CONSTRUCTING COMPLIANCE: GAME-PLAYING, TAX LAW AND THE REGULATORY STATE[?]

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Abstract

Taxation is key to the character and functioning of the state, economy and society. Its effectiveness and the levels of compliance greatly depend on acceptance by citizens of its legitimacy. This paper proposes a rethinking of approaches to compliance, extending perspectives which view regulation as an interactive or reflexive process mediated by socio-linguistic practices. These suggest that the meaning of rules is not fixed ex ante, but may emerge and change through such interactions, which therefore actually help to construct what it means to comply. The analysis supports proposals to base tax law on purposive general principles combined with detailed rules. However, it suggests that this should be the approach adopted for the tax code as a whole, instead of focusing mainly on the merits of a general anti-avoidance principle, as some of the recent debates have done. Although a general anti-avoidance principle may have a place, the aim of achieving a cultural shift in the regulatory system of tax compliance needs public debates on the substantive general principles of taxation. These have been neglected, as tax reform initiatives have tended to become fruitless exercises in trying to rewrite complex tax law in plain language. Unless the tax code itself is built on a sound foundation of principles generally accepted as fair, compliance will be problematic.

The first part of this paper explores the question of interpretation of rules and the problem of avoidance and game-playing. It re-examines the issue of the indeterminacy of rules and relocates it within the context of professional and regulatory practices, suggesting that it is these interactions that construct the meaning of rules and hence of compliance. In the second part the analysis is applied to income taxation, to sketch out how the international tax system has been constructed through the interaction of contending views of fairness in the allocation of tax jurisdiction, while in the process becoming refined into a formalist and technicist process of game-playing. I argue that the central factor in this process has been the inherent contestability of the core concepts of international taxation, the rules on corporate residence and source of income. The final section then considers some of the current proposals for improving tax compliance, in particular by reducing complexity, improving clarity, and the use of broad principles.

A. THE CONSTRUCTION OF COMPLIANCE

1. Negotiating the Meaning of Rules and Legitimacy

Much of the discussion of `compliance' with rules implies 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 regulator and regulatee both have a relatively clear understanding of what the rules mean, and indeed a shared understanding. Although there have long been

jurisprudential debates about the imprecision or indeterminacy of rules,[1] only relatively recently have some authors explored the implications of this from a socio-legal perspective (McBarnet & Whelan 1991, 1999, Reichman 1992, McCahery & Picciotto 1995, Black 1997, Braithwaite & Braithwaite 1995, Lange 1999, Braithwaite 2002).

However, even socio-legal studies tend 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'. Regulatees are generally seen as being on a continuum between the committed or compliant at one end, and at 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 that `whether or not a person interprets the request in accordance with its intent is far from certain' (V. Braithwaite 2003a: 276). This implies a different view, in which various players may have different and genuinely-held understandings of a rule's meaning, and may each consider theirs the correct and clear meaning.

Indeed, the existence of different understandings or interpretations of `what is required' by a rule is, I suggest, a frequent and even normal situation. Let us take a basic tax provision, 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.[2] 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.

This suggests that the primary task in designing a regulatory system is to build it on principles which are widely accepted as fair and hence help foster shared understandings. The instrumental view of law generally considers that compliance is best achieved by formulating law in clear language and using precise or specific rules rather than more abstract general principles. This view has been undermined by critiques, based in linguistic philosophy, which point to the indeterminacy of law. Socio-legal studies generate a separate concern, that instrumentalism takes a uni-directional view of compliance with law, which fails to take account of the ability of legal subjects to adapt their behaviour in response to the law and to its application by those responsible for its enforcement.

This opens a further perspective, that norms may be generated and derive their meaning through the interactions of all those involved in a social field. This has been examined in Bettina Lange's fascinating fine-grained study of waste disposal regulation, looking especially at the interaction between formal and informal rules (Lange 1999). The critique of indeterminacy and the view of law as a social process are inter-related in studies of regulation which view it as mediated by interpretive practices. This is captured by the term regulatory conversations, which has been developed by Julia Black as a metaphor for the analysis of the socio-cultural interactions between regulators and regulatees (Black 1997, 1998, 2002). However, this raises the question of whether esoteric conversational communities may

develop complex regulatory fields, insulating them from input from outsiders and broader democratic debate. Indeed, the issue of indeterminacy and formalism is fundamentally about democracy, since it concerns the processes for generating the authoritative meaning of laws.

2. Legitimacy in Tax Compliance and Avoidance

The problem of legitimacy of income taxation has been a key factor in the crisis of the Keynesian fiscal state since the mid-1970s. In many countries wage-earners became increasingly reluctant to accept tax burdens which they perceived as inequitable, especially due to the greater effectiveness of collection at source from employment income, compared with the greater opportunities for avoidance available for income from capital, business or self-employment. On the other hand, it has been argued that tax burdens on business or on high earnings hinder entrepreneurship and discourage achievement, and in a world of mobile money governments have generally preferred to try to boost revenues through economic expansion rather than increasing taxation of investment income. The pressures on income taxation have led to widespread reforms in many countries both of tax policy and administration. Policy reforms have generally entailed reducing high marginal rates of income tax while attempting to broaden the tax base by ending tax breaks and combating avoidance, as well as widening the tax net by introducing new sources of revenue such as sales and transaction taxes.

Unfortunately, the attempts at structural reform of income tax have largely failed. Although the virtues of tax `neutrality' have often been extolled, in practice tax provisions have been extensively used for political and social engineering purposes. This produces an ever-growing volume of tax law, including complex amendments to prevent the use of tax breaks in unintended ways. In the absence of structural reform, the attention has shifted to improving tax administration, involving new managerial techniques and professionalisation, with revenue authorities often being given greater autonomy from government, although within a defined remit. As with other areas of governance in the `new regulatory state'[3] there has been a shift to a culture of service delivery, with corporate plans, customer charters, and performance targets (Hamilton 2003). The aim is to rebuild the confidence and trust of citizens in public services, mainly through technocratic approaches to efficiency. However, as tax administrations are being asked to do more with fewer resources (to achieve `efficiency gains'), there has not surprisingly been talk of a crisis in tax administration (Aaron & Slemrod 2004: 2-4).

The new approach to regulation entails new relationships between the so-called public and private spheres which are more diverse and interactive, or `reflexive'. An important feature of governance in the regulatory state is reliance on formalised rules, which increasingly replace informal norms or shared understandings amongst closed groups. At the same time, the increased complexity of regulatory interactions has also brought a new awareness of the inadequacy of instrumental views of law and regulation. Taxation has features in common with other areas of economic regulation, but its particular character means that some of them are present in a much more extreme form. This is 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 comes from the attempt to draw up rules which are precise and which anticipate every contingency, resulting in a highly complex tax code. This derives from formalism:` 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). The alternative is more general, open-ended principles 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, often referred to as indeterminacy: that general legal rules are 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, the formalist approach does not prevent avoidance, but shifts it to a new level, involving game-playing and `creative compliance'. This has been pointed out especially by Doreen McBarnet and her collaborators in studies of avoidance both of tax and financial regulation. She has described `creative compliance' as `working to rule' (McBarnet 2003). Essentially, it entails recharacterising the legal form of economic transactions, in such a way as to avoid the purpose of the law while complying with the letter of the rule. Hence, as several commentators have pointed out, the complexity resulting from formalism also generates uncertainty (Miller 1993; Weisbach 1999; J. Braithwaite 2002, 2003a), especially if it results from cat-and-mouse game-playing, which generates `contrived complexity' (J. Braithwaite 2003a, 76). Thus, as John Braithwaite has recently argued, it may be better to combine general principles and specific rules (J. Braithwaite 2002, 2003a, 2005).

This paper argues a slightly different view of creative compliance, built on the insight that alternative interpretations of rules may each be potentially valid. Hence, a regulatory regime may be `created' through the interactions of those involved, mediated by contestations about the validity and legitimacy of different interpretations of rules. To consider this more closely, it is important first to try to clarify the issue of indeterminacy.

3. Three Levels of Indeterminacy of Rules

I suggest that there are three aspects or levels of indeterminacy. At the most general level, indeterminacy arises from the social nature of language. At least since Wittgenstein, linguistic philosophy has emphasised that the meaning of words is socially constructed. Hence, even physical objects have an ontological existence which depends on shared understandings and practices, reflected in the terms used to denote them 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, for example, specific terms may be used to denote 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 terms or statements which do not refer to sensorily verifiable objects or events, but to social activities, and even more to artificial concepts.[4] Thus, it has been suggested that income tax law is different in kind even from other laws (even other taxes, such as sales or transaction taxes), because its concepts do not refer to something which exists in nature.[5] This point is well taken for the central concept of income, which is almost entirely artificial, although I suggest that a concept such as residence does have some relation to physical reality, at least as much as does that of an exchange transaction. Thus, there is less indeterminacy in a drunk-driving law that refers to blood-alcohol levels (although that still depends on the social practices, e.g. of their measurement), than one which refers to capacity to drive (Endicott 2001).

There are two further levels of indeterminacy of legal or regulatory rules, due to their nature as norms in a liberal system of regulation. Liberal legality assumes that individuals should be free to decide on their own conduct provided it complies with rules of law expressed in general terms addressed to all citizens. Regulation may involve other kinds of decision-making process, such as a requirement of prior approval, which obviously provides more certainty.[6] However, such a power is regarded as absolutist and illegitimate unless it is subject to procedural safeguards, and exercised within a framework of rules. Nevertheless, the liberal principle of individual freedom subject to the rule of law gives rise to a range of positions in political theory on whether it is best safeguarded by laws expressed in general principles or precise rules (J. Braithwaite 2002: 49). At one end of the spectrum is the assumption that the freedom of citizens is best safeguarded by ensuring that state power is exercised only through rules drawn as precisely and specifically as possible, and at the other the view that law `must allow forms of private ordering, giving legal powers to individuals to create and to assume rights and duties in ways that are liable to be vague' (Endicott 2001: 382).

General norms require a process of inductive-deductive reasoning, from the particular to the general and vice versa. This gives rise to the second level of indeterminacy, the one with which lawyers are perhaps most familiar, since it is recognisable 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 (Hart 1958). This suggests 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 at their core that is generally understood, and that it is only the more or less marginal cases in the penumbra that may be doubtful.

However, applying to norms the interpretive approach to language (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. Thus, deciding whether a particular instance fits within a general principle is not just a factual inquiry but entails a value-judgement, if it concerns a legal principle. 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' (Fuller 1958: 670).

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 underlie 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'.

The Hart-Fuller debate centred on the relationship between law and morality, in that Fuller argued that the meaning given to a legal rule is inseparable from the moral values it is considered to embody, whereas Hart's essentially formalist view was that legal and moral reasoning could (and should) be separated. I suggest that a more helpful view comes from an understanding that epistemology is relative and based on different social practices, which nevertheless interact within society as a whole. The problem of formalism comes from a type

of reasoning that assumes that social behaviour can be comprehended in terms of the internal rationality of a particular social practice (law, morality, economics, science) without reference to other perspectives.

This is exemplified in legal adjudication by the literal approach to rules, which asserts that they should be understood according to their `natural', `ordinary', or `normal' meaning, in their `context', which generally means the linguistic context of the particular words. This implies that the legal meaning can be directly related to common social practices and understandings (unless the term itself is recognised as deriving from a particular technical sphere). From this perspective, the moral (or economic, or political) purpose of a rule is irrelevant in understanding its meaning. The literal approach to interpretation is generally contrasted with the purposive approach, which suggests that the specific words of a legislative provision should be interpreted in accordance with the general purpose of the legislation. This goes some way towards cognitive openness, in that it obliges the interpreter of the rule (usually a judge) to articulate the policy implications of the possible interpretations of the rule, and to select among them by reference to the objectives of the legislature. In the UK the courts have historically preferred the literal approach, especially in tax cases, although there has been some shift recently towards purposiveness (Avery Jones 1996).

To the extent that there are shared understandings among the various practitioners involved in the law, the indeterminacy of the rules may be greatly reduced, but only within that closed group. If a legal rule refers to a more widely understood or experienced ontologically verifiable object, or even a common social activity, indeterminacy may also be reduced. However, legal reasoning which remains closed to wider social practices and understandings relies for its legitimacy simply on the authority of lawyers as technical specialists. A wider, and indeed more democratic, legitimacy comes from adopting a more open epistemology, which acknowledges that legal rules have a wider social resonance and impact, and that their understanding must be informed by wider social practices, especially those of the persons to whom they are addressed. This is likely to be important to the legitimacy and hence stability of an interactive regulatory process or system.

4. Constructing Compliance

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 negotiations about these meanings, `regulatory conversations' to use Black's term, which in one way or another may 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, since they are by their nature normative.

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 means. A stable and effective regulatory system therefore is one in which such acceptance is as broad as possible. This will minimise the extent of disagreement or contestation about the meaning of the regulations.

The points made above about the indeterminacy of rules, 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 often 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, which are said to create `loopholes' in the logical fabric of the law, although it is legal arguments that generate the loopholes as well as constituting the warp and weft of 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 regularise. 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 formalisation can succeed only to the extent that legal organisation gives explicit form to a tendency already immanent within those practices', since ` [t]he rules which succeed are those which, as we say, *regularise* factual situations consonant with them' (Bourdieu 1987, 848-9).

The important point here is that contestation of the meaning of norms is generated from disagreements about what they *should* mean, for the social practices which they seek to regulate or `regularise'. 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 advance their own view as the correct one. 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 an interpretive view.

B. CONSTRUCTING INTERNATIONAL TAXATION

1. Contested Norms in International Taxation

The taxation of income or profit from international business is a field which has become increasingly complex, and rife with avoidance game-playing, especially in recent years. However, its basic principles were the subject of some debate from the earliest days when income tax began to replace indirect taxation, especially import duties, to become the centre-piece of the fiscal constitution of the 20th century welfare-warfare state, in which Britain led the way (Daunton 2001). From the viewpoint of the British state, fairness required taxation of residents on their income from all sources, and of non-residents on income from UK sources. 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 those 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. The issues were, when should a company 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).[7]

On the question of `residence', the decisive precedent was set by the case involving 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 company was a British resident, since `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'(*De Beers* 1906: 213). In the way of English judges, this decision was put forward as flowing from a common-sense interpretation of the term `resident'. The Lord Chancellor stated: `In applying the conception of residence to a Company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A Company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a Company.' (Ibid. 212-3).

In deciding that company residence depended on the location of its main shareholders, this reasoning ignored or overlooked the implications for the way global business was organised and financed. Some of the earlier court decisions had at least appreciated the implications of the issue for Britain as the world's leading source of international investment at the time. Thus, in 1876 Chief Baron Kelly showed an acute awareness that the cases involved `the international law of the world', since 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' (*Calcutta Jute* 1876: 88).

The issue looked very different from the viewpoint of some of the leaders of British international business. This was expressed perhaps most clearly by Sir William Vestey, who was to become well-known in UK tax law, and whose grocers' firm had grown by importing eggs from China and beef from Argentina. He argued for fairness in relation to his international competitors, and proposed a global approach based on the proportion of sales in each country.

> `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.'[8]

However, the British state was reluctant to modify its claim to tax all British residents (and companies based in the UK) on all their income, except by international agreement, which would take some time. Meantime, the Revenue was left to trying to apply the principle of residence based on the test of `central management and control' laid down by the courts. The decision in *De Beers* rejected the alternative test, put forward on behalf of the company, of the place of incorporation, on the grounds that this could easily be avoided `by the simple expedient of being registered abroad and distributing its dividends abroad' (De Beers 1906: 213). But the control test could also be avoided: indeed the Vestey group had moved its

headquarters to Argentina in 1915 to avoid being taxed at British wartime rates on its worldwide business. Sir William had said he would like to come back to Britain to live work and die; but as his tax proposals were not accepted, not surprisingly, the Vesteys (and other firms) took steps to organise their affairs to ensure that 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. Indeed, they went further, and with the help of tax advisers, set up a scheme centred on a trust formed in Paris, which could receive profits from their global business and make payments to members of the Vestey family at the discretion of the trustees (Knightley 1993). When the Revenue eventually discovered this, it secured legislation in 1936-8 to tax the income of such foreign trusts. But to be effective, this extended to all such `sheltered' income, even if not paid over to a UK-resident beneficiary, giving the Revenue very broad discretionary powers, which was later denounced by an eminent tax lawyer as `preposterous' and amounting to a `suspension of the rule of law' (Sumption 1982: 116, 138). The validity of these provisions, as well as subsequent legislative amendments, occupied lawyers and the courts profitably for many years. Indeed, the Vesteys scored two significant victories, although they had to take their cases to the House of Lords, and the judges at various levels disagreed with each other. In the hundreds of pages of judicial reasoning it is hard to discern any issues of principle, and the decisions turned on points such as whether the beneficiaries could be said to have a `power to enjoy' income (*Vestey's Executors* 1949: 69), whether a reference to a person could include more than one beneficiary (ibid.), and whether the provisions could extend to beneficiaries other than the original transferor of the assets (*Vestey* 1979).

Thus, the `game' of international tax avoidance was born early in the 20th century, out of disputes over the fairness of the basis for taxation of international business income. These different perspectives could be used to justify different interpretations of the basic principles such as `residence' and `source' of income. International coordination did develop, although only slowly. However, the tax specialists who tackled the issue rejected a global approach along the lines suggested by William Vestey, because they considered that it would not be possible to reach political agreement among states, especially on the formula for allocating global income (Picciotto 1992: 27-37). Instead, a network of bilateral tax treaties grew, based on internationally agreed models, which allocated rights to tax based on residence and source. This entailed treating activities which from a business perspective might be globally integrated as if they were carried out by separate unrelated entities.

Creative Jurisdictionality

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 the tax authorities and the professional advisers of internationally-operating businesses 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. However, this still meant that profits earned abroad in a low-tax country could be subject to the higher rate of tax of the country of residence of the investor, which was considered unfair by transnational corporations (TNCs). Hence, they developed more sophisticated versions of many of the devices pioneered by wealthy families such as the Vesteys, by establishing affiliates incorporated in convenient jurisdictions to shelter such foreign-source income, enabling retained earnings to benefit from a lower tax rate. Many went further and used such intermediaries as channels to provide financial or service functions for the corporate group, enabling them to reduce the taxable profits of operating

affiliates by deductions of interest charges, management fees, royalties for intellectual property, or insurance premiums. Such schemes were of more dubious legitimacy, depending on the acceptability of the claim that the functions are validly carried out by separate entities and actually in those locations, if the companies exist in effect only on paper.

To combat such devices, most developed countries enacted anti-avoidance legislation: for example, to bring `captive' affiliates within residence rules, by treating the income of `controlled foreign corporations' (CFCs) as attributable to their parent companies. However, the requirement of `control' for CFCs must be defined, often by complex rules, and the attributable income is generally limited to `passive' investment income. This accepts that some group functions or services can be provided to other parts of the TNC if they may arguably be said to be carried out `offshore' (and hence produce `active' income), such as shipping management, or insurance and other financial services. The jurisdictions of convenience, or tax havens, have therefore been further transformed into `offshore financial centres'. They have crafted special laws, often on the advice of specialists in corporate tax planning, which take advantage of the room for interpretation in other countries' legislation.

Thus international tax avoidance, or `planning', has become a complex field centring on the negotiation of the legitimacy and validity of business and financial arrangements in an increasingly complex maze of different national rules and their interactions. What constitutes compliance continues to be negotiated. The underlying reason is the inherent contestability of the principle of jurisdictional allocation based on treating the components of a global firm as if they were separate entities. The principle is contestable because it does not embody a generally accepted criterion of fairness for that allocation.

The alternative approach of global unitary taxation of TNCs based on formula apportionment has sometimes been put forward, but has generally been rejected by both tax administrators and business representatives. Certainly such an approach would, in principle, provide a much sounder basis for agreement on principles which could be recognised as fair to all taxpayers and states. However, most international tax experts remain fearful of an open debate on such principles of fairness, because they consider it too difficult to achieve political agreement.[9] A perhaps cynical view would be that they have too much intellectual capital invested in the complex and arcane system which has grown up historically.

There are genuine issues and disagreements about the definition and jurisdictional allocation of the income from international business, which are fought out in these struggles to `control the text'. The problem is that these issues have become largely obscured because the lack of any general principle of fairness in jurisdictional allocation means that the texts are so complex and esoteric that they are accessible only to a small number of specialists. Even these experts would find it hard to explain the underlying justification for many of the rules.

Formalism also derives from the disjuncture between the conversations about the rules which remain internal to tax specialists, and debate in the general public policy arena (which could also involve contributions from other specialists such as economists). International taxation is now a hot policy issue, and debates about it are conducted in language which is also highly contested. Terms such as `tax havens', `harmful tax competition', and even `passive income' or `high net worth investors' are deployed for their symbolic effects; but these contests are hard if not impossible to connect with the specific issues dealt with in the esoteric language surrounding for example the definition of `controlled foreign corporation'.

The result is both to impoverish the policy debate, and to cut away the political and moral considerations which should underpin the specialist practices of those involved with tax compliance. These are the structural reasons which turn a regulatory culture into one of game-playing. The tax avoidance `game' is one in which the players seek to interpret the rules to their advantage, but in a formalist and technicist manner, that is to say by referring only to the apparent internal logic of the rule-system, without feeling any need to justify their interpretation of a rule by reference to broader considerations. Those involved may consider they are simply doing a professional job, but to outsiders they are acting in a cynical and amoral manner. The problem of formalism is due not merely to the detailed nature of the rules, but to their being dislocated from any justifying rationale, a generally accepted principle of fairness.

C. LEGITIMACY, COMPLEXITY AND COMPLIANCE

The preceding analysis might help to illuminate some of the current debates about how to improve the tax regulatory system. The general concern to improve compliance by improving taxpayer confidence in the fairness of the system is linked to the need to find ways to reduce the opportunities for avoidance, and in particular to end the cynical perspective on tax rules that is entailed in game-playing. The difficulty is that the complex rules have been enacted and seem to be needed in order to combat avoidance. Thus, although many of the leading common-law countries have embarked on tax simplification exercises, little progress has been made in reducing complexity.

There is ample evidence 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). Acceptance of the fairness of taxation may derive from an identification with 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 globalisation) 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).

Tax Law Clarification, Simplification and Reform

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 the triple aims of (i) greater clarity, (ii) less complexity and (iii) a simpler and fairer tax structure.

The US prioritised structural reform, and its Tax Reform Act of 1986 aimed to reduce the complexity of the system and not just to improve clarity. However, 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). In contrast, Australia's Tax Law Improvement Project, initiated in 1993, 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). A more radical approach was proposed in the paper on *Tax Reform – not a new Tax, a New Tax System* (1998); this called for an integrated tax code, which would `use general principles in preference to long and detailed provisions' (p.149). However, the impetus for simplification was overtaken by the debates generated by major tax changes, notably the controversial General Sales Tax.

In the UK, although there has been much debate about both structural reform and reduction of complexity, the only progress made has been on clarification. The Tax Law Rewrite project has laboured since 1995,[10] and has resulted so far in five statutes on income tax, after which its attention will turn to corporation tax. Even its political progenitor admits that, although it could be said to have improved the quality of tax legislation, it has not reduced its quantity, while the annual Finance Act continues to add an enormous and uncontrollable number of pages of tax legislation (Howe 2001). Thus the exercise seems very like a classic case of repainting the Forth bridge. Its effects will not be felt outside a very small circle of tax lawyers, as a recent independent evaluation of one of the `clarified' statutes confirmed that even accountants and in-house tax specialists rarely look at the legislation itself (MORI 2006).

Simplification: the Purpose of Principles and the Utility of Rules

While structural reform is hampered by political conflicts (and economic inequalities), there seems little point in pursuing clarification without simplification (Owens & Hamilton 2004: 350). This has, however, been bedevilled by the concern that simplification would endanger clarity by reducing certainty. More recently, discussion has centred on the relative merits of laws cast in terms of general principles as against detailed 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. Thus, John Avery Jones has suggested a hierarchy, with overarching purposive principles at the top, less detailed legislation below, and Revenue rulings to deal with specifics (Jones 1996). 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.[11] John Braithwaite has also argued convincingly that tax law should be designed along these lines, with overarching binding principles supported by non-binding detailed rules (J. Braithwaite 2003a, 2005). 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. Judith Freedman has also lent her weight to the proposal that a General Anti-Avoidance Principle[12] should be enacted in the UK, bringing it into line with other countries, such as Australia and Canada (Freedman 2004).[13] Instead, the UK has preferred to introduce administrative procedures for notification of avoidance schemes, which raise their own questions and tactical games over what needs to be notified.

The analysis in this paper also supports proposals to base tax law on purposive principles combined with detailed rules. It would, however, seem undesirable that the first or only general principle should be on anti-avoidance.[14] Authors such as John Braithwaite and Judith Freedman argue, in my view correctly, that more certainty could be provided by a tax code based on broad general principles, supplemented by more detailed rules which could emerge from regulatory conversations between tax authorities and taxpayers or their advisers. Thus, Freedman suggests that a general anti-avoidance rule `would facilitate a debate around the

meaning of the difficult concept of tax avoidance which could be pursued between the taxpaying community and revenue authorities' (Freedman 2004: 357).

However, the analysis put forward here suggests that it is essential, not optional, to begin by formulating general principles in the substantive areas of tax law, which should adequately express a widely accepted principle of fairness or equity in relation to that type of tax. A general anti-avoidance rule itself may not help to guide tax planners as to what is acceptable since, as Nabil Orow has pointed out, the complexity of the tax laws as a whole has led to the invention of such fantastical tax-driven financing devices that ` tax lawyers and specialists have lost their sense and grasp of reality' (Orow 2004: 412).

Tax reform should not be viewed as a technical exercise. Nor can the vicious circle of game-playing and complexity be broken by introducing a general principle of adherence to the spirit of tax rules, if that spirit is not itself expressed in terms of broad and generally accepted principles. Regulatory conversations may not help to improve the quality of regulation if they are conducted only within closed circles of experts. Indeed, such specialist communities may generate their own esoteric language in which to negotiate interpretations of the rules. They may therefore remain impervious to attempts to introduce transparency by formal measures, such as publication of technical documents and consultation. Disagreements about the normative underpinnings of the rules may result in game-playing and hence complexity. Both specialist language and regulatory complexity may develop partly as a defence mechanism, through a misplaced lack of trust that public debate and political processes can help resolve normative conflicts.

As this paper has shown, indeterminacy results not merely from the inherent ambiguities of language, but from different normative perceptions. Hence, 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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[?] A first version of this paper was drafted during an all-too-short visit of four weeks to the Centre for Tax System Integrity at the Australian National University, and presented to a seminar attended by staff of the Australian Tax Office and the Treasury; a subsequent version was published as a CTSI Working Paper. My grateful thanks to John Braithwaite and all his colleagues at RegNet for the opportunity to work in such a stimulating and friendly environment, and more specifically to Val Braithwaite and her colleagues in the CTSI, especially Jenny Job and Greg Rawlings, and to ATO and Treasury staff, for all their help, comments, and discussions.

[1] For a recent discussion see Endicott 2001 and other papers in the same issue of the journal.

[2] I am not aware of any scientific empirical research on this question. However, I would urge any doubting reader to try asking any half-dozen or more friends or colleagues (as I have done), what their understanding is of the deduction rule. I have found qualitatively significant variations even among a group of tax researchers.

[3] Many writers have used the term or the general concept (notably Teubner 1987, Majone 1993, Pildes and Sunstein 1995, Loughlin 1997, Braithwaite 2000, Scott 2000), and with different actual states in mind; clearly the changes are far from uniform but vary greatly between different national contexts (for a recent comparative overview see Jordana & Levi-Faur 2004). Nor do they lead to a settled or even clearly identifiable outcome: indeed, Michael Moran argues that a key feature, at least of the British regulatory state, is `hyper-innovation' (Moran 2003). Most recently, John Braithwaite has explicitly applied the concept to the area of tax administration (J. Braithwaite 2005).

[4] I should perhaps say that I adopt a critical realist perspective which posits an objectivist ontology but a relativist epistemology, i.e. that reality can only be understood through the different perceptions of the various actors involved. Thus, our shared perceptions of the natural world provide a firmer common grasp of its reality, understandings of social activities are likely to be more relativistic, while shared understandings of abstract concepts must be generated by socio-linguistic practices.

[5] Prebble 1998: 113; prior to the emergence of the modern income tax, of course, direct taxes were levied on the indicia of wealth, such as windows, or carriages.

[6] For example, theatre performance was not liberalised in Britain until the requirement of prior approval of scripts by the Lord Chamberlain under the Stage Licensing Act of 1737 was ended in 1968. In the field of taxation, relative certainty is sometimes achieved by giving the tax authorities the power to determine whether a proposed arrangement is liable to tax, although such a determination is not usually final.

[7] 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.

[8] UK Royal Commission on Income Tax, Evidence, p. 452, Question 9460.

[9] Taxation on a unitary basis has been applied by the component states in a federal system, notably in the USA; however, a strong campaign was waged in the 1970s and 1980s against its extension globally (Picciotto 1992: 241-9). More recently, the European Commission has proposed taxation of business operating in the single European market on a Common Consolidated Corporate Tax Base (European Commission 2001); although this is viewed with scepticism by national Treasury officials, it has some support among business representatives (interview information).

[10] Its aim is `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' see http://www.inlandrevenue.gov.uk/rewrite/.

[11] It does seem to be the case that the problem of complexity or `hyper-lexis' is peculiar to common-law countries, perhaps for a combination of reasons which there is no space to consider here.

[12] Freedman has suggested the admittedly ugly acronym GANTIP for this, since GAAP is understood to refer to US accounting principles, and the alternative of GAAR which is often used runs counter to the distinction between general principles and specific rules.

[13] The proposal has developed into an interesting and typically British process of constitutional evolution (or buck-passing). The House of Lords, having appeared to take the bold step of introducing such a principle in its decisions in *Ramsay* (1982) and *Furniss* (1984), has now recast it as a principle of purposive interpretation, since it does not consider itself to have the constitutional power to introduce a general overarching interpretative principle (*MacNiven* 2003). Meantime, the government declined to put a proposal for such a general principle to the legislature (apparently bowing to business pressures), but has instead introduced a procedure requiring notification to the Revenue of new tax planning devices; the statutory power for this is drafted in impossibly wide terms, so its effectiveness will depend on the more detailed regulatory requirements, which have been more narrowly drafted (Richards 2004). It has been suggested that there is no need for a legislated anti-avoidance principle, as sufficient resources are available in the common law (Simpson 2004); while the judicial shift to purposive interpretation of existing tax law without a legislated anti-avoidance principle is likely to favour the taxpayer (Tiley 2004).

[14] Anti-avoidance principles (or the requirement to show a commercial justification rather than a tax-reduction motive) are already present in specific parts of UK tax law, and have been shown to operate with `reasonable objectivity' (Kessler 2004). This supports the view that it is the particular parts of tax law that need to be drafted in terms of purposive principles.