that association is a prerequisite to non-market transactions holds true, then identification of the latter can commence with the identification of the former. This makes the task much simpler as associates will generally be far more readily identifiable than non-market transactions due to the fact that characterizing entities and persons is easier th

WHO ARE ASSOCIATES?

In considering the link between associates and non-market transactions, it is instructive to consider which taxpayers are usually considered to be associates. Section 318 of the Australian *Income Tax Assessment Act* (1936) (ITAA 1936) contains the most extensive definition of associate used in Australian income tax law. It is used in a number of key areas along with other less extensive definitions for certain purposes[21]. It has been reproduced in Appendix A along with an extract from s995-1 (*Income Tax Assessment Act* 1997) that defines what a relative is. The definition of a relative is essential to the definition of an associate as a relative will be an associate. Relatives are also "related entitie

The success of legal and administrative measures that attempt to contain tax arbitrage through non-market transactions is brought about through the scrutiny and adjustment of interactions between associated taxpayers. Such scrutiny and adjustment is feasible as associated taxpayers are readily defined and identifiable as being relatives and entities with defined formal legal relationships that are recorded. The underpinning logic of this mechanism is that taxpayers will only engage in non-market transactions and arrangements with relatives or entities with the type of recorded formal relationship specified above.

ASSOCIATES AND THE HIDING OF TRANSACTIONS, ASSETS AND ACTIVITIES

As with arbitrage through planning and avoidance, the process of identifying wealth and signs of business activity in countering tax evasion needs to pay particular attention to the associates of the taxpayer

The need for formal institutional support is the driving factor behind the creation and availability of most documents, registers, records, accounts and contracts that record business activity, transactions and assets. These records are however then available to tax administrators and constitute their primary source of information to work with. This is clearly an undesirable outcome for a would-be tax evader. Returning to the parent above, the recording of the loan may lead to income tax on interest and stamp duty on contracts. It would also highlight the activity of the child for which the money is being used.

There is therefore a clear benefit and rationale for dealing with associates and relying on informal institutions for protection. If you sell to associates you may not need to issue receipts, if you buy from associates you may not need contracts and invoices, if you use associates as sources of credit and equity, you may not need to produce detailed and accurate financial statements or record ownership through a corporate register or partnership contract. Without these various records, the ability of the tax administration to determine the extent of a taxpayer's business activities is seriously hindered.

ASSOCIATE SCOPE

The previous sections of this paper have made several key assertions. The first is that the ability to successfully reduce or eliminate tax burdens through either arbitrage or evasion is highly valuable due to the significance of the legal tax burden in relation to private business in a developed economy.

The second key assertion is that the existence, extent and diversity of a taxpayer's associates have a direct bearing on the taxpayer's ability to successfully reduce or eliminate their income tax burden. This is the case regardless of whether this reduction or elimination is done through tax planning, tax avoidance or tax evasion. A person with a small group of associates may be able to divert a minor amount of income to take advantage of lower tax rates but is unlikely to be able to run their business through associate connections. The pool of associates would simply be inadequate to seek major debt or equity or locate supplies or custom.

The third key assertion is that the limiting of associates to specific close relatives such as those defined in s995-1 of Australia's Income Tax Act (1997) and entities with a formal specified relationship as covered in s318 (ITAA 1936) allows income tax law and administration to counter arbitrage and evasion by providing mechanisms to scrutinise, adjust or nullify interactions between what is a relatively discrete group of taxpayers. At the very least, these definitions mean that when deciding whether the interactions between two taxpayers should be investigated, the administration will be

defined or taxpayers with a specified formal relationship. Put another way it depends upon associates only being those close relatives and specified taxpayers.

The accuracy of this assumption in societies such as modern Australian society and other western societies where such rules of association have been developed seems reasonable. If any criticism were to be leveled at the definition of associate in the ITAA, it would be that it is overly harsh. This is because the assumption that dealings between relatives such as adult siblings or individuals and their uncles and aunts would be off-market or informal is just as often false as it is true. Even many parents and their adult children in modern Australia can be said to deal with one another at arm's length. However, the inclusion of relatives as defined is necessary as it is clear that in western societies such relatives may deal with one another informally and off market.

The ideal of individual independence is deeply rooted and strong in western society[23]. It is also growing stronger as witnessed by the growing propensity of even the closest familial relationships such as spouses to rely upon formal institutional specification of individual property rights rather than operate in a unitary fashion or trust informal institutions. This independence is reinforced by formal institutions and dependent on formal institutions. It in turn in itself reinforces these formal institutions. It leads to the belief that reality is that which is represented by formal institutions.

That is, an individual's property can only be that which is recorded as his or hers in titles, registers or contracts. To alter these records is to alter reality and to not have these records of ownership, say, is to not own. There are no strong informal institutions to create an alternative reality other than in the case, sometimes, of close relatives. Otherwise there must be a formally constituted relationship to offer appropriate formal institutional protection.

The result of the above situation is that associates (as defined in the ITAA) does largely capture the extent of possible non-market transactions and probably goes far beyond this extent. The fact that the associate definition used in the ITAA is not generally thought to be too narrow by tax administrators, policy makers or academics in Australia is testament to the adequacy of the definition in capturing those who may interact through informal institutions.

INCREASED SCOPE FOR ARBITRAGE IN A CHINESE SOCIETY

Focusing on Chinese society, a very different outcome emerges. The assumption that the group of taxpayers captured by the definition of relative and associate in the ITAA defines the extent of possible off-market or informal institutional interactions in relation to Chinese society is highly inaccurate. The extent of the group of persons who should be considered associates in Chinese society goes far beyond this group. It follows that in accordance with the second key assertion above, members of Chinese society have far more scope to engage in successful taxation arbitrage or evasion. In turn, in accordance with the first key assertion above, members of Chinese society possess a highly valuable tool if they operate as entrepreneurs in a state, such as Australia, that imposes income tax on business income at a high rate. If the entrepreneurs operating in that state come from various different social backgrounds,

[23] Fei, X. (1992). From the Soil: The Foundations of Chinese Society. Berkley, University of California Press. See Chpater 4 in particular

then the Chinese entrepreneurs have a significant competitive advantage through their extensive group of associates. As explained earlier, this competitive advantage may be so valuable in a competitive industry that it leads to domination of that industry by Chinese entrepreneurs.

THE PERPETUATION OF CHINESE BUSINESS MODALITIES IN STRONG FORMAL ENVIRONMENTS

Thus, it is a fallacy to assert that the strengthening of formal institutions will lead to the demise of the use of informal institutions in the manner that Chinese entrepreneurs have used them in the past. This is because their remains a significant benefit associated with these business modalities in the form of reduced tax burdens. Of course, there are also competitive disadvantages associated with the use of the modalities as an entrepreneur may be limited in the scope of their business operations due to the need to deal with associates. However, the cost associated with this often highlighted disadvantage needs to be compared to the value associated with reduced tax burdens. The advantage may indeed outweigh the disadvantage.

It is also worth noting that tax benefits may not be the only benefits associated with the use of informal institutions. In a highly regulated formal economy informal institutions can be used to reduce or eliminate other obligations in the same manner as taxation. For example liability and risk arising from customers and creditors can be reduced. In Australia, entrepreneurs go to great lengths to protect their assets from bankruptcy. This is attempted through formal methods such as trusts. However, the use of formal methods again opens the doors to authorities to counter such avoidance of liability. The widened scope of associates in the Chinese context is again an advantage here. As developed jurisdictions with strong formal institutions generally go hand in hand with high tax burdens and more regulation, the value of informal institutions is actually increased. It is interesting to note that the developed Chinese jurisdictions of Hong Kong and Singapore impose very low tax burdens.

COUNTERING ARBITRAGE IN CHINESE SOCIETY

Finally, to round off this discussion, the third assertion above needs to be returned to. It was asserted that authorities and laws can counter tax arbitrage and evasion also by focusing on associates. Here it must therefore be considered whether the increased scope of associates in Chinese society can be effectively countered by a wider definition of associate to be used in tax law and administration. If this is the case, the advantage of the informal institutions will be diminished or eliminated and there will be no value in them and no demand for them.

ASSOCIATES IN CHINESE SOCIETY

The literature on Chinese social connections, guanxi and networks is extensive. The key focus of this literature is the strong informal bonds (guanxi) that individuals in Chinese society have with certain other individuals that are mutually beneficial. The concept of the network refers to groups of individuals linked by these bonds for common benefit. The extent both in terms of numbers of individuals and in geographical terms is also a noted feature of networks. The strength of these informal bonds is what has allowed Chinese entrepreneurs to succeed in the face of a poor or antagonistic formal institutional environment. It would follow from the very nature of guanxi and networks that anybody that is linked to another person through a guanxi network should be considered to be an associate for taxation purposes if such a definition is to be effective in a Chinese society.

The question that arises from the above is whether persons that are likely to have the appropriate relationship with one another can be characterized in a way that allows the law to identify them. This is what is donwha0all033 Tc ( )T the cu rent Australian law where close

The strength and success of these bonds rests at least partly on the invocation of the institutions of trust, loyalty and connectivity as described by Fei. However, the very flexibility of whom these bonds can be formed between is in itself a key feature of Chinese social connections. The most important factor is not the commonality seized upon but the talent of the individuals involved at building relationships. This flexibility is recognized even in the earliest works such as Fei's where after indicating that the familial bonds are so strong carries his analysis further to show that despite the strength of these bonds they can actually be discarded when they are not useful and be generated with others who are not members of the family. He indicates that a successful person is one that is good at "extending" himself[27]. That is, at extending his strong informal bonds.

ALL THAT MATTERS IS WHETHER THERE IS A RELATIONSHIP

Ultimately, in Chinese society what counts is whether two persons have the "guanxi"

record of specific rights is more a feature of these Australian entrepreneurs and their relationships with others.

The advantages of the use of informal institutions are actually maximized when other groups operating in a particular jurisdiction do not rely upon informal institutions as the reduced costs of taxation and potential liabilty give those operating through informal institutions a competitive advantage that is extremely significant. Of course, they have competitive disadvantages as well but these need to be valued against the massive advantages.

Thus the use of informal institutions such as guanxi networks should be expected to continue regardless of attempts made to strengthen formal institutions. This is because there is significant value associated with this modality of operation. This is regardless of whether the future development of China or Malaysia is being considered or whether the exposure of, say, Australia to Chinese business modalities is being considered. In the global economy this exposure of states such as Australia is not a case of immigrant society. Without any local Chinese community, the Australian tax system is fully exposed to Chinese business modalities through international trade and investment.

Finally, it is worth considering whether strong formal institutions can be developed or maintained in the face of the significant use of informal institutions. When a significant group of persons makes use of informal institutions, the formal institutions are ultimately weakened for those that depend on them. This weakening increases the value of the use of informal institutions for the same reason they were used in China in the first place. That is to counteract a weak formal institutional environment. Thus the use of informal institutions weakens the formal institutional environment while the weakening of the formal institutional environment increases the use of informal institutions. This is a sobering thought in a globalizing world that calls for a single institutional environment as this global institutional environment may not be dominated by strong formal institutions.

APPENDIX A – DEFINITION OF AN ASSOCIATE

Section 318 Associates

318(1) [Entity]

For the purposes of this Part, the following are associates of an entity (in this subsection called the "primary entity") that is a natural person (otherwise than in the capacity of trustee):

(a) a relative of the primary entity;

(b) a partner of the primary entity or a partnership in which the primary entity is a partner;

(e) a company where:

(i) the company is sufficiently influenced by:

(A) the primary entity; or

(B) another entity that is an associate of the primary entity because of another paragraph of this subsection; or

(C) another company that is an associate of the primary entity because of another application of this paragraph; or

(D) 2 or more entities covered by the preceding sub-subparagraphs; or

(ii) a majority voting interest in the company is held by:

(A) the primary entity; or

(B) the entities that are associates of the primary entity because of

paragraph, because of another paragraph of this subsection or because of subsection (3);

(e) another company (in this paragraph called the "controlled company") where:

(i) the controlled company is sufficiently influenced by:

(A) the primary entity; or

(B) another entity that is an associate of the primary entity because of another paragraph of this subsection; or

(C) a company that is an associate of the primary entity because of another application of this paragraph; or

(D) 2 or more entities covered by the preceding sub-subparagraphs; or

(ii) a majority voting interest in the controlled company is held by:

(A) the primary entity; or

(B) the entities that are associates of the primary entity because of subparagraph (i) of this paragraph and the other paragraphs of this subsection; or

(C) the primary entity and the entities that are associates of the primary entity because of subparagraph (i) of this paragraph and the other paragraphs of this subsection;

(f) any other entity that, if a third entity that is an associate of the primary entity because of paragraph (d) of this subsection were the primary entity, would be an associate of that third entity because of subsection (1), because of another paragraph of this subsection or because of subsection (3).

[Subsection (2) amended by Act No 41 of 1998 s 3 and Sch 6, Item 18, with effect effect from 4 June 1998, by deleting `application of this' from sub-subparagraph (e)(i)(B).]

318(3) [Trustee]

For the purposes of this Part, the following are associates of a trustee (in this subsection called the "primary entity"):

(a) any entity that benefits under the trust;

(b) if a natural person benefits under the trust - any entity that, if the natural person were the primary entity, would be an associate of that natural person because of subsection (1) or because of this subsection;

(c) if a company is an associate of the primary entity because of paragraph (a) or (b) of this subsection - any entity that, if the company were the primary entity, would be an associate of the company because of subsection (2) or because of this subsection.

318(4) [Partnership]

might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); and

(c) an entity or entities hold a majority voting interest in a company if the entity or entities are in a position to cast, or control the casting of, more than 50% of the maximum number of votes that might be cast at a general meeting of the company.

318(7) ["Spouse"]

In this section, and in any other provision of this Act insofar as that provision has effect for the purposes of this section, a reference to the spouse of a person (in this subsection called the "first person") does not include a reference to a person who is legally married to the first person but is living separately and apart from the first person on a permanent basis.

Section 995-1 (ITAA 1997)

relative of a person means:

(a) the person's *spouse; or

(b) the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or *adopted child of that person, or of that person's spouse; or

(c) the spouse of a person referred to in paragraph (b).

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The Becker model was first applied to tax fraud by Allingham & Sandmo (1973), who used a concave utility function, i.e. one with decreasing marginal utility, in order to determine the optimal amount of fraud when the audit rate is constant and known to the taxpayer. Other applications, which also included the behaviour of the auditor, have been studied by Reinganum & Wilde (1986) and Erard & Feinstein (1994). The theoretical tax fraud models are well described in a survey by Andreoni, Erard & Feinstein (1998).

Reinganum & Wilde (1986) studied the optimal allocation of audit resources to a homogenous group of taxpayers when the cost per audit is given. Such a homogenous group may consist of craftsmen in one-man enterprises or taxi companies with one car. An important assumption is that the only information available to the auditor regarding the individual taxpayer is the declared income. In addition, the auditor knows the distribution of true income, for instance from earlier random audits.

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effect of tax advisors (paid preparers) is studied since this may have influence on the effect of audit information.

In the Minnesota experiment (Blumenthal et al, 2001), taxpayers were informed that their tax returns would be audited; this led to significantly higher declared incomes for high-opportunity groups (taxpayers with business or farm income) with low and medium incomes. The same effect was not noted for high income earners. A possible explanation for this surprising result is that high-income earners increased their use of tax advisors under the threat of audit, and that those advisors were able to identify legal means for tax evasion, leading to lower declared income.

In the UK experiment (Hasseldine et al, 2007), more than 7,300 small enterprises were studied. They were considered to belong to a high-risk group, with a turnover just below the limit above which a more detailed tax reporting would be required. The companies were divided into six groups, one control group and five groups which received different letters characterised by the terms *"Enabling"*, *"Citizenship"*, *"Increased audit"*, *"Audit/penalties" and "Preselected audit"*. The principal result was that significantly higher turnover and net profit were reported in the three audit-related groups than in the control group. The monetary profit effects amounted to GBP 176 – 770 in the three groups compared to the control group.

The Australian experiment (Wenzel & Taylor, 2004) was carried out on 9,000 taxpayers in order to measure the effect of a specific form (Rental Property Schedule, RPS) for itemizing deductions made in conjunction with rental property income. The

Does information about a rational audit strategy with a decreasing audit rate reduce tax fraud as compared to information about a random audit strategy?

TEST DESIGN

This paper concerns an empirical test of the effect of information to taxpayers concerning different audit strategies. The test was carried out by the Linköping

Agency expected a possible negative reaction to the audit letters, especially from the Rational Group. Therefore, a service phone number was provided in the audit letters. The Tax Agency registered a total of only 11 phone calls, none of which with negative or critical content.

The effect of the strategy information in the audit letters was measured by comparing declared income for 2003 with declared income for 2002. The hypothesis was that the Rational Group would show a larger increase compared to the Control Group, and that the Random Group would fall between the other two since all information to taxpayers regarding audits is assumed to have a certain deterrent effect.

In the analysis, it was evident that additional delimitations should have been made in the selection of taxpayers. First, firms with income from employment in the year 2003 should have been excluded, in consistency with the exclusion of such firms in 2002. Moreover, a number of firms had used subcontractors extensively, and it can be argued that they should have been excluded like firms with employees.

As Sweden has a loss-carry-forward system, firms showing a loss in 2002 may have had losses in previous years which are included in the 2002 loss. In addition, the result in 2003 includes a carry-forward of the loss shown in 2002. Therefore, firms showing negative income in 2002 should be excluded.

The results reported below refer to data where firms with employment income exceeding SEK 10,000 in 2003 as well as firms with negative income in 2002 have been excluded. Regarding subcontractors, we present results from two sets of data, one excluding firms using subcontractors and one including such firms.

The data set included the Swedish Industry Classification Code (SNI) for each firm. It is evident from Tables 1 and 2 that the construction industry is predominant in the data.

An assumption behind the experiment is that all taxpayers belong to a homogenous

Table 1. Industry classification of participating firms, excluding firms with subcontractors

Industry	SNI code	Rational Group	Random Group	Control Group
Manufacture of metal products, machinery and equipment	28, 29	0	0	0
Demolition of buildings, earth moving	451	6	13	19
Construction of buildings etc	452	40	54	41
Installation (electric, plumbing etc)	453	16	20	13
Painting, plastering, floor and wall covering, glazing etc	454	39	48	28
Renting of construction/demolition equipment with operator	455	4	6	18
Auto repair	502	6	5	8
Hairdressers	93021	7	12	15
Total number of taxpayers		118	158	142

Table 2. Industry classification of participating firms, including firms with subcontractors

Industry	SNI code	Rational Group	Random Group	Control Group
Manufacture of metal products, machinery and equipment	28, 29	1	0	2
Demolition of buildings, earth moving	451	16	25	24
Construction of buildings etc	452	71	91	71
Installation (electric, plumbing etc)	453	47	35	30
Painting, plastering, floor and wall covering, glazing etc	454	79	76	65
Renting of construction/demolition equipment with operator	455	9	8	25
Auto repair	502	12	12	12
Hairdressers	93021	13	22	22
Total number of taxpayers		248	269	251

STATISTICAL ANALYSIS

2.0%. If a change in audit strategy would result in a change in declared income by 4%, the change would be statistically significant at the 5% level.

Actual data for the three groups are shown in Tables 3 and 4. The expectation regarding the standard deviation was apparently wrong, as the standard deviation was 35-50% of the average income instead of 25%. Furthermore, the size of the groups was reduced due to the additional limitations

audits do not discover all fraud, especially not hidden income which is kept out of the accounts.

The quality of the study may have been affected by the use of net household cash flow as a parameter for the audit strategy when the effect of the strategy is measured as the

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APPENDIX 1: LETTER TO MEMBERS OF THE RATIONAL GROUP

Riksskatteverket (Swedish Tax Agency)
NN
Each year the Linköping Regional Office of the Swedish Tax Agency conducts various activities for purposes of information and control so that the tax assessment will be as correct as possible. In some cases we provide advance notice that a certain type of control will be carried out. You are part of a group of randomly selected business proprietors who are being informed at this early stage that their income-tax returns to be submitted in 2004 may be audited.

Which returns will be audited?
After the tax returns have been filed, we will select the returns be audited. Your return is one of those subject to a possible special audit, where we will select the returns of taxpayers with the lowest net cash flow.

In order to determine your net cash flow, we examine the data that you have provided in your tax return and the remuneration statements received by the Tax Agency. We then calculate how much money you have received and how much you have paid out. The difference between what you have received and what you have paid out is your

net cash flow. In the enclosure to this letter, you can see a sample calculation of net cash flow.

If most of the taxpayers in the group have a lower net cash flow than you, your tax return will not be audited. On the other hand,

Best regards
Bertil Olofson

Table A3:2. Maximum likelihood estimates for two normally distributed sub-groups, subcontractors excluded

	Narrow sub-group			Wide sub-group		
Amounts in SEK 1000	Mean	Standard deviation	Weight factor	Mean	Standard deviation	Weight factor
Rational Group	16.6	26.2	0.539	39.5	66.1	0.461
Random Group	12.9	21.2	0.678	20.7	93.5	0.322
Control Group	12.9	22.4	0.734	15.7	101.4	0.266

It is striking that the mean values and standard deviations for the three narrow sub-groups are so similar. This finding gives rise to a hypothesis that the populations consist of two distinct groups, one with stab