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**CONSTRUCTING COMPLIANCE:
ANOTHER LOOK AT GAME-PLAYING
IN INTERNATIONAL TAXATION**

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CONSTRUCTING COMPLIANCE: ANOTHER LOOK AT GAME-PLAYING IN INTERNATIONAL TAXATION

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It is now some 200 years since Adam Smith suggested his four 'canons' of a good tax system: equity, certainty, convenience and economy.¹ We are still wrestling with the problems of achieving these ideals. From one point of view it could be said that tax systems have become remarkably effective, at least in OECD countries, where tax revenues amounted on average to some 37% of GDP in 2001. On the other hand, most of those who work with or study tax systems, let alone the general public who are exposed to them, would probably think that Smith's standards are some way from being met.

This paper aims to make a further contribution to some of the recent debates about the improvement of tax systems and the problem of tax compliance. My own interests are in international taxation and tax avoidance, but in discussing the issue of compliance and avoidance in this paper, I will also give some consideration to small business and individual taxpayers. The first part of the paper explores the question of interpretation of rules and the problem of avoidance and game-playing. My starting-point is the issue of lack of clarity or indeterminacy of rules and how they are interpreted, which brings in the question of creativity. Here I discuss in particular the work of Doreen McBarnet, although I take a slightly different approach to the issue of creativity. I explore this in the context of the historical development of international taxation principles.

This leads on to the issue of fairness and complexity in tax law, and the relationship between the way tax rules are formulated and taxpayer attitudes, and in turn to the issue of the relationship between detailed rules and broad principles and standards, which has recently been explored by John Braithwaite, following up work by David Weisbach and others, and applied to taxation. My approach gives I think added weight to John Braithwaite's proposal for the use of broad principles in conjunction with exemplary (but not exhaustive) detailed rules in tax law. However, I suggest that this approach should not be limited to the adoption of a broad anti-avoidance principle (usually referred to, confusingly, as a general anti-avoidance rule or GAAR), but should be applied to the tax code more generally. I end by exploring the issue of improving compliance by the general run of individual taxpayers and reducing their propensity to game-playing and avoidance, in relation to those taxpayers' views about the fairness of the tax code in general, and to the ability of large taxpayers to employ game-playing and avoidance techniques.

TAX COMPLIANCE, AVOIDANCE AND GAME-PLAYING

Taxation has some features in common with other areas of economic regulation, but its particular character means that they are present in a much more extreme form. This is

¹ *Wealth of Nations*, Book IV, Ch II, Part II

especially so for two key features of modern tax systems, which are in many ways related. The first is their complexity, and the second is the prevalence of tax avoidance, especially when it develops to the point where it becomes an elaborate 'game' between tax officials and the tax 'planning' industry.

Legal complexity derives from the attempt to draw up rules which are precise and which anticipate every contingency, resulting in a highly complex tax code. This entails what has been described as a formalist approach to regulation. 'Formalism implies a narrow approach to legal control - the use of clearly defined, highly administrable rules, and an emphasis on uniformity, consistency and predicatibility, on the legal form of transactions and relationships and on literal interpretation.' (McBarnet & Whelan 1991, 849). However, such a formalist approach does not prevent avoidance, but shifts it to a new level, game-playing and 'creative compliance'. This has been pointed out especially by Doreen McBarnet and her collaborators in their extensive work on avoidance both of tax and financial regulation.² She has described 'creative compliance' as 'working to rule' (McBarnet 2003). Essentially it involves recharacterizing transactions to avoid the purpose of the law while complying with the letter of the rule.

The alternative to formalism and complexity is to base regulation on more general, open-ended rules which focus on substance rather than form, and are expressed purposively or in policy-oriented terms. However, this comes up against a problem endemic in liberal legality, that of indeterminacy. That is, that legal rules are generally open to different possible interpretations. '[L]aw in itself is complex and elusive, open to different interpretations: its application to specific facts, even more so' (McBarnet & Whelan 1999, 217). It is to avoid the uncertainty created by broad principles that regulators seek precision in detailed rules.

However, as several commentators have pointed out, detailed rules lead to complexity, which may also generate uncertainty (Miller 1993; Weisbach 1999; J. Braithwaite 2002, 2003). The regulatory system may also be substantially undermined if complexity results from cat-and-mouse game-playing, which generates 'contrived complexity' (J. Braithwaite 2003, 76). Thus, as John Braithwaite has recently suggested, it may be better to combine general principles and specific rules (J. Braithwaite 2002, 2003). However, before considering this more closely, it may be useful to explore the issue of indeterminacy.

Negotiating the Meaning of Rules and Legitimacy

Much of the discussion of 'compliance' with rules is based on a rather instrumental view of law, in which the aim of the regulator is to induce the regulatee to comply with the requirements of a rule. This assumes that both regulator and regulatee (or in this context, tax official and taxpayer) have a relatively clear understanding of what the rules mean, and indeed a shared understanding. Some authors have explored the implications for regulatory compliance of the imprecision or indeterminacy of rules (see especially Reichman 1992; Black 1997, McBarnet & Whelan 1991, 1999, Braithwaite & Braithwaite 1995).

However, even this work tends to assume that there is basic agreement on the meaning of the 'core' of the rules, and that any ambiguity lies in the 'penumbra', or the 'grey areas'. Thus, regulatees tend to be seen as being on a continuum between the committed or compliant on

² Some of the relevant works are cited in the Bibliography

the one hand, and on the other the avoiders or evaders, those who enjoy game-playing or like to 'play for the grey'. Avoidance also tends to be seen as involving 'creative compliance', complying with the letter while avoiding the spirit or policy of the law (McBarnet 2003, 229). This again implies that those involved share a common understanding of the requirements of the rules. However, Valerie Braithwaite has recently asked the question 'What Does it Mean to Comply?' She suggests that it is not always easy to assess whether a person has done 'what is asked of him or her', and even that 'whether or not a person interprets the request in accordance with its intent is far from certain (V. Braithwaite 2003, 276).

Yet the existence of different understandings or interpretations of 'what is required' by a rule is, I would suggest, the normal situation. Let us take a basic tax rule, such as what deductions are allowable against employment income. Even a cursory piece of research would show, I think, that taxpayers have very different understandings of 'what is asked' of them by this rule.³ This may of course be due to a variety of factors, not least that few people are enthusiastic about reading tax legislation. It must nevertheless be a concern for any regulatory regime, and to researchers studying compliance with it, if there can be different understandings or interpretations of the rules to which its subjects are expected to adhere. It may mean, for example, that people who regard themselves as compliant, based on their understanding of the regulatory requirements, may from the regulator's viewpoint be avoiders or game-players. To consider the implications, we need to analyse the issue of indeterminacy a bit more closely.

I suggest there are three aspects or levels of indeterminacy. At the most general level, indeterminacy arises from the social nature of language. Since Wittgenstein, linguistic philosophy has emphasised that the meaning of words is socially constructed. Hence, even for objects that have an ontological existence, the terms used to denote them depend on shared understandings within a particular linguistic group or community. Furthermore, linguistic terms also carry a range of social connotations, for example about the normal or socially acceptable uses of an object. Thus in English, different terms are used for an umbrella and a parasol because they are generally used for different purposes, although they are very similar objects and in practice may be substitutable. The implications of the social construction of meaning are clearly much greater for non-ontologically verifiable terms or statements.

There are two further levels of indeterminacy of legal or regulatory rules, due to their nature as norms in a liberal system of regulation, or what Weber described as formal rationality. This type of system involves establishing general norms to guide the conduct of individuals in specific situations. Hence, it requires a process of inductive-deductive reasoning, from the particular to the general and vice versa. This involves the second level of indeterminacy, the one with which lawyers are perhaps most familiar, since it is recognizable even from a positivist perspective on legal rules. Its most well-known exposition is in H. L. A. Hart's discussion of the core meaning and the 'penumbra' of legal rules. This implies that the broader a legal rule the more fuzzy its core and the wider the penumbra. It also implies that all rules have an objective meaning that is generally understood at their core, and that it is only the more or less marginal cases in the penumbra that may be doubtful.

³ In the brief period available to me to write this paper, I was able only to carry out a very small and totally unrepresentative and unscientific survey, of a half-dozen CTSI staff, asking them what their understanding is of the deduction rule. There were indeed qualitatively significant variations. See further below.

However, applying the interpretivist approach to language to norms (the first level of indeterminacy mentioned above) suggests a third level of indeterminacy. Fuller's famous critique of Hart (Fuller 1958) was essentially based on the view that legal precepts are not merely positivist statements of a general character but norms, so that interpreting their meaning when applying them to particular cases entails a normative judgement. Fuller argued that this is not limited to the 'penumbra' of borderline or doubtful cases, but that *every* application of a general rule to a particular case involves purposive interpretation. He argued for a view of 'fidelity to the law' which would 'accept the broader responsibilities (themselves purposive, as all responsibilities are and must be) that go with a purposive interpretation of law' (ibid., 670).⁴ He also criticized Hart's 'pointer theory of meaning', and referred to the then recent developments in logical analysis of Wittgenstein, Russell and Whitehead.

The implication of this is that even the core meaning of a legal norm depends on a shared view of the values or purposes which underly it. Differing views about those values will result in different interpretations of the meaning of the norm, which are equally potentially acceptable. Fuller's concern was with the responsibility of judges in applying legal rules. For him, the judges' responsibility in interpreting laws included a responsibility to uphold certain core values of what law *should be*, and not simply applying the law 'as it is'.

Looking more broadly at regulatory systems as social processes, we can say that interpretative judgements are made about rules or regulations by all those involved: by those who are expected to comply with the regulation, the specialists who they may consult for advice about it, and the officials tasked with monitoring compliance. Each person's understanding of a regulation will to some extent depend on what they think it *should* mean, and this will affect how far they are willing to accept what another person thinks it means. Their interactions involve discussions about these meanings, which have been described as 'regulatory conversations' (Black 1997). These interactions in one way or another result in shared understandings about the meaning of the rules. How far they do so, however, greatly depends on a shared acceptance of the values or purposes which underlie them.

Hence, 'constructing compliance' with a regulation entails more than persuading those who are subject to it to ensure that their conduct complies with the regulation. It entails constructing a shared view of what the regulation itself actually means. A stable and effective regulatory system therefore is one in which such acceptance is as broad as possible. This will minimize the extent of disagreement or contestation about the meaning of the regulations.

The important point here is that contestation of the meaning of norms is generated from disagreements about what they *should* mean. The parties may not know that they do not have a shared understanding; or some or all of them may realise that different views exist, and may seek to support their own view. Hence it may be a misnomer to describe such contests as 'game-playing'. A game generally relies on a very strong shared understanding between the players of the purpose and meaning of the rules. Thus, the term 'game-playing' implies an instrumental view of rules, rather than the interpretivist view outlined above. I will explore this further in the next section using some examples from taxation.

⁴ This has some affinity with what Deputy Commissioner Jim Killaly of the ATO has described as "Taking a Whole of Code Approach" (speech to Australian Tax Summit, February 2004)

Contested Meanings in International Taxation

The taxation of income derived from international economic activities rests on a few general principles. Since tax systems are national in scope, each country must decide what persons are subject to taxation, and on what income. Britain, the first state to introduce a general income tax back in the 19th century, applied it to residents on income from all sources, and to non-residents on income from UK sources.⁵ When incorporation began to be more widely used in the last part of the 19th century, it became necessary to interpret the application of these provisions to companies formed in the UK whose activities largely took place abroad. From the 1870s on, decisions taken by the Inland Revenue on these matters were resisted by some companies, and ultimately referred for authoritative decisions by the courts. These entailed interpretations of when a company should be regarded as 'resident' in the UK, and what income should be regarded as attributable to a company, as well as how to characterize such income (due to the schedular structure of the UK income tax).⁶

The courts took the view that a company was resident where the 'central management and control' was exercised, and further that this meant where the strategic decisions were taken, by the Board of Directors. The key case involved the De Beers mining company, which was formed under South African law; not only that, but the head office and all the mining activities of the company were at Kimberley, and the general meetings were held there. Nevertheless, the House of Lords held that 'the directors' meetings in London are the meetings where the real control is always exercised in practically all the important business of the company except the mining operations'.⁷ In the way of English judges, the decisions were put forward as flowing from the language of the rules, but some of the reasoning did reveal the values or purposes underlying these interpretations. Thus, in 1876 Chief Baron Kelly showed an acute awareness that the cases involved 'the international law of the world', especially as many of the shareholders were foreign residents, so that much of the earnings of the company belonged to individuals not living in Britain and therefore 'not within the jurisdiction of its laws'. However, he contented himself with the thought that if such foreigners chose to place their money in British companies, they 'must pay the cost of it'.⁸

⁵ Pitt's property and income tax of 1798 was levied

"upon all income arising from property in Great Britain belonging to any of His Majesty's subjects although not resident in Great Britain, and upon all income of every person residing in Great Britain, and of every body politick or corporate, or company, fraternity or society of persons, whether corporate or not corporate, in Great Britain, whether any such income ... arise ... in Great Britain or elsewhere" (39 Geo.3 c.13, sec. II).

This broad applicability was repeated in Schedule D of Addington's Act of 1803, and again when income tax was reintroduced by Peel in 1842.

⁶ Different categories of income were (and still are) taxed differently according the Schedule and Case to which they might be attributed; in particular income or profits of a trade were taxable as they arose, while income from securities or possessions were taxable only when remitted to the UK. Thus, UK shareholders of a foreign-resident company would only be liable for UK tax on dividends remitted to the UK; whereas if the company itself were regarded as UK resident, its worldwide trading profits would be regarded as directly taxable in the UK. For further details of the court decisions and interpretations involved see Picciotto 1992, 6-8.

⁷ *De Beers v. Howe* [1906] A.C. 455.

⁸ *Colony of the Cape v. The Cape Colony* (1876) 1 T.C. 82, 88.

However, by that time the world market was already globalized, and British companies were acutely aware of the competitive pressures on them. Thus, Sir William Vestey, whose grocers' firm had grown by importing eggs from China and beef from Argentina, argued strongly in his evidence to the British Royal Commission on Taxation which reported in 1920 that he should be put in a position of equality with his competitors. He singled out the Chicago Beef Trust, which paid virtually no UK tax on its large sales in Britain: not only did it escape UK income tax on its business profits by being based abroad, it also avoided tax on its sales in Britain by consigning its shipments f.o.b. to independent importers, so that its sales were considered not to take place in Britain. The Vestey group had moved its headquarters to Argentina in 1915, to avoid being taxed at British wartime rates on its worldwide business, but Sir William expressed his preference to be based in London. He argued for a global approach to business taxation:

'In a business of this nature you cannot say how much is made in one country and how much is made in another. You kill an animal and the product of that animal is sold in 50 different countries. You cannot say how much is made in England and how much is made abroad. That is why I suggest that you should pay a turnover tax on what is brought into this country. ... It is not my object to escape payment of tax. My object is to get equality of taxation with the foreigner, and nothing else.'

Not surprisingly, firms like the Vestey's took steps to organize their affairs to ensure they were not, as they saw it, unfairly subjected to tax. This involved ensuring that their foreign business was carried out by entities which could not be said to be resident in the UK.

The concept of 'residence' as applied to artificial legal persons such as companies or partnerships was not defined by statute in the UK.⁹ In practice, the Revenue interpreted it to mean the place where the key strategic decisions of Directors were taken, as against the 'passive' control exercised by shareholders (Simon 1983, D 101-111). However, this provided at best a shaky basis for asserting a right to tax the worldwide profits of multinational company groups (TNCs) controlled from the UK. In the 1970s, as the pace of internationalization accelerated, and TNCs evolved more complex patterns, the control test could be used to enable companies to arrange financial or servicing functions in affiliates whose central management and control could be said to be located offshore, and thus reduce UK tax by deducting interest charges, management fees or insurance premiums from the UK trading profits of their related entities.¹⁰

⁹ Under the 'control' test, even a company formed under UK law could be a foreign resident: *Egyptian Delta Land and Investment Co. Ltd v. Todd* (1929). This decision created a loophole which in a sense made Britain a tax haven: foreigners could set up companies in the UK, which would not be considered UK resident under British law because they were controlled from overseas, but might be shielded from some taxation at source because they were incorporated abroad. This possibility was ended by the Finance Act of 1988 (s. 66), which provided that companies incorporated in the UK are resident for tax purposes in the UK, bringing the UK substantially into line with many states (especially European Community members), which use both incorporation and place of management as tests of residence. However, the control test still applied to companies incorporated outside the UK, as well as to unincorporated associations such as partnerships, and remained relevant for tax treaties.

¹⁰ In 1981, the Revenue published a consultative document favouring a move to the test of 'effective management', which had been used in tax treaties and had been thought to amount to much the same in practice as 'central management and control'. Criticism of these proposals led to their withdrawal. The Revenue restated

Furthermore, tax planners could set up foreign-resident companies to ensure that individuals resident in the UK could escape tax on income from foreign activities. Thus, the entertainer David Frost in 1967 set up a foreign partnership with a Bahamian company to exploit interests in television and film business outside the UK (mainly his participation in television programmes in the USA); the courts rejected the views of the Revenue that the company was a mere sham to avoid tax on Frost's global earnings as a professional - the company and partnership were properly managed and controlled in the Bahamas and their trade was wholly abroad.

The Vestey family were pioneers of international tax planning, which became the focus of a long-running conflict with the Revenue, resulting in a series of court judgements, most of which they won. As already mentioned, the Vestey brothers had left the UK in 1915 and moved the control of their business to Argentina, to avoid the consequences of the British rule on residence of companies. In his evidence to the Royal Commission in 1919 for measures against international double taxation, William Vestey stated that while his tax position in Argentina suited him admirably, he would prefer to come back to Britain to live, work and die. He also wrote to the Prime Minister, Lloyd George, stating that if the brothers could be assured that they would pay only the same rate of tax as the American Beef Trust paid on similar business, they would immediately return. Failing to receive such assurances, they took legal advice from 1919 to 1921, as a result of which they established a family Trust in Paris. Returning to London, they leased all their properties, cattle lands and freezing works in various countries to a UK company, Union Cold Storage, stipulating that the rents should be payable to the Paris trustees. The trust was set up so that its income should be used for the benefit of their family members (but not themselves); the trust deed also gave the Vestey brothers power to give directions to the Trustees as to the investment of the trust fund, although subject to such directions the Trustees were given unrestricted powers (Knightley 1993).

When it eventually discovered the existence of these (and no doubt other similar) arrangements, the Revenue put through Parliament in 1936 and 1938 the first provisions against foreign trusts. These aimed to prevent a UK resident from continuing to enjoy income by transferring assets to a foreign entity and receiving benefits from it. The terms of the statute were extremely widely drafted, especially the notion of 'power to enjoy' income derived by the UK resident as a result of the asset transfer. To be fully effective against any possible circumvention, the provisions aimed to include any beneficiaries and to tax the whole of the income sheltered (potentially including all the income of the transferee whether or not derived from the transferred assets), even if not actually paid over to the resident beneficiary, which gave the Revenue very broad powers. The provisions were later denounced in the standard monograph on the subject by an eminent Q.C. and tax Counsel as creating a 'preposterous state of affairs' which could only be made tolerable by the Revenue's exercise of 'discretion as to whom, and how and how much income to assess', a discretion so wide as to amount to a 'suspension of the rule of law' (Sumption 1982, p.116, 138). An assessment by the Revenue on the Vestey brothers for the years 1937-1941 for a total of £4m, in respect of the receipts of the Paris trust was upheld by the judges until the case reached the House of Lords in 1949. Evershed, L.J. in the Court of Appeal considered that the power to give the Trustees directions gave the brothers effective control over the revenues produced

that the 'effective management' principle used in many tax treaties (based on the OECD model treaty) involved a different test, and therefore by implication the UK would apply this different test where its tax treaties used the 'effective management' principle, at least for the purposes of the treaty.

from the assets, and that this was a benefit which amounted to a 'power to enjoy' income (*Vestey's Executors v. IRC* 1949, p. 69). The House of Lords disagreed, on the grounds that under English trust law the trust funds were to be applied for the benefit of the beneficiaries; the brothers' power to give directions gave them no more than a right to direct the trustees to give them a loan on commercial terms, which would not amount to a payment or application of the income for their benefit as contemplated by the statute (Lord Simonds, p.83, Lord Reid, p.121). In any case, the power to direct the investments was given to them jointly, while the statute referred plainly to the power to enjoy of a person, in the singular.¹¹ Thirty years later the Vestey trust gained an even more decisive victory when the House of Lords confined the scope of the anti-avoidance provisions of the statute to the actual transferor and not other beneficiaries (*Vestey v IRC* 1979).¹²

The point of these examples is that, although people like the Vestseys and David Frost were clearly tax avoiders, they regarded their behaviour as legitimate. It was also accepted as legal by judges, who in their interpretation of the rules must also have been convinced of the legitimacy of the arguments. The Revenue could not provide convincing arguments for subjecting to UK taxes income which could be said to have been earned abroad by a foreign entity. The fundamental problem, in my view, was that the legal arguments were not underpinned by an acceptable rationale of UK tax jurisdiction. Although complaints about international 'double taxation' by businesses such as the Vestseys helped to stimulate international negotiations, it took many decades to establish a system for jurisdictional allocation based mainly on a loose network of bilateral treaties (Picciotto 1992). In the meantime, the Vestseys and others (aided by well-paid accountants and lawyers) had developed various techniques for avoiding what they regarded as the illegitimate claims to tax jurisdiction put forward in the Revenue's interpretation of the rules. Many of these, as we have seen, were accepted as valid by the courts. Often the government responded with legislation to change the rules. Through this process the UK international tax regime emerged.

Although this process was in some respects one of cat-and-mouse game-playing, I suggest that to see it only in this way is a mischaracterization. The various interactions between internationally-operating businesses and the tax authorities (mediated by their professional advisers) over a long period of time helped to *construct* the international tax system. Thus, the claim to tax the worldwide profit of residents was mitigated by the introduction of foreign tax credit arrangements. Although most developed countries introduced measures in the 1970s and 1980s to combat the avoidance of residence rules using foreign 'base' companies, through provisions against 'controlled foreign corporations' (CFCs), these are generally limited to 'passive' investment income. Thus, some services can be provided to internationally-operating businesses which, if they can arguably be said actually to be carried out 'offshore' (and hence produce 'active' income), may benefit from a low tax rate in the chosen jurisdiction, as well as reducing tax on trading profits of the operating companies which pay for these services.

¹¹. This loophole was partly blocked by Finance Act 1969 s.33.

¹². Although the position was substantially restored legislatively in 1981 (Finance Act 1981 ss. 45-46, now ICTA 1988 ss. 739-741) the liability of beneficiaries other than transferors became limited to the benefits actually received and not the entire income from the transferred assets (*Sumption* 1982 ch 7)

The extent to which these types of arrangements are valid depends on an increasingly complex maze of different national rules and their interactions. Thus, what constitutes compliance continues to be negotiated. However, the concern of national tax authorities to ensure their 'fair share' of the tax base of international business is also counterbalanced by concerns to ensure their country maintains its international competitiveness in attracting investments and as a base for such business.¹³

The general points made in this section about the indeterminacy of rules, and illustrated with the examples from international taxation, should also be considered in terms of the sociological analysis of fields of regulation. As Mark Tushnet has pointed out, the indeterminacy thesis is not simply an argument in analytic jurisprudence, but one of political or social theory (Tushnet 1996, 339). The 'construction' of a regulatory field is a social process, mediated by interpretative practices. Thus, Pierre Bourdieu has discussed the practices of interpretation of legal texts, involving the appropriation of the 'symbolic power which is potentially contained within the text', in terms of competitive struggles to 'control' the legal text (Bourdieu 1987, 818). However, he suggests that coherence emerges partly through the social organization of the field, and partly because to succeed competing interpretations must be presented 'as the necessary result of a principled interpretation of unanimously accepted texts' (ibid.). This explains the apparent paradox that, while lawyers spend much of their time disagreeing about the meaning of texts, they do so from an objectivist perspective. They generally deny that indeterminacy is inherent, and tend to attribute disagreements to bad drafting and lack of clarity in the texts, creating 'loopholes' in the logical fabric of the law.

Finally, we should remember that legal and regulatory practices operate upon and in the context of the overall social fields which they help to regularize. Thus, while Bourdieu points to 'the relatively autonomous creative capacity of the law which the existence of its specialized field of production makes possible', he stresses that '[t]he shaping of practices through juridical formalization can succeed only to the extent that legal organization gives explicit form to a tendency already immanent within those practices', since '[t]he rules which succeed are those which, as we say, *regularize* factual situations consonant with them' (Bourdieu 1987, 848-9).

LEGITIMACY, COMPLIANCE AND COMPLEXITY

This section will discuss the implications for the development and design of regulatory systems, in particular taxation, of the interpretivist view outlined above.

There is ample evidence, not least in the work of the CTSI, that taxpayer compliance largely depends on having a favourable attitude towards the tax system, and in particular on considering that it is on the whole a fair and just system (V. Braithwaite 2003a; Rawlings 2003; V. Braithwaite 2003b). Taxation is the main economic nexus between the state and the citizen. Hence, acceptance of the fairness of taxation may derive from an identification with

¹³ Thus, the Review of International Taxation initiated by the Australian Government in 2002 asked for 'particular attention to be given to whether current international tax arrangements impede Australian companies expanding offshore, whether they impede attraction of domestic and foreign equity, and how they affect holding companies and conduit companies being located in Australia'. The consultation paper by the Treasury (2002) and Report by the Board of Taxation (2003) both opened with chapters discussing maintaining (Treasury) and promoting (Board) Australia's competitiveness in a global economy.

the state and a general confidence that its tax system treats everyone equitably. There is also evidence that such a generalized acceptance is undermined in a period of rapid social change, especially such as that experienced in recent years (termed globalization) which has tended to dissolve the 'imagined communities' of nationhood.

In these circumstances, tax authorities must seek more refined means of maintaining or re-establishing taxpayers' confidence in the tax system and its integrity. An important aspect of this is certainly procedural fairness: compliance is more likely if taxpayers feel they have been treated respectfully, honestly and impartially (Murphy 2003). Confidence in substantive fairness is more difficult to achieve. Setting aside the rather large question of fairness of the system as a whole, let us focus on the more specific issue of confidence in the fairness of specific taxes and tax provisions.

Debate in recent years has focused on tax reform and simplification as a means of restoring confidence in the fairness of tax systems. Many a Treasury minister has vowed to simplify the tax laws. Such promises have sometimes resulted in tax reviews, and occasionally even in reforming legislation. Some reforms achieve a degree of success, but it seems to have been difficult, if not impossible, to achieve both the aims of (i) greater clarity, and (ii) less complexity.

Thus, the US Tax Reform Act of 1986 aimed at structural reform to reduce complexity of the system and not just improved clarity; but it has been shown that although it 'did deliver some important simplifications' it 'did not turn the tide of growing complexity of the tax system' (Slemrod 1992, 55).

The UK's Tax Law Rewrite project has laboured since 1995, aiming 'to rewrite all (or most) of the United Kingdom's existing primary direct tax legislation to make it clearer and easier to use, without changing or making less certain its general effect'. It has resulted so far in the Capital Allowances Act of 2001, and the Income Tax (Earnings and Pensions) Act in 2003. The latter covers only taxation of income from employment, pensions and social security, and consists of 725 sections plus 8 very substantial Schedules.¹⁴

Australia's Tax Law Improvement Project, initiated in 1993, appears also to have aimed mainly at clarification. Its first project was legislation to simplify the 'substantiation' rules for claiming expenses as deductions from salary income, which were reduced from 19,000 to 11,000 words; however the initial evaluation seems uncertain whether the result was easier to understand (James & Wallschutzky 1997, 453, 457). The subsequent paper on *Tax Reform – not a new Tax, a New Tax System* (1998) called for an integrated tax code, which would 'use general principles in preference to long and detailed provisions' (p.149). This was echoed in the *Review of Business Taxation* (Ralph Report 1999).

Combining Purposive Principles with Specific Rules

Some commentators have suggested that new ways can be found to combine the advantages of general purposive principles with the precision of more detailed rules. This idea was put forward by John Avery Jones in the UK simplification debate (Jones 1996). He suggested a hierarchy, with overarching purposive principles at the top, less detailed legislation below,

¹⁴ See <http://www.inlandrevenue.gov.uk/rewrite/>

and Revenue rulings to deal with specifics. Acknowledging that this would entail a far-reaching transformation of British legal and regulatory culture, he expressed the hope that the catalyst might be provided by the influence of European Community law.

John Braithwaite has also suggested that tax law should be designed along these lines, with overarching binding principles supported by non-binding detailed rules (J. Braithwaite 2003). He emphasises in particular the need for a general anti-avoidance principle, in order to deter the 'contrived complexity' resulting from tax avoidance especially by the rich. Economic analysis of compliance costs does seem to suggest that simplification could reduce the overall costs of tax compliance, but that this would benefit mainly smaller taxpayers.

Complexity and Compliance Costs

From the economic viewpoint, both complexity and game-playing raise concerns about the costs of tax systems. Indeed, two of Adam Smith's four 'canons' mentioned above are essentially concerned with the costs of taxation. Despite this, it is perhaps surprising that until comparatively recently economists have neglected this issue (Evans 2001). Especially since the 1980s, however, much more systematic research has been done, covering not only the operating costs of administering the system, but the broader compliance costs especially for the taxpayer. This has been part of the broader growing concern with the costs, or cost-effectiveness, of regulation.

In principle it would seem self-evident that a complex system would be more inefficient and costly. However, for this connection to be valid we need to take account of both the operational costs of the regulator and the compliance costs of the regulatee, since operational costs may be contained by shifting the burden to compliance. Thus, a complex tax system may bear more heavily on taxpayers, for example, if they have to employ accountants or advisers, or if self-assessment is introduced. However, economic research has also shown that compliance costs are steeply regressive: they are much greater in proportion to the tax bill for smaller taxpayers, especially small business (Chittenden et al. 2003). This was clearly shown by a study carried out by ATAX for the Australian government in 1997 (Evans et al. 1997), based on data for 1994-5 (see Table 1).

Table 1: Average Compliance Costs per AUS\$000 of turnover

	Small below AUS\$100k	Medium AUS\$100k-9,999k	Large above AUS\$10m
Overall compliance costs	34.13	1.74	1.84
Overall compliance costs after tax	26.96	1.18	1.34
Overall average compliance costs	24.71	0.98	0.60

Source: Chittenden et al 2003, citing Evans et al. 1997

These data relate only to tax refunds, and do not take account of the often much greater savings that can result from advanced tax planning. Indeed, large taxpayers (big business and high-wealth individuals) can significantly *reduce* their tax bill by investing in such tax planning, so that they may have *negative* compliance costs. Small taxpayers, especially salary-earners, have far fewer opportunities for reducing their tax bills in this way.

Using Principles to Construct Understandings of Fairness

The analysis in the first part of this paper also supports proposals to combine general principles and detailed rules. More particularly, it suggests that the general principle should express the fairness or equity concept underlying the provision in question. This follows from the argument that indeterminacy results not merely from the inherent ambiguities of language, but from different normative perceptions. It also suggests that there are real limits to what can be achieved merely by redrafting existing regulations. Articulating the fairness principles underlying tax law should clearly be part of a wider democratic deliberation, including tax law reform. At the same time, a shift towards discussing taxation in terms of general fairness principles instead of the arcane complexities of detailed rules may also make a significant contribution to such a democracy.

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