

**MANAGING COMPLIANCE :
MORE CARROT, LESS STICK**

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Background

The Australian Customs Service (Customs) is responsible for administering a range of indirect tax and industry assistance regimes worth about \$30 billion. This includes the collection of Customs duty, excise duty and sales tax, the payment of bounties and rebates, and revenue forgone under a range of concessional schemes.

The size and diversity of Customs' revenue responsibility highlights the importance of having a co-ordinated approach to its operational activities and an effective strategy to manage compliance.

In April 1994 the Government accepted the findings of the Conroy Review of Customs¹, including the need to overhaul the industry audit function which forms the core of the organisation's compliance management program. Later that year, the Minister responsible for Customs convened an Industry Panel to assist the organisation to establish an effective compliance strategy, and to provide a forum for Customs to consult with its clients on initiatives which impact on them.

The Panel included representatives of the importing, exporting, manufacturing, accounting and broking industries as well as academics, a senior tax official and a senior Customs representative.

The Panel's report² which was accepted by the Minister in March 1995, has provided Customs with a comprehensive blueprint for the future and has been publicly acclaimed as the most significant element in the organisation's post-1993 reform program.

As a result, Customs has now implemented a more effective approach to compliance management which not only recognises the need to balance enforcement with assistance, but further recognises the benefits of providing industry with incentives to comply. In other words, more carrot and less stick.

The new approach was recently reinforced by the launch of the organisation's Cargo Management Strategy³ which introduced the concept of partnerships with industry. This strategy recognises the fact that companies with a good record of compliance do not require the same level of scrutiny as those with a history of poor compliance.

As a consequence, a key element of the strategy seeks to provide highly compliant companies with more latitude to self-assess their revenue liability, by relying primarily on their internal accounting systems and procedures. This in turn provides compliant companies with a high degree of flexibility in the way in which they interact with Customs, resulting in a range of commercially attractive outcomes.

¹ *The Turning Point, Review of the Australian Customs Service, AGPS, 1993.*

² *Looking to the Future - Compliance Improvement, Industry Panel on Customs Audit Reforms, Australian Customs Service, 1995.*

³ *The Cargo Management Strategy, Australian Customs Service, 1997.*

A key benefit for Customs is the willingness displayed by industry to invest in those systems and procedures which impact on their compliance levels, in order to achieve the benefits of the partnership arrangements.

Compliance Improvement

The philosophy which Customs has adopted is one of "compliance improvement", where the principal objective is to maximise compliance by seeking to achieve a continual improvement in the level of voluntary compliance. Under this regime the main focus is on future compliance rather than the correction of past errors, and in ensuring that an appropriate balance exists between incentives for compliance and sanctions for non-compliance.

The focus on future compliance is something which has traditionally received little attention. Until recently, for example, Customs adopted a four step approach to compliance management:

- audit a company,
- find an error,
- penalise the company and;
- leave.

The compliance improvement strategy seeks to establish why an error was made and seek to ensure that it doesn't recur. For example, the error may have occurred because of a control problem within the company - its systems or procedures may be flawed. On the other hand, the legislation may be unclear or the administrative requirements may be ambiguous.

What Customs then does to help companies get it right for the future will of course depend on the cause of the problem. It may be necessary to address systemic problems within the company, it may be appropriate to make officers available to the company or perhaps the particular industry sector to advise on compliance issues, or perhaps formal clarification of the law through binding rulings or other means may be the most appropriate solution.

In the process of assessing the level of industry compliance, officers will of course encounter two situations: compliance and non-compliance. The non-compliance spectrum will in turn range from innocent mistakes to blatant fraud. Needless to say, while the solutions discussed above will be appropriate in the majority of cases, as the error nears the fraudulent end of the spectrum, some form of sanction will come into play. This may include administrative penalties or, in the worst cases, prosecution.

In all cases, however, the new direction seeks to strike an appropriate balance between incentives for compliance and sanctions for non-compliance, recognising that the overall objective is to achieve an improvement in future compliance.

Customs' experience with the compliance improvement philosophy has led to a clear recognition of the need to adopt specific and often quite different strategies when dealing with companies which have a very good record of compliance.

Risk Management

A central element of the organisation's approach is the adoption of a sophisticated risk management strategy to ensure that efforts and resources are focussed on areas of highest risk.

In this regard, Customs has been actively involved in the development of the Australia/New Zealand Standard⁴ for Risk Management and has developed a corporate Risk Management policy which is based on that Standard.

In identifying the areas of greatest risk in the context of its compliance activities, the various elements of the Standard have been closely observed. This has involved:

- *establishing the context*, particularly the overall \$30 billion for which Customs has administrative responsibility,
- *identifying areas of potential risk*, which includes a detailed analysis of the client base,
- *analysing the risks*, which involves asking the questions "what's the likelihood?" and "what would be the consequences?",
- *prioritising the various risks* to identify the "hot spots",
- *identifying an appropriate risk treatment* which may include education, audit, leverage exercises, monitoring or some other measure, and
- *undertaking ongoing evaluation and review*, in recognition of the fact that risks are not static. In this regard, a resource capability with the flexibility to quickly respond to new and emerging areas of risk is clearly required.

A recent audit by the Australian National Audit Office⁵ recognised the significant achievements which had been made in this area:

"In concluding that a sound risk management framework has been established within the Branch for considering compliance risks, it is our view that the ACS is now in a position to apply that framework to the whole of the organisation and extend consideration to other types of risks. In doing so, it can capitalise on its own considerable experience and achievements as well as those of other agencies, in adopting and implementing comprehensive risk management." (p.xvi)

More Carrot, Less Stick

In discussing social motivations to comply, Cialdini⁶ comments that there appears to be a dearth of appropriate channels for directly influencing taxpayers regarding compliance, and those that do exist tend to be oriented toward threats of sanctions.

The need to look beyond sanctions for non-compliance is now widely recognised. Indeed, there is an increasing trend among tax administrations to seek to achieve a balance between enforcing legislation and encouraging compliance through such things as taxpayer education.

⁴ *AS/NZS 4360 : 1995 Risk Management*, Australian/New Zealand Standard, Standards Australia, Standards New Zealand, 1995.

⁵ *ANAO Report No. 6 : Risk Management in Commercial Compliance*, Australian Customs Service, Australian National Audit Office, 1997.

⁶ *Social Motivations to Comply : Norms, Values and Principles*, in *Taxpayer Compliance Volume 2 : Social Science Perspectives*, ed. Roth and Scholz, University of Pennsylvania Press, Philadelphia, 1989.

The Customs experience is demonstrating that the provision of tangible carrots, combined with a reduced emphasis on sanctions is proving to be a most effective way of achieving an improvement in the level of voluntary compliance. While the "less stick" philosophy is now being widely adopted by regulatory agencies, the additional step of providing special benefits to highly compliant taxpayers is rarely taken. In this regard, while client education is to be commended as a legitimate and effective compliance improvement tool, it could hardly be described as a "carrot".

In a paper presented to the 1995 Compliance Research Conference, Professor Henk Elffers⁷ identified the need to influence taxpayers' views in order to change their "willingness to non-comply" into a "willingness to comply". Elffers suggests that this can be achieved by seeking to influence taxpayers views such as:

- feelings that the tax system is unfair,
- illusions about what one really pays, and
- illusions that nobody else pays the right amount of tax.

The last point is often cited as a major hurdle to achieving compliance. There is often an expectation that taxpayers will comply simply to demonstrate that they are good corporate citizens. This is not as simple as it sounds, as there is often a perception that, by paying the right amount of tax, a business may be commercially disadvantaged due to the often widespread practice of tax avoidance, particularly in certain industry sectors. On this issue, the Small Business Deregulation Task Force⁸ comments that:

"Many small business representatives expressed concerns about the cash or black economy. They believe this problem results in them paying additional tax and having to compete on unequal terms." (p.30)

Similarly, in the context of sales tax, the Task Force reports that the primary concerns of small business include competitive disadvantages arising from perceived or actual non-compliance by others.

In addressing this issue, Elffers stresses the need for "campaigns for influencing people's views". However, he goes further and touches on the concept of providing rewards for those who are highly compliant and suggests that a financial reward could be provided to what he terms the "clean cases".

The report of the Cash Economy Task Force⁹, also identified the need to strike a balance between incentives for compliance and sanctions for non-compliance. The Task Force identified a variety of reasons why taxpayers failed to comply, including a lack of incentives to get it right:

"Taxpayers complain that there are few incentives for them to do the right thing by declaring cash payment or reporting cash transactions, particularly where their competitors are perceived to be failing to do so." (p.5)

⁷ *Make them happy to join the compliers club*, paper presented to the 1995 Compliance Research Conference, Australian Taxation Office, 1995.

⁸ *Time For Business*, Report of the Small Business Deregulation Task Force, AGPS, 1996.

⁹ *Improving Tax Compliance in the Cash Economy*, Cash Economy Task Force Report, Australian Taxation Office, 1997.

The Task Force concluded that more effective compliance improvement initiatives needed to be developed and that these should include incentives for compliance as well as sanctions for non-compliance. Measures proposed by the Task Force included less stringent tax return and record keeping requirements for taxpayers with a good compliance record.

Partnerships

A key element of the compliance improvement strategy emphasises the need for the relationship between Customs and industry to be one of partnership and trust. That is, one which reflects a mutual commitment to accountability and improving compliance. Such partnerships, as the term implies, must be a two-way thing. There will be costs and responsibilities for both parties.

Companies which propose to enter into such partnerships must, for example, be prepared to open up their operation to analysis by auditors. They also need to advise of any changes to their systems or operations which may impact on Customs assessment of their level of compliance.

In this regard, a number of companies have made the point that they wish to know specifically what concerns Customs may have which cause them to be rated higher than "low risk". That's something which Customs has agreed to do. After all, if a company doesn't know what the problem is, how can it be expected to fix it?

On the other side of the partnership equation, Customs is seeking to create an environment in which companies can maximise their entitlements and meet their obligations for revenue payment and trade compliance with minimum commercial impact. Equally, they are seeking to provide companies with the means to achieve certainty and clarity in assessing their liabilities and entitlements, to allow them to conduct subsequent business without fear of additional imposts after the transaction is concluded and the opportunity to recover costs has passed. In other words, no unpleasant surprises.

Industry has played a major role in identifying the range of incentives which may be made available under the partnership arrangements. These include:

- facilitated clearance of cargo,
- the ability to account for goods periodically (as opposed to the present transaction approach),
- a facility to defer the payment of duty (normally paid on a shipment by shipment basis),
- off-setting arrangements under which companies self-assess any refunds or other moneys due, and simply pay the net amount to Customs, and
- the establishment of an "account manager" which provides the company with a single national point of contact within Customs.

These arrangements are currently being evaluated with eight "pilot" partnership companies:

- Panasonic Australia Pty Ltd
- DuPont (Australia) Pty Ltd
- NS Komatsu Pty Ltd
- Kinney Shoes Australia Ltd
- Myer Stores Ltd
- Ericsson Australia Pty Ltd
- Kodak (Australasia) Pty Ltd

- Nortel Australia Pty Ltd.

A further benefit which is currently being pursued in the international arena is the facilitated Customs clearance of a partner company's exports in the country of destination. Under this proposal, overseas Customs agencies would, in effect, accept Australia's low risk rating of a company and, as a result, facilitate the clearance of their goods on arrival.

This is a particularly exciting concept for both Customs and industry as clear benefits exist for both parties. In order for such a scheme to be effectively administered, Customs agencies will need an assurance that the risk assessments provided by their overseas counterparts are sufficiently sound. To achieve this, the Customs audit process will be required to meet internationally recognised standards. This in turn will require the adoption of appropriate audit methodologies as well as an assurance that those who are conducting the audits are suitably qualified.

The issue of international standards is currently being pursued jointly by Customs in Australia, Canada and the USA. Australia has already made significant progress in this area, having established Customs-specific audit standards and an auditor accreditation program, tailored to the Customs environment. The latter initiative is the result of a joint venture between Customs and the University of Canberra which has since established a Centre for Customs Studies.

Service Providers

The introduction of the partnership arrangements has received an interesting response from service providers such as customs brokers and freight forwarders.

Recognising that many traders rely on the systems and procedures of their service providers to comply with Customs legislation, brokers are steadily inviting Customs auditors to assess the integrity of their internal systems. Should they prove to be of an acceptable standard, a compliant broker (we must resist using the term honest broker!) would have the capacity to act as a conduit for their clients to gain access to the various benefits of the partnership arrangements. Needless to say, the sight of brokers proactively seeking a Customs audit is rather novel!

Another interesting spin-off has been the renewed interest in the concept of prudential audit. In this context, a prudential audit is defined as an audit arranged and funded by a company to assure itself about its level of compliance with statutory or other requirements.

The concept of prudential audit was addressed by the organisation in 1995¹⁰, at which time it was concluded that such audits should be left to the commercial discretion of traders and that Customs would, where possible, take the results of such audits into account when assessing the risks associated with the trader.

Not surprisingly, there has been little commercial interest in prudential audits to date. However, if a clean bill of health is regarded to be a prerequisite for entering into partnership arrangements, there is likely to be a significant number of companies looking to be audited once the partnership arrangements are implemented fully (currently planned for January 1999). With finite Customs audit resources, the commercial viability of prudential audits will no doubt

¹⁰ *Prudential Audit in the Customs Context*, Australian Customs Service, 1995.

increase as they will be regarded as a potential entree into the partnership arrangements and the associated commercial benefits.

Comment

Implementation of the new initiatives represents a major element in the Customs reform agenda.

The new approach is seen to be a particularly successful one in that it provides a range of tangible commercial benefits to those companies which can demonstrate a high level of compliance and an ongoing commitment to comply.

As a result, there is now a significant incentive for traders and their service providers to invest in those systems and procedures which impact on their level of compliance.

The new arrangements are already providing Customs with a more co-ordinated, focussed approach to its considerable range of compliance responsibilities. The measures are also providing industry with a better way of meeting its compliance obligations. Finally, they are providing Government with a greater assurance about the level of compliance in respect of the \$30 billion for which Customs has administrative responsibility.