CENTRE FOR TAX SYSTEM INTEGRITY

Constructing Compliance: Game-Playing, Tax Law and the State

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This series of working papers is designed to bring the research of the Centre for Tax System Integrity to as wide an audience as possible and to promote discussion among researchers, academics and practitioners both nationally and internationally on taxation compliance.

The working papers are selected with three criteria in mind: (1) to share knowledge, experience and preliminary findings from research projects; (2) to provide an outlet for policy focused research and discussion papers; and (3) to give ready access to previews of papers destined for publication in academic journals, edited collections, or research monographs.

Abstract

The first part of the paper explores the question of interpretation of legal rules and the problem of avoidance and game-playing. The paper re-examines the issue of the indeterminacy of rules and relocates it within the context of professional and regulatory practices. In the second part the analysis is applied to income taxation, in particular 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. The final section then considers some of the current proposals for improving tax compliance, in particular by reducing complexity and the use of broad principles.

Constructing Compliance: Game-Playing, Tax Law and the State[*]

Sol Picciotto

INTRODUCTION

Transformations of the Fiscal State

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 subjected to them, would probably think that Smith's standards are some way from being met.

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. The views of enlightenment thinkers such as Smith entailed a critique of the tax systems of the absolutist monarchies which, although they had been a key element in the formation of centralised states, were experienced as capricious and oppressive. Britain's success in establishing a 'fiscal-military state' in the 18th century could be contrasted with the tax revolts and crises of France, where the fiscal crisis eventually sparked the French revolution (Daunton, 2001, p. 7); while Britain's failure to legitimise taxation by extending representation in its overseas possessions (which was advocated by Smith) led to colonial revolts, one of which overthrew British rule in North America. Although enlightenment ideas about the basis of legitimacy of the state differed, they generally agreed that the state's central role was to safeguard its citizens and their property (Frecknall Hughes, 2004). In Britain, economic growth and the absence of major wars during the 19th century enabled Peel

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[1] *Wealth of Nations*, Book IV, Ch.II, Part II.

and Gladstone to fashion a strong 'fiscal constitution', establishing a high degree of mutual trust between government and taxpayers, based on restraint and efficiency in public expenditure and a shift to direct taxation of income on the principle of proportionality.[2]

Significant further changes were necessary to cope with the needs of the welfare-warfare state of the 20th century, during which state expenditure rose from around 10% to some 40% of GDP. The principle of proportionality shifted to an acceptance of graduation, or higher tax rates on higher income, justified by the concept of ability to pay (Daunton, 2001, p. 144). Although this has greatly helped to legitimate income taxation, there has always been a potential threat due to the inequities of collection from different types of income. Collection has always been more effective where tax can be deducted at source, or from income which is easily verifiable, such as a regular wage or salary. It has been more difficult, and the liability subject to contestation, for income from capital, from business, or from a self-employed trade or profession. Indeed, the very concept of income has been continually contested (Daunton, 2004), both in direct interactions between tax officials and taxpayers or their advisers, and in wider public debate.

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 (and in advance, via pay-as-you-earn), compared with the many opportunities for avoidance available for some types of 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. 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

[2] Daunton 2001: 26-30. Fiscal discipline rested on firm Treasury control of expenditure based on the introduction of a clear and uniform accounting system, and principles of fiscal probity which Gladstone considered `at the root of English liberty'. These were, notably, budgetary unity (the rejection of hypothecated taxes), annual parliamentary votes to approve specific budgetary heads with no discretion for government to vire among them, no carry-forward of end-of-year surpluses, and no pledging of future revenue to finance spending (ibid. 66-76).

new sources of revenue such as sales and transaction taxes. Although the virtues of tax 'neutrality' have often been extolled, in practice tax rules have been extensively used for social engineering purposes. In parallel, there has been an introduction of new managerial techniques into tax administration, which has become more professional, with revenue authorities often being given greater autonomy from government, although within a defined remit.

It may be said that in taxation, as in other areas of governance, there has been a transition to a new regulatory state.[3] Many state functions have been delegated to autonomised public bodies working within a culture of service delivery (corporate plans, customer charters, performance targets, etc.). The aim is to rebuild the confidence and trust of citizens in public services, mainly through technocratic approaches to efficiency. It entails new forms of networked interaction and relationships between the so-called public and private spheres . In place of the top-down model of action by a centralised state, the fragmentation of the public sphere results in networks operating through new kinds of regulation which are more diverse and interactive, or 'reflexive'.

Regulatory Interactions and Conversations

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. However, there are a wide variety of types of rules, which often operate interactively, and at different levels, involving both meta-regulation and micro-regulation.[4] National government legislation, and its interpretation by court adjudications, may now be subject to supranational

[3] Many writers have used the term or the general concept (notably Teubner 1987, Majone 1993, Pildes and Sunstein 1995, Loughlin & Scott 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 and 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).

[4] The term meta-regulation has been used to describe rules governing how others should regulate, or `governing at a distance', especially where law specifies how firms should regulate their activities (Gunningham and Grabosky 1998), and has now been applied to the relationship between international trade rules and national law (Morgan 2003).

meta-regulation,[5] while its application to legal subjects may be mediated by a variety of codes, guidelines, practice directions and administrative clearances or rulings.
The increased complexity of these regulatory interactions has also brought a new awareness of the inadequacy of instrumental views of the social effects of law and regulation: the assumption that social behaviour automatically falls into line with that desired by the legislator as expressed in the regulations. An important problem in implementation is regulatory avoidance, or steps taken by those subject to a regulation to modify their behaviour so as to comply with its letter but not its spirit or intention. There are several aspects to this. First, there is the question of interpretation, often identified as the problem of vagueness or indeterminacy of the language in which regulations are expressed. Secondly, especially in relation to economic regulation such as taxation, there is the possible disjuncture between the economic character of an activity and the legal form it takes, which may make it possible to achieve a desired economic objective using a legal form other than that proscribed by a regulation. Third, and most broadly, there is the understanding that regulation is not a one-off but a continuous and interactive process. The promulgation of new regulations is commonly preceded by extensive consultations with those likely to be affected, often on the basis of draft proposals, which are often modified before being formally adopted. Adoption is not the end of the story, but the experience of implementation may lead to subsequent amendments, or even wholesale reform of the regulations.

Much of this is captured by the term regulatory conversations, which has been used as a metaphor for the socio-cultural interactions between public official charged with implementing regulation and citizen/subject of the regulation (Black, 1997). The term helps to indicate the interactive nature of regulatory processes, and especially their mediation through socio-linguistic practices, and this has been perhaps most thoroughly explored by Julia Black through the lens of discourse analysis (Black, 2002).

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[5] For example, a series of recent decisions by the European Court of Justice (ECJ) have struck down some key provisions of national taxation of cross-border business as discriminatory under European Community law; the potential impact for example on British tax revenue has been estimated at £8bn per year (Crooks 2003), and these decisions have once again raised the issue of national `sovereignty' (Craig 2003). Similarly, the US Congress was obliged to make far-reaching changes to bring US corporate taxation in line with World Trade Organisation (WTO) rules, following an adjudication by the WTO's Appellate Body, though it took two years of debate and negotiation, and some $140bn of new corporate tax breaks. This is only the most recent chapter of a long-running saga of interaction between national tax and international trade rules (McDaniel 2001) which goes back some two decades (Lubkin 2002), and is likely to continue (Minder & Alden 2004).

This paper aims to apply and develop these perspectives on regulation to make a contribution to some of the recent debates about the improvement of tax systems and the problem of tax compliance. The first part of the 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. In the second part the analysis is applied to income taxation, in particular 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. The final section then considers some of the current proposals for improving tax compliance, in particular by reducing complexity and the use of broad principles.

REGULATORY COMPLIANCE, AVOIDANCE AND GAME-PLAYING

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 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, p. 849).

However, such a 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.
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, often referred to as indeterminacy: 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, p. 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, p. 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 is important to try to clarify 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. Although there have long been jurisprudential debates about the imprecision or indeterminacy of rules,[6] only relatively recently have some authors explored the implications of this from a socio-legal perspective (e.g. McBarnet & Whelan 1991, 1999; Reichman 1992; McCahery & Picciotto 1995; Black 1997; Braithwaite & Braithwaite, 1995).

However, even this work sometimes assumes 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 tend to be seen as being on a continuum between the committed or compliant on

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

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, p. 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,a p. 276). This implies a different view, in which various players may have different and genuinely-held understandings of a rule's meaning, and may even each consider theirs the true 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 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.[7] 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.

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 for objects that have an ontological existence, the terms used to denote them

[7] 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.

depend on shared understandings and practices 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 ontologically verifiable objects or events, but to social activities, and even more to artificial concepts.[8] 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 (Prebble, 1998, p. 113) . 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 has at least some relation to ontological 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.

There are two further levels of indeterminacy of legal or regulatory rules, due to their nature as norms in a liberal system of regulation. This type of system involves establishing general norms to guide the conduct of individuals in specific situations. Regulation may involve other kinds of decision-making process, such as a requirement of prior approval.[9] However, in post-absolutist societies such a power is regarded as illegitimate unless it is subject to procedural safeguards, and normally also based on some general norms. General norms require 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 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

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[8] 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.

[9] 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.

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 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.

However, applying to norms the interpretivist 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. 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., p. 670).[10] 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 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

[10] This has some affinity with what Deputy Commissioner Jim Killaly of the ATO has described as Taking a Whole of Code Approach, (Killaly 2004).

of reasoning that remains closed and assumes that the conclusions derived from the internal rationality of a particular social practice (law, morality, economics, science) should be determinative of an issue. 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.[11] This implies that the meaning can be derived from formal reasoning within the system of legal rules of which the particular rule is a part.

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 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.

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 discussions about these meanings, or 'regulatory conversations'. 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.

[11] This may be extended to the `context', which generally means the linguistic context of the particular words, rather than the social context to which they are being applied, and hence remains a formalist approach.

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 minimize the extent of disagreement or contestation about the meaning of the regulations. The general points made in this section 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, p. 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, p. 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.

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 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, pp. 848-849).

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 interpretivist view.

CONSTRUCTING COMPLIANCE IN TAXATION

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. 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).[12]

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

[12] 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.

of the company except the mining operations'(De Beers, 1906, p. 213). 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'. [13]

However, by that time the world market was already globalised, 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 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.

[13] *Calcutta Jute* (1876): 88.

Not surprisingly, firms like the Vesteys 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.[14] 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. 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 internationalisation 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 elsewhere, and thus reduce UK tax by deducting interest charges, management fees or insurance premiums from the UK trading profits of their related entities. 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 (*Newstead*, 1980).

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

[14] 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.

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). Nevertheless, 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 from the assets, and that this was a benefit which amounted to a

'power to enjoy' income (*Vestey's Executors,* 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 (ibid., p.83 (Lord Simonds); , p.121 (Lord Reid)). . 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.[15] 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,* 1979).[16]

The point of these examples is that, although people like the Vesteys 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. It can be seen that the underlying problem 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 Vesteys helped to stimulate international negotiations, it took many decades to the establish a system for jurisdictional allocation based mainly on a loose network of bilateral treaties (Picciotto, 1992).. In the meantime, the Vesteys 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.

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[15]. This loophole was partly blocked by Finance Act 1969 s.33.

[16]. 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).

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 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. Similarly, most developed countries extended their claims to tax the world-wide profits of TNCs which they considered should fall within residence rules, by introducing measures in the 1970s and 1980s to combat the use of foreign 'base' companies, by treating the income of 'controlled foreign corporations' (CFCs) as attributable to their parent companies. However, CFCs must be defined, often by complex rules, and the attributable income is 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.

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.

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 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 derives not only from this obscurity, but from the disjuncture between the conversations about the rules which remain internal to law, and debates among other specialists such as economists, or indeed in the general public policy arena. 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 'highly mobile individuals' 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.

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). Before looking more closely at the problem of reducing complexity, it may be helpful to consider the question of its cost, and how that is distributed.

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, and the findings are revealing.

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, derived from Evans et al. 1997

The data on net (after tax) costs 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 are likely to have *negative* compliance costs. Small taxpayers, especially salary-earners, have far fewer opportunities for reducing their tax bills in this way, because tax planning techniques such as re-characterization of the nature of the income or of the recipient, are much less applicable to individual salaried taxpayers. Businesses derive income from capital, which gives greater scope for recharacterization. In any case, the transaction costs of setting up such avoidance devices are likely to be disproportionately high for small especially salaried taxpayers, although they may be reduced by standardization and mass-marketing to specific sectors (e.g. construction workers).

This distribution of costs clearly generates perverse incentives. The greater proportional costs being borne by smaller taxpayers is likely to exacerbate their sense that the system is unfair. At the same time, it means that tax administrations (and governments) are likely to devote much more attention to trying to improve their procedures for this broad mass of taxpayers than for the much smaller number on whom the costs of compliance are proportionately much lighter. On the other hand these large taxpayers have very strong incentives to spend large sums on tax planning.

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, p. 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, pps. 453 &, 457). A more radical approach was proposed in the paper on *Tax Reform – not a new Tax, a New Tax System* (Australian Government 1998); this called for an integrated tax code, which would 'use general principles in preference to long and detailed provisions' (p.149).[17] However, the impetus for simplification was overtaken by the debates generated by the structural reform proposals, 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.[18] However, 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).

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. 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. This idea was put forward by John Avery Jones in the UK simplification debate (Jones, 1996). He suggested a

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[17] This was echoed in the *Review of Business Taxation* (Ralph Report 1999).

[18] The 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. See http://www.inlandrevenue.gov.uk/rewrite/.

hierarchy, with overarching purposive principles at the top, less detailed legislation below, 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.[19]

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. Judith Freedman has also lent her weight to the proposal that a General Anti-Avoidance Principle[20] should be enacted in the UK, bringing it into line with other countries, such as Australia and Canada (Freedman, 2004).[21] However, it has also been pointed out that the existence of such a provision does not help to guide tax planners as to what is acceptable, since 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, p. 412).

The analysis in this paper also supports proposals to base tax law on purposive principles, and in particular to combine general principles and detailed rules. It would, however, seem

[19] 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.

[20] 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.

[21] 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).

undesirable that the first or only general principle should be on anti-avoidance.[22] Instead, the analysis put forward here suggests that a general principle should express the fairness or equity concept underlying each type of tax provision. This follows from the argument that indeterminacy results not merely from the inherent amibiguities of language, but from different normative perceptions. An important implication of the analysis of this paper of regulation as an interactive and interpretative process is to overturn the Weberian view that the central function of law is to provide certainty within which legal subjects may predictably plan their private economic activities. Instead, regulation should be multi-layered, and should facilitate `conversations' between regulators and regulates, as well as (perhaps most importantly) the professional advisers who mediate between them. Thus, the aim of a general principle is not to provide certainty or predictability, but to express the general policy objectives of the enactment, i.e. its purpose. It should be entirely acceptable, indeed welcome, if taxpayers (or their advisers) then seek to justify their specific commercial transactions and business arrangements in terms of their own interpretation of the principle.

The paper 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.

[22] 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.

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