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# Taxation

*An Interdisciplinary Approach to Research*

*Edited by*

**Margaret Lamb,  
Andrew Lymer, Judith Freedman,  
and Simon James**

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# Taxation

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MARGARET LAMB  
ANDREW LYMER  
JUDITH FREEDMAN  
SIMON JAMES

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*The Editors*  
*July 2004*

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PART

# I

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## INTRODUCTION

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# Interdisciplinary Taxation Research—An Introduction

*Margaret Lamb*

## 1.1 Introduction

This book introduces ‘an interdisciplinary research approach’ and comments upon how disciplinary-based approaches to tax research have developed in law, economics, accounting, political science, and social policy. Topical studies provide bibliographic surveys of specific areas of tax research. In this introductory chapter I explain the objectives of this book, the background in which it was developed, its approach, and its outline content.

## 1.2 Objectives

The editors’ aim has been to produce a book that offers an innovative introduction to tax research by combining commentary on disciplinary-based and interdisciplinary approaches. As such, we hope that we can enrich the existing literature and perspectives on the study of taxation. The main objective of this book is to guide and encourage readers to produce more good taxation research. To do this we provide a map of the taxation research field and outline what we mean by ‘single-disciplinary’ approaches to tax research and ‘interdisciplinary’ approaches. Our secondary objective is to open up the field of tax research to readers. All too often potential researchers hesitate to tackle a tax research topic because

## 4 INTERDISCIPLINARY TAXATION RESEARCH

they do not know where to start. In this book we provide suggestions of topics, readings, and approaches that are intended to help the new researcher to begin to research tax problems. Both objectives for our book require that we explore the challenging problems that arise in connection with taxation and let readers begin to see and understand the dominant themes and patterns in this field of study. In the chapters that follow, tax researchers explain what they find compelling about the study of taxation. Each author also makes clear how the tax research problems that he or she finds interesting are linked to other tax research problems and perspectives within their own discipline and in other disciplines. This interlinking approach is, we argue, one way to ensure that the study of taxation is seen to be a relevant and rigorous area of research and to demonstrate why good tax researchers should be regarded as valuable contributors to the core of their own research disciplines and academic departments.

### 1.3 Disciplinary Approaches and a Multidisciplinary Field

Taxation provides a focus for rich academic research, but its nature represents a set of challenges to the researcher. I argue that taxation does not define an academic discipline in itself. By ‘disciplines’, I mean ‘recognizable communities of scholars that develop conventions governing the conduct of research and its adjudication’ (Salter and Hearn 1996: 20). I argue that a common interest in taxation serves to define an existing multidisciplinary ‘field’ of research or clustering of research interests. In this field, researchers based in different disciplines may adopt different approaches to tax research. The revenue lawyer looks closely at the interpretation and application of tax law. The economist examines the revenue, expenditure, and distributional implications of tax policy and practice. The accountant considers how tax calculation, reporting, and collection operate in the public and private sectors. The political scientist evaluates the impact of taxation on the aims and practices of government. The social policy specialist calculates the impact of taxation on the potentialities and realities of social welfare and services. Each academic discipline—law, economics, accounting, political science, and social policy—has its own particular set of concerns about taxation, as well as an understanding of what taxation is and how it should be researched.

At one level, our book is a compendium of how scholars in this multidisciplinary field of research examine and analyse tax problems. The value of the compendium is in making sure that tax researchers are aware

of existing research and approaches and the options available to them as they plan new research or design challenging teaching that is well-versed in relevant scholarship. Existing research tends to be conducted and written from the point of view of distinct academic disciplines. Law, economics, and accounting guide the majority of tax researchers, but other approaches, such as political science and social policy, are adopted as well. These last two tax research traditions have fewer academic researchers than the other three, but academics in these disciplines are distinctive and influential in debates over tax policy and practice. In this sense, they represent traditions that have helped shape and refine our conceptual thinking about tax just as much as law, economics, and accounting. This book brings these distinctive bodies of tax research together.

As a form of multidisciplinary tax research, the project to produce this book follows on from a number of initiatives taken in a UK academic context. In the 1950s and 1960s, the London School of Economics and Political Science (LSE) was home to a number of practitioner-academics of law, accounting, and economics who wrote thoughtful, provocative pieces on taxation.<sup>1</sup> The LSE tax seminar series has been sustained as a multidisciplinary forum for discussion between academics, policymakers, and practitioners ever since.<sup>2</sup> Founded in 1956 by LSE revenue lawyer-practitioner Ash Wheatcroft, the *British Tax Review* (BTR) continues to provide academics working within law as well as other disciplines with a publication that serves a set of diverse interests in tax research. Occasionally, the BTR has sponsored multidisciplinary conferences that have generated special issues.<sup>3</sup> The Institute for Fiscal Studies (IFS) has provided a splendid example of how the economic analysis of tax policy and problems can be developed in a research centre with a dedicated research staff and a network of associated economists drawn from research universities.<sup>4</sup> As its editorial policy makes clear, the IFS journal *Fiscal Studies* prides itself on presenting economic analyses of taxation in terms that are accessible to the well-informed non-specialist. The journal also publishes studies from non-economists that complement its principal interests. The IFS also can be credited with a number of multidisciplinary tax policy and research initiatives that extend well beyond the United Kingdom.<sup>5</sup> Under the leadership of the late Professor Cedric Sandford, the University of Bath Centre for Tax Research demonstrated how a group of economists and accountants could define a particular tax research problem (compliance cost), influence policy and practice through its research activities, and outline appropriate research methodologies to a widening group of researchers across the globe.<sup>6</sup> Tax Research Network (TRN) was formed to provide an organizational framework to connect tax researchers, especially those based in law and business

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schools. The TRN annual conference now attracts participants from a wide range of disciplines and countries outside the United Kingdom. Other TRN initiatives have been directed toward better understanding and exchange of ideas about issues and methods of tax research. It is through TRN initiatives that the authors of this book have begun to move toward interdisciplinary engagement in tax research. The Institute of Chartered Accountants in England & Wales (ICAEW) Research Report on interdisciplinary research in taxation (Lamb and Lymer 1999a) emerged from a TRN collaboration.<sup>7</sup>

### 1.4 Taxation as ‘Action’ or ‘Fact’

Taxation can be defined as ‘the imposition or levying of taxes; the action of taxing or the fact of being taxed’ (*Shorter Oxford English Dictionary*). An emphasis on ‘action’ or ‘fact’ creates different perspectives for defining particular taxation problems for research. The first may be associated with the processes of setting, interpreting, and administering tax legislation. The second may be associated with measuring the size of taxes and tax effects. The nature of taxation has been explored from both perspectives by scholars from a wide range of academic disciplines and jurisdictional perspectives. In Part II of this book, introductions to taxation processes and summaries of tax effects are suggested by the authors. In addition, historical works on taxation may provide suitable introductions to researchers who are new to the taxation field: Grapperhaus (1998) offers a short introduction to the world’s taxation over two millennia; Webber and Wildavsky (1986) provide a comprehensive comparative history of taxation in the western world; Daunton (2001, 2002) has written an authoritative history of British taxation in the last two centuries; and Brownlee (1996) gives a short history of US federal taxation.

### 1.5 An Interdisciplinary Approach

However the researcher chooses to define taxation for a particular research purpose, the definition reflects a complex process, rooted in a diverse context and having multifarious aspects. Many issues of taxation are interconnected and causation is difficult to pin down. One type of tax analysis nests within another, seemingly without limit as one moves from the specific to the general, or vice versa. The process of taxation rests on law and furthers

the aims of government. The politics of state spending is twinned with the politics of public revenue. Taxation concerns are ubiquitous in economic decision making and also affect patterns of social interaction. Behavioural responses to the taxing process by taxpayers, professional practitioners, and tax officials raise issues of justice, ethics, efficacy, and administration. Accounting techniques give visibility to the objects of taxation and help to regulate them.

In this book, my co-authors and I argue that we should consider going beyond a multidisciplinary treatment of the tax subject. We argue that taxation research will be enriched if multidisciplinary perspectives are complemented by interdisciplinary perspectives. As an object for research, taxation can be seen to represent an 'interdisciplinary problem'. As such, this may be a problem of knowledge and practice that would best be understood and pursued in the round. In other words, you may have to look at tax problems through the eyes of specialists in several academic fields before you gain a clear grasp of how the multiple facets of taxation fit together and affect each other. To conduct tax research you may also need to choose carefully, but not too narrowly, from among the research knowledge and tools on offer from the various academic fields that study taxation. We recognize that it is necessary for the researcher to have a base in one academic discipline, but in our view it may not be sufficient. The researcher may have to adopt the perspectives and research approaches of at least one other academic discipline, too. We call this an 'interdisciplinary approach', meaning that the tax researcher adopts the perspectives and research approaches of more than one academic discipline. This book introduces an approach to interdisciplinary tax research.

## 1.6 Organization and Content of this Book

There are four parts to this book.

*Part I.* In this part, I introduce the multifaceted nature of taxation itself and pose some of the problems associated with researching tax.

*Part II* considers taxation as a research problem explored in distinct academic traditions: law, economics, accounting, political science, and social policy. Five chapters present a deep analysis of how disciplinary-based approaches to tax research have developed in particular academic disciplines. Each author surveys the development of tax research within his or her own discipline and elaborates what is necessary for tax research to conform to its norms and standards. In each chapter, the author discusses the

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general characteristics of tax research in the research tradition; leading paradigms of disciplinary research and characteristic research approaches derived from these paradigms; and exemplary tax research within the particular research context. In addition, the authors give some indication of typical research outlets and some suggestions of possible approaches to future tax research within the tradition discussed.

In the chapters of this part, my co-authors and I start with the specific traditions with which we are most familiar, that is, the variants in the United Kingdom. Each chapter does, however, broaden the analysis to address variants of the disciplinary traditions in other parts of the world. North American characteristics receive coverage by each author and there is some discussion of Australasian and continental European research.

*Part III* considers particular taxation research topics for which interdisciplinary research methods have been and can be adopted. These nine chapters are topical studies providing bibliographic surveys of specific areas of tax research. This part of the book surveys tax research as it has been conducted in practice. From this survey, readers can begin to discern the characteristics of the tax research field and identify how one might proceed with new research on particular tax problems or using particular research approaches.<sup>8</sup> In each chapter, authors characterize the sorts of research problems that are addressed by literature in the field that they had chosen to explore. Authors also discuss exemplary tax research within the field; identify appropriate and accessible research outlets for publication; and indicate directions for future research within the field. Authors highlight interdisciplinary approaches adopted by researchers, and where relevant cite seminal works.

While the majority of chapter authors in this part are based in the United Kingdom, there is representation of tax research done in and on other parts of the world by non-UK-based authors of chapters and inclusion of topics that are explicitly focused on non-UK tax problems.

*Part IV.* A concluding chapter provides a discussion of our approach to taxation research. It is directed toward some of the practical issues of 'doing' taxation research from single-disciplinary and interdisciplinary perspectives. We argue that all tax research requires a disciplinary base, but some tax research will require an interdisciplinary approach. We argue that sound interdisciplinary research involves: (1) recognition of an interdisciplinary object of research; (2) adoption of a 'home' discipline; (3) familiarity with (an)other discipline(s); and (4) use of research methods that are interdisciplinary. Our conclusion suggests how the themes and disciplinary approaches developed in the book may be expanded and extended through interdisciplinary approaches.

## NOTES

1. Professor Harold Edey was the LSE accounting professor of his generation who took the greatest interest in taxation. Three of his articles from the 1950s and 1960s are cited in Freedman (1995: n. 1). Along with his LSE colleagues William Baxter, David Solomons, and Ash Wheatcroft, Edey was influential in developing UK academic and professional thinking about the tensions in existing methods of measuring income (including for tax purposes) and what principles might guide alternative methods (Whittington 1994). For a discussion of this period of LSE tax academic history, see Park (1997).
2. See Section 2.2.2 of Chapter 2, this volume, for a discussion of the LSE seminar and the origins of the *BTR*.
3. An influential example is the March 1995 conference on Accounting Standards and Taxable Profits. The papers from this conference were published in the *BTR* as 1995, issue 5. See further discussion in Section 2.2.5 of Chapter 2, this volume.
4. See <[www.ifs.org.uk/staff/index.shtml](http://www.ifs.org.uk/staff/index.shtml)> for a list of IFS staff and <[www.ifs.org.uk/staff/indexrfs.shtml](http://www.ifs.org.uk/staff/indexrfs.shtml)> for details of the IFS network of research fellows and associates.
5. The IFS economists have been influential policy analysts in international settings. For example, the European analysis of tax competition and the reform of corporate taxation has benefited greatly from the participation of IFS economists and other affiliates. See <[www.ifs.org.uk/corptax/taxcomp.shtml](http://www.ifs.org.uk/corptax/taxcomp.shtml)> for electronic access to some relevant papers.
6. The influence of Sandford and the University of Bath research centre are explored in Evans, Pope, and Hasseldine (2001).
7. The TRN research report on interdisciplinary research in taxation (Lamb and Lymer 1999a) was sponsored by the P. D. Leake Trust associated with the Centre for Business Performance of the Institute of Chartered Accountants in England & Wales. Lamb and Lymer (1999b) summarize the history of TRN and discuss the emerging approach to interdisciplinary tax research conducted within the accounting academic tradition. A tax research directory and bibliographic survey across several related fields were compiled in 2000–1 (Lamb 2002).
8. The majority of these topics emerged in the process of completing the ICAEW Research Report (Lamb and Lymer 1999a). Initially, the editors suggested twenty themes or topics around which tax research has clustered (or was expected to cluster in the future) to potential authors. The idea was not to encompass all tax research with the chosen themes and topics, but to explore particular areas, each with a well-developed or developing research literature. The eleven chapters of the Research Report emerged as particular authors agreed to contribute to the project and as some negotiation over chapter titles took place. This was an important element of the process, given that the object was to permit authors with recognizable expertise in tax research to define the part of the wider field that they were willing to examine. In the current book the majority of the topical chapters of the ICAEW Research Report have been updated and extended.

We have also added new chapters on the European law of taxation and taxation in the context of business strategy. We would emphasize, however, that Part III of this book does not represent a complete mapping of tax research topics, but merely a reasonably comprehensive collection of extant tax research that illustrates the breadth of subject and technique so far explored by tax researchers. This part offers the new researcher ample opportunity for finding his or her feet and understanding the possibilities of the tax research field.

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PART

# II

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## TAXATION RESEARCH AS PART OF RESEARCH TRADITIONS

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# Taxation Research as Legal Research

*Judith Freedman*

## 2.1 Characteristics of Legal Research

There are many traditions of legal research. Academic lawyers disagree on the relative merits of each type of activity but each has its own validity and purpose. The questions raised in relation to taxation research mirror the more general issues arising in relation to legal research as a whole. These general issues must therefore be our starting point here.

Research has been defined as a ‘careful study or investigation, especially in order to discover new facts or information’ (*Oxford Advanced Learner’s Dictionary*). Legal research is rarely concerned with finding new facts or information. It is more likely to consist of ‘careful study’—classification, analysis, and theorization. Empirical work in commercial law remains rare, although this is slowly changing. For most legal research, the real issue is whether this ‘careful study’ will consist mainly of an attempt to fit the cases and legislation into a rational framework, pointing out the internal inconsistencies and the supposed ‘principles’ (which we shall call here a ‘black-letter’ approach),<sup>1</sup> or whether a wider framework is used.

The black-letter approach treats law as a distinct body of knowledge with some kind of internal coherence, exploration of which can provide answers. ‘The textual formulation of the law is regnant’ (Hutchinson 2001). Some, but not all, practitioner-oriented writing is of this kind. If the legal

This chapter was prepared for publication in September 2001 and was updated in October 2003.

tax researcher chooses to look beyond black-letter law and to undertake a wider investigation, this may take a number of forms. His<sup>2</sup> work may be historical or comparative, or it may be supported by a theoretical underpinning taken from another discipline such as economics, political philosophy, or sociology. He may seek to make explicit the implicit theory on which he argues that the legal rules are based, as in critical legal theory which rejects the idea of law as having an autonomous existence separated from politics and morality (Thompson 1992), or the work may be descriptive but set against contextual material.

Some legal scholars, particularly those in North America, are proponents of one or other approach and may question the validity of other types of work. This is especially true of critical legal studies' scholars, and the law and economics school. In the United Kingdom, the 'schools' are less well developed. This may mean that the theoretical underpinning for some writing is unclear or even absent, but has the advantage that flexibility is retained and scholarship remains pluralistic.

Most UK academics would now agree that it is important to go beyond pure black-letter law. It is argued here, however, that the best legal writing of whatever school or type is well grounded in an understanding of the underlying technical law: in Otto Kahn-Freund's phrase, legal scholars need to go not around legal technique but through it to the policies (Kahn-Freund 1996). Where a legal scholar adopts concepts and methods from other disciplines, perhaps this attention to legal technique, an embodiment of the link of legal scholarship with legal practice, is the only aspect of his work which marks it as being specifically 'legal' (Murphy and Roberts 1987).

Other roles have been urged for the legal scholar in the area of taxation. For example, it has been argued that even when using economic analysis and relying upon the empirical findings of economists, legal scholars can identify policy questions not amenable to meaningful economic analysis and point out real world conditions and institutions that are not adequately accounted for in economists' models. Their role may also be to ensure that value judgements and distributional choices are made explicit in tax policy analysis (Brooks 1985). These are all areas where lawyers may indeed have a different approach and perspective from that of economists, but they will not be unique in raising these issues, which will also be of concern to political and social scientists of other descriptions. Legal technique and the link with legal practice are what is unique to legal scholarship. It is important to maintain that link, while also being prepared to be interdisciplinary and multidisciplinary in order to ask and seek answers to the most interesting questions in tax law.

This chapter is written from a distinctly UK perspective and quotes the UK literature more extensively than that from other jurisdictions. This reflects the origins of this book and the author's own background, but is not intended to give an exaggerated sense of the importance of the UK literature in this area. The UK starting point also acknowledges that there may be some difference between legal research and other forms of taxation research, the latter being less rooted in national issues and developments than is much legal scholarship. Other jurisdictions are referred to and it is hoped there are sufficient references to lead potential researchers to the rich literature available in those countries and which is increasingly accessible over the Internet. There is a vast tax law literature in the English language, particularly if one includes practitioner books and students' texts. This chapter can offer only a selected bibliography, with a UK bias: examples rather than a comprehensive list. The references given here are intended to give a flavour and a starting point to anyone approaching tax law research or seeking to understand its role in the wider endeavour of tax research.

## **2.2 Tax Law Research**

### **2.2.1 Tax Law in UK Universities**

Despite the many possible avenues for study it offers, tax seems to have a reputation in some law schools for being dry, technical, and complex. Some even question whether it can be a true academic subject (an attitude noted by Lazar 1970). This perception of tax law may be a consequence of the way the subject has been taught over the years. Tax law is a relative newcomer to the UK law degree curriculum. It was not until G. S. A. Wheatcroft began publishing and teaching in the 1950s that it was accepted as a serious subject, and even Wheatcroft thought it suitable only for post-graduate law students (Wheatcroft 1970; Park 1997). There are few academics teaching tax law and engaged in tax law research. Not all university law schools have tax courses, so that many law students, and thus potential legal academics, come across taxation only by chance, when reading cases concerning trusts law, for example or, worse still, when on their vocational training courses, in which the tax element is not extensive. Therefore, the law student's experience of taxation can be one of disembodied statutory provisions and isolated cases. Out of context, taxation law is indeed complex and often incomprehensible.

In these circumstances, it is not surprising that the generality of legal academics are unaware of the importance and interest of tax law. This is unfortunate for tax specialists but also for others, since tax cases and statutes play an important part in shaping the general law. Tax law research is a perfect area for application of theory, interdisciplinary study, and a policy-based approach. There is an abundance of literature available in the fields of economics, politics, sociology, history, and accountancy, as this book shows, and tax legislation can only be properly understood in terms of its broad economic, political, and social objectives (or lack of them). Why, then, has this topic not thrived in the same way as other legal research topics and attracted academics to pursue its study?

The dominance of practitioners in the field can feed the notion that taxation is a 'practical' or 'vocational' subject, and that this precludes it from being 'academic'. This practical-academic divide presents a false dichotomy. Practitioners play an important part in teaching tax in UK universities and the best, in the mould of Wheatcroft, make a superb contribution to teaching. Some of the best tax research and writing in the United Kingdom has come from practitioners rather than academics.<sup>3</sup> On the other hand, over the years there have been tax courses taught by practitioners, which have been heavily vocational in nature and may have done more harm than good to the reputation of tax law studies. Teachers of this type of course may well not research at all. This is clearly a circular problem. Uninspired teaching will not provide the role model needed to encourage the brightest law students to take up taxation as a subject. If tax is not studied by potential legal academics it will not figure high on the university legal curriculum.

In addition to the fact that few lawyers have studied taxation at university, there are other reasons, not least financial, for the dearth of tax law academics.<sup>4</sup> Efforts are being made to increase numbers, assisted most recently by benefactions from the professional services firm KPMG to both Oxford and Cambridge Universities for new tax law posts.<sup>5</sup> This may have prompted Tiley to write that, as the new millennium breaks, 'tax is seen to be trying to make a more substantial presence in law curricula' (Tiley 2000). Others have noted, however, that there is some way to go since, in other universities, tax law teachers have not been replaced or those reaching retirement have been told they will not be replaced when that time comes (Kerridge 2001). There is a twofold task to tackle: first, that of convincing law schools of the importance of tax law on the curriculum and second, encouraging good scholars to become tax academics. The key to dealing with both these issues is to show that valuable and exciting tax law research can be produced and published, making tax an important subject for the universities to support and for young academics to pursue. Research is therefore central

to improving tax teaching, just as tax teaching is essential to stimulate research.

### 2.2.2 Through Technique to Policy—Legal Texts, Treatises, and Primary Sources

Legal writers on taxation during the 1950s were beset with few of the doubts about methodology that concern academics now. They were unashamedly interested in black-letter law. Some of the earliest academic legal tax writing in the United Kingdom sought to ‘deduce basic principles’ from the decided cases, particularly where express statutory provision was lacking or where undefined terms were employed in the legislation such as ‘trade’, ‘capital’, ‘residence’, or ‘profits’ (Hannan and Farnsworth 1952). The aim of Whiteman and Wheatcroft (1971) remained similar. It was to demonstrate ‘that the law of tax, no less than any other branch of the law, is a matter of principles susceptible of logical and orderly analysis and presentation’. The judges called upon to work out these ‘principles’ relied upon such notions as ‘judicial common sense’ and understanding of ‘ordinary’ meanings of words as well as drawing upon their own background in the principles of equity and property law and statutory interpretation (Monroe 1981). At an early stage, however, the courts began to find their own resources inadequate and started to look to commercial practice, economics, and accounting principles for guidance, albeit in a somewhat unsystematic and elementary way and with questionable success (see, for example, *John Smith & Son v. Moore* [1921] 2 AC 16; *Edward Collins & Sons Ltd. v. CIR* [1930] 12 TC 773).

The influence of economics and accounting on the case law and the fact that taxation is the subject of frequent political decisions had its effect. Even those who were engaged in a search for ‘legal principles’ recognized the importance of other disciplines to a proper understanding of taxation. Wheatcroft commented that: ‘Taxation is a subject which forms a bridge between economists, accountants and lawyers’ (*British Tax Review* 1958, cited in Park 1997: 144).

Wheatcroft founded an interdisciplinary seminar, still continuing at the London School of Economics and Political Science (LSE), as a forum for lawyers, accountants, and policymakers to discuss issues in taxation. His writing, albeit aimed at practitioners, always showed awareness of the context in which taxation issues arose.

Though Wheatcroft and others paid attention to these other disciplines, however, these writers did not turn their backs on the legal techniques.

Further, they grounded their writing in a knowledge of the underlying substantive law applicable to the type of property, transaction, or procedure discussed—whether that was trust law, contract, family law, the rules governing inheritance, domicile and residence, corporate law, or administrative law. This must remain the central key to differentiating tax research by accountants or economists from that undertaken by lawyers. This legal work looks beyond taxation for its principles to broader concepts taken from the underlying legal system. In the United Kingdom, these will be concepts of common law and equity as well as, increasingly, administrative law and human rights legislation. In civil law systems, principles such as that of abuse of law, indivisibility of property ownership, and constitutional doctrines will be applied by lawyers in their consideration of taxing statutes.

This mix of black-letter law and policy is the basis of John Tiley's textbook, *Revenue Law* (first published 1976). It was argued above that if a subject area is not developed as a teaching topic within the law schools, it is very difficult for legal academics to pursue it as a research area. A good textbook is a prerequisite for the development of a topic and its acceptance into the mainstream curriculum. Such a textbook helps to define the area it seeks to cover and stimulate ideas for further study. Tiley's preface in 1981 shows that he felt he was battling against misperceptions of his subject; it was important to eliminate such misperceptions if tax was to have a future as a research area, just as it was vital to alter these perceptions for teaching purposes. He commented: 'The reputation of the subject is such that students tend to think of it as more complex than land law and more uncertain than tort while lacking "relevance" through being concerned simply with money. Such reactions stem from ignorance and perhaps from the failure of some courses to emphasize policy as distinct from book keeping' (Tiley 1981). Tiley's book dealt scrupulously with the cases and the legislation but also drew on North American writing, works on public finance, parliamentary papers, reports, and the publications of the Institute for Fiscal Studies (IFS). Discussion of these materials was not limited to isolated 'policy' chapters but was integrated into the more technical discussions. This was more than a textbook: it was an original contribution to the literature. It undoubtedly stimulated tax law teaching in the 1980s and a number of leading tax lawyers active now were introduced to the subject through this medium.

The book was also a success with practitioners and ironically this led to its downfall as an academic text. After 1981 the publishers decided that *Revenue Law* should become the *UK Tax Guide*, geared for the more lucrative practitioner market; for the current volume, see Tiley and Collison (2003). Tiley and Collison is a valuable book but is not designed to serve the academic market. Detail gathered while policy discussion was excised. Some of the

policy material was published in the *UK Tax Guide Policy Supplement* but this did not meet the need for a book which genuinely integrated the legal and non-legal materials. Other good textbooks and teaching materials have been produced, but these were not tax *research* in the same way as was Tiley's *Revenue Law* (examples are: Shipwright, Keeling, and Price 2000; Morse and Williams 2000; Whitehouse 2003). The absence of a new edition of Tiley had a 'measurable negative impact' (Kerridge 2001).

Against this background, the publication of a fourth edition of Tiley's *Revenue Law* in 2000 by a new publisher was a most welcome development for tax teachers and researchers alike. Containing the same combination of technical and policy discussion as previously, it provides not only an excellent guide for all serious students at university level but also a starting point for researchers, complete with references to academic literature, on most points of inquiry into tax law. Value Added Tax (VAT), stamp duty, and national insurance contributions are omitted and the absence of the first of these topics, in particular, leaves a gap, but the omission can be understood when it is noted that the 2000 version is already more than half as long again as the 1981 edition. This reflects the growth of tax legislation and the ever-increasing complexity of the subject, which, even in a book dealing with principles, has its effect. This complexity, volume, and pace of change may itself be a deterrent to those contemplating research into taxation. Perhaps this book will give them the courage to take on this challenge. Regrettably, the best collection of legal primary sources for students (Salter and Kerr 1990) is now badly out of date, although it is still of value since it makes certain more obscure sources accessible. It is hoped that a new version of this book will emerge as part of the current renaissance of tax law studies in the United Kingdom.

In addition to student textbooks there is a wealth of practitioner books and encyclopaedias, many loose-leaf or produced annually (too numerous to list). These range from excellent guides to books which do little more than repeat the legislation in different words. These latter books are of little value to the academic tax researcher, nor, one would have thought, to the practitioner, who might as well go straight to the source. The best of these practitioner books constitute research in the broad sense discussed above. Wheatcroft's own publications have given birth to the *British Tax Library* which has been taken up by many talented practitioner-writers (*Whiteman on Capital Gains Tax* 1989; *Whiteman on Income Tax* 1989; *Taxation of Companies and Company Reconstructions* Bramwell 2002). For academic tax law researchers these volumes provide detailed background and guidance, although an academic researcher will usually want to travel through this material towards asking broader questions. Unfortunately, the

pressures on practitioner-writers make it difficult for these texts to be kept up-to-date. New editions are rare events and cumulative supplements are not a true substitute for a rewrite after a while.

Any account of the sources for research into tax law cannot omit primary sources. Statutes are of course a basic tool for any tax researcher, as are the decided cases, but legal technique equips lawyers to make fuller use than those from other disciplines of case law as a rich database for study and discussion. The legal context of judicial decisions and the legal training of those engaged in presenting and deciding such cases will often result in tax points being accompanied by other points of law (e.g. property, contract, European law, employment law) and procedural issues (e.g. judicial review cases). Tax points may arise in cases which first arise in another context (e.g. cases on trusts and damages). The law reports, especially the specialist tax reports (*Tax Cases*, *Annotated Tax Cases*, *Simon's Tax Cases*, and *CCH Tax Cases*) will be familiar to readers. These are now available as part of online and CD ROM services so that searching is made easier and the problem can be that there are overwhelming amounts of research material rather than too little. A very useful, if more old fashioned, research tool is *Harrison's Inland Revenue Index to Tax Cases* which digests and picks out *dicta* and cross references in a less comprehensive but more considered way than a full text electronic service can do.

Tackling national tax systems is challenging. International and comparative work offer yet more opportunities for research but the difficulties of finding reliable, up-to-date materials, particularly for those starting out and for teaching, can be even greater than at a national level. At an international level, the lawyer has a special role to play in terms of treaty interpretation and examination of the interaction between general issues in international economic law and international tax law. Leading treatises on the model treaties include Vogel et al. (1997) which is a translation from German, and Baker (2001)—Baker being another example of a practitioner in the Wheatcroft mould—making a contribution to academic literature and teaching. For students of international tax law the best starting point is probably Arnold and McIntyre's *International Tax Primer* (Arnold and McIntyre 2002). The difficult area of comparative taxation has recently been made more accessible by an international team which has produced a valuable comparative analysis of income taxation suitable for students (Ault 1997). A further contribution to comparative tax law studies intended for students has been made by Thuronyi (Thuronyi 2003), who also edited a two-volume work on tax law design and drafting, originally for the IMF (Thuronyi 2000). Scholars studying international and EC tax law will find that the materials collected in a new publication by the International

Bureau of Fiscal Documentation (van Raad 2002, to be updated annually) will make an excellent starting point.

### 2.2.3 Monographs

Monographs are by definition more research oriented than texts and treatises. There are some excellent tax law monographs, although they date quickly and are not always revised. Often these books explore tax in the context of other legal topics. A book which attempted to bridge the gap between tax and trust law was produced in the 'Modern Legal Studies' series (Thomas 1981). Picciotto's text on international business taxation goes beyond technical tax law and is a serious contribution to interdisciplinary research in both taxation policy and more generally on the law of multinationals (Picciotto 1992). These books contribute not only to tax but also to general legal scholarship.

European developments have provided a fruitful area for research and writing (Easson 1980; Farmer and Lyal 1994; Terra and Wattel 1997).<sup>6</sup> The speed with which the case law in this area is developing makes this a very significant area for further work, though not an easy one. Tax lawyers writing on the European case law must also absorb and assess the relevance of cases being decided on quite different substantive matter, since the tax cases will draw upon treaty provisions (notably the four freedoms found in Articles 39, 43, 49, and 56 of the EC Treaty) and general approaches elaborated in the decided cases on those provisions. On the other hand, general students of the decisions of the European Court of Justice (ECJ) struggle to understand the tax cases (as indeed can the non-specialist judges of that court). There is a clear specialist role for tax researchers in this area: not only to examine the significance of the decisions for tax purposes but also to ensure that the tax issues are being properly understood by non-tax lawyers. This could assist the development of the jurisprudence generally and for tax purposes.

In addition, lawyers contribute to the interdisciplinary literature on tax harmonization and have been particularly active recently in the contentious field of corporation tax in a European and global context. An example is the contribution of Gammie and Troup to the recent work of the IFS on corporate tax harmonization (Bond et al. 2000), one of many books and articles to which Gammie has contributed on this subject, knitting together technical mastery of the material and knowledge and understanding of the economics of taxation (e.g. the reports of the IFS Capital Taxes Group, which he chaired: Capital Taxes Group, 1987, 1989, 1991). Gammie has also published extensively

on new approaches to corporate taxation in the European Union (EU) (see, for example, Lodin and Gammie 2001). Of the many other monographs by lawyers published by the International Bureau of Fiscal Documentation especially worthy of note are Harris (1996), Holmes (2001), Couzin (2002), and Westberg (2002). Other contributions to comparative and international tax literature by lawyers are discussed in Section 2.2.6. Legal theorists have tended to neglect tax law, seen purely as the province of practitioners, or as involving too many empirical uncertainties about the economic consequences of different choices to be usefully discussed in terms of a theory of justice (Murphy and Nagel 2002). A notable attempt by legal philosophers, stimulated by a very productive seminar series at the New York University Law School on Justice and Tax Policy, has now been published and provides much food for thought (Murphy and Nagel 2002).

#### 2.2.4 Lawyers and the IFS

Lawyers have always been involved with the work of the IFS, although economists have dominated the research output of the Institute. John Avery Jones, for example, was a member of the influential Meade Committee (Meade 1978). The work of the Tax Law Review Committee (TLRC) brings legal perspectives within a wider policy framework to the IFS's work, so far covering tax legislation, tax avoidance, the tax appeals system, tribunals, as well as employment status issues in taxation and employment law, and the alignment of taxable and accounting income (TLRC 1995, 1996*a,b*, 1997, 1999; Freedman 2001; Macdonald 2002). Other examples of lawyers working with the IFS are the Institute's report on Family Property Law which attempted to integrate work on pensions, social security, taxation, and property rights within the family (Freedman et al. 1988), Gammie and Shipwright (1996) on tax avoidance, and Gammie and Troup's work on corporation tax cited above. A small number of articles by lawyers has appeared in the journal of the IFS, *Fiscal Studies*: some arising from the work of the TLRC (e.g. Freedman and Chamberlain 1997), and others on topics requiring legal expertise, for example, Savory (1992) and Chan (1997).

#### 2.2.5 Journals

The *British Tax Review* (BTR) is the main journal outlet for academic research on taxation law published in the United Kingdom. Many other

English language tax journals are of course published and can be accessed by UK authors and researchers, but this section concentrates on UK law journals. The *Tax Journal* is a frequent source of practitioner articles by lawyers, some of which make a very useful contribution to the debate, although they are generally less detailed and policy oriented than articles in the *BTR*. The *BTR*, following the objectives set for it by its founder, Wheatcroft, attempts to provide a forum for communication between academics and practitioners and contains longer articles covering subjects in greater depth than is possible in the more frequently published tax practitioner magazines. There is a danger that this will satisfy neither group, but it is a noble aim. The *BTR* is well known for the seminal articles on international taxation, especially those written by an international group of lawyers led by John Avery Jones (e.g. Avery Jones et al. 1996, 1998, 1999). European law also receives good coverage (e.g. Eden 2000 and the European special issue in 2001, which includes Gammie, Schon, and Richardson).

Without attempting to list the full extent of the *BTR*'s coverage of issues by lawyers, it can be noted that it ranges from historical contributions (e.g. Stebbings 1993, 1994) to the details of share buy-back provisions (Tiley 1992) and from questions of constitutional law (Bartlett 1985) to compliance costs issues (Walpole et al. 1999) and to criminal law aspects of tax law (Mumford and Alldridge 2002; Salter 2002). The *BTR* has published contributions from lawyers from many jurisdictions and has also encouraged interdisciplinary research. A number of special issues make a particularly good starting point for a researcher in those areas. Some of these are interdisciplinary, for example, 'Accounting Standards and Taxable Profits' (Freedman and Green 1995) and 'VAT' (1998), while others are in areas where lawyers can make a particular contribution, for example, 'Human Rights' (BTR 2000; especially Baker 2000), a burgeoning area of UK law at present following the introduction of the Human Rights Act 1998 and 'Tax Avoidance' (BTR 1998). Tax avoidance is an excellent example of an area where lawyers have a unique contribution to make to analysis of complex cases, not simply seeking to 'legitimize an incoherent theory of the role of legal decision-making' but 'challenging judges to make their value judgements explicit, unmask hidden assumptions, and examine consequences' (Brooks 1985; for good examples of such analysis, see Tiley 1987, 1988; Tiley and Jensen 1998).

In addition to the many significant contributions by lawyers in the *BTR*, the journal has brought articles by economists, historians, management and marketing experts, and other academics to the attention of the tax law research community. The importance of an interdisciplinary forum cannot be overestimated, even though each discipline will also look to its own specialist journals.

In fact, general academic legal journals in the United Kingdom have never carried large numbers of tax law articles. This may be partly the result of a dearth of contributions but also reflects the pressure on space in the few prestigious law journals published, which must appeal to a wide range of readers. It is interesting to note that there has not been a noticeable decrease in tax law articles in recent years: there was no golden age but there has been a small but steady trickle of articles published, plus a number of case notes and notes on recent legislation. This is a different position from that found in the United States where there does appear to have been a decrease in tax articles in law reviews (Turnier 2000, discussed further below). A review of the leading general law journal indexes in 2001 showed that *The Modern Law Review* has published nine tax articles since it was established in 1937 and two of those contributions were from accountants. *The Cambridge Law Journal* has published only three tax articles, the *Oxford Journal of Legal Studies*, three, and the *Law Quarterly Review*, nine.

Technical specialist writing will not be appropriate for these journals, but they will publish articles on issues in taxation of wider interest, such as avoidance (e.g. Millet 1982), family taxation (Kerridge 1988), and European taxation (Tiley 1992; Roxan 2000—the latter the winner of the Wedderburn prize in 2001). In addition, as noted above, articles by specialists in other areas may well deal with tax issues or with matters of great pertinence to tax specialists (see, for example, McBarnet and Whelan 1991). It is in this area of general law reviews in the United Kingdom that a breakthrough most needs to be made by tax specialists to show that, just as other topics are relevant to them, so tax topics are of importance to non-tax lawyers. Publication in these general law journals is also of significance in gaining status for the subject generally, and for the position of academic tax law researchers in the universities in particular, because of the emphasis on publishing in refereed and highly respected journals when it comes to decisions to engage, employ, and promote academics and in research funding decisions. There is significant competition for space in these journals and they are unlikely to publish more than one or two tax articles a year but tax lawyers should not assume that there is no point in submitting articles. The figures cited above should not be seen in a negative light but as offering an opportunity. There are so few tax articles published that there is clearly room for some more good tax articles, which ask wider questions and link with other areas of jurisprudence. The fact that few tax articles are published is not a new development but is very possibly in part the result of very few tax submissions.

This short survey should suffice to show the breadth and depth of tax law research in the United Kingdom at present. The contribution of academics

needs to be strengthened but practitioners and practitioner-academics, as well as a handful of full-time academics, have produced a strong and pluralistic literature, drawing on many disciplines, including, but not wholly dominated by, economics, and grounded in the underlying law. There is some way to go in establishing tax as a mainstream legal subject and submission to general law journals needs to be increased to this end. Tax law researchers also need to maintain input into specialist tax journals so that their work enters into the interdisciplinary tax research community. This is a demanding set of tasks for would be tax law academics.

### 2.2.6 Other Jurisdictions

From a UK perspective, the tax law research literature in North America appears to be rich and well developed. In fact, however, there are great tensions in these jurisdictions (Brooks 1985; Livingston 1998; Turnier 2000). In part this is because the relatively rigid divisions between different approaches to legal studies in the United States make the pluralistic approach advocated in this chapter much more difficult to pursue in the United States than in the United Kingdom. There is also pressure for academics on the one hand to publish in general refereed journals, and on the other, to publish to a specialist tax audience.

Many of the classic American tax law articles were written by lawyers who were or are also proficient economists such as Bittker, Surrey, McDaniel, and Halperin. There are too many important articles of this genre to note here but, for a valuable starting point, the reader is referred to White (1995). Tax law articles were once a regular feature of the major law reviews, such as the *Harvard Law Review*, the *Yale Law Journal*, and the *Stanford Law Review*. This seems to have changed over the last decade or so: Turnier's research shows that there has been what he calls 'a virtual abandonment by the major reviews of taxation as a topic for scholarly discourse' (Turnier 2000) although, as pointed out by Moran (2003), given what academics in the Commonwealth face, US tax scholars are 'lucky indeed'. Turnier's figures show a decrease in the percentage of law review space devoted to tax from 12.11 per cent in 1941–2 to 2.27 per cent in 1996–7. Various explanations are offered, including the failure of the tax lawyers to open up tax law to non-tax insights (Caron 1994).

Others see tax lawyers as losing their way. For example, Livingston (1998) argues that the traditional tax law literature using economic concepts was good legal scholarship, providing the bridge between theory and practice

which only academic lawyers can provide. He is concerned, though, that as the economic concepts used become more sophisticated and complex, economics is coming to dominate tax law. This is a far greater problem in the United States (where law is a graduate degree) than it could possibly be in the United Kingdom, where few lawyers have economics training. Livingston questions how tax lawyers can avoid becoming either second tier economists or mere technicians. His answer is that tax lawyers should aim for an 'eclectic, interdisciplinary scholarship that borrows from several fields without being dominated by any'—what he calls a 'practical reason approach'—which should also be well grounded in non-tax legal scholarship. This is not worlds apart from the approach which has emerged, without design, in the United Kingdom. There is more to be done in the United Kingdom in terms of the methodologies used and the intellectual underpinning of some of the work undertaken, but the eclectic approach is certainly present.

Turnier suggests other reasons for reduction in tax law articles in general journals. American law reviews are edited by students: they focus on issues which seem to them to be of immediate concern and also take some time to publish. Tax articles need to be topical and this may explain why *Tax Notes*, with its very quick turn around time, has become one of the most important outlets for tax policy research. Other specialist tax law journals in the United States include New York University Law School's *Tax Law Review* and the *Virginia Tax Review*. This is in addition to interdisciplinary journals such as the *National Tax Journal*. These specialist journals may be attracting articles away from the general journals or may be providing tax lawyers with a 'hospitable refuge' as Turnier puts it. This may not matter as a pure question of tax research: indeed these good specialist outlets are more easily accessible to non-lawyers than are general law journals. It is a matter of concern for tax law scholarship in the universities, however. Tax scholarship will be judged by non-specialists on the basis of material accessible to them and it should be possible to write about tax in such a way as to show the relevance of the underlying legal issues and the impact of tax questions upon the general law. On a more mundane level, decisions about tenure and promotion may depend on publishing in the major law journals. It can only be hoped that tax law contributions will be recognized for themselves regardless of where they are published. There is no reason why a really good piece of research should not be of interest to policymakers and others in the tax community as well as of a high academic standard, but misperceptions may surround certain journal titles and approaches. The *Oxford Handbook of Legal Studies* contains a chapter on taxation (Moran 2003) which evaluates legal tax scholarship entirely on the basis of

what the author calls 'cross-over' literature—that is writings which are aimed at a general academic legal audience. Regrettably the so-called cross-over journals are not identified in the piece and so it is not entirely clear that all the criticisms are warranted, but the chapter further underlines the importance of tax academics writing for non-specialists and participating in the more general legal arena if their scholarship is to be taken seriously. Moran is in fact critical of the US literature as being inaccessible, lengthy, and dense and of the UK literature as being too sparse. The lack of UK literature follows mainly from the limited number of tax law academics in universities as compared with the United States and so is not entirely surprising, although hopefully the volume is increasing.

The growing importance of *Tax Notes* as an outlet for US tax law academics and the policy orientation of its contents can be seen from the coverage it receives in the tax law abstracts circulated by the SSRN Electronic Library's Legal Scholarship Network. This now has three tax titles: *Tax Law and Policy, Practitioner Series* (both Bankman and Caron, eds.), and *International and Comparative Tax* (Caron and Zolt, eds.) (for details see, [www.SSRN.com](http://www.SSRN.com)). This excellent service underlines the importance of speed of access in a fast moving area like tax as well as giving wide access to tax literature. Reading of the problems perceived to exist in the United States, it is striking how little non-US literature is discussed or even cited. Tax law researchers in the United Kingdom, not being blessed with such an extensive domestic literature as an American researcher would enjoy, are forced to look further afield and the availability of this electronic service, coupled with wider access to overseas law journals through services such as Lexis and Westlaw, expands the boundaries of tax research enormously. Hopefully, the new technology will enable this to become an exchange in the opposite direction too, albeit with an uneven flow.

There is no space here to discuss or even list the many treatises, practitioner books, and case books on tax law produced in the United States for the much larger audience, both student and practitioner, than we have in the United Kingdom. One recent book—*The US Income Tax* by Professor Graetz of Yale Law School (1999)—will be referred to, though, as a reminder that tax law professors can write in a lively fashion and with wide appeal, underlining that tax law studies need not be, and should not be, a rarefied activity. Tax relates to central political issues affecting all citizens. Tax law research and writing can be relevant, problem oriented, interdisciplinary, and joyous (Brooks 1985).

This concentration on US literature should not detract from the important contribution made by literature being produced in other English speaking jurisdictions, notably Canada, New Zealand, and Australia where there are

strong tax law communities. There is also English language literature now emerging from other European countries and from international organizations. Publications of the Canadian Tax Foundation, including the *Canadian Tax Journal*, and of the Australian Tax Research Foundation, as well as the *Australian Tax Review* and the *Australian Tax Forum*, have played an important role in developing legal tax scholarship in the English language. Some very interesting work is now beginning to emerge from the Australian Taxation Studies Program (ATAX) at the University of New South Wales and from the Centre for Tax System Integrity at the Australian National University. The latter is an interdisciplinary group but showcases work by John Braithwaite and other regulation lawyers which is of great relevance to tax administration and is an excellent example of the value of bringing more general legal scholarship to bear on tax issues (Braithwaite 2003). The publications of the International Bureau of Fiscal Documentation in the Netherlands are also an important vehicle for the dissemination of tax law research as well as providing practitioner material. The Bureau publishes the well-respected *IBFD Bulletin* as well as regional journals such as *European Taxation*. In addition to the monographs referred to above, recent edited volumes provide a challenging range of essays from lawyers as well as from writers from other disciplines (see, for example, Cooper 1997; Schon 2003).

Despite the emphasis of this chapter on UK writing as a starting point and the fact that legal studies more than most disciplines are rooted in national learning, no tax law researcher can afford to confine himself to any one jurisdiction. The new electronic tools available mean that theoretically, there should be easy access to worldwide materials<sup>7</sup> and there is much good writing available, even if it has shifted to new locations.

### 2.3 The Future of Tax Law Research

The health of tax law research is inextricably linked with that of tax law teaching and journals. In the United Kingdom to date we have been fortunate in the number of talented individuals who have combined the roles of practitioner and researcher. Cross-fertilization needs to continue but this is becoming more difficult in the light of commercial pressures on practitioners and the professionalization of university law teaching. Success in tax research in universities demands publication in general law journals, while lawyers also need to publish in specialist tax journals. Tax law research must be technically competent, but go beyond technical competence to ask broader questions. This is a demanding set of requirements, though if it is

done well the same research should be of value and interest to various types of audiences.

Legal tax researchers face resistance from tax specialists in other disciplines as well as from non-tax lawyers, who have a tendency to see tax lawyers as mere technicians to be brought in once policy has been decided (Reese 1980). In addition, they must deal with non-tax lawyers who fear tax as a dull and difficult subject dominated by legislation and numbers. Academics may be thought by practitioners to be dealing with issues in too theoretical a way to be of practical assistance. All these forms of resistance will be overcome if tax lawyers produce accessible and analytical books and articles which integrate sound technical law with the methodologies and knowledge bases of other disciplines and which reveal the links between developing legal concepts and the problems faced in taxation.

Future tax law research may develop in many directions. Fruitful areas for further work in the near future of particular appeal to tax lawyers seem likely to include the impact of the EC Treaty and the decisions of the ECJ as well as further harmonization efforts by the European Commission. The current Tax Law Rewrite being undertaken by the Inland Revenue, the issues of tax simplification and drafting, and the problem of parliamentary procedures for enacting tax law also deserve attention from lawyers. Recent developments bring the issue of the relationship between criminal and civil law into high relief and of course the Human Rights Act is giving rise to a wealth of litigation. New technology and new legal creations in the world of financial instruments raise novel problems. On the international scene, double taxation treaties and the activities of international organizations such as the UN, OECD, and WTO require analysis by lawyers as well as economists and political scientists. This is by no means a comprehensive list: indeed tax law researchers may find material in almost any area of law. There is no problem of shortage of material, only of shortage of researchers.

Given adequate support, academic tax lawyers should be well placed to develop new dimensions to tax law research, to ensure its development and integration with research in other legal areas and to integrate tax law with tax research in other disciplines, without allowing the legal elements of their work to become overwhelmed by those other disciplines. To achieve this, the general legal journals need to be persuaded of the relevance of tax to non-tax lawyers so that tax law research can be properly disseminated and its importance for non-specialists can be appreciated. Tax lawyers need to take up the challenge of submitting material to these journals, since nothing can be accepted that is not submitted. In addition, tax academics need to sustain their own strong specialist journals, since whatever their discipline, academic tax researchers need good refereed

academic journals of their own in which to publish and to provide a forum in which to share developments.

The United Kingdom has not had as strong a tax law community as that found in other countries in the past, especially the United States, but the United Kingdom's pluralistic tradition and flexibility may be its strength and flexibility for the future. There is great scope for tax law research and there are good role models upon which to draw and build. While there are real concerns about shortages of tax law academics, there are exciting opportunities open to those willing to take up the challenge.

## NOTES

1. On the origins of the term 'black-letter' (taken from the bold face type used for basic principles in traditional law texts) and for stringent criticism of this approach to legal studies, see Hutchinson 2001.
2. The male pronoun is used for convenience and has no other significance.
3. As Tiley states in the Preface to his book, 'John Avery Jones, David Oliver, and Malcolm Gammie have shown, like Ash Wheatcroft before them, that the boundary between the academic and the practical does not have to exist in this area' (Tiley 2000). There are, of course, several other part-timers who make an important contribution to tax teaching and scholarship in the United Kingdom.
4. The combination of significant financial rewards elsewhere for those with tax or other commercial law knowledge and the lower pay of academics coupled with increasing pressure on those working in the universities have had an effect. This is not unique to lawyers: accounting and economics departments have also suffered. In the case of law there is the additional problem that the traditional career structure for a law student is to go straight from the undergraduate law degree to professional training. Take-up of graduate courses in law seems to be increasing but it is difficult to persuade lawyers to sign up for doctoral studies. Increasingly, however, law departments are looking to recruit staff with doctorates. This reflects the professional status of legal academics and brings them into line with other academics but makes it yet more difficult to recruit tax specialists as there are very few tax doctorates written at present. This may in part result from the difficulty of finding suitably qualified supervisors, making the problem partially a circular one, although the fast changing nature of the subject matter may also deter prospective students, as does the obvious allure of financial benefits which await those who put taxation expertise to more immediate practical use.
5. The author has benefited from the new post at Oxford. Cambridge has appointed Dr Peter Harris who joins the United Kingdom tax law community from Australia.
6. See Chapter 13 by O'Shea in this volume.
7. In practice, not all UK tax law academics have access to the library resources they need for serious tax research. Tax books are even more expensive than other law books and cannot be afforded especially where there is only one tax law academic in a university. The answer to this problem seems to be to build up tax law collections at certain centres and then permit all academics to have good

access—London (the Institute of Advanced Legal Studies, KCL, LSE, and Queen Mary), Cambridge, and Oxford all have substantial tax law coverage, though each library has some gaps. Electronic sources should help.

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# Taxation Research as Economic Research

*Simon James*

## 3.1 Introduction

Economics is concerned with the production and distribution of wealth. Taxation has either direct or indirect effects on almost every aspect of production and distribution in modern economies and is therefore an important aspect in economic research. Indeed taxation is associated with almost everything economic from globalization (Owens 1993) to divorce (Cebula and Belton 1995).

The result has been an enormous body of literature and all that can be attempted here is to indicate some of the main areas of research activity. The research ranges from highly technical and theoretical work to more practical economic analyses of policy questions. It includes theoretical contributions, econometric studies, interview surveys, and some experimental work. In terms of interdisciplinary research, it is the policy area that has the most scope for successful work because it is here that an economic approach has the greatest opportunities to strengthen the research by drawing on other disciplines such as accounting, law, psychology, and sociology.

In economics the main direct contribution to tax research is based in the general subject area of public finance. Taxation is therefore dealt with as a major part of general public finance texts such as Brown and Jackson (1990) and Cullis and Jones (1998). Atkinson and Stiglitz (1980) give an introduction to the subject at graduate level and a further technical treatment is supplied

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by Jha (1998). Tax is the specific focus of other textbooks. These include Kay and King (1990) who deal with the subject with reference to the British tax system and James and Nobes (2000) who offer a more general treatment.

Although much of the emphasis in economics research relates to markets of one sort or another, it is widely agreed by economists that the public sector has important economic functions. Therefore a general theme in tax research is how the necessary tax revenue to support the public sector can be raised in the most efficient and equitable way. The next two sections of the paper deal with economic efficiency, Section 3.2 with respect to the allocation of resources and Section 3.3 with tax and incentives to work, save, and invest. Section 3.4 turns to equity and the distribution of income and Section 3.5 to macroeconomic considerations. Section 3.6 gives a brief account of experimental work in economics. Section 3.7 turns to research focused on particular types of taxation and Section 3.8 to some specific areas of tax policy and reform. Finally, there has been some criticism both inside and outside the profession that the contribution of economics to policy research may not always be as relevant as it might be and this is discussed briefly in Section 3.9.

### **3.2 Economic Efficiency and the Allocation of Resources**

'He's spending a year dead for tax reasons', wrote the science fiction writer Douglas Adams in *The Restaurant at the End of the Universe*. Generally, it is thought that if people do things for tax reasons, rather than because of the underlying economic costs and benefits, they are behaving inefficiently in economic terms even if they gain some personal financial advantage. While it is possible that people might in the future wish to spend time dead as a matter of personal choice, it is not economically efficient if they do so only to avoid taxation.

Economic efficiency is about maximizing economic output given the resources available to the community. This is not just maximizing production but also producing the goods and services that consumers value most. It is possible to show that, in certain circumstances, markets are economically efficient. If a tax distorts an otherwise efficient market this is known as the *excess burden* of taxation. This is the extra economic cost imposed on the community because taxes have caused people to make economic decisions they would not otherwise have made. In the Douglas Adams case it would be the loss of one year of life given up to save tax. There are countless examples throughout an economy of distortionary behaviour caused by taxation and a great deal of economic tax research has been undertaken

into the excess burden caused by different taxes in different circumstances (James and Nobes 2000).

Some of the economic research in this area is very technical but general conclusions can be drawn, subject to a number of limitations and exceptions. In *efficient* markets, taxes that have a wider base are less likely to create distortions than those with a narrower base. Thus a tax on all goods and services is likely to be less distortionary than taxes on only a limited number of goods and services. Another conclusion relates to goods and services that are inelastic in demand or supply, in other words the amount bought and sold changes relatively little when the price changes. Higher taxes on such goods cause a relatively low fall in consumption and also, therefore, the level of tax revenue is more robust. Examples include the taxation of alcohol and tobacco. With *inefficient* markets, there may be scope to use taxation to guide economic behaviour in the right direction. For example, some economic activities, such as those causing pollution, impose costs on the wider community. It might be possible to assign such costs to the producers and consumers by imposing a special tax. The result has been the development of various forms of corrective taxation, including 'pollution charges', 'green taxes', and so on (Cordes, Nicholson, and Sammartino 1990; Nicolaisen, Dean, and Hoeller 1991; Smith 1992; Symonds, Proops, and Gay 1994; Oates 1995). A particularly topical issue here is the debate regarding road congestion taxes (Newbery and Santos 1999). There may be other costs to the consumers themselves and this has been used, for instance, as part of the justification for higher taxation on alcohol (Irving and Sims 1993; Cook and Moore 1994) and tobacco (Viscusi 1994).

### 3.3 Economic Efficiency and Incentives

Another very large part of tax research relating to economic efficiency is concerned with incentives, particularly the effects of taxation on the willingness of individuals to work, to save, and to invest.

The effects of taxation on work effort, or labour supply, have generated a huge amount of research. When an income tax is increased, this reduces the net financial return to work and individuals might substitute other activities or leisure for paid employment—and this is known as the *substitution effect*. On the other hand, a tax increase would make individuals worse off and therefore that might make them work harder to maintain their incomes—the *income effect*. The overall effect of taxation on labour supply is therefore an empirical question and has been subject to a very large number of investigations.

Interviews asking individuals about the effects of taxation on their work effort might well be subject to bias of one sort or another. However, an early interview study by Break (1957) became something of a classic because of the care it took to avoid influencing the respondents. This study was replicated by Fields and Stanbury (1971) and similar studies have been conducted by Barlow, Brazer, and Morgan (1966) and others. There is also a considerable amount of econometric evidence largely based on the relationship between labour supply and net wages. Useful sources covering the material include Brown (1983) for a general overview, Pencavel (1986) with respect to the labour supply of men, and Killingsworth and Heckman (1986) regarding female labour supply. A survey of the subject is presented by Blundell (1992).

The main result of this work is the conclusion that in general taxation does not have much effect on the labour supply of most individuals. However, some econometric evidence has been taken to suggest that the effect of taxation on married women provides a significant disincentive to paid labour supply. For instance, Killingsworth's (1983: 432) survey found that 'most of the available evidence suggests that female labour supply, measured either as labour force participation or as hours of work, is considerably more wage and property income elastic than male labour supply'. This seems to be an example of an area where economic analysis and econometric studies can be enhanced by a multidisciplinary input. For instance, there is psychological and sociological evidence that, despite many years of discussion about possible changes in gender roles, many women with children still see themselves primarily as care-givers, while their male partners still see themselves as 'breadwinners' (James, Jordan, and Redley 1992; James 1995). If women have difficulties in combining their family and paid work with current labour market practices this may affect econometric evidence of the effect of taxation on their labour market behaviour. Also, further econometric work which has tackled some of the problems of estimation has indicated that the effects of taxation on the paid employment of women is less than earlier work has suggested—see, for example, Mroz (1987) and Blundell (1992).

The effects of taxation on saving have also received a considerable amount of attention. Only through saving can economic resources be released for capital investment and the rate of saving can affect the level of economic activity by influencing the aggregate level of demand. The tax system can make a substantial difference to the rate of return to saving. However it is not clear how far this adversely affects saving since different researchers have produced different results. For example, Boskin (1978) found empirical evidence to suggest a significant effect but other studies have found a much weaker influence. Whatever the overall effect of taxation

on savings, tax systems sometimes treat different ways of saving differently and another area of research has been how this affects the pattern of saving—see, for example, Carroll and Summers (1987). Taxation and saving is also examined in Boadway and Wildasin (1994), Gapinski (1993), and Robson (1995).

Investment is also important and requires enterprise and a willingness to take economic risks. Some of the findings here may be unexpected. Profits from enterprises are usually taxed but losses may also normally be set against profits in calculating taxable income. The government can therefore find itself as a sort of sleeping partner, sharing in both profits and losses of enterprise. In such circumstances Domar and Musgrave (1944) have shown that the overall amount of economic risk-taking could actually increase following an increase in tax. This has been analysed further, for example, by Stiglitz (1969) who drew attention to the importance of factors such that losses should be allowed in full against taxable income. The issues with respect to risk-taking are examined further by Kaplow (1994).

### **3.4 Equity and Distribution**

There are two main aspects of interest—what constitutes a ‘fair’ tax and how taxes are distributed throughout an economy—the subject of ‘tax incidence’. There is also the topic of optimal taxation which attempts to combine efficiency and equity.

The definition of a ‘fair’ tax is, of course, at least partly a matter of opinion. However, some progress has been made using concepts such as horizontal equity which suggests that people in similar circumstances and with the same taxable capacity should be taxed in the same way. Another concept is vertical equity which suggests that those with differing taxable capacities should contribute different amounts. This overall ‘ability to pay’ approach includes the ‘sacrifice approach’ to taxation discussed by earlier economists such as Mill (1871) and Pigou (1928). According to the sacrifice approach, individuals’ tax liabilities should be linked to the sacrifice of utility involved in their tax liabilities. Although it might be thought that those on higher incomes would have a lower marginal utility of income than those on lower incomes have, this is not necessarily true. There is therefore no single scientific prescription as to how this approach would translate, for example, into the most desirable degree of progressivity of a tax system—see, for instance, Blum and Calven (1953). Other relevant concepts include the ‘benefit approach’ to taxation—that individuals should pay tax in line with the benefits

they receive from public expenditure. This has also been discussed by earlier economists such as Smith (1776) and Mill (1871) but this approach has a number of limitations, not least of which is the difficulty of estimating such benefits. These issues are examined further in James and Nobes (2000).

### 3.4.1 Tax Incidence

Tax incidence is a fascinating topic as it examines how the burden of taxation can be passed around the economy through changes in prices, wages, or other economic variables, sometimes with unanticipated results. Taxes will normally affect both supply and demand sides of the market. For example, a tax on 'luxury goods' consumed by the rich might also adversely affect the living standards of poor people who supply those goods. Another example is that Value Added Tax (VAT) which in legal terms is supposed to be passed on in full to consumers. However the economic burden of VAT will normally be partially borne by suppliers since the after-tax price and the amount sold are both likely to be lower than if the tax had not been imposed. Furthermore, taxes on some goods will shift demand to substitute goods to the benefit of those supplying them. The result is that there may be political pressure in favour of some taxes—those on rivals—and the most common case is probably the pleas of domestic producers for taxes (tariffs) to be imposed on their overseas competitors. Tax incidence suggests that domestic consumers would bear much of the cost of such a policy through higher domestic prices. Tax may also be capitalized into the value of assets if it affects their expected yield. For example, a tax on company dividends will, other things being equal, mean that share prices will be lower than they would be without the tax. Further discussion and results of work in this area can be found, for example, in Pechman (1985) and Musgrave and Musgrave (1989).

### 3.4.2 Optimal Taxation

The term 'optimal taxation' describes attempts to combine both the criteria of efficiency and equity, implicitly deriving the relative importance of each. While most individuals would accept that both efficiency and equity are desirable in a tax system it may not be possible to achieve both. An efficient tax system may not necessarily be considered fair and one that is considered equitable may not be efficient. For example, society may consider a very

progressive tax to be equitable but such a tax might distort incentives to work, save, or invest. The challenge in this case is to establish the tax structure that gives the best trade-off between incentives and equity.

Most of the literature on optimal taxation tends to be highly mathematical. However, a brief non-technical account of optimal income taxation appears in the Meade Committee Report (1978: ch. 14) and a useful survey is provided by Heady (1993). A more general, but also more technical, discussion appears in Atkinson and Stiglitz (1980). While the optimal taxation approach has yielded important insights, it has also proved vulnerable to criticisms centred on a relative narrowness of approach. For instance, Brennan and Buchanan (1977: 255) went so far as to describe it as institutionally vacuous and Ricketts (1981: 44) concluded that 'the literature on tax policy . . . is almost exclusively concerned with factors which are entirely missing from models of optimal taxation'.

### 3.5 Macroeconomic Aspects

The main aims of macroeconomic policy are to promote economic growth, high levels of employment, and a stable price level. The main methods of achieving these aims are through monetary policy and fiscal policy. Monetary policy influences the money supply or rates of interest and fiscal policy is operated through changes in public expenditure and taxation. For example, if and when the UK's currency becomes part of the Euro, the control of monetary policy will pass to Europe and the limited stabilization policy remaining with the United Kingdom would have to be conducted largely through fiscal policy.

There has been a considerable debate as to the effectiveness of fiscal policy. In simple Keynesian models, if aggregate demand falls below the full employment equilibrium the problem could be dealt with by increases in public expenditure or tax reductions or both. The issue was complicated first of all by an apparent trade-off between inflation and unemployment that became known as 'the Phillips curve' (Phillips 1958; Lipsey 1960) and then the experience in the 1970s that both could be unacceptably high at the same time. Apart from the difficulty of forecasting macroeconomic difficulties in time to take appropriate action, fiscal policy has a number of limitations. A particular drawback is length of time before tax changes have an effect on the economy—a point stressed early on by Friedman (1948). Another issue covers the most appropriate features of a tax system that allow it to be used effectively for this purpose. An extensive analysis of fiscal

models is given in Dornbusch, Fisher, and Startz (1998) and the conduct of fiscal policy is discussed by Currie (1985).

One much researched aspect of this topic is the possibility that governments might use fiscal policy for political advantage rather than in the interests of long-term macroeconomic stability. The specific concern, of course, is that government might manipulate the situation by holding the economy back at the beginning of its term of office and then encourage a boom just before the next election. Economic models developing this area are discussed in Alt and Chrystal (1983) and Alesina (1988). One very clear model is that of Nordhaus (1975) who developed a model incorporating 'the Phillips curve' analysis with the electoral process.

### **3.6 Experimental Economics**

Experimental economics has developed into a new and vigorous branch of economics and the scope for economic tax research in this area is enormous. Economists have long taken advantage of natural experiments and Rosenzweig and Wolpin (2000) provide a recent survey. Natural experiments relating to taxation appear to be under-represented in this work but there are some examples. One was the introduction of the US Tax Reform Act of 1986 (Auerbach and Slemrod 1997). A much smaller one was the effect of the introduction of independent taxation in the United Kingdom on female paid labour supply (James 1992: 727). The arranged negative income tax experiments are mentioned in Section 3.8.2 but there is also a great deal of work being conducted with smaller-scale experiments.

The scope for laboratory-type economic experiments in taxation also appears to be underexploited so far. The handbook of experimental economics (Kagel and Roth 1995) does not even mention tax in the index. However, economists have conducted such experiments, for example, Sillamaa (1999) focusing on taxation and labour supply. It is probably safe to conclude that there will be further contributions to tax research from this approach.

### **3.7 Types of Taxation**

While the research described above can largely be applied to taxation in general, other contributions are more focused on particular types of taxation.

### 3.7.1 Income Taxation

Not surprisingly, one fundamental issue in income taxation has been the concept of 'income'. Haig (1921) defined income as 'the money-value of the net accretion of economic power between two points in time'. Henry Simons' definition (1938) was that personal income 'may be defined as the algebraic sum of (a) the market value of rights exercised in consumption and (b) the change in the value of the store of property rights between the beginning and end of the period in question'. Hicks (1946) defined income as the 'maximum amount of money which the individual can spend this week, and still be able to spend the same amount in real terms in each ensuing week'.

The development of the concept of income has a number of important implications, for example, that 'capital gains' are a form of income and therefore on grounds of both efficiency and equity should be treated in a similar way as income that is more conventionally defined.

One topic often associated with income taxation is 'tax expenditure' when some advantage is given to a particular activity or group by a tax concession rather than by direct subsidy (Surrey 1973; Davie 1994).

### 3.7.2 Wealth Taxation

There are two aspects to wealth taxation—taxes on the transfer of wealth, often on death, and net wealth taxes. These will be dealt with in turns and the case for both of them includes efficiency and equity arguments.

It has been argued that death duties or inheritance taxes should include transfers made during life since otherwise the rich could avoid such taxation by passing on their wealth before they died. However, Whalley (1974) found evidence that the rich did not find this a good reason to give their wealth away. Possibly therefore such taxes might be considered to be voluntary taxes paid by those who dislike their relatives even more than they dislike paying tax. The UK attempt to tax such transfers—the ill-fated Capital Transfer Tax—was introduced in 1975, constantly modified, and finally repealed in 1986. It could not be considered a success (Sutherland 1984). The role of such taxes has also been considered by Aaron and Munnell (1992).

The case for annual net wealth taxes is examined, for example, by Flemming and Little (1974) and James and Nobes (2000). Such taxes are found in European countries such as the Scandinavian countries, Austria,

Germany, and the Netherlands, but the attempt by the Labour Government to introduce a wealth tax in the United Kingdom failed (Prest 1976).

### 3.7.3 Corporate Taxation

Economic research has contributed in a number of ways to the study of corporate taxation—for instance whether corporation tax should be a separate form of taxation or integrated with personal income tax—as discussed, for example, by Musgrave and Musgrave (1989). Mintz (1995) provides a more recent survey on corporate taxation which he suggested might be the most well-studied tax found throughout the world.

## 3.8 Tax Policy and Reform

A good overview of the contribution of economics to tax policy is provided by Kay (1990) and more specifically to tax reform by Slemrod and Bakija (1996). Particular issues discussed here are tax compliance, negative income tax, the flat tax, a personal expenditure tax, and fiscal federalism but there are many more that could have been included.

### 3.8.1 Tax Compliance

An overview of tax evasion is provided by Tanzi and Shome (1993) and of compliance more generally by Andreoni, Erard, and Feinstein (1998). There is also a recent survey of the economic theory of public enforcement of law (Polinsky and Shavell 2000). An early model of tax evasion frequently quoted is that of Allingham and Sandmo (1972) and there have been many refinements since. For instance, there has been work on the tax structure—that is the set of tax rates (Pencavel 1979; Clotfelter 1983; Alm, Bahl, and Murray 1990). The chances of getting caught are obviously important and there has been research into risk and penalties in these circumstances. There is almost no end to the possibilities here—for example, even to the extent of the willingness of the tax authority to renegotiate penalties (Cho, Linn, and Nakibullah 1996).

Compliance costs have also been subject to a great deal of attention, for example, by Vaillancourt (1987) and Sandford, Godwin, and Hardwick (1989) and attention has also been drawn to the difficulties of tax simplification (James and Wallschutzky 1997).

### 3.8.2 Negative Income Tax and Income Maintenance Schemes

The basic idea behind negative income tax (NIT) schemes is that the income tax and important elements of social welfare support are combined in a single coordinated system. The income of each individual or family unit would be assessed. If income exceeded the relevant amount, tax would be payable in the normal way and if income fell below that amount, it would be supplemented with a cash payment. There is an extensive literature on this subject but Barr (1998) provides a good overview. Proposals include those of Tobin, Pechman, and Mieskowski (1967), Meade (1972), and Parker (1989); and Atkinson (1989) addresses the issue of the costs of such schemes. In the United States there has been some experimental work which is described in Watts and Rees (1977) and a survey of the incentive effects is provided by Burtless (1986). Some disincentive effects were found by the NIT experiments but the results are subject to a number of limitations.

A similar concept to the NIT is the basic income scheme, as for instance discussed by Atkinson (1995) where it is presented in combination with an income tax levied at a single rate—the ‘flat tax’ as described below. Under such a basic income/flat tax scheme, social security benefits and income tax allowances are replaced with a basic income given to everyone and then all other income is subject to the flat tax.

### 3.8.3 The Flat Tax

In principle, a pure flat tax would be imposed on the entire tax base from the first pound or dollar upwards. However, the actual proposals usually incorporate a zero rate on income up to some threshold after which a single rate applies to the excess. Above this threshold, the proportion of income that is taken in tax rises as income rises so that such a tax is progressive and the degree of progressivity is determined by the level of the threshold and the rate of tax. The issue has been discussed by, among others, Feld (1995) and Hall and Rabushka (1995).

### 3.8.4 A Personal Expenditure Tax

The idea of a personal expenditure tax can be traced back a long way, for example, to Hobbes (1651: ch. 30) and eminent economists have returned to the idea frequently. Alfred Marshall (1925) argued that a progressive personal tax on expenditure was ‘ideal perfection’. Pigou (1928) devoted a whole chapter to it and Kaldor (1955) a whole book arguing, among other things that such a tax does not discriminate against either saving or enterprise and risk-taking, and it ‘alleviates, even if it does not remove, the disincentive effects of progressive taxation on work’. In the United States the concept was pioneered by Fisher (1937), examined further in Pechman (1980), and more recently raised, for example, by McLure (1992). Serious policy proposals for such a tax have appeared in a number of countries such as, Meade (1978) in the United Kingdom and *Blueprints for Basic Tax Reform* (US Treasury 1977) in the United States.

### 3.8.5 Fiscal Federalism

A different but related area of economic tax research is fiscal federalism—how taxes are used to support different levels of government. The seminal work analysing how different local tax and spending regimes can improve economic welfare was produced by Tiebout (1956) and a good account of the topic is to be found in Oates (1999). In the United Kingdom the main question is how local authorities should be financed and which taxes are the most suitable for this purpose. The introduction and later repeal of the community charge or ‘poll tax’ generated a considerable amount of tax research. The European dimension to such issues has already generated a flow of tax research, for example, James (1999), and there is scope for a great deal more.

## 3.9 Trends in Academic Economics

There has been concern regarding developments in academic economics and its contribution to the community and Lawson (1997) and Mayer (1993) document comments from eminent economists to that effect. For instance, Arnold Harberger (Harberger et al. 1992: 1) was concerned about ‘the general malaise a number of us feel concerning the direction in which the economics

profession is going. The malaise . . . [arises] from a sense that the scientific material being produced is not doing the job that economics was traditionally assumed to do'. Wassily Leontief (1982: 107), a Nobel Prize winner in economics, wrote 'page after page of professional economic journals are filled with mathematical formulas leading the reader from sets of more or less plausible but entirely arbitrary assumptions to precisely stated but irrelevant theoretical conclusions'. Mayer, himself a distinguished economist, referred to the phenomenon as a 'mathematical arms race' and speculated what might happen if it continued and 'papers became more and more abstract and elegant, and less and less concerned with explaining actual economic behaviour' (Mayer 1993: 163). Such reservations also seem to extend to economics students. For instance, Klamer and Colander (1990) interviewed graduate students in six top-ranking US economics departments—Chicago, Columbia, Harvard, MIT, Stanford, and Yale. They found that what 'students believe leads to success in graduate school is definitely techniques; success has little to do with understanding the economy, nor does it have much to do with economic literature' (Klamer and Colander 1990: 28).

In the United Kingdom the Research Assessment Exercise (RAE) has been alleged to discourage interdisciplinary work and it is such work that is required to provide a full analysis of many important tax policy questions. To investigate the effects of the RAE on interdisciplinary research, the UK higher education funding bodies commissioned a survey by Evaluation Associates Ltd (1999). It found that 'one quarter of researchers (24%), and nearly one fifth of the RAE 1996 panel members (17%), believe that the RAE strongly inhibits interdisciplinary research'. Harley and Lee (1995) conducted a survey of economists in order to establish the effect of the RAE on academic economists and received 380 questionnaires from 79 institutions. A central hypothesis was that there are lists of core journals (see, for example, Diamond 1989; Johnes and Johnes 1993) that pose a serious risk to academic diversity in the economics profession. Among their conclusions was that academic economists, both mainstream and non-mainstream, 'report changes in recruitment policies which emphasize the mainstream and look to track records in publication in core journals' (Harley and Lee 1995: 32). The result, for example, was that apparently the nineteen departments of economics 'in the old and new universities which improved their 1992 research ratings in the 1996 RAE deliberately hired almost exclusively mainstream economists' (Lee and Harley 1998: 44). There are economists who follow a wider approach and some of these are associated with groups such as the Society for the Advancement of Behavioural Economics (SABE) or the Society for the Advancement of Socioeconomics (SASE) and both have

websites. However, it is not always easy to take an alternative approach. In doing so, as Ormerod (1995) puts it, the 'obstacles facing academic economists are formidable, for tenure and professional advancement still depend to a large extent on a willingness to comply with and to work within the tenets of orthodox theory'.

Even if the trends towards more technical and mainstream work continues, economics will still make a major contribution to tax research, but it may need to be supplemented by other approaches in achieving *successful* tax research.

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# Taxation Research as Accounting Research

*Margaret Lamb*

## 4.1 Introduction

Accounting involves processes of calculating, valuing, reporting, and evaluating financial transactions, performance, and events. Accounting processes involve techniques, apply principles, and attract theories of improvement and explanation. Accounting research focuses on these processes, their outputs, and the institutions created around them. As an object of accounting research, taxation represents a cost for which accounting is required, a separate process that interacts with and influences accounting, and a specialist practice area of accounting. And, like accounting research, a focus on tax generates research with emphasis on theories, principles, and techniques.

In this chapter, I survey the development of tax research within the broader field of accounting and discuss some of the ways in which accounting is understood. In the first section I consider the changing (and somewhat contentious) definition of the accounting discipline itself. In the following section I summarize tax research done in the traditions of academic accounting research. My analysis focuses on the United Kingdom, but extends to the United States. Approaches, methods, and indications of possible research outlets are outlined. In my concluding remarks, I suggest some of

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the challenges facing tax researchers in an accounting context, together with some general advice on how such research might be presented.

## 4.2 What is Accounting?

One might think it a straightforward matter to define ‘accounting’. Most of us say with confidence that we recognize accounting when we see it. So we know what accounting *involves*, but it is harder to agree on the significance of accounting or what is its essence. These areas of elusive agreement mean that the academic field of accounting is remarkable for the variety of views of what accounting *is*. It seems to be common ground that accounting is understood essentially as practice. Variation starts to creep in if we try to focus on the objects of accounting or its outputs.

### 4.2.1 Accounting Practice Change

Accounting practice changes over time and with context. Changes in the technologies of accounting practice and wider society—from vellum ledger books and quills, to standardized pre-printed ledger systems and ball-points, to integrated corporate information systems and computers—help explain some of the shifts in what has been commonly recognized as accounting. Also, the background, and often the professional affiliation, of an individual or group will shape definitions of accounting.<sup>1</sup>

The difficulty in defining ‘accounting’ is acknowledged within the academic literature and the ‘remarkably complex and ambiguous’ nature of accounting practice is cited as a factor (e.g. Stone 2001a). Accountancy leaders (e.g. the professional organizations and standard-setters) of each generation have defined it in terms that are consistent with and represent the normative objectives of contemporary accounting practice as they know it. In the mid-twentieth century ‘accounting’ tended to be viewed as a technical process and was defined by an authoritative professional body as ‘the art of recording, classifying, and summarizing . . . transactions and events . . . and interpreting the result thereof’ (Kam 1990: 33). Acceptable accounting practices and measurement guidelines (summarized as ‘generally acceptable accounting principles’ or ‘GAAP’) represented the consensus of expert practitioners (Kinney 2001: 279). Accounting was what was *done* by professional accountants. Academic accounting reflected concerns with

what accountants did in practice, but there was also a lively tradition of theorizing about what accountants *should* do and accounting *should* be (see Edwards 1994 for a survey of twentieth century accounting thinkers). By the 1960s the range of measurements done and standardized reports prepared by accountants had increased, and academic emphasis was placed on the ‘usefulness’ and ‘relevance’ of accounting and accounting information to economic decisionmaking by the users of financial statements. This ‘information relevance’ approach was complemented by concerns with ‘information reliability’ in practice and in academic consideration (Kinney 2001). By the 1990s, accounting standard setting bodies—like the Accounting Standards Board (ASB) in the United Kingdom—had institutionalized such functional definitions of accounting. For example, the ASB’s *Statement of Principles* (1999) states: ‘The objective of financial statements is to provide information about the reporting entity’s financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity’s management and for making economic decisions’ (p. 16). The challenges for accounting practice to generate relevant and reliable accounting information have changed in character in the twenty-first century because many basic accounting processes are automated through information technology and embedded in firms’ management systems. Therefore, the coordinating, integrating, and regulating roles of accounting are more prominent parts of practice than was the case several decades ago. And, after the corporate financial scandals of the early 2000s (Enron, Worldcom, and others), these roles are also much more controversial and less taken for granted.

#### 4.2.2 Accounting Research—Questions of Scope and Relevance

The preceding outline of changes in the character and approach of accounting practice makes clear that the academic accounting community has a moving target for its research. Accounting research has a very wide scope and its practitioners adopt a range of views about where they should look for accounting and how they should see it. As Ryan, Scapens, and Theobald (2002: ix)<sup>2</sup> write: ‘Research is uniquely about discovery and that research entails disagreement, criticism, chance and error’. They go on to say that ‘accounting and financial research cuts across many boundaries—it divides researchers into political and philosophical camps, it brings world views into sharp conflict, and it is tied to the paradoxes of our uncertain social and value systems’ (ibid.). This section considers some of these different views.

Many authoritative voices have attempted to define the acceptable scope of accounting scholarship. The divergence of views can be demonstrated by outlining how two influential accounting professors describe their discipline; William E. Kinney, Jr., of the University of Texas at Austin, is a former editor of *The Accounting Review*, and Peter Miller, of the London School of Economics and Political Science, is associate editor of *Accounting, Organizations and Society*. Kinney articulates views that are mainstream and dominant in the United States, and that would be accepted by many UK academics. Miller articulates an alternative approach that would be accepted by many in the UK academic accounting field, but that would find relatively fewer advocates among US accounting academics.

Kinney defines accounting scholarship as 'knowledge of the individual and aggregate effects of alternative standardized measurement and reporting structures' (2001: 278). This, he notes, is 'broader than the choice of particular numbers for a specific firm and conditions. Rather, it attempts to understand the costs and benefits of standardized measurement methods that we apply to all firms in all possible conditions over a period of time' (p. 282).

His definition emphasizes what he regards as the unique claims of accounting scholarship.<sup>3</sup> The subject of scholarship is 'value-adding' accounting, which has three hallmarks: 'a) [the] relevance of a set of standardized financial measurements for a wide variety of decisions made by diverse decision makers, b) precision or care in applying the measurement criteria, and c) trustworthiness of measurement displays' (p. 275). He notes that these essential elements are 'operationalized through four sequential activities or observables: 1) choice of a standardized financial measurement structure, 2) application of the structure to particular entities, 3) customization of resulting information for particular decisions, and 4) resulting decisions and outcomes' (p. 275). He goes on:

Accounting professionals typically perform the first two activities, accountants and others perform the third, non-accountants typically make the decisions, and these decisions interact with Nature to determine the outcomes. Accounting scholars study all three elements, all four activities, and their interrelations, but I believe that choice of a standardized ('one size fits all') measurement structure and understanding of the consequences of that choice is central to accounting scholarship. (ibid.)

Accounting practice fits within a definition of 'assurance services', according to Kinney (2001: 275) who argues that these are '*independent professional* services that improve the *quality* of information, or its *context*, for decision makers'. Each emphasized word represents a challenge for accounting practice in reaching its 'value-adding' goals. A core accounting activity, he argues, involves the development and application of standardized

financial measurement criteria to be applied across a multitude of entities and across time. Other accounting activities involve verification of the construction and application of the 'one size fits all' framework, as well as customization to particular transactions, users of financial information, and specialized contexts. Accounting scholarship embraces all of these activities of accounting practice, and more:

It is important to recognize that managers' action choices and resulting outcomes of future transactions, events, and conditions are beyond the scope of assurance services, internal control, and management accounting and tax planning. However, scholarly accounting includes them along with structure choice, application of the structure to particular firms, and customization of standardized displays. (p. 278)

The language that Kinney uses to define accounting is abstract and technical. Humans are referred to as 'users' of accounting information or 'decision makers'; information, he implies, has power. For example, '[p]ublic disclosure of standardized information relevant for investor customization creates social value by allowing managers, investors, regulators, and society as a whole to direct capital to its most productive uses' (ibid.).

Peter Miller's language is no less abstract, but he defines the scope of accounting more broadly and would tend to recognize the human object or actor in accounting practice in different terms than Kinney's. Miller's approach to accounting scholarship makes him more interested in gaining knowledge of the scope of accounting, broadly defined, by examining and revealing how it operates in a wide range of locations at different times. Accounting change is a diffuse process that often operates a long way from the core of what would popularly be seen as the accounting profession or accounting techniques.

Miller (1990: 316–317) conceptualizes accounting as 'a process of attributing financial values and rationales to a wide range of social practices, thereby according them a specific visibility, calculability and operational utility'. He goes on to say that accounting 'is located as a central component within a broad range of practices of economic calculation, rather than being viewed as an independent set of techniques' (p. 317).

'Accounting', Miller (1994: 1) says, 'has come to be regarded as a *social and institutional practice*, one that is intrinsic to and constitutive of social relations, rather than derivative or secondary'. The reference to 'practice' in a general sense, he goes on to explain, implies 'a view that accounting is, above all, an attempt to intervene, to act upon individuals, entities and processes to transform them and to achieve specific ends'. More specific, discrete accounting 'practices' create and define the financial data 'whose reality actors and agents are asked to acknowledge and respond to' (pp. 1–2).

Miller suggests that by ‘looking at the margins<sup>4</sup> of accounting, we can understand how this influential body of expertise is formed and transformed’ (1998: 618). He notes:

Accounting has been made and re-made by borrowing calculative technologies and rationales from a disparate range of knowledges and associated ideals. . . . Even though there are often fierce arguments and disputes when a new way of calculating is introduced, and appeals are made to various matters of principles, the malleability of accounting is quite remarkable. The criteria for what can count as accounting are historically contingent and only temporarily stabilized. Accounting is riven with tensions as to its identity and its boundaries. Proposals for new ways of calculating merely serve to heighten these tensions, and to make them manifest. (pp. 618–619)

Miller (1998: 619) likens accounting to ‘a form of *bricolage*, an activity whose tools are largely improvised and adapted to the tasks and materials at hand’. He draws attention to ‘the ways in which the calculative practices and rationales of accounting have been assembled in an ad hoc fashion in relation to historically and geographically localized concerns and issues’ (ibid.). Kinney, in contrast to Miller, is interested in accounting at the core of current and future practice (what he calls ‘value-adding accounting’), and he places a requirement on accounting scholarship that it should be relevant to that core of accounting practice. Miller is interested in the core of current and future practice, but his view typically stretches to the past and to the boundaries of accounting for evidence of change, trends, and *re-* or *pre-*definitions of the core, scope, and character of practice. As he notes, the nature of the core changes over time and space. To the extent that Miller places a requirement on accounting scholarship, it is that it should add to our knowledge of the unique contribution made or role played by accounting practice in the wider pattern of social relations.

#### 4.2.3 Accounting Research—the UK Context

For purposes of this chapter, I am not going to choose between Kinney’s and Miller’s approaches to accounting scholarship. It is enough to let their views indicate that accounting researchers may adopt different relationships to the core and boundaries of the accounting domain and may choose, or not, to make their research directly relevant to contemporary accounting practice. In this and the sections that follow, I will try to show the variety of approaches to accounting research that exist and may be adopted. This inclusive approach claims legitimacy in the UK context in which the author

writes based on the comments made by the 2001 Research Assessment Exercise (RAE)<sup>5</sup> panel for accounting and finance (Otley 2002*a,b*).

The accounting and finance RAE panel acknowledged that UK accounting research is 'eclectic' and it 'covers a very broad range of topics ranging from taxation and auditing through financial reporting and corporate governance to management accounting and control systems, as well as history and education' (Otley 2002*b*: 1). Its interdisciplinary nature and deliberate engagement with a variety of 'source disciplines' (e.g. economics, the behavioural sciences, and history) are acknowledged (RAE 1999: 3.35.3; Otley 2002*b*).

#### **4.2.4 Accounting and Finance—Areas of Overlap and Distinctions**

In everyday speech, the terms 'accounting' and 'finance' tend to be used interchangeably (QAA 2000: 1.4). Accountants describe themselves as engaged in 'finance' and various financial subjects form part of their professional training and practice sub-specialties. Accounting and finance are combined in programmes designed to precede professional training as accountants. A number of UK-based academic journals publish accounting and finance research: for example, *Accounting and Business Research*; the *British Accounting Review*; and the *Journal of Business, Finance and Accounting*. In very many ways, therefore, accounting and finance are closely related in practice and in research. This suggests that finance research belongs in a chapter that considers the traditions of accounting research. Many accounting academics would agree with this assertion either because finance theory and practice underpin a large body of accounting research. However, there are other academic readers who will disagree with the assertion either because they perceive finance to have other closer 'relations' among the academic disciplines or because they perceive it to be an academic discipline with its own research traditions and links to practice. These differences of viewpoint can create tensions. While some accounting and finance specialists recognize, cultivate, and highly value their mutual kinship ties, other specialists concentrate exclusively on their particular field.

The distinction between 'accounting' and 'finance' now gets made routinely and systematically in UK academic circles. The accounting and finance RAE panel took care to report on each research field separately (Otley 2002*b*). While a significant number of UK researchers based in accounting and finance groups think of themselves as working in *both*

research fields, many others think of themselves as working *only* in accounting *or* finance. Indeed, some finance researchers may feel that they share more common ground with economists than academic accountants.

Economists make their own claims to finance. Ross (1989: 1) writes: 'Finance is a subfield of economics'. The editors of *The New Palgrave* note that in the 1940s finance was 'primarily the province of business specialists who dealt descriptively with "corporate finance" and "stock markets"' (Eatwell, Milgate, and Newman 1989: xi). By the late 1980s, they go on to say that finance had become 'a coherent branch of applied economics that among its other tools makes brilliantly perceptive use of value theory in order to understand the real workings of financial markets' (p. xi).

For purposes of this chapter, we will include finance as an influential part of the accounting research tradition. It is in this spirit that later chapters in this book will discuss the development of research in tax planning and on tax influences on capital markets. The economists' perspective will be developed in a subsequent chapter concerning tax aspects of corporate finance (see James: ch. 9).

The UK accounting and finance RAE panel noted a striking increase in the amount of finance research being done in UK accounting and finance departments or within larger business and management studies departments or schools (Otley 2002*b*). Asset pricing and market efficiency research was most prominent, but there was also strength in work on finance theory, banking, derivatives, markets for corporate control, and international finance. Events studies were cited as an area of research strength with an explicit overlap with accounting in market-based accounting events studies. The panel noted that there was relatively less research done in corporate finance. Empirical research methods dominate finance research, with emphasis on large statistical samples and the application of econometrics.

### 4.3 Taxation as Accounting Research

'Tax research in an accounting context' includes research that deals with taxation in the functional context of accounting practice—financial reporting, auditing, managerial accounting, financial management, and tax accounting. It also includes tax research that contributes to academic literature on the measurement and reporting of accounting information, the management and organization of accounting functions, and the interactions between accounting information and capital market behaviour and individual financial decisionmaking. 'Just like accounting research in general . . . tax

research in this context may be normative or positive, historical or policy-oriented, theoretical or technical, orthodox or critical, domestically focused or internationally comparative' (Lamb and Lymer 1999: 750).<sup>6</sup> Riahi-Belkaoui (1997) and Ryan, Scapens, and Theobald (2002) provide detailed introductions to accounting research. Mathews and Perera (1996) provide a comparative overview of accounting theories and research methodologies.

#### 4.3.1 Tax Within the Traditions of Accounting Research

##### 4.3.1.1 Fields of accounting research

While accounting practice consists of financial reporting (including auditing), managerial accounting, financial management, and tax accounting, the dominant fields of accounting research are financial accounting, finance, and management accounting. A great deal of tax research takes place *within* these recognizable research fields. Financial accounting focuses on measuring and reporting accounting information for particular organizations to entities outside those organizations. Finance research considers capital market behaviour in aggregate and of individuals, as well as valuation and financial decision making more generally. Management accounting focuses on how accounting information meets the needs of managers. 'Interdisciplinary perspectives on accounting'—an approach that considers accounting in its social context—forms another recognizable field in which tax research is done. Some tax accounting research stands apart from the other research fields. This is especially the case in North America where taxation research is emerging as a separate field in the accounting domain.<sup>7</sup>

Within *financial accounting* research, normative and positive research approaches are well developed. Normative research typically asks: 'What principles should be used to measure business performance?'; Macve (1997) provides a recent survey. Ancillary questions are: 'How should accounting information be reported?', and 'How should financial reporting be regulated?' Some researchers ask if tax principles should have a role in financial reporting measurement; in a UK context, see Macdonald (1995) and Whittington (1995). Positive research asks: 'What factors explain accounting policy choices?' Watts and Zimmerman (1979, 1986, 1990) influenced the development of this perspective. Subsidiary questions of this research strand seek to identify the economic consequences and valuation consequences of accounting policy choice; Zeff (1978) and Solomons (1978) influenced research of these issues. In connection with taxation, research

questions have included: 'What accounting policy choices are explained by taxation?' (Sunder 1975) and 'What are the economic consequences of accounting for taxation policy choices?' (Arnold and Webb 1989).

Theory-building and empirical testing in *finance* are closely linked to economics. A fundamental question is: 'How do individuals and society allocate scarce resources through a price system based on the valuation of risky assets?' (Copeland and Weston 1988: iv). Subsidiary questions include: 'What information causes capital markets to react?'; 'What factors influence the market decisions of managers?'; and 'What factors affect the valuation of risky assets?' In the strand of accounting research that considers market reactions to public dissemination of accounting information, there is an important overlap between financial accounting and finance. Increasingly, the term 'financial reporting' is used to describe this academic field. Taxation represents a market imperfection and generates 'tax effects' in valuation and behaviour. Researchers have asked: 'Does taxation affect the valuation of corporate debt and equity?'; Mintz (1995) provides an introductory international overview of this literature and Ashton (1991) considers a UK analysis. Another research question is: 'Do tax changes cause capital markets to react?' Chapter 14 of this book by Kevin Holland reviews the literature concerning taxation and capital markets.

*Management accounting* research traditionally asks: 'What are relevant costs for decision making and control?' and 'What practices are used to recognize and manage such costs within organizations?' As the field has developed, questions have become more focused on how the functions of traditional cost accounting are integrated with internal management and business strategy. Newer questions might be: 'What is the relevant accounting information for decision making and control?' and 'What accounting practices are used to align and monitor managerial policies and report relevant information for decision making purposes?' Many researchers adopt a perspective derived from microeconomics, while others take an organization theory perspective. Taxation represents a cost to be managed and controlled, but also a process with behavioural and organizational implications for accounting. Capital project appraisal involves identification of relevant tax costs, but management accounting research relies on analyses of tax costs and 'tax shields' from the finance literature; see, for example, Buckley (1996: ch. 2). Researchers who adopt microeconomic approaches have considered the question: 'What tax factors have an impact on agent-principal contracts?' Chapter 10 of this book considers tax planning from a microeconomic perspective. Researchers who adopt organizational approaches have considered the question: 'What tax factors have an impact on organizational form and transactional exchange?' Chapter 11 of this book considers

organizational, as well as microeconomic, approaches to international transfer pricing. Management accounting researchers may ask: 'What factors are relevant for the control of taxation costs themselves?' Porter (1999*a,b*) explores how managers within companies control and evaluate tax costs.

*Interdisciplinary perspectives on accounting* (IPA) emerged in the 1970s in reaction to normative and positive accounting research.<sup>8</sup> These approaches cut across boundaries between financial accounting, finance, and management accounting, and tend to emphasize 'interpretation' rather than explanation or prediction. Work in this 'school' of accounting research tends to adopt interdisciplinary approaches that look beyond economics. Although IPA researchers adopt myriad approaches, they tend to focus on the question: 'What are the social and political antecedents and implications of accounting?' Accounting is *not* seen as an accurate mirror of the facts of economic reality (Knights and Collinson 1987). Instead, '[a]ttention has been directed to the ways in which accounting exerts an influence on, and in turn is influenced by, a multiplicity of agents, agencies, institutions, and processes' (Miller 1994: 1). Research of 'accounting in motion' is a method for seeing how accounting is implicated in the construction of organizational and social orders (Hopwood 1987). Many IPA researchers adopt a sociological approach; see Roslender (1992) for an introduction. Social theory forms the lens for other researchers; for example, Bryer (1999) turns to Marx, Power and Laughlin (1996) use the lens of Habermas, and Hoskin (1994) adopts a Foucauldian approach.<sup>9</sup> Political processes that condition and transform accounting are considered (Gilmore and Willmott 1992). An historical approach forms an essential part of much IPA research (Hopwood and Johnson 1986; Miller and Napier 1993). Tax can be considered from an interdisciplinary accounting perspective by asking the question: 'What are the social and legal processes by which taxation influences accounting practice?' Tax is included in studies of legal influences on accounting practice; see Freedman and Power (1992) and Bromwich and Hopwood (1992). Using a concept developed in the legal literature (McBarnet and Whelan 1992), Shah (1996) explores the mechanisms of 'creative compliance' with financial reporting rules and law, including tax law.

#### 4.3.1.2 Tax research in UK accounting journals

Lamb and Lymer (1999) reviewed the inclusion of tax research in seven leading UK-based accounting journals<sup>10</sup> for the period 1995–9. They confirmed that only a relatively small number of papers (19 of 893, or a simple average of 2.1 per cent) incorporated taxation as the research subject or a major element of research.<sup>11</sup> If the period is extended to 2002, the average

is 2.5 per cent (42 of 1,653).<sup>12</sup> The interdisciplinary journal the *British Tax Review* (*BTR*) represents the single most important UK location of tax accounting research, some of which is interdisciplinary research written by authors based in disciplines other than accounting. In the period 1995–2002, thirteen papers were published that fall into this category.<sup>13</sup> In recognition of the role played by the *BTR*, Brinn, Jones, and Pendlebury (1996) included it in their survey of accounting journals' perceived quality and familiarity among UK academic accountants. Unsurprisingly, accountants in general were less familiar with the *BTR* than with more mainstream accounting journals. This relative lack of familiarity suggests that relevant tax research may not reach a significant portion of its intended accounting audience. The editors of the *BTR* have taken steps to address this, but it is important that tax researchers direct some of their publishing efforts toward the more prestigious of the accounting journals as well.

#### 4.3.1.3 Topical clusters of tax research

Lamb and Lymer (1999) found that United Kingdom published tax research with a strong orientation toward accounting has tended to cluster around eight topics. These are discussed below.

*4.3.1.3.1 Reporting tax costs in published accounts* Many published papers falling in this category are descriptive, with emphasis placed on the historical development of relevant accounting standards as they interact with relevant features of particular tax systems. Contributions to the *European Accounting Review* (*EAR*) 1996 supplement on tax and accounting in Europe are of this type.<sup>14</sup> Given the frequency of changes in accounting standards and tax regulation, as well as the complexity of each, there will continue to be a place for sharply observed, clearly explained pieces of this sort that deal with significant and topical features of tax accounting.

An alternative approach to the subject considers the market relevance and valuation implication of reporting methods. This approach is closely linked to capital markets research and the valuation theories of finance. Its focus, however, is the information content of accounting disclosures. Citron (2001), for example, compares the UK effects of partial provision versus full provision reporting of deferred tax information. He finds 'that the full amount of deferred taxation is not valued as a liability and does not appear to convey any market-relevant information. There is evidence, however, that the market views the partial deferred tax provision component as the measure of the actual deferred taxation liability . . .' (p. 823). Holland (1998) also considers the information content of accounting disclosures,

but in a study designed to elucidate the patterns of managerial choices of accounting policies. This positive accounting research hypothesizes that large firms will have higher costs of political interference in the form of higher taxes. Thus, it explores the relationship between firm size and taxation, measured as effective tax rates. Hodgkinson (2002) provides an example of research that uses accounting disclosures as data representative of underlying financial circumstances. She examines how shareholders react to differential taxation in the form of companies with different corporate tax characteristics (amounts of surplus advance corporation tax). Her work is closely linked to work in finance on the information content of dividends—the so-called signalling literature. Work such as this, which uses UK data, engages with leading US accounting literature in two senses: in the extent to which theories empirically demonstrated with US data can be generalized to cover the United Kingdom, and over refinement of the measures and techniques used for analysis. Such studies are few in the UK context, and there is considerably more work to be done to understand the tax effects of reported financial information.

*4.3.1.3.2 Tax influence on financial reporting and degrees of conformity*  
Another cluster of research focuses on tax influence on financial reporting and degrees of conformity between profit measurement for tax purposes and for financial reporting. This research tends to have a higher descriptive and normative content than some other clusters of tax research. The 1996 *EAR* Supplement, for example, tried to capture a description of the salient relationships and mechanisms of influence for a number of national systems as they developed and as they exist at a particular point in time. Noke (2000) provides an example of research prompted by a proposed change that might unsettle existing patterns of influence and degrees of conformity. He considers how proposed changes to a fundamental UK accounting principle ('realization') might impact taxation through a network of legislative and practical connections.

There are numerous examples of closely argued normative research around this topic. For example, Freedman (1995), Macdonald (1995), and Whittington (1995) all argue, in different ways, that greater separation between tax calculation and accounting calculation is appropriate. James (2002) argues for careful review of these issues. A discussion paper published by the Tax Law Review Committee (Macdonald 2002) updates the analysis of the advantages and disadvantages of greater conformity between tax and accounting measurement and reporting. This work highlights questions for debate. Other research tries to understand the patterns of policy and practice at the intersection of tax and accounting. For example, Lamb (1995)

traces concepts of 'group' for reporting and anti-avoidance purposes in and out of tax and accounting authoritative documents. Given the tendency of successive UK Governments to view greater conformity of tax and financial reporting profit calculation as cost effective, and given EU commitments to adopt by 2005 the international financial reporting standards (IFRS) issued by the International Accounting Standards Board for many financial reporting purposes, the question of tax influence and accounting conformity will be a relevant research area for years to come.

*4.3.1.3.3 Comparative international studies* Comparative international studies tend to focus on tax cost reporting and tax influence on financial reporting. These have usually taken one of two forms. The first type of study involves researchers from different tax jurisdictions writing about the systems with which they are familiar in a framework—often descriptive—shared with all other authors. The *EAR* 1996 supplement is an example of this sort of study. A second type of study adopts a more systematic form of comparative analysis. Work by Lamb, Nobes, and Roberts (1998) is an example. This research used a classificatory method to differentiate the degree and nature of conformity between corporate financial reporting and tax accounting in France, Germany, the United Kingdom, and the United States. As tax systems change, and as a more international literature on business decisionmaking and organization develops, there will continue to be a need for these sorts of study. It is probable that journal editors will be most interested in work that applies rigorous research frameworks to documentary or empirical analysis. There are opportunities for research, for example, in the way that EU Member States implement and integrate the 2005 requirement to adopt IFRS for (some) corporate financial reporting purposes and also in the ways that tax burdens are calculated and reported across countries.

*4.3.1.3.4 Interrelationships between taxation and accounting* Studies that cluster around this topic consider interrelationships between taxation and accounting in broader social and political contexts and practice. Research studies that fall into this category tend to highlight the issues or tensions in the tax system that are closely associated with accounting processes. Boden (1999), for example, considers the pressures and problems created among the self-employed by legal and practical requirements to calculate and report self-assessments of income for tax and benefit purposes. Preston (1989) traces the ways in which tax requirements can shape accounting systems and practices in business. In two historical studies, Lamb (2001, 2002) considers how control of accounting calculation (of expenses, income, and

profit) is achieved and used to reinforce the powers of tax authorities to enforce taxpayer compliance. In a study of tax accounting in ancient Egypt, Ezzamel (2002) explores the accounting practices that are integral to all 'cycles of taxation': identification of taxable subjects; estimation, assessment, and collection of the taxes; and the transportation, delivery, and storage of taxes collected in kind.<sup>15</sup> Further studies of how taxation and accounting interact and form interdependencies in practice are important for several reasons. First, they help make visible forms of accounting that are taken for granted and, therefore, often escape the scrutiny to which accounting systems in other settings (for example, private companies) are subject. Second, they help us understand what may make taxation work well (or less well) in practice.

*4.3.1.3.5 Implications of tax legislation* The emphasis in this research tends to be the implications of tax legislation for corporate decision making and management. There is a well-established tradition in accounting research of explicating how tax law changes are likely to impact corporate performance, decision making, and management. Elliott (1995) considered how international agreements (new OECD transfer pricing guidelines) would interact with UK law and practice and affect UK corporations. Casson's (1998) study of international aspects of the UK imputation system put then recent changes in their historical context. Eden, Dacin, and Wan (2001) extend this approach further with a more theoretical framework of analysis. They examine the sociohistorical evolution of transfer pricing regulation in the United States, Mexico, and Canada, and develop a cross-border model of diffusion that deals with the variables of timing, motivation, and form. There are plenty of opportunities for reflective studies of policy implementation and taxpayer reaction that would contribute greatly to our understanding of the links between policy and action.

*4.3.1.3.6 Organization and management of tax practice, compliance, and planning* In the United Kingdom a limited amount of work has been done on private sector tax practice. Porter's (1999a,b) work on the corporate tax function is an important starting place. Green's (1999) research on regulation of the tax profession represents another piece of work that could fruitfully be extended. This area remains an important focus for future research, given concerns about conflicts of interest within diversified professional services firms and the sorts of inherent tensions that increased commercialization of tax practice can generate (see Roberts 2001). US work on the organization and management of tax planning, including outsourcing, represents a launching-off point for research elsewhere (see, for example, Dunbar and

Phillips 2001). Work in UK public sector tax practice has tended to consider the compliance practices required of and costs imposed on taxpayers, and the internal tax authority practices that most affect these (e.g. Hansford and Hussey 2000; Hansford and Hasseldine 2002). Hasseldine (2001) opens up the research possibilities for other angles and connections with a piece that explores how behavioural studies of taxation and compliance cost studies might intersect. Hoskin, Lamb, and Tuck (2001) consider how organizational change in the Inland Revenue itself might alter tax accounting practices of compliance and planning in the private sector and of assessment and enforcement within the department. As Tomkins et al. (2001) make clear, the organization and management of taxation remain research problems that have been little explored. There is much work to do in this direction.

*4.3.1.3.7 Tax education and training* One focus of UK research on tax education and training has been to distinguish its practices and requirements in the accounting domain compared with the legal domain (Freedman and Power 1992; Craner and Lymer 1999; Miller and Woods 2000). A study sponsored by the Chartered Institute of Taxation (Miller 2002) updates earlier UK surveys of tax education. James and Evans (1996) provide a UK–Australian comparative study of tax education and professional training. One valuable research exercise that might be undertaken would be careful contextual comparison of tax education and training in the United Kingdom and the United States, where there is a substantial body of published journal material on education practice and effectiveness.

*4.3.1.3.8 Tax influence on individual and corporate financial behaviour* This approach to tax research reflects the concerns and methods of finance. One type of UK-published research seeks to adapt and apply finance theory and models developed around the institutional detail of another tax jurisdiction (most frequently the United States) to UK circumstances (e.g. Ashton 1991). Acker, Ashton, and Green (1997) consider how a UK legislative innovation—in their case the foreign income dividend scheme—alters prior analysis. Dobbs and Miller (2002) seek not only to highlight models applicable to UK capital budgeting and valuation purposes, but to feedback the implications of errors in earlier models. There are many areas of tax influence that could be investigated analytically or empirically. Perhaps the key matter for researchers new to this area to bear in mind, however, is the implicit obligation on non-US researchers to root their research problems and methods in the large body of US-published finance literature on related subjects.

### 4.3.2 Methods of Research

The process of doing accounting research is approached in many different ways. As should be clear from the preceding discussion of the variety of definitions of accounting itself, the ontological dimension of methodology is contentious. So is the epistemological dimension. Chua (1986) provides a seminal discussion of the mainstream versus alternative assumptions that underlie methodologies of accounting research. Stone (2001*b*) has tried to summarize the distinguishing features of research quality in different parts of the field: 'The best quantitative research uses theory to build empirically grounded descriptions of phenomena. The best case and field studies create theories and descriptions of people doing actual things in the actual social world' (p. 286). Intriguingly (and no doubt, provocatively), Stone (2001*a,b*) goes on to argue the role for unconventional methods such as fictive treatments and analyses.

As Ryan, Scapens, and Theobald (2002) state: '[W]e believe that a plurality of methodologies is possible and each can lead to fruitful research. However, we would argue that rational debate and enquiry and the sensible use of evidence in the resolution of competing truth claims is most likely to lead to the advancement of knowledge, although every step in the research process is problematic and fallible' (p. 30). When it comes to the particular methods adopted by accounting researchers, we can see the variety in the literature discussed in the section above. Numerous studies adopt textual analysis. In some cases, the texts are legislation and case law (see Macdonald 1995; Lamb 2002). In other cases, the texts are more focused on accounting pronouncements (see Noke 2000). Lamb (2001) illustrates the deconstruction of a narrative account of being taxed (in this case, Jane Carlyle's mid-nineteenth century journal entries) and interpretation in its historical context. Eden, Dacin, and Wan (2001) employ a broader analysis of all relevant forms of discourse to theorize about the patterns of policy and practice diffusion between tax jurisdictions. Preston (1989) employs a case study method—involving interview, observation, and review of documents—to explore the nature and extent of tax intervention into the design and operation of a company's accounting system. Research methods that facilitate quantitative analysis, hypothesis testing, and (possibly) generalization are evident, too. Postal survey techniques are used (see Craner and Lymer 1999). Hypothesis testing using large-scale datasets generated from corporate financial information services (e.g. Datastream and Extel) are used by researchers working in the finance tradition or accounting capital markets tradition (see Holland 1998; Citron 2001; Hodgkinson 2002).

Interpretation of results relies upon the conventions and techniques of statistics and econometrics. The papers just cited also have an analytical modelling element to them, but in some cases research may be almost entirely analytical (see Dobbs and Miller 2002).

#### 4.3.3 US Taxation Research in the Accounting Domain

As Otley (2002a: 398) says in characterization of UK accounting research: 'the eclecticism shown in UK work is not mirrored in the United States where the predominant approach is still based upon economics'. Baker and Bettner (1997) explain the absence of interpretive and critical research from mainstream accounting research journals by reference to the social construction of the accounting research community in North America. They point out the constraints that are imposed on researchers who try to move out of the mainstream. They argue that mainstream researchers control doctoral programmes and the leading journals' editorial policies. These factors make it difficult for new researchers to obtain training in alternative research methods. Therefore, new entrants build up their intellectual capital in mainstream research. This enhances the power of the mainstream. These observations have been cited by Ryan, Scapens, and Theobald (2002). They echo Panozzo (1997) who compared the doctoral training and social construction of US and European accounting academics and Cooper (2002) who compares European doctoral training with North American programmes.

Tax research done in the US accounting domain reflects these differences from the more diverse UK and European approaches. As a recent paper by Slemrod (2003) makes clear, the 'meeting of accountants and economists to talk about taxation' is the essence of US multidisciplinary tax research.<sup>16</sup> It is more homogenous in approach and there is a larger body of academic literature. Two long-established journals are devoted to taxation topics: the *Journal of the American Taxation Association (JATA)* (a refereed journal published three times per annum by the tax interest group of the American Accounting Association)<sup>17</sup> and *Advances in Taxation (AIT)* (one of the series of annual journals in the JAI accounting series). These two journals published a body of 196 papers in the period 1995–2002.<sup>18</sup> In addition US mainstream accounting journals tend to publish more papers dealing with taxation than their UK counterparts. Lamb and Lymer (1999: table 1) found that of the 1,441 papers published by 10 leading journals,<sup>19</sup> 76 considered tax issues. This represents a simple average of 5.3 per cent, more than twice the

level (ignoring *JATA* and *AIT*!) in UK journals during the same period. Extending the survey until the end of 2002 found 118 tax papers among 2,402 papers published: 4.9 per cent. In 2001 one of the leading tax researchers working within academic accounting, Professor Terry Shevlin of the University of Washington, was appointed editor of the mainstream academic journal *The Accounting Review*. (This prestigious accounting research journal has the highest tax research content—12 per cent—of all non-specialist journals surveyed in the United Kingdom or United States.) One could say, based on this fact, that tax research was a field at the core of accounting research in a way and on a scale that has not (yet) been achieved in the United Kingdom.

Tax research published in the US journals is more heavily clustered in areas that can be studied using analytical and empirical/statistical approaches than is the case in Britain. The tax research published in the *Accounting Review*, *Journal of Accounting and Economics*, *Journal of Accounting Research*, *Journal of Finance*, and *Journal of Financial and Quantitative Analysis* falls into this category. It tends to be divided into research into the tax influence on investors, capital markets, and financial reporting behaviour, and behavioural studies of professional decisionmaking in tax practice. These journals account for 76 per cent of the total 118 tax research papers published in US-based accounting and finance journals. Small clusters of research can be seen around tax education and training and tax history. In general, the US tax research tends to focus more on domestic issues and less on international comparisons than UK tax research, and it tends to be more consistent in the research approach adopted (e.g. positive approaches, decision-making oriented, analysis of contractual relationships and incentives).<sup>20</sup> However, some leading US researchers have begun to work on non-US tax problems (e.g. Shackelford, Lang, and Maydew 2001).

The largest body of US tax research that is published in leading accounting journals is microeconomics-based. Three recent survey articles (Shevlin 1999; Maydew 2001; Shackelford and Shevlin 2001) represent excellent introductions to this body of research. Maydew (2001) characterizes such research and researchers:

[T]ax research is interdisciplinary in that it is produced by accountants, economists, and finance researchers. Accountants tend to specialize in certain areas of tax research in which they have a comparative advantage over economists and finance researchers. The comparative advantage that accounting researchers most often possess is a superior knowledge of institutional factors, in particular, knowledge of the complexities of the tax law and financial accounting. This institutional advantage is often accentuated with knowledge gained from teaching tax strategy and financial accounting. (p. 394)

Taken together, the three articles cited are particularly important for understanding the Scholes–Wolfson paradigm which is ‘central to current empirical tax research in accounting, important in public economics, and somewhat influential in corporate finance’ (Shackelford and Shevlin 2001: 322).<sup>21</sup> This approach is ‘intended to inject economics and finance into tax research in accounting’ and can be expected to employ ‘increasingly sophisticated economic theory’ for its analysis in the future (Maydew 2001: 399). The *National Tax Journal* special issue of interdisciplinary research in which Slemrod (2003) appears extends an understanding of this approach. The Social Science Research Network <[www.ssrn.com](http://www.ssrn.com)> represents an excellent source of current working papers and published research by tax researchers working in the empirical accounting tradition, and the related fields of public economics and finance.

#### 4.4 Conclusions

This chapter has traced some of the research routes through the tax accounting field that are available to researchers. Whatever choices the individual makes, it may be useful to bear in mind the general advice offered by Largay (2001), editor of US journal *Accounting Horizons*, on presenting research to particular audiences. Certain journals are prominent publishers of so-called discovery research (e.g. *Accounting, Organizations and Society* in the United Kingdom and the *Accounting Review* and *JATA* in the United States), in contrast with others (e.g. the *BTR* in the United Kingdom and *Accounting Horizons* in the United States) intended to address an audience of practitioners and academics where papers representing ‘scholarship of integration’ (e.g. survey articles) and ‘scholarship of application’ predominate (p. 71). He also cites good general characteristics for most pieces of research or scholarship done in an accounting context:

*Readability* refers to the effectiveness with which the paper’s messages are communicated and the accessibility of those messages to a diverse group of readers. . . . *Relevance* means that papers must address topics that appeal to a broad audience . . . and often implies linkages to real-world developments. *Rigor* means thoughtful, well-articulated arguments and logic, and appropriately designed examples, experiments, and tests. (ibid.)

He goes on to advise that in the abstract for a piece of research and early in the paper itself, an author should make sure that brief explanations of the ‘four Ws’ are provided: ‘*what* they are doing; *why* they are doing it; *what* they found; and *why* the findings are important’ (ibid.).

As tax researchers in the accounting domain, we can sometimes research tax problems of such significance or interest that we have little difficulty in publishing them in appropriate journals. This may be the case with new tax legislation or emergent problems. However, much of our tax research aims to generate better knowledge and theories about tax policies, processes, practice, and effects as they operate in the realm of accounting calculation, valuation, reporting, and evaluation of financial transactions, performance, and events. We gain a better foundation for such tax research if we can gain a richer understanding of what accounting is and how we might research it. As a practical measure, it is probably most important to understand what aspects of accounting are involved in a particular piece of tax research. You may think of this in terms of accounting *in* the processes of taxation, accounting *interacting with* taxation, taxation *as* accounting, or tax effects *in* accounting. Make your readers see the problem or issue as you do. This framing of tax problems in accounting terms is very important if you wish to publish research in accounting journals. It is almost inevitable that an accounting journal editor or reviewer will ask: 'Where (or what) is the accounting?' If the tax researcher does not have a ready answer or strategy to get past this inquisitorial hurdle, there is a risk that the paper will be rejected. There is little chance, then, of reaching the next interrogatory: 'So what (is the value of this research)?' Even with a strong argument for the merit of your research, there may be another potential question to stump the author: 'Where is the theory?' The importance of a theoretical framework may vary from journal to journal, and researchers are well advised to review the editors' policy and typical paper content as a way of gauging theory's importance for themselves.

Tax researchers in an accounting context face many challenges from the interdisciplinary nature of their field and the choices of theories, approaches, and tools available. Mainstream empirical tax research in the accounting domain draws heavily on economics and is closely associated with finance and financial reporting. More eclectic approaches to tax research are adopted in Britain and elsewhere. The latter draw heavily on other fields such as law, sociology, organization theory, and history, but may draw upon work in economics, too. Such tax research is often associated with the interdisciplinary perspectives on accounting (IPA) approach, but may adopt management accounting and financial accounting approaches, too.

To end this chapter, let me encourage new tax researchers in the accounting domain to get to know the existing approaches to tax research and the published literature in the field. But, remember too that there are new approaches and new questions that will emerge only if researchers

stay alert to changes in practice and what is happening in complementary academic fields. Creativity and variety will enrich the field.

## NOTES

1. A strand of accounting research considers how the accounting profession and its claims to expertise have developed. Work by Abbott (1988) has been influential in recognizing the significance of contests that take place at the boundaries of professions. Freedman and Power (1992) draw together studies of the variety of ways that law and accounting have competed for influence, areas of practice, and styles of expertise and technique. Roberts (2001) takes a critical look at the impact of increasing commercialization on tax professional services.
2. Ryan, Scapens, and Theobald (2002) provide a comprehensive study of research methods employed, and associated methodological questions, in financial accounting, management accounting, and finance. Their expressed intention is to 'stimulate and motivate research' (p. x). This work is essential reading for tax researchers working in an accounting context.
3. Attempts to define accounting are driven in part by a desire to clarify and in part by a desire to claim disciplinary space. As Kinney (2001: 275) puts it: 'We must have value-adding knowledge that others can't create and transfer better than we can'. Academic accounting in the United States and in the United Kingdom faces competition from other fields over areas of technical and theoretical competence that have been traditionally claimed by accounting academics (Albrecht and Sack 2000). For example, expertise in valuation would now be claimed by finance specialists as well as by accountants, and the design of accounting systems would be the domain of computer scientists and information system specialists just as much as accountants. Declining numbers of new entrants and PhDs in accounting on both sides of the Atlantic are cited with concern (see, for example, Demski and Zimmerman 2000; Otley 2002*b*). Such decline is attributed to the competing claims of accounting and the related specialist fields, and the general salary competition between academia, the professions, and commerce for relatively scarce intellectual talent.
4. 'Margins' mean, to Miller (1998: 605), 'that part of the terrain or surface of accounting that, at a particular point in time, is immediately within its boundaries. Categories of fixed and variable costs, principles of discounting and practices of standard costing were all initially located at the very boundary of accounting practice, and only gradually moved towards its centre. To attend to the margins of accounting is to attend to the ways in which these calculative practices and their related rationales have, in certain countries, initially permeated accounting at its boundaries, and gradually come to occupy a dominant position'.
5. RAE is used by the UK higher education funding councils as the basis for allocation of research funds to universities. Expert subject panels assess the quality of published work of individual academics and their departments in sixty-nine subject areas every four or five years. Each individual is submitted for consideration by the panel of his or her department's 'home' discipline, and panels have the discretion

to refer specialist or interdisciplinary work to other panels. The most recent RAE was conducted in 2001. There are distinct subject panels, among others, for law, economics and econometrics, politics and international studies, sociology, business and management studies, and accounting and finance. Taxation is not a separate subject area, but is assessed according to the standards of the tax researcher's home disciplinary panel. See <[www.rae.ac.uk](http://www.rae.ac.uk)> for further details.

6. Accounting research can be classified as 'normative' (emphasizing what accounting ought to be, rather than what it is) or 'positive' (seeking to explain accounting as it is). 'Orthodox' accounting research tends to perceive its subject as a specialist discipline that may be understood within a rational, scientific framework. 'Critical' research tends to link accounting institutions and practices to wider social and political phenomena and seeks understanding of the conditions and consequences of accounting.
7. Chua (1986) emphasizes that within these fields of research, the same problem may be addressed but from different perspectives. Her analysis distinguishes 'mainstream accounting', with a worldview that places 'emphasis on hypothetico-deductivism and technical control', from other schools of research that she calls 'the interpretive and the critical' (p. 601). Her point is that the different sets of assumptions associated with each perspective 'change both problem definition and solution' (pp. 602–603).
8. Roslender and Dillard (2003) write of the emergence of the contemporary IPA project 'as a further phase in the long established tradition of exploring the non-technical aspects of accounting, employing the lens of another discipline. A predominantly UK development, its defining feature was a growing reliance on the metadisciplinary perspective afforded by sociology, including, but not exclusively that of, critical sociology. Consequently, the contemporary perspective was very different from its immediate predecessor, behavioural accounting, and the emergent mainstream financial economics paradigm, both of which had their origins in the United States. While some within behavioural accounting were comfortable to gravitate to the more sociologically informed interdisciplinary project, the majority worked to reformulate the former development in the image of social psychology or financial economics' (p. 332).
9. 'Which social theorist?' can be an important question in the IPA school. Roslender and Dillard (2003: 338) distinguish between 'critical accounting' researchers and the Foucauldians. The first group engages in 'explicitly radical and politically engaged practice'. Their approach dominated the IPA during the 1980s. 'Its links with Marxist theory ensure that the critical accounting project evidences a [high] order of interdisciplinarity'. The Foucauldians, more influential in the 1990s, share a high degree of interdisciplinarity, especially with sociology. 'Although this latter project is also often given to questioning of accounting's legitimacy, it is normally content to advance a more conventional critique, and is not characterized by the radical, politically engaged commitments of the critical accounting project'.
10. The review covered the five leading UK-based journals according to a survey of perceptions of journal quality among UK accounting academics (Brinn, Jones, and Pendlebury 1996: table 4A): *Accounting and Business Research*; *Accounting, Organizations and Society*; the *British Accounting Review*; the *Journal of*

*Business, Finance and Accounting*; and *Management Accounting Research*. Also included were two UK-based accounting journals that focus on history and education respectively (*Accounting, Business and Financial History* and *Accounting Education: An International Journal*).

11. Identified by the appearance of 'tax' or 'taxation' in the paper title or among keywords, or based on the subjective analysis of paper content by the authors of this paper.
12. Data calculated by the author. Available for inspection from the author.
13. The following papers published in the *BTR* are explicitly written to consider accounting and tax issues: Casson (1998); Elliott (1995); Freedman (1995); Green (1995, 1996); Hansford and Hussey (2000); James and Evans (1996); Macdonald (1995); McMahon and Weetman (1997); Noke (2000); Porter (1999*a,b*); and Whittington (1995).
14. Full citations for the *EAR* contents (1996, volume 5, supplement) are included in Lamb and Lymer (1999). See Hoogendoorn (1996) for a summary of the research project.
15. Lamb (2003) suggests an approach to taxation research in an accounting history context that would help the researcher satisfy the interdisciplinary demands of both 'accounting' and 'history'.
16. Slemrod (2003) appears in a special issue of the *National Tax Journal* (56/1, part 2) that consists of papers presented at the 2002 Tax Symposium held at the University of North Carolina. This symposium, reports Slemrod, has met annually since 1990 (bar one year). 'The idea was simple enough', he writes (pp. 145–146), 'to regularly bring together academics from accounting and economics to present work-in-progress on taxation, and to ensure that at least one discussant of each paper came from the other discipline'. In his paper, Slemrod summarizes the processes of interdisciplinary learning and agenda-setting that were well represented in the symposia.
17. There is, in addition, the *Journal of Legal Tax Research* published by the American Taxation Association. It is the intended home for interdisciplinary research adopting legal research methodologies to study taxation problems of interest to the accounting academic community.
18. In *JATA* 130 papers, including discussion pieces in the annual supplement, have been published in volumes 17–24. In *AIT* 66 papers have been published in volumes 7–14. Author's calculations. Data available on request.
19. Lamb and Lymer (1999) included the five leading US journals of accounting and finance in their survey: *The Accounting Review*; *Journal of Accounting and Economics*; *Journal of Accounting Research*; *Journal of Finance*; and *Journal of Financial and Quantitative Analysis*. In addition, they included leading US-based specialist journals: *Journal of Management Accounting Research*; *Critical Perspectives on Accounting* (strictly, US/Canadian-based editors); *Issues in Accounting Education*; *Journal of Accounting Education*; and *Accounting Historians Journal* (currently with a British editor).
20. Lee (1995) found that more than 80 per cent of the papers in the *Accounting Review* and the *Journal of Accounting Research* adopted positive accounting research methods that involved the testing of hypotheses derived from economics-based models. Brinn, Jones, and Pendlebury (2001) present similar observations.

21. The Scholes–Wolfson paradigm will be discussed in greater detail in later chapters, namely Chapters 10 and 14 of this book by Macnaughton and Mawani, and Holland, respectively.

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# Taxation Research as Political Science Research

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## 5.1 Introduction

Taxation is politics. Taxes are an essential component of the budget, affect the distribution of income across social groups, and hit the voter's pocket-book. The link between taxation and representation is an inherent aspect of democracy. The structure of the tax system reveals the preferences of the government for redistribution and equity. It also shapes the size of the welfare state and the amount of resources available for social protection. Taxes have an impact on economic decisions, and governments may try to use tax policy to encourage certain types of economic behaviour. At the same time, economic actors can use their political power to obtain tax exemptions and other forms of 'privileged' fiscal treatment. Tax policy, therefore, provides an invaluable point of observation for the analysis of the relationship between the state and the society.

In an open international economy, countries compete to attract the tax base. The interdependence of the tax policies of different countries has led to both episodes of unbridled competition and attempts to create institutions and policy regimes to coordinate international tax policy. In the extreme scenario of open markets without barriers to capital movement and no institutions of international tax policy coordination, competition can sever the link between taxation and representation. Thus, the 'globalization' of tax policy can fragment the state.

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There are good reasons, therefore, to expect a substantial involvement of political scientists in the study of tax policy. Yet until a few years ago a leading political scientist, Guy Peters, could argue that 'to date the study of tax policy has been largely abandoned to economists' (Peters 1979: 787). Almost twenty years later, another influential political scientist, Sven Steinmo, opened his impressive edited collection on tax policy with the following words: 'It is only recently that political scientists have turned their attention to tax policy or more broadly, how governments raise the monies needed to pay the costs of governing' (Steinmo 1998: ix). This chapter will provide a slightly more optimistic assessment of the analyses and insights provided by political science, especially in the light of recent research.

The chapter proceeds in the following manner. Section 5.2 presents the thrust of political science as a research tradition or 'discipline' and the main questions raised by the political analysis of taxation. Sections 5.3 and 5.4 review the main results achieved by political science in terms of the explanation of tax policy outcomes and the role of non-governmental actors, that is, public opinion and pressure groups. Section 5.5 adds a dynamic element to the analysis of taxation by considering the explanations of tax policy change. Section 5.6 introduces the theme of tax policy in an open economy. Section 5.7 draws some conclusions and suggests some directions for future research. A common feature of Sections 5.5 and 5.6 is the presence of explicitly interdisciplinary research, most typically the studies of political scientists who are engaged in a close dialogue with economics. Indeed, the most interesting research presented in this chapter has been produced by political scientists with a substantial familiarity with the economic literature.<sup>1</sup>

The main argument of the chapter is that interdisciplinary approaches have considerable potential for the understanding of taxation as a problem of politics. Political science is increasingly attracted to the study of taxation, and therefore the assessment of 'what has been done' (perhaps one should say 'what is being done') is moderately optimistic. But the best results seem to be generated with conceptual frameworks which, although retaining a political science focus, are conversant with the economic literature. 'Conversation' does not mean identity of results, however, and this chapter will illustrate how a political science focus leads to original results in terms of research questions and empirical findings.

## **5.2 Political Science Research and Tax Policy**

Political science as a discipline is not defined by a single methodological approach—indeed, holism and methodological individualism, deductive

and history-sensitive approaches, quantitative and qualitative methods coexist and intersect repeatedly. Rather, political science is defined by its substantive concern with the creation and use of constrained social power (Goodin and Klingemann 1996: 7). Unconstrained power is pure force, and hence of very limited interest. Contemporary political systems are characterized by constraints, and political science explains the nature and source of the constraints under which political actors operate, and the strategies used to relax or change them.

The use of power—Goodin and Klingemann (1996: 8) explain—covers international action as well as unintended consequences, decisions and non-decisions (that is, the power to keep certain issues off the political agenda), internalized norms, and explicit sanctions and threats. The sources of power can be manifold, including legal resources, economic power, membership, time, and knowledge. The recent literature on the ‘politics of ideas’ and the use of knowledge in the policy process has revealed how ideas can change or remove constraints (Haas 1990; Majone 1996). As such, this is an exercise in power-building, and tax policy change presents several manifestations of the politics of ideas, as will be shown below.

This expansive definition of the political goes beyond the traditional distributional notion of politics as ‘who gets what, when and how’ (Lasswell 1950). Political decisions have important distributional consequences—and tax policy is often an arena for distributional struggle—but ‘many political acts are, at least in the first instance, distinctly non-distributional’ (Goodin and Klingemann 1996: 8). To research taxation from a distributional perspective means to investigate who gets what in tax policy choices—the most classic approach for political scientists. But there are deeper meanings of taxation as politics, which lead to a debate on the nature of the state and international policy regimes, as will be argued below.

Having sketched the discipline of political science, what are the typical research domains of taxation as politics? Perhaps with a hint of exaggeration, Steinmo argues that economists explain how governments should behave in order to get closer to efficient forms of taxation, whereas political scientists ‘tend to focus on explaining what it is that governments actually do and understanding why they do it this way’ (Steinmo 1998: ix). Expanding on this, political science and policy studies with a political science focus have typically addressed the following questions:

1. How does one explain the actual tax policies of contemporary democracies? In other words, how do policymakers make (constrained) use of power to produce tax policy?

2. What is the influence of pressure groups and public opinion in tax policy? In turn, this question leads to an enquiry into the nature of the state in modern democracies, the relationship between political power and economic power, and the legitimacy of tax policy choices.
3. When and how are the constraints on the use of social power modified or relaxed in order to produce tax reform? What do tax reforms tell us about the creation of power and the role of ideas, interests, and institutions in policy change?
4. What is the impact of economic globalization and technological innovation on domestic tax policy choices? Can governments still pursue their own agendas? Can international tax policy coordination provide an effective response to unbridled competition for mobile factors in open economies and if so at what costs?

### 5.3 The Logic of Choice: Governments and Tax Policy

Let us start with the explanation of tax policy outcomes. Tax policy can be analysed by using the political science lens of 'constrained power', with particular reference to the typical constraints of governments, that is, popularity and elections. Indeed, popularity and tax policy represent polar opposites. Even politicians who do well in tax policy do not get much popularity. By contrast, public expenditure is more visible to the relevant constituencies. Targeted public expenditure can be used by a politician to allocate concentrated gains to key constituencies, whereas the corresponding cost can be made opaque by diluting it into the macro-aggregates of the budget.<sup>2</sup> Politicians need both revenue and popularity. Their best option is to use expenditure to produce gains for their constituencies and to manage the tax system in an incremental fashion (Robinson and Sandford 1983; Witte 1985). Policymakers introduce incremental changes to accommodate particular interests without raising too many controversies. The cost of incremental policy is that it can reduce the overall coherence and rationality of the tax system.

Rose and Karran (1987) propose instead an inertial model in which new governments inherit the choices of previous governments. The new incumbent can secure a constant flow of revenue without the need to intervene in such a politically dangerous area as taxation: by doing nothing, politicians in office can still benefit from an ongoing system. Those who benefit from current tax laws provide a formidable constituency for the status quo. Tax policy tends to be locked-in by legacy of the past and the power of pressure

groups—a theme that chimes with the importance that political scientists assign to path dependency and policy legacy (Pierson 2000). Rose (1985) explains the role played by policy legacy with the following words:

*Non-decision making is preferred to decision-making in taxation ...* Whether or not the existing tax structure is optimal from an economist's point of view, it is usually optimal from a politician's point of view. Doing nothing enables a politician to avoid identification with proposals to levy new taxes or increase the rates of existing taxes. If keeping out of trouble is a basic law of politics, then not making decisions is one way to avoid trouble—in the short run at least. (Rose 1985: 306, emphasis in original)

Tax administration is an important constraint in tax policy (Hood 1985). Indeed, it is yet another source of inertia. Policy implementation is at least as important as policy formulation in taxation. To understand this, compare monetary policy and tax policy.

The management of monetary policy is all about policy formulation. Implementation concerns the reaction of the financial markets, but administrative structures—although important—are not crucial. So much so that to announce a monetary policy is often equivalent to producing results via the expectations of market players. Tax policy is completely different. To draft a rule on tax avoidance may require the same length of time required by a decision on interest rates. However, to implement tax anti-avoidance schemes is a laborious task involving tax inspectors, banks, other financial institutions, and operations coordinated with the police. Consequently, the analysis of inertia and change in taxation cannot be limited to the formulation of new tax laws, but should include the examination of the results—and unintended consequences—achieved at the implementation stage. An inefficient administration can turn innovative tax policy designs into very limited change.

This does not necessarily mean that tax policy delivers stability. Revenue can increase because of economic growth and inflation, thus making fiscal inertia compatible with the increase in public expenditure (Rose 1985). More importantly, incremental changes are cumulative. Year after year, fiscal incrementalism can alter the very structure of direct taxation, thus generating an unfair system (Witte 1985). Briefly, in incremental models, changes originated by the political intention to please specific interests create tax 'monsters': incoherence, an extensive presence of loopholes, and ultimately unfairness are the final result.

By the same token, inertia does not imply a static model of tax policy. Inertia can become highly dysfunctional when the economy changes, and a point of policy self-destruction can be reached. Short-term inertia reverts

in the long term to politically untenable configurations: at that point, the tax policy regime 'explodes' (Hood 1994).

These observations introduce the dynamic aspects of taxation and raise the question: under which conditions can the political system generate non-incremental tax policy change? Before we analyse the dynamics of tax policy and the politics of tax reform, however, the relationship between the state and the society has to be explained. The next section will therefore discuss the role played by public opinion and pressure groups in tax policy.

#### **5.4 Institutions, Public Opinion, and Pressure Groups**

Pressure for change in otherwise static tax systems stems from the electorate and pressure groups. If the general public is well informed about tax policy, voters will punish tax-raising governments. This, in combination with the option of choosing among jurisdictions (i.e. the possibility of voting with one's feet and leaving jurisdictions offering an undesirable bundle of services and taxes), should limit the power of governments to increase revenue (Tiebout 1956). By contrast, when no attentive public exists, 'predatory' policymakers encounter fewer constraints in extracting revenue (Brennan and Buchanan 1980; see Levi 1988 on the 'predatory rule').<sup>3</sup> Big government can be explained by the lack of mass political vigilance on taxes. Politicians seeking re-elections and budget-maximizing bureaucrats can exploit the voter's scant responsiveness to taxation. Research on this issue tends to conclude that ignorance prevails over accurate information.<sup>4</sup> In turn, confusion and fiscal illusions are deliberately increased by the political use of less-visible taxes and tax policy instruments which anaesthetize the electorate.

However, if the ordinary citizen, being unaware of tax policy, does not hold the policymaker accountable for taxes, how does political science explain tax revolts?<sup>5</sup> Arguably, tax revolts are manifestations of symbolic politics. Lowery and Singelman (1981) and Listhaug and Miller (1985) have shown that public resistance to taxation is not a rational response to the actual level of taxation. Hence tax revolts are expressions of wider dissatisfaction: big government, the public sector, the welfare system, perhaps the very concept of modernity are the real triggers of tax revolt. Tax revolts are symbolic in that taxation becomes the symbol of a larger crisis of legitimacy of the state (Peters 1991: ch. 5). It has also been argued that the history of taxation teems with riots and uprisings (Adams 1998). The relative tax peace of the 1950s and the 1960s might have been quite extraordinary.

Additionally, systematic surveys of European citizens conclude that tax protest is diffuse (citizens accept the fundamental principles of progressive taxation and public expenditures, yet question the way the tax system operates in practice), but tax revolt<sup>6</sup> is not (Confalonieri and Newton 1995).

As hinted above, politicians can accommodate pressure groups by using specific exemptions, tax expenditures, and selected tax breaks. Good (1980), in his study of Canadian federal tax policy, adds that tax policy-makers anticipate the reactions of the attentive public when fleshing out new tax measures. The politics of anticipation is therefore another mechanism of power pressure.

However, the power of pressure groups should not be exaggerated, for at least two reasons. To begin with, several authors, notwithstanding their different perspectives, emphasize the relative autonomy of politicians and non-elected bureaucrats from societal forces (Brennan and Buchanan 1980; Hansen 1983; Levi 1988). Second, the systematic comparison of tax systems reveals substantial variability in the permeability of institutions to pressure groups and different historical patterns of state–society relations (Steinmo 1993).<sup>7</sup> Not all political systems are captured by interests. The characteristics of the political system make a difference. A general point made by this literature is that the long-term evolution of the tax system reflects the essential characteristics of political institutions (King 1993; Steinmo 1993; Steinmo and Tolbert 1998). A corollary of this argument is that research on pressure groups should be recast more productively in terms of institutional analysis.

Other authors, such as Martin (1991) and King (1993), prefer to avoid the dichotomy between institutional autonomy and ‘capture’ and, in different ways, underline the symbiotic relationship between state and society. King concludes his monumental study of US tax expenditures arguing that both Democrats and Republicans promote tax breaks not as a short-term concession to powerful industrial interests that subjugate the democratic will, but as a technical and political precondition essential for long-term growth: ‘The tendency for government intervention into economic markets with subsidies intended to augment owner investment thus arises, ironically, not from the overwhelming power of business elites, but from the attempt to strengthen social integration and civil peace’ (King 1993: 4).

In market economies, policymakers are successful when they provide an effective narrative ‘in which continued national progress and complementary individual satisfactions are anticipated, contingent in part upon reduced short-term distributional militancy and increased acceptance of a capital-hegemonic accommodation’ (King 1993: 5). Thus, political-cognitive leadership is more important than pressure groups’ power, although King

emphasizes the structural dependency of market economies on capital accumulation.<sup>8</sup>

Martin affirms that American corporate tax policy is driven by prevailing strategies for economic growth. These strategies originate from symbiotic relationships between state actors and specific segments of the business community. Her argument is that corporate tax policy represents a zero-sum game *within* the business community: for example, a decision can benefit finance and housing but penalize capital-intensive manufacturing. The changing coalitions between state and firms develop in an institutional system characterized by fragmentation:

Each new direction in corporate taxation creates a new set of winners and losers. Fragmentation in the private sector is matched by fragmentation in government. An exaggerated separation of powers, federalism, overlapping jurisdictions, and the lack of clear authority hierarchies all contribute to a fragmented system with many competing points of power. (Martin 1991: 5)

Political scientists have classically focused on the 'supply side' of tax policy (i.e. what governments do). But future research is most likely to develop our knowledge of the 'demand side', especially corporate responses to international tax competition (Bernauer and Styrsky 2004).

## 5.5 The Dynamics of Tax Policy

Although change can be explained by models of inertia and incrementalism, 'most of the models of tax policy available appear better suited to explaining why the reforms were impossible, than for explaining how and why they did succeed' (Peters 1991: 271). However, recent studies have focused on tax reforms and their diffusion across the world. On balance, tax reforms in the 1980s have privileged the goal of efficiency, whereas in the 1960s and 1970s equity and stabilization played a larger role. 'The focus of the 1990s'—the head of the Fiscal Affairs department of the Organisation for Economic Co-operation and Development (OECD) argued some years ago—'is definitively on international issues' (Owens 1997: 28). The 1990s were also years of assimilation and consolidation of the reforms undertaken in the 1980s, although tax reform was still prominent in countries such as Germany and Italy. The studies reviewed in this section are mainly concerned with tax reforms in a domestic setting, whereas the political dimension of international tax policy will be discussed in the next section.

Economics and political science provide different conceptual lenses on tax reforms, although the vast majority of policy studies presented in this section are at least conversant with the economic analysis of taxation. While political scientists are interested in the politics of tax reform (and in the impact of tax policy change on the political system), economists assess tax reform by measuring its efficiency. Tax reforms which are considered of great political relevance by political scientists in terms of their impact on the balance of power (Conlan, Wrightson, and Beam 1990; Mucciaroni 1990) have not impressed economists (McLure and Zodrow 1994). Economists observe pessimistically that new tax structures of the type suggested by economic theory have not as yet materialized in any country. In their language, political systems have been unable to produce fundamental tax reform. No political system has gone so far as to embrace the radical proposals of the Meade Committee in the UK (1978) or the so-called flat tax (Hall and Rabushka 1995; Swedish Employers' Confederation 1999). Policymakers reply cynically by criticizing the metaphysical content of economic theory (this is the argument of the former head of the OECD Fiscal Affairs department, Messere 1993). The reality is that economists have been instrumental in fleshing out the design of major policy change (Birnbaum and Murray 1987; Conlan, Wrightson, and Beam 1990; Sandford 1993; Radaelli 1997), although their input has been filtered (and altered) by the political system.

Models of tax reforms with a political science orientation start from the content of policy change. As averred, a typical goal of tax reform has been efficiency. This implies a strategy based on simplification, elimination of tax loopholes, reduction of the highest marginal tax rates, fights against tax avoidance, and a wider revenue base. In turn, the tax base has been widened in order to secure revenue neutrality (a very desirable goal for policymakers engaged in the difficult exercise of balancing the budget). The result of this orientation towards revenue-neutral tax reforms is that the 'defence of the treasury'—as Swank (1998) puts it—is still possible in the age of tax competition.

The focus on base broadening, in turn, is indicative of a reorientation of policymakers' beliefs (Steinmo 1999). 'Carrot and stick' tax policies have failed. Accordingly, certain types of investment relief, tax expenditures, and the paraphernalia of 'market-directing' tax policy have been limited via base broadening. Beliefs have changed—as Swank notes—and the 'economic management' (or 'market-directing') role of business taxes has been substituted by 'market-conforming' tax policy orientations (Swank 1998). The use of tax incentives to stimulate specific industries is now considered distortive, ineffective and, for the members of the European Union (EU), in

potential breach of the Community's laws on state aid. Thus, the idea of a neutral tax system is preferred. In turn, policy ideas, beliefs, values, and material interests 'are related to one another in a dynamic and interactive process' (Steinmo 2003: 207).

A more radical reorientation of beliefs refers to the abandonment (*de facto*, although not always in the political rhetoric) of taxation as an instrument of 'social policy responsibility' of the state in terms of redistribution. Comprehensive analyses (McLure and Zodrow 1994; Steinmo 1999) have shed light on the shift from redistribution to efficiency in domestic tax reform. This shift is entirely consistent with the search for 'market-conforming' tax policies. Taxation, in short, is now perceived more as an instrument for the creation of an appropriate business environment than as an instrument of social justice.

The elimination of special tax provisions and the fight against tax avoidance face the political hurdle of overcoming the resistance of pressure groups (Mucciaroni 1990, 1991). The path to tax reform is quite narrow. Accordingly, Conlan, Wrightson, and Beam (1990)—drawing upon Kingdon (1984)—argue that tax reform is typically led by committed policy entrepreneurs who join together policy solutions elaborated by experts, policy problems, and political attention. Typically, problems, solutions, and the political cycle are not synchronized. They follow independent 'streams' (Kingdon 1984). Policy entrepreneurs exploit 'windows of opportunity' during which the three streams can be joined together. In doing so, policy entrepreneurs engage actively in 'the politics of ideas, argumentation, and persuasion'—a point consistent with the recent trends in political science mentioned in Section 5.2.

Sandford (1993) agrees on the pivotal role of individuals and leadership, but sheds light on the wider policy process (e.g. the construction of tax reform as a package wherein costs and gains are balanced) and the policy environment (such as pressure from other countries) as additional explanatory variables. Steinmo (1995) notes that, given the poor cognitive resources of the ordinary citizen in tax policy, public opinion is not a major catalyst of tax reform. By contrast, political leadership (and administrative leadership) matters. However, Steinmo—an ardent advocate of 'historical institutionalism' in political science—stresses the structure of political institutions as the key factor in the long-term dynamics of taxation (Steinmo 1995). Indeed, institutions matter in tax reform. For one, institutions are active players, and not mere arenas where political action takes place. For another, 'institutions also make up the topography, the banks and the riverbeds that channel and shape participant behaviour' (Mucciaroni 1992: 466). In conclusion, tax reforms provide a formidable

example of modification (even eradication) of some constraints on the use of power—the core of politics according to the definition introduced in Section 5.2. Leadership, ideas, and institutions are the main factors explaining the creation of power needed to reform tax policy.

## 5.6 The Political Aspects of International Tax Policy

The political dilemmas raised by the internationalization of tax policy represent one of the most interesting avenues of recent research with a political science focus. Virtually all political science studies reviewed in this section acknowledge the advantages of cross-fertilization with economics. There is also evidence of cross-fertilization between the legal tradition, history, and political science, as epitomized by the colossal work of Sol Picciotto (1992)—a study with great potential in terms of interdisciplinary research.

Recent scholarly work on the politics of international taxation tends to focus on two aspects, that is, how countries react to the challenge of tax competition and the efforts to create an international tax order via international organizations and institutions such as the OECD and the EU.

Let us start with the politics of tax competition. In an open economy, taxes are not the main driving force behind (1) foreign investment, (2) finance decisions, and (3) the choice to locate certain functions in one jurisdiction or another, but they matter (Kenyon and Kincaid 1991; Hines 1999). This provides governments with a rationale for engaging in tax competition. A country competing for the mobile components of the tax base, typically capital and skilled labour, will have strong incentives to lower taxes with the hope of attracting tax base from other jurisdictions. The incentives are particularly high for small countries (Kanbur and Keen 1993). Drawing upon the early literature on fiscal federalism (Oates 1972), the conventional argument (Sinn 1990; Tanzi 1995) is that the other governments will seek to match the initial tax cut. At the end of this race to the bottom, all governments will be worse off because they will get less revenue, and the final allocation of capital across jurisdictions will not have changed much. In game-theoretic terms, the process can be modelled as a prisoner's dilemma (Gordon 1992).

The main innovation brought about by political science is the demonstration that capital mobility may be a necessary condition, but not a sufficient condition, for a race to the bottom to take place. In doing so, political science has cast doubts on the validity of the prisoner's dilemma as the

main game-theoretic interpretation of strategic interaction in international taxation. There are many reasons behind these doubts. To begin with, it can be observed that capital is not fully mobile internationally: investors have more information on their residence country than on markets abroad. Thus, a fundamental assumption of race-to-the-bottom models of tax competition may not be valid—a point acknowledged by economists (Gordon and Bovenberg 1996).

More importantly still, the race-to-the-bottom argument assumes that governments can change their tax systems easily, whereas political scientists tend to point out how difficult it is to overcome inertia and the political obstacles to tax reform (see Sections 5.3 and 5.5 above). The use of social power is always constrained, and taxation presents its own daunting problems to the policymaker willing to engage in cut-throat tax competition. Thus, political science models of international tax competition dedicate explicit consideration to political players with veto power and pressure groups' resistance to tax reform (Hallerberg and Basinger 1998; Basinger and Hallerberg 2000). Governments will not engage in race-to-the-bottom tax competition if the domestic political costs are high. Third, and elaborating on the previous point, policymakers can react to greater mobility of capital with any combination of the following options: less expenditure, more taxation on labour, or more deficit. In the EU at least, welfare commitments are difficult to reverse, unemployment makes higher taxes on labour extremely unpopular, and the growth and stability pact poses severe limitations on deficits in the Euro-zone. Thus—Ganghof (2000) argues—although there may be greater pressure for tax cuts coming from capital mobility—governments may hesitate because of internal pressure. Fourth, political scientists have presented alternative game-theoretic models of international tax policy, thus exposing the flaws of the 'spiral to the bottom' interpretation of tax competition (Radaelli 1998; Dehejia and Genschel 1999; Basinger and Hallerberg 2000). The scepticism surrounding the race-to-the-bottom argument is consistent with empirical observations. Indeed, the percentage of gross domestic product (GDP) absorbed by tax revenue has increased steadily in OECD countries, and corporate tax revenue is stable in major countries.

On balance, there is a lively debate as to whether it is possible to provide a precise answer to the question 'when is the process of tax competition harmful?'<sup>9</sup> Political scientists argue that the race-to-the-bottom model may not be the best interpretation of how tax competition is changing the contemporary state. They accept the point that tax competition is a serious challenge for the state, but its institutional impact should be examined

beyond the standard model of the prisoner's dilemma (Swank 2002). Be that as it may, both the EU and the OECD are engaged in an attempt to curb harmful tax competition (European Commission 1996; OECD 1998). For political scientists, it is important to acknowledge that policymakers—whatever the doubts may be about the possibility to define what is harmful in tax competition—have shared beliefs on harmful tax competition and accordingly seek to create political power by dint of international policy regimes which curb undesirable policy effects (see Krasner 1983 on the concept of policy regime). The questions for research are therefore what is producing this convergence of beliefs, to what extent are policymakers committed to international policy coordination, and with what policy effects?

Recent studies have shed light on the cognitive convergence of policymakers (both in the EU and the OECD) around the theme of harmful tax competition. It has been argued that harmful tax competition provides a 'policy narrative' through which policymakers make sense of an elusive reality and make uncertain tax policy problems amenable to human action (Radaelli 1999). EU tax policy has been examined by economists and political scientists in terms of efficiency (Cnossen 1990; Devereux and Pearson 1995), the content of policy (Kanavos 1997), the politics of tax policymaking in Brussels, the Europeanization of domestic tax systems, and the use of new policy instruments (Radaelli 1997, 2003). Special inquiries and lively debates on harmful tax competition took place in national parliaments, bringing the issue to the attention of the public opinion (French Senate 1999; House of Lords 1999).

Intellectual and political initiatives do not necessarily mean that policymakers are tackling the real issues and that alternative approaches should not be pursued. The Institute for Fiscal Studies (IFS)—a London-based think tank—has argued that the legitimacy of coordinated action against harmful tax competition at the EU level hinges crucially on whether the EU can be considered a relatively small open economy or not (Bond et al. 2000). Should the answer be positive, tax policy coordination in the EU would not be effective. Both the IFS study and reports sponsored by the Centre for European Policy Studies (CEPS 2000, 2001) suggest that the EU policymakers are not tackling the real issues of tax policy in the single market. CEPS and the IFS suggest a reorientation of the EU policy agenda, from harmful tax competition to corporate tax reform. Initiatives such as these highlight the potential of interdisciplinary research on taxation in terms of usable knowledge for and active participation in the current debate.

## 5.7 Conclusion

A focus on the constrained use of power sheds light on the actual choices of tax policymakers, the political obstacles to policy change, the role of institutions, ideas, and leadership in the process of reform, and the strategic nature of tax competition in a globalizing economy. As such, research on tax policy problems is also research on politics. Interdisciplinary analysis has proved fruitful, especially in the areas of tax reform and in international taxation, where political science and economics are engaged in a lively debate. There is also preliminary evidence that interdisciplinary research with an explicit consideration of the constraints that real-world political actors face has potential for the development of current policy at the domestic and international level.

Thinking of future directions, there is a gap between political science and law in the analysis of taxation. The vast majority of political scientists are conversant with economic theory, but the interaction between political dynamics and law has been neglected. This is a serious problem because courts and the evolution of legal systems have a deep impact on policy development both at the domestic and the EU level (where the jurisprudence of the European Court of Justice is generating substantive policy change). Another problem is that political science research on taxation is still considered relatively 'off the beaten tracks' by mainstream tax analysts. Even the 'lively debate' between political science and economics referred to above, is rather an asymmetric debate wherein political scientists try to make their voice heard. This is certainly the result of a long period in which political scientists have neglected tax policy issues, but an intensification of interdisciplinary projects is necessary if political science demands a 'right of citizenship' in the tax debate at the academic level and in public policy circles.

## NOTES

1. And occasionally with history. Notable examples are Levi (1988) and Webber and Wildavsky (1986).
2. A similar result can be achieved by tax expenditures. See King (1993) and the chapter by Pope in this volume.
3. Levi (1988) assumes that rulers maximize revenue subject to the constraints of bargaining power, transaction costs, and discount rates. Her theory of predatory behaviour should not be confused with exploitative behaviour. 'Predatory action connotes a choice of policy based on a calculation of its pros and cons for maximizing revenue' (Levi 1988: 3, footnote).

4. See Page (1983: 49), Hansen (1983), and, for a dissenting opinion, Bowler and Donovan (1995). Hibbs and Madsen (1981) argue that the composition of taxation (rather than the general level of taxation) triggers public discontent. In their study of the 1993 federal election in Australia, Wallschutzky and Lewis (1995) show that citizens vote on the basis of incorrect perceptions about tax policy change. Hadenius (1985) and subsequent literature (Confalonieri and Newton 1995) demonstrate that citizens are discontented with taxes, but when asked about both taxes and social programmes at the same time, they tend to express a positive attitude. Studies of the political business cycle (Hibbs 1977; Tufte 1978; Lewis-Beck 1988) assign greater voter responsiveness to variation in the GDP, personal income, inflation, and unemployment than to variations in taxes.
5. See Sears and Citrin (1982) and, for the so-called poll tax, Butler, Adonis, and Travers (1994).
6. Tax revolt designates a critical reappraisal of the principles of income redistribution and progressive taxation.
7. For example, the myriad of tax exemptions, credits, and special allowances of the US federal tax system have been explained by the structure of the US political system (Steinmo 1993). The intentionally fragmented structure of political authority that emerges from the US system of multiple checks and balances creates many points of access to the political system.
8. Indeed, King refers explicitly to the notion of hegemony formulated by Antonio Gramsci (King 1993: 67). In King's words, hegemony connotes 'patterned social relations emerging from ... a non-zero-sum distributional game asymmetrically dependent upon capital investment' (King 1993: 67).
9. See Edwards and Keen (1996) for a clear treatment of this issue.

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# Taxation Research as Social Policy Research

*Rebecca Boden*

## 6.1 Introduction

This book is a paradigm example of the fact that, to be sensitively understood, taxation must be viewed and researched in its social and organizational contexts. Taxation systems will always be sets of rules and tools that impact upon and are shaped by policies, socioeconomic objectives, and politics. As such, and again as this book explicates, researching taxation is best approached through the medium of a base discipline. In this chapter, I attempt to view taxation through the lens of social policy research.

This chapter does four things. First, it explicates the general nature of social policy research. Second, it maps out the relationship between social policy and taxation using three broad categories. Third, it looks in detail at the theoretical issues and practical developments in each of those three categories by reference to events and the literature. Fourth, it concludes by suggesting possible avenues for fruitful further research. The chapter both lays out a general framework for approaching taxation through the study of social policy and discusses opportunities that exist within that framework for UK-based studies.

## 6.2 What is Social Policy Research?

Social policy, like taxation, is a complicated epistemological domain and might be characterized as being more of a field of study than a discipline in

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itself. Social policy studies typically seek to analyse and critique policy approaches to questions of social welfare. Taylor-Gooby (1997: 172) has said that, 'the central concern of social policy is who gets what, or rather, since we must take tastes into account, who has the opportunity to get what and who is denied the opportunity'.

Social policy research covers a range of issues, including social security, housing, disability, children, education, provision for old age, and issues around gender and families (see for instance, Sandford, Pond, and Walker 1980). Within these areas of study, social policy research tends to have two main strands. Researchers making valuable practical contributions to the formulation and analysis of welfare policies mark the most dominant of these strands. Much of this work is characterized by painstaking articulation of social welfare issues through detailed empirical work. This tends to be the kind of work that is supported financially by 'policy customers' in government departments.

A second strand embraces comprehensive theorizing on the nature of the welfare. In this second, and less-dominant area of work, social policy research provides a set of heuristics with which to shape and direct social policy at a more fundamental level. Taylor-Gooby (1997) suggests that the reason for the comparatively weaker presence of such research is because social policy research is (resentfully) subordinated to 'more sophisticated sociological theory and to economic policy' (1997: 172). Social policies themselves therefore might be viewed as the product of sociological and economic analysis and theorizing, and it is these products that social policy researchers then study.

Taylor-Gooby (1997), in critiquing UK social policy, challenges the validity of the currently dominant sociological and economic paradigms of globalization, individualism, and diversity. In doing so, he questions the social policies that are grounded in them. He is concerned that the so-called New Welfare generated by these social paradigms excludes groups such as marginalized workers and women. Instead, he asserts that notions of class, state, and capital are still important theoretical tools in developing welfare policies. In making his challenge, Taylor-Gooby usefully highlights the importance of understanding the pivotal role played by dominant social paradigms (and their sustaining social theories) in critically analysing social policy and in fundamentally shaping its nature (in contradistinction to assisting government with evaluation and development).

I argue in this chapter that recent changes in the dominant welfare paradigm in the United Kingdom have created the intellectual space in the social policy field for the development of new sorts of research, especially

tax research. In this arena, tax researchers approaching their subject through the medium of social policy can make important contributions both through the articulation of the more 'technical' issues associated with taxation and the more theoretically complex issues allied to sociological analysis.

### **6.3 The Connection Between Social Policy and Taxation**

An important starting point in understanding the relevance of the social policy approach for the tax researcher is to consider the nature of the relationship between taxation and social policy. Taxation represents one of the major tools directly or indirectly deployed by government in the implementation of social policies. Three distinctive roles can be identified. First, taxation is the principal means of raising money to fund social policies—a role that arises directly from the redistributive potential of taxation and the distributional concerns of social policies. Second, tax regimes can be, and frequently are, used as direct instruments of social policy. For instance, tax allowances may be given to certain individuals to achieve wealth redistributions for welfare purposes. And third, taxation regimes may have an indirect (and perhaps unintended) impact on social policy objectives. For instance, the effects on an individual of a tax regime may conflict with the objectives of social policies.

While social policies extend well beyond matters of social welfare benefits payments (in cash or kind), it is these payments which pose some of the most immediately interesting research questions with regard to tax. Hockley (1992) suggests that the main social security benefits encompass cash benefits such as unemployment, retirement, sickness, and family benefits as well as expenditure on health, education, and housing.

Given the centrality of taxation systems in raising the revenue necessary for the implementation of social policies and in the general redistribution of resources and opportunities, it is hardly surprising that taxation issues are frequently touched upon in the social policy literature. But, despite the obvious relevance, historically social policy writings rarely address the subject of taxation directly. Moreover, in the tax literature (at least, such as there is in the United Kingdom) social policy issues emerge only infrequently. There is little by way of systematic theory building and conceptualization of the problems and issues, making a bibliographic review of this area problematic while simultaneously offering fertile ground for the development of new research.

The next three sections of this chapter will consider each of the three distinctive roles of taxation in social policy in turn.

#### **6.4 Taxation as the Means of Financing Social Policy**

Taxation is the primary means of raising revenues to finance social policy measures, including benefit payments and support for areas such as housing, health, and education. The fundamental conceptualization of social welfare issues in any society will impact upon the form and direction of the tax regime. This section will demonstrate this relationship by reference to unfolding events in the United Kingdom.

The form of social policies dominant in the United Kingdom in the post-war period since 1945 have frequently been collectively referred to as the 'Welfare State'. The concept of the Welfare State was first established in the United Kingdom following the Beveridge Report of 1942 (Cmnd 6404). The scheme inspired by Beveridge was grounded in a traditional social paradigm characterized by male full-time life-long employment as the norm, heterosexual nuclear families in which the wife did not work, social class, and the nation state. The Beveridge model sought to provide a social safety net for those who fell outside the bounds of this model and to facilitate their re-entry to it. That is, citizens were to be offered a ladder of work-based opportunity underpinned with a benefits safety net.

The benefits safety net envisaged by Beveridge was to be funded by social insurance contributions and taxation, making the state and its taxation system major constituents of the welfare scheme. Sometimes this activity has, perhaps pejoratively, been called 'tax and spend'.

Beveridge's plan construed work and benefit dependency as bipolar opposites. This bipolarity was reflected in the construction of separate and often conflicting policies and administrative arrangements for the tax and benefits systems (see for example, Boden and Corden 1994, 1998). The Department of Social Security was quite separate from the Inland Revenue, each with their own cultures, rules, and imperatives. For example, for many years the United Kingdom tax rules had no interest or concern with cohabiting couples as this was of no fiscal consequence. In contrast, the welfare system based on the means-testing of household income did take cohabitation into account. This unproblematic functional separation between taxation and social security regimes led social policy writers during the postwar period up to 1979 largely to ignore issues of taxation (e.g. Pond 1980). That is, to a large extent, taxation was merely a fiscal means to an end

and taxation was functionally distinct from the design and delivery of social policies.

During the years of Conservative Government from 1979 to 1997 a radical reappraisal of the Welfare State began to place this 'tax and spend' nexus under strain. Central to this, was the argument that an overlarge and over-generous Welfare State had resulted in escalating levels of taxation. This, it was reasoned, had created an environment in which the poor were encouraged into benefit dependency and the entrepreneurial were dissuaded by the tax regime from working harder (Hockley 1992). As a consequence, a primary objective of successive Conservative Governments was to roll back the welfare (or the pejorative 'nanny') state, replacing it with a system of low taxation and low benefits, with individuals being required to take greater responsibility for themselves. Ruth Lister has characterized this as the establishment of 'economic citizenship' (Lister 1990, 1997): a citizenship predicated on a contestable notion of personal economic empowerment and the private rather than state provision of welfare. Lister argues convincingly that the reality of economic citizenship is that it promotes the social exclusion of certain social groups, particularly women who do not participate in the labour market or who are economically marginalized within it.

These conceptual shifts were mirrored by changes in the taxation system. Thus tax rates (especially for the much better off) fell under Conservative Governments along with real benefit levels (but not the total benefit budget). Tax cuts still feature prominently in the Conservative campaigning agenda. From 1979 to 1997 tax policies increasingly came to encourage self-investment and risk-taking.

It is difficult to find any social policy research during this period that supports the Conservative's central thesis of a voracious welfare system pushing tax rates ever higher and thus harming work incentives for rich and poor alike. However, this is not to say that critiques of the old Welfare State were absent. Indeed, the bipolarity in tax and benefits systems was identified as ultimately fatally problematic as postwar society developed rapidly from the 1980s onwards. Parker (1989) presents an alternative fundamental critique of the Welfare State to that of Conservative Governments. She argues that the Welfare State based on the traditional Beveridge model was problematic by the late 1980s for five principal reasons. First, it had failed to tackle issues of poverty connected with variations in family size. That is, families in work would be excluded from being benefit recipients, but low earnings from work combined with large family size could lead to considerable unalleviated poverty. Universal benefits, such as child benefit, were paid at such a low level that they did little to ameliorate this problem.

Second, the schemes put in place after the war had failed to adapt to the fact that, forty years on, society was not principally composed of married heterosexual couples, widows, and heterosexual celibates living alone or with their parents. As such, the tax and benefits systems were mismatched with real needs. Third, married women were increasingly financially independent of their husbands, further undermining a central premise of the male breadwinner paradigm. Fourth, government had long since abandoned the notion of maintaining full employment. And finally, it was no longer sustainable to equate full employment with male lifetime full employment with no retraining.

Successive Labour Governments since 1997 have sustained the rejection of the concept of the 'tax and spend' Welfare State in favour of some notion of economic citizenship under which the role of the state is to facilitate opportunity and choice rather than compulsorily redistribute wealth. However, rather than the Conservative's *laissez-faire* economic rationalism, the Labour approach is driven by a Giddensian notion of the Third Way (Giddens 1998). This conceptualizes modern society as one where globalization, fluidity, and risk-taking are determining factors. Writers such as Taylor-Gooby (1997) label this view of society as 'post-Fordist'. Post-Fordism is an analysis that perceives major work, market, societal, and political shifts as having occurred in modern western societies. Work is seen as having moved away from factory-based male lifetime employment to flexible and fluid employment opportunities characterized by new forms of labour such as self-employment. Enhanced communications have resulted in the globalization of markets, rupturing old notions of society and community. Socially, traditional patriarchal family forms are seen to have mutated into a wide variety of household types, marked in the United Kingdom by the growing number of cohabiting and sole adult member households. And politically, post-Fordism suggests that notions of class no longer play an important part in voting intentions.

The implication of a shift to a post-Fordist society rang the death knell of the Beveridge Welfare State, resting as it did on the twin notions of male full-time lifetime employment and the patriarchal male breadwinner paradigm. Consequentially, successive Labour Governments have swung to a social policy that emphasizes adaptability to flexible employment opportunities, the maximization of workforce participation as a route out of poverty, equality of opportunity, and personal risk-taking. In many senses, Labour policies do not represent a sharp discontinuity with those of the Conservative Government that preceded them. For instance, Labour has not revived its previous commitments to full employment and emphasizes the importance of private sector capital in wealth generation. Perhaps the

most radical shift to accompany the coming to power of Labour has been to recognize that 'traditional family values' (that is to say, the dominance of patriarchal heterosexual nuclear family units) are not sustainable and provide no basis for the elaboration of social policy. There is, in addition, a more ready acceptance than previously evident of the role of the state in supporting and sustaining opportunity. Above all, under the Third Way, government has a central role in facilitating a benign capitalist society.

These fundamental changes in the approach to social policy have been reflected in radical changes in the personal tax system. There has been a major paradigm shift in the primary nexus between taxation and social policy, as the old bipolarity of the tax and benefits systems is dismantled. In sharp distinction from the Beveridge notions of lifetime full-time employment with an underpinning safety net, government social policy now actively rewards those who work, and promotes social welfare payments as rewards for work. There is renewed emphasis on in-work benefits, a fundamental rejection of universal benefits, and a consequential emphasis on means-testing. Making social welfare payments through the pay packet in the form of tax credits makes the social welfare rewards for work explicit. Government sees this approach as addressing the family size problems identified by writers such as Parker (1989). Thus taxation is no longer simply the source of funding for a distinct social welfare system. Instead, it has grown as a direct aspect of social policy itself. A substantial merger of Inland Revenue and Department of Social Security functions has accompanied this change.

These policy shifts by both Conservative and Labour Governments have been reflected in social policy writings that have sought to critique them. The challenge to the tax/social policy nexus occasioned by the election of the Conservative Government in 1979 brought into doubt the logic of researchers *not* looking at revenue raising as an aspect of social policy, and a number of authors began to consider these issues.

Critics such as Lister (see especially Lister 1990) argue that New Welfare policies have serious implications for egalitarian social policy. She argues that they do little to redistribute income, and they concentrate resources in male hands while increasing the amount of 'social' (e.g. caring but unpaid) work done by women within the private realm of the family. Cook (1989) argues that such New Welfare approaches are founded upon notions of one law (or set of social principles) for the poor and another for the rich.

Lister (1990), Taylor-Gooby (1997), and Cook (1989) all argue that New Welfare policies increase social exclusion and social inequality. As Taylor-Gooby (1997: 177) puts it: 'The role of government is less to tax and spend and more to provide opportunities for individual activity. However, there

are real problems in reconciling this approach with the parallel claim that the programme will respect the equal worth of citizens'. He suggests that the post-Fordist theoretical underpinnings of the 'New Welfare' (for both the Conservative Party and New Labour) implies an acceptance of the creation or extension of difference. He also suggests that the New Welfare may be wearing the Emperor's New Clothes, theoretically speaking, arguing convincingly, that old concepts of class, state, and capital may be more useful in explaining the adaptation of ideas about taxation and social welfare.

In a similar vein, LeGrand (1997) argues that the policy shift to New Welfarism results from a conceptualization of human motivation and behaviour grounded in notions of people acting purely out of self-interest, whereas the traditional Welfare State conceived people as either altruists or passive recipients. He argues that neither concept is grounded in any evidence and that a defensible approach to redistribution aspects of tax and social policy cannot rely on crass conceptualizations of human behaviour.

Cook (1989), in one of the few studies which sought to directly compare the old bipolar taxation and welfare benefit systems (in this case, how they regarded fraud) points to how myths about the operation of the Welfare State may have served to ensure its weakening. For instance, she discusses the 'Robin Hood' myth that the Welfare State has resulted in a massive redistribution of wealth from the rich to the poor since 1945 by means of the tax system. This myth, she asserts, serves to excuse tax fraud on the grounds that it merely redresses an imbalance created by an outmoded and too progressive tax system which has destroyed the incentive to work harder by denying people too much of the fruits of their labours. At the same time, the Robin Hood myth stigmatizes benefit fraud: if the redistribution of wealth has gone so far in the favour of the poor, then the poor are denied the opportunity to argue that benefit fraud is motivated by survival not greed. Similarly, incentive arguments work to undermine old welfarism. The new arguments are that the successful and entrepreneurial must be incentivized by keeping more of their cash while the poor must be incentivized by more and more onerous schemes to inhibit welfare take-up.

This determining conceptualization of the relationship between taxation and social policy makes for fertile research ground in any country. Throughout Organisation for Economic Co-operation and Development (OECD) countries, there has been a sustained movement away from bipolar tax and benefit systems, and tax and spend policies. In the United Kingdom this shift has been recently pronounced, yet it is relatively under-researched, especially at the theoretical/conceptual level. The central social policy issues are the implications for citizen welfare of the policy shift towards individualism, the dismantling of the traditional Welfare

State, and its substitution with an integrated tax and benefits system. Gainers and losers are important here: there are certain groups in society (such as women, or those on very low incomes) who may not be in a position to take advantage of opportunities created by the New Welfare policies. Such groups might benefit more under a traditional 'tax and spend' old-style Welfare State.

A further major area of research that might usefully be pursued by tax researchers is the impact of the transition from tax-benefit bipolarity on the cultures and approaches of the administrative departments concerned. The British Inland Revenue and the Department of Social Security have previously operated under very different policy imperatives and traditions with different missions. Moreover they have independently developed quite different rules (including those for income measurement) and administrative systems. The dismantling of a system where, primarily, tax exists in part to pay for social security to one where distinctions between tax and social security are largely eradicated offers significant research opportunities.

## **6.5 Taxation as an Instrument of Social Policy**

The second area of interaction between taxation and social policy is where the former is used as a direct instrument for the implementation of the latter. Such usage may take the form of 'tax expenditures' (income foregone by granting tax allowances and reliefs) that complement (or sometimes conflict with) separate social welfare systems. Traditionally, the tax system was used in the United Kingdom to promote certain sorts of welfare through tax expenditures. For instance, the now defunct 'married man's allowance' (subsequently replaced with the also now defunct married couple's allowance) was introduced after the First World War to encourage married women to vacate their paid employment so that their jobs could be filled by men demobilized from the armed forces. Alternatively, and increasingly in the United Kingdom, the tax regime may begin to actually supplant the social welfare system as the distribution of welfare payments is achieved through the tax regime itself.

Problems can arise from the combined use of tax expenditures and social security benefits that provide fertile ground for tax research. Some writers have pointed to the illogicality and inefficiency of paying social welfare benefits to individuals or families and then taxing those selfsame people (Kay and King 1990). Moreover, different authorities, using different rules and

generating different outcomes often do the giving and the taking (Boden and Corden 1994, 1998). This can be inefficient in terms of administration costs.

Kay and King (1990) argue that asymmetries between bipolar tax and benefits systems can create poverty and unemployment traps. They occur when people progressing out of poverty or unemployment experience transitory but disincentivizing reductions in income. The poverty trap can even work against those who are in employment but also in receipt of welfare benefits. For instance, the progressive removal of in-work means-tested benefits as earned income increases can result in marginal 'tax rates' in excess of 100 per cent, effectively removing the incentive to move into better paid or more work. Unemployment traps are where people are better off financially not taking work because the loss of benefit exceeds the benefits plus earned income that they would receive in a low-paid job. The calculation of relative welfare and tax burdens is a complex task. Help with the technique may be found in Creedy (1998).

Problems with the interaction of tax and benefits systems are evident in many countries. Numerous writers have attempted to address the issue of how to create a seamless system that avoids the effects of the poverty and unemployment traps. The resulting conclusions tend to fall into two groups—one that advocates universal benefit payments and another that promotes integrated tax and benefit systems. Universal benefit payments have the advantage of being cheap to administer but are likely to benefit the rich as well as the poor unless tax regimes compensate for this. They are also associated with low levels of stigma while reducing work incentives. Integrated tax and benefit systems are hard to successfully construct and may result in harsh marginal tax rates for those at the lower end of the income range. They are also expensive to administer because of the need for extensive means-testing. However, theoretically at least, they more efficiently target resources to those who need them, although such schemes may not benefit those with no earned or otherwise taxable income. Moreover, schemes which make payments through tax credits may offer advantages within the power dynamics of families to those who work (generally men) at the expense of those who do not (primarily women) but who do undertake most of the caring work in families.

A good example of the problems that can arise where tax and benefit systems conflict can be found in the United Kingdom in the area of support for in-work low-income families with children. In the United Kingdom, Family Credit, an in-work means-tested benefit for low-income families, was so named because it was originally intended that it would be paid through the pay packet as a tax credit. In fact, this proposed payment route was abandoned before the scheme came into place and Family Credit was

always paid directly to the claimant in the same way as other social security benefits (Boden and Corden 1994). Family Credit epitomizes the United Kingdom approach up to 1997—to keep taxation and social security functionally distinct. By 1997 it was felt that Family Credit had insufficient take-up rates and was failing to emphasize the connection between work and the benefit: failing to create the feeling that work really did ‘pay’.

The incoming Labour Government in 1997 decided to examine the interaction between the tax and benefits systems to look for ways to ‘streamline and modernize’ them in order to maintain work incentives, reduce poverty and reduce welfare dependency (Strickland 1998). A series of specific policy actions followed designed to break down the bipolarity between the tax and benefits systems and thereby enhance work incentives.

The Chancellor set up a special task force, one of the results of which has been the introduction of the Working Families Tax Credit. This has effectively transferred the Family Credit system (including the staff) into the Inland Revenue. The scheme gives an income and family-size related tax credit, calculated in an almost identical manner to Family Credit, through the pay packet. It is this new payment route that marks the most significant change from Family Credit. Early research (NACAB 2001) suggests that this explicit linkage between work and social welfare payments is very unpopular with both employers (who object to the compliance costs) and workers (who find the privacy issues problematic). For those beneath thresholds or outside Pay As You Earn (PAYE) (e.g. the self-employed) payment is made directly to individuals by the Inland Revenue (Strickland 1998). Working Families Tax Credit represents the beginning of an attempt to more comprehensively integrate the tax and benefits systems. It is complemented by smaller schemes such as the Disabled Persons’ Tax Credit.

The inspiration for Working Families Tax Credit is the US Earned Income Tax Credit (EITC), which some commentators see as being influential in alleviating poverty while reducing ‘benefit culture’ and sustaining the perceived rewards of work (Belcher and Fandetti 1995; Howard 1997). Others, for instance Liebman (1997), have suggested that EITC will not work in UK-type social and labour market conditions.

In any event, Working Families Tax Credit is to be a short-lived phenomenon. The Chancellor has now announced plans for a seamless set of tax credits and benefits for low-income families. These involve a somewhat complex layering of universal benefits such as Child Benefit together with an Integrated Child Tax Credit designed to replace all existing child welfare provisions for in-work families. This scheme appears to embody large degrees of complexity, high marginal tax rates for the less well off, and a high level of costly means-testing. The notion of universal benefits, such a

significantly increased Child Benefit, appear to have been rejected out of concern over the effect of such payments on work incentives.

In a reflection of Taylor-Gooby's (1997) concerns, Working Families Tax Credit marks a significant erosion of the principle of independent taxation: the system whereby married women finally achieved privacy in their tax affairs from their husbands (Boden, Childs, and Wild 1995). That principle is now challenged by a system of tax credits that requires a measurement of household rather than individual income by the tax authorities (Williamson and Deacon 2000).

The general use of tax regimes as direct instruments of social policy has been substantially researched in the past. Wilkinson (1986) details the differences between tax 'expenditure' (tax income forgone) and public expenditure (actual money flowing out of the Treasury) and the complex relationship between the two. In particular, she draws attention to the greater visibility (and hence lower acceptability) of public expenditure compared to tax expenditure. She suggests that this led to a reluctance to reform child support by removing the (predominantly male claimed) child tax allowance and its substitution by Child Benefit (usually paid to women).

More recently, Greve (1994) stresses that tax expenditures represent something of a 'hidden welfare state' that strongly influence social policy. Thus cross-national comparisons may be distorted unless tax expenditures and benefit payments are considered together. Greve's ultimate conclusion is that tax expenditures can strongly influence all aspects of the formulation, financing, and delivery of social policies. In the United Kingdom there are already press concerns that the plans for the Integrated Child Tax Credit reflects only a Labour Government's desire to obscure social welfare payments as tax expenditures, thereby making such expenditure less visible.

Researchers have long mooted integrated schemes of tax and benefits. The Meade Report of 1978 (Meade 1978) addressed the question of income maintenance schemes directly, discussing four types of options. Other schemes have included 'basic income' approaches (see for example Brittan and Webb 1990).

Other research in the area of taxation as an instrument of social policy looks at more narrowly focused areas of social policy. These areas include social security, housing, pensions, and the role of women and families. Examples of such policies would include the granting of substantial tax relief for pension contributions, mortgage interest relief, and tax relief for childcare. Sandford, Pond, and Walker (1980) provide an excellent introduction to these issues, but sadly their comprehensive work has not been updated. Wilkinson (1986) points out that the problem with tax expenditures in such areas is that they can have a perverse effect of social policy

objectives. Shaver and Bradshaw (1995) present an international comparison of fifteen countries and how they financially support women engaged in housework and childcare. They do so by looking at the net effects of tax and benefit packages. They acknowledge, as does Greve (1994), that failure to consider tax and benefits together may result in distorted perceptions when undertaking international comparisons.

One specific area of social policy where tax plays a role that receives comparatively large amounts of attention is that of financial support for the elderly. Katz (1992) discusses dominant arguments that the costs of supporting ageing populations are imposing excessive intergenerational tax burdens. His Foucauldian analysis concludes that such arguments are unnecessarily alarmist. Parker and Clarke (1997) address the issues of who should pay for care for the elderly directly. They conclude that while many people expect a high level of state support they are unwilling to pay for it through increased taxation now, or indeed the prospect of family housing capital not being subject to high rates of intergenerational transfer. Knox (1990) offers a model of tax expenditures used to support occupational pensions.

The shift towards the greater integration of tax and benefits in the United Kingdom, together with the disruption of the traditional notion of tax as merely paying for welfare expenditure, points to the necessity for further research in the area of integrated tax-benefit systems. Of particular concern under integrated schemes is the disruption and confusion caused in the lives of the so-called 'ins and outs': people who lead a precarious existence of short periods of employment interspersed with periods on benefit. Research might also usefully be undertaken in the area of how tax policies might be used to promote New Welfare policies of independence and self-sufficiency, such as in pensions policy.

## **6.6 The Indirect Effects of Taxation on Social Policy**

Thus far, this chapter has dealt with the use of tax regimes as revenue raisers for social policy and as instruments of that policy. Finally, we turn our attention to the fact that tax measures may affect social policy formulation and implementation in non-deliberate and indeed adverse ways.

Taxation can help to shape and influence social behaviour and actions, and this may have input into the formulation of social policy or conflict with stated social policies. Often such impacts may represent historical anomalies: tax arrangements put in place some time ago that persist because

of vested interests yet whose impact currently conflicts with social policy objectives. Wilkinson (1986) highlights the problems caused by historical anomalies in her discussion of the former married man's tax allowance. This went to the husband alone and was introduced in 1918 perhaps in 'recognition of the special legal and moral obligation he has to support his wife' (Cmnd 8093). This allowance resulted in the targeting of welfare benefits to families where there were no children and two working people at the expense of, say, single parents for a long time. The allowance became entrenched within the system because its removal would have had a politically unacceptable impact on men's pay packets even though the justification for it in modern conceptualizations of marriage was long gone (Boden, Childs, and Wild 1995). There are many similar 'wallets to purses' debates, where concerns are expressed about the payment routes and the effect on welfare targeting. The central debate here is about the distinction between making social security payments to women or giving tax reliefs/allowances and credits through male pay packets.

A further area of indirect influence arises from problems related to administrative differences between the tax and social policy administration agencies in the United Kingdom, principally the Inland Revenue and the Department of Social Security. The practices of one system may have a serious impact on another when policy imperatives are misaligned. For instance, tax allowances that promote capital investment in business may have the effect of decreasing Working Families Tax Credit payable. This is because increased profitability may decrease tax credits payable. There have been many policy developments in recent years to introduce better sharing of information and efforts between the Inland Revenue and the Department of Social Security in particular. The Government's *Modernising Government* white paper (Cm 4310) stresses the importance of the creation of integrated services for citizens which cut across existing, and often anomalous, departmental divides. One might expect that such increased policy alignment and shared working arrangements would lead to an amelioration of the 'law for the rich-law for the poor' situation found by Cook (1989).

On the subject of conflicting administrative arrangements, Boden and Corden (1994, 1998) have looked at the measurement of self-employed income for both Family Credit applicants and in the assessment of child maintenance by the Child Support Agency (both activities came under the remit of the Department of Social Security). Difficulties, confusion, and resentment often arose among individuals as a result of the sometimes radically different rules that exist between Department of Social Security-operated systems and the Inland Revenue. The replacement of Family

Credit with the Working Families Tax Credit, moves to align the Child Support Agency with the Inland Revenue (Cm 3992), and the taking over of the work of the Contributions Agency by the Inland Revenue all point to attempts to achieve the Government's stated intention of further aligning tax and social security systems. However, the newly expanded Inland Revenue merely embodies the pre-existing conflicts of practice, law, and rules that characterized the previous bipolar system.

Opportunities for further research in this area are similar to those where taxation is used as an instrument of social policy under regimes where greater integration is sought, the purpose of such schemes being to minimize indirect and unwanted effects. There are further, major, opportunities for research in the area of enhanced administrative cooperation between agencies dealing with social policies and the Inland Revenue. For instance, proposals (Cm 3992 1998) that the work of the Child Support Agency should be integrated much more comprehensively with the Inland Revenue provide ample scope for consideration of the likely effects on the tax system of the broadening of the scope of the major administrative body which deals with it. Similarly, the effects of the Government's attempts to create integrated services for citizens, including in the areas of social policy, provide good opportunities for further research.

## 6.7 Development of Research

This chapter has looked at three key aspects of the interaction between taxation and social policy: tax as a revenue raiser, taxation as an instrument of social policy, and the indirect impact of tax regimes on social policy. I have made suggestions for further research in all three areas. Utilizing social policy research approaches in the study of taxation offers the opportunity to both consider the more narrow 'technical' aspects of the tax and social policy interface as well as the broader social paradigms on which social policy formulation rests.

The reconceptualization of welfare away from the Beveridge design and towards the encouragement of opportunity, greater personal responsibility, and the creation of incentive (as opposed to safety nets within a much more stable social and economic climate) marks a wholly new direction in the development of social policy, both in the United Kingdom and elsewhere. The consequential effects of such changes on tax regimes are self-evident.

Most literature in this field is currently in social policy books and journals such as the *Journal of Social Policy* and *Social Policy and Administration*.

In addition the Department of Social Security (now the Department of Work and Pensions) published its own series of reports. Tax journals such as the *British Tax Review* would welcome papers dealing with these issues. Some research, such as that dealing with administrative reform, would sit well in journals such as *Public Money and Management*, *Public Administration* or *Policy and Politics*. Accounting journals such as *Critical Perspectives on Accounting* and *Accounting, Organizations and Society* are sympathetic to critical work in this area. Economics and econometric journals such as *Fiscal Studies* also carry work on taxation and social policy. Despite the latter journal's orientation and its emphasis on the economic analysis of both social policy and taxation, there are few papers where both tax and social policy are considered together.

In terms of research methodologies, it may well be that policy studies, case studies, and above all interdisciplinary work with social policy academics offer the best prospects. The increasing Europeanization of much UK policy means that EU aspects cannot be ignored here either (Shaver and Bradshaw 1995).

In summary, the importance and relevance of taxation regimes to the conceptualization, formulation, and delivery of social welfare policies and programmes indicates that research in this area is likely to be both fruitful, fascinating, and highly policy relevant.

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PART

# III

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## **APPLYING INTERDISCIPLINARY APPROACHES TO TAXATION PROBLEMS**

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# Taxation and Ethics

*Jane Frecknall Hughes and Peter Moizer*

The Chancellor of the Exchequer is a man whose duties make him more or less of a taxing machine. He is intrusted with a certain amount of misery which it is his duty to distribute as fairly as he can.

Robert Lowe, Viscount Sherbrooke, 1870.

## 7.1 Introduction

Moral choices relating to taxation are inevitably influenced by an individual's view of how resources should be distributed within society and the role of government. Taxation is used by governments for many purposes, including: raising monies to fund government expenditure, controlling the economy of the country, and redistributing wealth. All forms of taxation involve taking money away from individuals and their attitude to giving money to the State will be determined in part by their view of the legitimacy of the taxation process. How one views the giving of taxes to a government and the use to which those taxes are put has far-reaching implications and influences opinions about public policy, politics, compliance with the law, etc. The taxation practitioner plays a significant role in this process and this role forms the focus of this chapter.

Here an ethical framework is developed to examine the decisions made by tax practitioners in the work they do on behalf of taxpayers. Tax practitioners have to make choices about the information which they advise their

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clients to disclose to the tax authorities and about how they advise their clients to structure their affairs so as to reduce the amount of tax payable. Accordingly, tax practitioners will be faced with a number of moral dilemmas primarily revolving around the notion of truth and the need to tell the truth as they see it. The aim here is to present the resolution of such dilemmas using the two main streams of Western ethical thought: consequentialism and deontology. One must be aware, however, that any given individual will have his/her own appreciation of what actually constitutes ethical behaviour, depending on background, education, religion, culture, etc., and obtaining universal agreement on whether a particular action is ethical or unethical might be problematic (Vogel 1974; Song and Yarbrough 1978; Westat Inc. 1980; Kaplan and Reckers 1985—all cited by Cruz, Shafer, and Strawser 2000). Some issues are more clearly defined than others, but it should be borne in mind throughout this analysis that there will exist individuals who actively choose to act unethically: not every practitioner will fit neatly into the above taxonomy.

## 7.2 Research Problems and their Relevance

Central to the consideration of the legitimacy of the tax process are the notions of distributive justice developed principally by Rawls (1971) and Nozick (1974), still the most influential original sources for these ideas. Recent research on taxation and ethics (Burns and Kiecker 1995; Kaplan, Newberry, and Reckers 1997) has not explicitly explored distributive justice in this context. The basic ideas, in relation to tax policy, are summarized by Porcano (1984), a leading article in this field. Distributive justice theories may be used to evaluate the equity in a tax system by determining how much individuals should receive or pay in a particular setting, and whether they are receiving what they deserve. Such theories are often examined from an economic perspective (e.g. Hochman and Rodgers 1969; Varian 1976; Sen 1987; Noreen 1988). Porcano suggests that the social interaction perspective, which is also relevant, has not yet been used to evaluate fairness.

The basic problems are to determine what people deserve, and how much they should be taxed. In reference to these problems, Porcano (1984: 620) uses the 'justice rules' developed by Leventhal (1976): the *contributions rule*, whereby a distribution's fairness is determined according to individuals' overall contributions; the *needs rule*, whereby individuals' legitimate needs are satisfied; and the *equality rule*, which requires individuals to receive similar outcomes regardless of the differences in their situations. He also

adds the *benefits rule*, which requires that taxpayers should make payments in line with the marginal benefits received in public goods and services.

Entitlement theory, a different form of distributive justice developed by Nozick (1974), undercuts some of these concepts. This theory proposes that a distribution is just if everyone is entitled to the holdings they possess under the distribution. Given that there are very few ‘unheld’ things, the main way that individuals acquire holdings is as a result of transfers, hence the question arises of whether the holdings were justly transferred. A just transfer is one that is chosen or agreed to by both parties. Where parties do not so agree, a transfer is unjust. There are obvious implications for taxation, which, when given to government or redistributed by it, constitutes a transfer.

While the above consideration of the ethical background is necessarily brief, it is of great relevance to the role of the tax practitioner as it colours the view taken of the practitioner’s work. If a tax practitioner is involved in the process in giving advice, helping complete returns, etc., his/her involvement in the decision making process helps shape tax morality for individuals and multinational corporations alike (Boucher 1993; Gordon 1988—both cited by Marshall, Armstrong, and Smith 1998). We shall concentrate below on the role of the tax practitioner. Other ethical areas related to taxation are dealt with elsewhere in this book.

### 7.3 Ethical Reasoning: Tax Practitioner Perspective

The tax practitioner is employed by his or her client to do a variety of work, but underlying all work is the consideration of how much (or little) tax the client should pay. The fact that a tax practitioner works for another individual creates, in itself, moral dilemmas for the practitioner. These revolve around the following issues: how much of the truth about a client’s affairs to disclose; how much to bend the truth; and how far to go in creating artificial truths. However, practitioners must also consider the impact of their client dealings on other interested parties—the Inland Revenue, their firm, their profession, and the wider public, to all of whom they owe a duty (Loeb 1971; Dox 1992, as cited by A. Stainer, L. Stainer, and Segal 1997; Crawford and Ryan 1998; Yetmar and Eastman 2000). Often ethical issues may arise because of a perceived need to satisfy simultaneously the constituents to whom they owe a duty, which can lead to conflict of interest and ambiguity about the role the practitioner fulfils (Yetmar and Eastman 2000). Cruz, Shafer, and Strawser (2000: 223, citing Jackson and Milliron 1989; Brody and Masselli 1996) report that in the United States, the Internal Revenue Service’s philosophy is

that the tax practitioner's ultimate loyalty should be owed to the federal tax system and that practitioners should act as government agents. The American Institute of Certified Public Accountants (AICPA), however, acknowledges that a duty is owed also to the client (AICPA 1997).

Two main systems of ethical thought have been used to suggest how tax practitioners might frame the choices that they have to make: consequentialism and deontology (Armstrong 1993; Burns and Kiecker 1995; Italia 1998). In *consequentialism*, actions are judged in terms of their consequences. This is the idea that 'the end justifies the means'. The use of evil means to achieve a good end may be justified, provided that the end is sufficiently good to outweigh the bad created by the means. *Deontology* takes the view that some acts are morally obligatory: 'what everyone ought to do' (Flew 1979: 191; Raphael 1981: 56). Thus, a proposed action could be analysed in terms of its moral character. A decision could be made whether it is morally obligatory or morally wrong on the basis of this moral analysis alone, without considering what else is involved. For example, consider a conscientious objector in Britain in the Second World War. He could adopt the deontological principle that to kill is morally wrong, even though the consequences to his fellow countrymen following that principle would be that Nazism would triumph.

#### **7.4 Deontological Analysis of Tax Practitioner's Choices**

For the tax practitioner, a deontological approach to the resolution of dilemmas has some advantages. It resolves the issues relating to how much of the truth to disclose and by how much the truth can be bent. Thus, the tax practitioner should disclose whatever facts he or she regards as being relevant to the affairs of a particular tax client, irrespective of the effects that such disclosures will have. Hence, the tax practitioner should attempt to be as neutral as possible in the process, reporting all the information to the best of his or her ability.

The area of tax avoidance work is not easily framed in deontological terms, since by its nature tax avoidance advice produces a different situation requiring a different description. If one is following the rule of acting as everyone 'ought' to act, then the tax practitioner has to consider his or her attitude to distributive justice. An individual could take the deontological view that resources should be equally distributed within society because the members of society are owed equal respect and that equality in material goods and services is the best way to give effect to this ideal of equal

respect. Such a believer would presumably favour any form of redistributive taxation on the grounds that it moved the distribution of income and wealth in society in the 'right' direction. However, given that the fundamental belief of equality in distribution of resources would be so at variance with the aims of his or her clients, it is hard to see how such a tax practitioner could maintain a clientele. In contrast, a deontologist accepting the principles of entitlement theory would probably regard most forms of taxation as being unjust transfers and hence would feel justified in proposing legitimate measures to avoid them. He or she would presumably argue that taxpayers have no moral obligation to pay taxes (Jackson 1996: 156). If there are legal loopholes overlooked by legislators, it is the job of the legislature to remove them and the job of the tax practitioner to exploit them. Such an individual would be much more attractive to taxpayers whose aim was to pay the least amount of tax. Hence, it would seem reasonable to suppose that a tax practitioner favouring the deontological approach would have a set of views that would create few ethical problems in the avoidance area. The only likely causes of disputes with clients would be in the belief that one should always tell the truth. Cruz, Shafer, and Strawser (2000: 237) report empirical findings consistent with this.

## 7.5 Consequentialist Analysis of Tax Practitioner's Choices

The consequential analysis of the tax practitioner's moral dilemmas is necessarily more complex than the deontological approach. One way of analysing the consequences of the tax practitioner's actions would be to consider the parties affected. The individuals to whom the tax practitioner owes a duty are numerous, but we consider three parties here: the tax practitioner himself, the client, and the general public. Once the effects on each group have been evaluated, the individual tax practitioner must decide how much importance to attach to these effects. It is possible to argue that the weights are likely to be influenced by how close the individual is to the tax practitioner. There is also the need to consider the tax practitioner's attitude to the State and the notion of distributive justice.

### 7.5.1 Consequences to the Tax Practitioner

The consequences to the tax practitioner depend on the type of work undertaken: *compliance* work where the practitioner is essentially

reporting what has already taken place with the aim of minimizing the taxpayer's liability to tax; and *avoidance* (or *planning*) work where the practitioner aims to restructure the client's affairs with the aim of so organizing them that the tax payable in the future is reduced. Judging the quality of compliance work is in principle relatively straightforward. A performance measure would be how many errors or omissions the tax return contained and how many were discovered by the tax authorities. In this context, it is assumed that such errors or omissions are *unintended* and could be attributed to laziness, lack of knowledge, or some unforeseen circumstance. These differ profoundly from *intentional* errors, deliberately made to reduce a taxpayer's liabilities. Intentional errors constitute tax evasion and could not be justified ethically by reference to the tax practitioner, although it is conceivable that there might be justifications from a client's perspective.

In the tax avoidance area, the situation is more complicated, because the notion of quality tax avoidance advice is itself problematic. If the tax practitioner fails to advise clients to modify their activities in such a way that tax could be reduced, the tax practitioner is likely to be thought negligent. If a tax practitioner failed to suggest a tax avoidance scheme that most practitioners would have suggested, then presumably that individual could be said not to have followed professional standards. However, if a tax practitioner suggests too artificial a tax scheme, which is subsequently challenged successfully by the tax authorities, then this may be irresponsible behaviour.

Fortunately, for tax practitioners, evaluating the quality of their work is difficult for clients, because they will have little information on which to judge performance. For example, if the tax practitioner provides avoidance advice as well as routine compliance service, it is often impossible to evaluate whether apparent poor performance on the part of the tax practitioner is due to sub-standard compliance work or speculative tax avoidance schemes which ultimately proved not to work in law. Even for purely tax compliance work, it is not easy for individual clients to evaluate the service provided by tax practitioners, since they have no benchmark against which to assess them, as the clients would not know what a good practitioner would have done in similar circumstances. The only feedback is the amount of queries and general aggravation that they receive from the tax authorities. Hence, the effects on the tax practitioner are hard to predict, as much of client satisfaction is probably related to matters other than the quality of the tax work, such as how organized the tax practitioner appears to be, the speed of response to queries, and the general level of customer care.

The only occasion on which a tax practitioner may make a noticeable difference is in the creation of elaborate tax avoidance schemes, which clients perceive have saved them money. Word of mouth may ensure that those tax practitioners, who appear to be successful at reducing their clients' tax bills by creating legally acceptable tax avoidance schemes, will gain more business from a particular type of tax clientele and hence prosper. On the other hand, tax practitioners who become known for 'shady' schemes may experience a greater level of Revenue investigation. In the end, this creates more costs than tax savings. There is likely to be spectrum of tax practitioners from the ultra-cautious who follow the law precisely and take no risks, to the ultra-speculative who indulge in activities that occasionally are judged to constitute tax evasion by the authorities. In such circumstances, it would be expected that clients would choose the tax practitioners on the basis of their own moral convictions and attitudes to risk. Hence, the main result of a consequentialist approach as far as the tax practitioner is concerned is the notion that he or she should establish an approach and stick to it. Once he or she becomes known for that approach, like-minded clients will be attracted to the practitioner. How individual practitioners position themselves will depend on their moral view of the consequences to the other groups affected by their activities.

### 7.5.2 Consequences to the Client

The main effect of the tax practitioner's compliance activities will be to determine the amount of tax, interest, and penalties that the client has to pay to the authorities. If tax practitioners make too many unintentional errors or omissions, then they run the risk that the tax authorities might impose penalties on the client in addition to interest on any unpaid tax. It is possible for the tax practitioner to make intentional mistakes and not to report the economic reality, but it is hard to conceive of circumstances where the consequences of such actions would justify the action of telling an untruth. The principal cash effect of telling a falsehood would be to lower the immediate tax demand and hence to give taxpayers greater cash resources than they would otherwise have. To justify such behaviour, the consequences to the taxpayer of not having the cash must be catastrophic and it is difficult to conceive what those circumstances would be, since it implies a failure on the part of all the other sources of finance available to the taxpayer.

However, compliance work effects on the client are likely to be fairly minor. The bigger effects will be caused by tax avoidance work, where the

activities of the client are changed as a result of the practitioner's advice. The purpose of tax avoidance from the client's perspective is to produce the lowest possible tax bill and so, in principle, the lower the eventual tax bill, the greater the client's satisfaction.

Occasionally, the use of tax avoidance measures may produce direct negative outcomes for the client, as is evidenced by the bad publicity surrounding the disclosure that John Birt, the Director General of the British Broadcasting Corporation (BBC) in the late 1990s, received his salary via a limited company rather than as an individual employee. The tax liability was less but the furore so great that he changed the method of payment to that of a normal employee to avoid further criticism.

### 7.5.3 Consequences to Society

The effects on the wider public of the compliance activities by tax practitioners should be fairly minor. More accurate completion of tax returns will ensure that tax is paid more in accord with the intentions of the government. It should also mean that less time is required by tax inspectors in checking the individual tax returns and hence less government expenditure on administration. The greater effect on society will come from the avoidance efforts of tax practitioners. How greatly such activities affect society will depend on the extent to which the government predicted the activity when setting the targets for taxation in any particular year. Given that certain tax laws are created to ameliorate hardship, it would be quite in keeping with the intentions of the government to frame the taxpayer's affairs in such a way that they benefited fully from the reliefs that the government had created. For example, during a period of high inflation in the United Kingdom in the 1980s, the government introduced 'stock relief', which exempted businesses from having to pay tax on profits that arose from inflationary gains on closing stock (inventory) values. As companies could benefit from such a relief only if they had taxable profits, it was worthwhile for groups of companies to ensure that, at their year-end, the group companies which had high year-end levels of stock also had some taxable profits which could be relieved by stock relief. The issue for the consequentialist tax practitioner is whether the creation of artificially high levels of stock in certain companies within a group and artificially low levels in others was in keeping with the spirit of the legislation that introduced the stock relief. The tax practitioner could argue that when the government introduced such legislation, it must have expected companies to move

stock around in order to gain maximum benefit from the relief and so it would be within the spirit of the legislation to advise clients to do the same.

Alternatively, if the tax practitioner is able to devise schemes that exploit loopholes in legislation to benefit individuals other than those originally intended, then there will be a shortfall in government revenues from taxation, which could lead either to higher taxation of the rest of the population or to lower levels of government expenditure. The individuals who benefit from the avoidance schemes will inevitably come from the wealthier members of society, since only they will both need and be able to afford tax advice aimed at preserving their personal income and wealth. The individuals who lose from the avoidance schemes will be the poorer members of society who have to pay increased taxes or who receive a lower level of welfare benefit. Hence, it can be argued that tax avoidance activities are a way of transferring wealth from the poorer members of society to the wealthier members, which would be contrary to the principles expressed by Rawls (1971) as the position of the least advantaged is likely to be worsened.

In addition, the activities of tax avoidance practitioners will inevitably lead to greater work on the part of the tax authorities to counter such schemes as they will have to spend time devising ways of plugging the gaps in the legislation: by proposing additional anti-avoidance legislation (thus creating further complexities); taking cases to Court; or responding by technical or press releases. Furthermore, it is possible that the misuse of tax reliefs designed to help the disadvantaged or deserving may mean that such reliefs are withdrawn to counter the avoidance schemes. The withdrawal of the reliefs then impacts on the people and organizations that they were originally intended to help. A good example concerns charities which receive favourable tax status because of the good work they do. Tax practitioners have created schemes that mimic the activities of a charity to reduce tax, and some reliefs have been lost as a result of the government repealing them in order to plug tax loopholes. It is thus hard to see how consequentialist tax practitioners who attach significant weight to the effects on the general public can engage in the production of artificial tax schemes designed purely to reduce clients' tax liabilities and increase their own fees from the tax advice. One argument used to justify the use and/or invention of schemes is that they help clarify tax law and thus lead to its development and improvement. The counter-argument is that such a process of discovering loopholes in tax law and then plugging them is wasteful of resources and the resultant 'improvements' are only of value because the tax practitioners created the need for them in the first place.

## 7.6 Future Directions and Research Outlets

In 1995 the Institute of Chartered Accountants in England & Wales and the Chartered Institute of Taxation jointly issued *Ethical Rules and Practice Guidelines—Professional Conduct in Relation to Taxation*. These form a detailed set of rules designed to ‘cover’ the tax practitioner’s professional activities, such that he or she knows when it is appropriate to disclose information, to whom and in which type of circumstances, and what to do if a client refuses to cooperate. Thus, they are deontologically based, though as regards tax mitigation and/or avoidance, they are more consequentialist: ‘The member should consider carefully the merits of arrangements that are artificial: those which are within the letter but not the spirit of the law’.

The tax profession in the United Kingdom is, however, fragmented, and anyone at present can set up in business as a tax adviser, so not all practitioners will be covered by the above guidelines. Indeed, the fact that detailed guidelines exist does not, of course, preclude tax practitioners acting unethically, even when supposed to be acting otherwise. If unethical behaviour is proved, then members are disciplined by their own professional body. Parker (1994) sees this as favouring the private interests of members, as it maintains control over members, excludes external disciplinarians, and enhances the profession’s perceived authority within its own sphere. (It may also remove a perceived need for regulation if carried out effectively.) There is little research which looks at the motivation of tax practitioners to breach their rules of professional conduct, though much is written (in various accounting, economics, econometrics, ethics, and psychology journals) about the individual taxpayer’s misdemeanours (Loeb 1971, 1984; Hasseldine, Kaplan, and Fuller 1994), and as with the majority of work already cited, this is derived from US sources. Jackson and Milliron (1986) comment that, in compliance issues, the influence of preparers is a potentially important (and unexplored) variable, but there is only one study by Cressy in 1953 (reported in Schaefer and Walker 1994), which examines motivation: most prior research examines the characteristics evinced by offenders.

It is evident from the comments throughout this chapter that there are many areas under the general umbrella of taxation and ethics which remain to be explored: a fuller analysis of the ethical background to tax; a more detailed examination of UK Ethical Guidelines, perhaps with a view to comparison with the AICPA code or that of related bodies, such as the Law Society; empirical research into motivations for acting unethically; and the influence of tax practitioners on their clients, to name but a few. Research in this area is only in its infancy.

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# Behavioural Studies of Tax Practice

*John Hasseldine*

## 8.1 Introduction

The nature of tax practice has radically changed in recent years. Purdie and Roberts (1995) note that tax clients now expect a tax accountant to be a business adviser, and not just a source of technical tax knowledge and provider of routine compliance. Second, there have been a number of changes in practice management, and finally there has been a growth in the technical competence and expertise required by professional tax accountants.

This chapter outlines the areas where academia has tackled issues relating to tax practice using behavioural methodologies. Specifically, this chapter examines the following four areas: judgement and decision making by tax professionals, taxpayer compliance and planning, taxpayer perceptions of fairness, and the demand for tax services.

Behavioural tax research asks: 'How do the relevant parties in the tax environment make decisions, and how can these decisions be improved?' The research methods chosen range from mail and field surveys to laboratory and field experiments, where the experimenter randomly assigns subjects to different groups and 'manipulates' some type of information either between or within subject groups (i.e. a between-subjects or within-subjects design). All of these methods have their own strengths and weaknesses, but there are a number of trade-offs, and researchers should choose the least costly option in investigating specific research problems. Behavioural research methods by their nature involve some intrusion on

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the part of the experimenter, but this intrusion leads to experimental control. Such control assists in the maximization of internal and external validity (Campbell and Stanley 1963).

There are of course problems that can arise with behavioural and experimental research methods. Cloyd (1999) notes that many of the decisions made during the conduct of experiments are irreversible once the experiments have been conducted. Thus, researchers new to this field would be well advised to seek the advice of someone with a background in social psychology or in conducting experimental research in a different discipline involving attitude and behaviour measurement. There are four types of validity that should be present in experimental work, but which if lacking may lead to wasted effort on the part of the researcher(s) as well as the subjects. These four types of validity are: (1) statistical conclusion validity, (2) internal validity, (3) construct validity, and (4) external validity.

As the first and last types are generally well understood, further comments are restricted to internal and construct validity. In an experiment, prior theory is used to make a prediction (hypothesis) that 'A causes B'. In actual practice and in order to conduct the research, this prediction is refined at an operational level to ' $A_m$  causes  $B_m$ ' where the subscript 'm' refers to a measure of the theoretical concept involved. If  $A_m$  is a reliable measure of A, and  $B_m$  is a reliable measure of B, then there is said to be construct validity. If they are unreliable measures of the theoretical constructs, then the researcher may be measuring some other variable. This is likely to lead to weaknesses in the research.

In addition to construct validity issues, there are a number of threats to internal validity (which would lead us to conclude that  $A_m$  does *not* cause  $B_m$ ). These include experimental effects described by Campbell and Stanley (1963) as: history (something happened during the experiment), maturation (subjects matured naturally), testing (the test rather than the treatment caused the change), instrumentation (problems with scales and instruments), classification problems (such as self-selection problems), and subject mortality (where subjects drop out of an experiment). Exemplary research (some examples are discussed later in this chapter) minimizes these threats to internal validity.

## 8.2 Characterization of Research Problems and Relevance

Behavioural tax research has been classified in four major areas (Outslay 1995). Each of these areas is discussed in turn.<sup>1</sup>

### 8.2.1 Judgement and Decision Making by Tax Professionals

The area of research into judgement and decision making (JDM) by tax professionals is relatively recent and follows on from a similar interest by academics and large accounting firms in the JDM skills of auditors. Some of the reasons for this growth have been the ever-increasing knowledge and skill requirements, not to mention litigious environments, now facing auditors and tax professionals.

Essentially the research problem is: 'What factors affect the judgements and decisions of tax professionals?' and 'How can tax JDM be improved?' The most recent and comprehensive literature review in this area is Roberts (1998), who suggests the following categories of factors:

1. *Individual psychological factors*—for example, cognitive factors (such as experience, knowledge, formal education, position, and problem-solving ability) and affective factors (such as ethical attitude, risk preference, and attitudes relating to professional status and firm size).
2. *Environmental factors*—for example, client characteristics (such as client importance, tenure, and sophistication) and the tax authorities' positions on such matters (such as audit probability, penalties, and applicable regulatory standard for reporting).
3. *Task factors: inputs*—for example, complexity of tax law, amount of legal authority, and similarity of authoritative sources.
4. *Processing factors*—for example, information order, framing of issue as gain/loss, accountability, time pressure, and decision-aid availability.
5. *Task factors: outputs*—tax planning versus routine compliance context.

Much remains to be researched with regard to the effect that knowledge and problem-solving skills have on tax professionals' JDM. For instance, how effective are on-the-job learning, feedback, self-study, and formal course and job aids in improving tax professionals' performance? Prior research has shown that advocacy attitudes consistently affect tax JDM; however, the extent to which motivation improves tax JDM remains to be tested. The overall goal of this area of research is to understand how successful tax accountants solve complex problems for their clients, and to use this understanding to help other tax professionals and tax students to improve their tax JDM.

In a relatively new branch of this literature, it is suggested that when a firm faces a transaction for which the financial accounting treatment and the tax accounting treatment are ambiguous, the degree of financial accounting conformity (with the tax position) affects the recommendations made

by tax preparers (Cloyd, Pratt, and Stock 1995). Cloyd (1995) finds that tax preparers recommended more aggressive tax positions in the presence of financial accounting conformity than in its absence. This is because preparers believe that the tax position is less likely to be attacked by the tax authorities, or if it is challenged, it can be defended more easily with the 'backing' of having used the same method for financial accounting purposes.

### 8.2.2 Taxpayer Compliance and Tax Planning

The problem of tax non-compliance is a global problem and estimates of tax evasion range into high percentages of GDP in many countries—for example, the Internal Revenue Service estimates that the annual income tax gap in the United States is over US\$170 billion. For this reason, a voluminous literature now exists on tax compliance. Note that non-compliance can be distinguished from tax minimization. The latter suggests taxpayers comply but structure transactions to pay the least amount of tax.

Because tax non-compliance is such a huge problem, which in turn affects public provision of goods and services and alters income distribution, it is very easy to motivate research that seeks to improve voluntary rates of tax compliance. Initially the key research question usually asked was about the factors which contributed to non-compliance, for example, what makes taxpayers evade tax? However, as researchers sometimes saw quite high voluntary compliance rates, they then asked the question: 'Why do people comply?' (see Alm 1991). Some of the research problems are:

- What effects do tax audits have on taxpayer reporting decisions?
- Do alternative sanction mechanisms used by a tax agency work?
- Do positive incentives encourage compliance?
- Do tax amnesties result in increased or decreased future compliance rates?
- Does withholding status at year-end (tax owing/refund) affect voluntary compliance?
- What role do tax preparers play in tax reporting decisions?

One interesting feature of this research area is its interdisciplinary nature. For example, in 1986 the US National Academies of Science convened an interdisciplinary panel to assess the state of knowledge on tax compliance and to suggest directions for future research. This culminated in two major edited volumes (Roth and Scholz 1989; Roth, Scholz, and Witte 1989)

which are an absolute essential for a researcher in this area. Research into tax compliance is routinely conducted by economists, accountants, lawyers, sociologists, criminologists, and psychologists.

A recent area of interest is the role of tax practitioners in maintaining the integrity of a tax system, so the first two areas of research in this chapter overlap. For example, research has focused on the factors that influence tax professionals' compliance, especially how aggressive a tax professional is when giving advice to a client. These factors include the effect of tax preparer penalties, client payment status, withholding payment position, etc. (Reckers, Sanders, and Wyndelts 1991; Cuccia 1994; Schisler 1994; Shields, Solomon, and Jackson 1995).

In a more recent trend, the focus is starting to move away from a single focus on tax compliance and more into the context of tax practitioners in tax planning (Bonner, Davis, and Jackson 1992; Spilker 1995; Cloyd 1999; Magro 1999). As Magro (1999) notes, tax practice is characterized by both planning and compliance activities. If these two contexts are significantly different, then the information processing of tax professionals is also likely to differ. For example, an important decision of tax managers is the amount of time to budget for tax research and differences in complexity, ambiguity, and justifiability demands between planning and compliance activities may influence the amount of time budgeted for tax research.

### 8.2.3 Taxpayer Perceptions of Fairness and Alternative Tax Structures

The last decade has seen comprehensive tax reforms throughout the world. Tax rate structures themselves may be perceived as inequitable and this may in turn lead to negative attitudes about the tax systems (and result in non-compliance). Furthermore, perceptions of tax inequity, complexity, and high compliance costs may also lead to non-compliance.

One of the earliest studies related to tax complexity is the academic literature on the readability/comprehensibility of taxation. James, Lewis, and Allison (1987) pioneered this technique in the tax arena with an empirical study of tax communications. Subsequently, this type of approach, using the Flesch Readability Index has been extended to other countries such as Australia (Smith and Richardson 1999). Researchers have also begun to investigate the relationships between tax complexity, equity perceptions, and tax reporting decisions in more depth (e.g. Hite and Roberts 1991; Maroney, Rupert, and Anderson 1998; Cuccia and Carnes 2001). Now it is

apparent that taxpayers' equity perceptions vary across areas of the tax law. In some cases, taxpayers readily accept that there is a need for tax complexity, and it is evident that justification and education of taxpayers can assist in improving perceptions of tax fairness (Wartick 1994). A further area of fairness perceptions researched has been horizontal and vertical inequity. Moser, Evans, and Kim (1995) examined taxpayer responses to a tax rate change and found that when subjects were inequitably treated relative to other subjects, they reported less income as tax rates increased, but this did not occur when they were equitably treated relative to others.

Although the tax incentive literature suggests that the effects of tax incentives on decision making assumes that taxpayers know their marginal tax rate, a number of studies suggest that taxpayers' perceived marginal tax rates differ significantly from their actual tax rates. In addition, Rupert and Fischer (1995) find that taxpayers who have higher income, who do not receive preparation assistance and who use professional consultants for investment advice are more accurate in estimating their own tax rates.

## 8.2.4 Demand for and Evaluation of Tax Services

This area of behavioural tax research seeks to explain the reasons why clients engage tax advisers. For instance, the following factors may be involved in selecting tax advisers:

- personnel
- risk of being audited
- firm's reputation
- firm's attitude regarding tax minimization
- taxpayer time savings
- preparation fee
- firm's assistance with compliance.

From the small amount of research conducted in this area, there are some interesting results. For example, in a US survey, Collins, Milliron, and Toy (1990) reported that 70 per cent of their respondents indicated that their primary objective was to file a correct return with only 25 per cent reporting that minimizing their tax liability was their primary objective. Hite and McGill (1992) find that taxpayers on average do not have a preference for aggressive tax advice. Their subjects tended to disagree with aggressive advice and agreed with conservative advice. Christensen (1992) confirmed this result, but in addition found that tax preparers' perceptions

of what clients expect from a quality tax service significantly differed from clients' expectations, especially in the area of tax savings strategies. Both of these studies suggest that much more research could be conducted in examining the relationship of taxpayers and their preparers.

### **8.3 Interdisciplinary Approaches Used in Behavioural Studies of Tax Practice**

Of the four research areas characterized above, tax compliance research is the best example of the use of a truly interdisciplinary approach. Tax evasion models originated in public economics and modelled taxpayers' decisions to evade tax, for example, Allingham and Sandmo (1972) with the key parameters being tax rates, probability of audit, penalty tax rate, and actual income. Since then, there have been a number of theoretical extensions to analytical research, although the most outstanding growth has been in experimental and survey studies of taxpayers' attitudes and compliance decisions, and those of tax advisers.

Experimental studies (some of which include experimental economics methods—see Bonner, Davis, and Jackson 1991; Davis 1995) have used both student and adult subjects. In some cases, compelling reasons exist for the use of student subjects—for example, because relative (and not absolute) effects are being measured or it is desired that subjects have no prior tax experience. On the other hand, there are instances of 'convenience samples' being used, although these tend to be rejected from the leading journals. If prior tax experience is required, then adult subjects will presumably be preferable, for example, prospective jurors, adult students, university staff, etc. (see, for example, Hite 1988; Roberts 1994).

In the case of preparers, actual tax advisers—most often US certified public accountants—have been used in experimental research. Often such subjects are recruited at a staff training day of one of the 'Big Six' (as was) accounting firms—after the researcher has made a contact with a partner in charge in order to gain access to these subjects (Cuccia, Hackenbrack, and Nelson 1995).

In one case, Roberts (1995) was granted access to IRS officers as subjects. In the future, tax agencies should be aware that by opening up their staff as potential subjects, not only will academic knowledge be enhanced, but the tax agency may become aware of a hitherto unknown bias (e.g. hindsight bias, outcome bias, effects of information presentation order) which may affect the judgements and decisions of their staff.

There is some evidence that tax agencies are becoming more open to participation with outside researchers. In Australia, research events with similar themes have operated with the participation of the Australian Tax Office such as the International Conferences on Tax Administration held by the Australian Taxation Studies Program at the University of New South Wales. The Australian Tax Office has also funded a Centre of Tax System Integrity at Australian National University. Even in the United Kingdom, both revenue departments are cooperating with academics in the area of behavioural tax research, as well as compliance costs and e-commerce (see Chapter 15).

Survey methods are useful for providing accurate descriptions of practical problems in the areas of tax consulting, practice management and technical expertise, and frequency of admitted tax evasion. Although experimental and survey methods have a number of strengths and weaknesses, used in conjunction in an ongoing research programme they can contribute to existing knowledge.

Two examples of exemplary research are now briefly described. First, Cloyd (1997) investigated the separate and joint effects of prior knowledge and accountability on performance in the information search phase of a tax research task. Using sixty-three tax staff from a 'Big Six' public accounting firm, the task was a special allocation of partnership losses between two partners. Prior knowledge was measured using a multiple-choice test, and accountability was manipulated by varying whether subjects' performance would be reviewed by superiors within the firm. Effort and performance were measured from the computer software used in the experiment. Cloyd's results suggest that first, effort can partially substitute for knowledge in performing information search tasks and second, accountability has a positive incremental influence on the performance of subjects with high levels of prior knowledge.

Second, in a large experiment the Minnesota Department of Revenue (reported in Slemrod, Blumenthal, and Christian 2001), in association with a panel of external experts, conducted a controlled field experiment using actual taxpayers. Over 20,000 taxpayers were in the sample and a number of different strategies were tested: (1) an increased examination and audit threat with prior notice to taxpayers, (2) enhanced customer services, (3) redesign of the standard tax return, and (4) letters to taxpayers with information on the importance of voluntary compliance. It should be noted that the only prior study to use actual taxpayers were Schwartz and Orleans (1967) which has come to be regarded as a classic in social psychology (Hasseldine 2000). However the Slemrod study differs from the 1967 study

where taxpayers were contacted by the experimenters, because in the Minnesota study, taxpayers were directly contacted by the tax agency.

#### 8.4 Future Directions and Research Outlets

In terms of research outlets, the most common outlets in rough order of popularity are *Journal of the American Taxation Association*, *Advances in Taxation*, *National Tax Journal*, and *Journal of Economic Psychology*. However a number of other journals also publish behavioural tax research, but to a lesser extent, for example, *Australian Tax Forum*; *Journal of Accounting Research*; *Accounting, Organizations and Society*; and *Law & Policy*. Other potential outlets are *Bulletin for International Fiscal Documentation*, *Asia-Pacific Journal of Taxation*, *Revenue Law Journal*, *Fiscal Studies*, and *British Tax Review*.

Much of the literature cited in this chapter originates from the United States. There is obviously scope for researchers from other countries to make relevant contributions to tax policy and academic research by extending prior research to other countries. There needs to be good coordination between researchers, practitioners, tax administrators, and funding providers. Although the payoffs from research into the topics reviewed in this chapter are not immediately measurable, they are likely to have a positive influence on taxation systems and administration.

The accounting profession has long been very supportive of accounting research in general, and this includes tax research. However, in order for the boundaries of behavioural tax research to be extended, the cooperation of tax agencies must be enlisted. For example, in the United States, the IRS has in the past held interdisciplinary research conferences (although the proceedings are unpublished), attracting participation from economists, accountants, lawyers, psychologists, and other behavioural scientists. Events which can help to integrate practical tax administration problems with academic research could also be organized in the United Kingdom and Europe, as Aaron and Slemrod (2003) report has been done in the United States.

It must be noted that tax professionals include both practitioners and revenue enforcement agents. Until now, research has been one-sided as academics have only had research access to practitioners. There are only a few published studies where researchers have published work using revenue agents (Roberts 1995; Hite and Sawyer 1998; Hansford and Hussey 2000).

Further research which compares both clients' perceptions and practitioners' perceptions of tax services could help in developing a better understanding of clients' needs and reduce any 'tax expectation gap'. If this leads to the development of higher quality tax services, other consequences for tax practice should include greater client loyalty, more client referrals, and ultimately, higher revenues.

One of the main contributions of the Slemrod, Blumenthal, and Christian (2001) study is in the methodological contribution and possibilities that can be explored if tax agencies can take the bold step of considering the testing of social norms, audit threats, conscience appeals, and 'positive' approaches such as information provision etc. on actual taxpayers. To do this successfully, it will be necessary to have the input of an interdisciplinary range of professional researchers and a commitment to a long-term strategy in relation to the integrity of the tax system. Future partnerships between academics and tax policymakers would seem highly desirable.

## NOTE

1. Aspects of behavioural research relating to tax practitioners' ethics, regulation of tax practice, and the measurement of tax compliance costs fall within these areas, but are not discussed in this chapter because they are explored in other chapters of this book (See Chapters 7 and 12).

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# Taxation and Business Strategy

*Simon James*

## 9.1 Introduction

‘It is not economical to go to bed early to save candles if the results are twins’ runs an old Chinese proverb. Saving tax can also come at a price. Minimizing tax liability is not an end in its own right and sometimes can have disadvantages in other respects. After discussing some introductory matters, this chapter deals in turn with the ‘textbook approach’ to these issues, developing business strategy including the taxation, ‘the future’, and finally draws some conclusions.

The key to incorporating taxation in a successful business strategy is to include it as an integral part in the decision making process. It is then related directly to the process of pursuing the goals of the enterprise—maximizing shareholder value or other objectives as in the case of not-for-profit organizations. The aim should be to optimize tax liability given all other factors, not to minimize it. Furthermore, including taxation in the formulation of business strategy should be done not only in terms of decisions made on the basis of current considerations but also in terms of possible future changes in the environment in which the business operates.

There is some evidence that the role of taxation, at least in the past, has been considered largely a technical matter to be dealt with by backroom specialists after the important business decisions had been formulated on other grounds. For instance, in a widely quoted article dating back to the 1960s, Strümpel found evidence about the effect of tax incentives on

investment behaviour that seemed to suggest that the influence of taxation on private investment was relatively insignificant. Decisions about capital investment projects were determined almost exclusively by considerations of 'profitability'. Tax considerations came into play only in connection with the financing of projects already decided and for determining the time of their execution (Strümpel 1969: 20).

Possibly the importance and pervasive nature of taxation in commercial transactions is clear to many, not least to those reading this book, but it does not always seem to be so to some of those involved in business strategy. Perhaps it is labouring the obvious but, for instance, figures compiled by the Organisation for Economic Co-operation and Development (OECD) have indicated for many years that tax revenue of its member countries has varied from about a quarter to half of GDP. It is very difficult to think of any economic decision that is not affected by taxation in one way or another and possibly in several ways. A particular transaction can be subject to one or more substantial taxes such as personal income tax, social security taxes, corporate income taxes, and indirect taxes. Even goods and services that are 'tax free' might be affected by taxation. Obvious examples include the prominent advertisements for 'duty free' products offered to international travellers. In reality such goods are rarely priced so as to pass on the full benefit of their tax-free status to customers but only just enough to give them a competitive advantage over the domestically taxed competition. Such effects of taxation have important implications for business strategy and some of these are discussed below.

## 9.2 The Textbook Approach

It is not easy to know how far the wider implications of taxation are taken into account even by large corporations. One indication of the factors thought to be important in commercial decision making might be found by examining modern management courses in business strategy. Perhaps it is surprising but there are textbooks on business strategy that hardly mention taxation.

For example, one of the best textbooks on business strategy is Johnson and Scholes (1999). This book has been considerably expanded with the 330 page second edition published in 1988 increased to 972 bigger pages in the fifth edition published in 1999. Remarkably, neither contains any reference to taxation in the index. 'Taxation policy' is listed as a factor to be considered in conducting an analysis of environmental issues but no more. Some

technical issues such as cost-benefit analysis are discussed but not tax matters.

Textbooks on finance and investment normally have a significant coverage of taxation though it tends to be technical rather than strategic—for instance Daniels and Radebaugh (1993). They point out that taxation has a 'strong impact' on the choice of location of operations, legal form of enterprise, method of finance, and internal pricing but the discussion of these issues is relatively small and largely consigned to a part of one of the final chapters.

Textbooks in finance normally include some taxation. One of the most prominent textbooks of corporate finance is Brealey and Myers (2000) and this contains significant tax coverage as does Arnold (1998). Textbooks covering corporate finance and investment specifically also have some coverage as in the case of Pike and Neal (1999). This is also true of books primarily dealing with investment such as Haugen (2001) and textbooks directed at finance more generally. In the foreword to Brodie and Merton (2000), Paul Samuelson describes Merton, who shared the 1997 Alfred Nobel Memorial Prize in Economics, as 'the Isaac Newton of modern finance theory' but the space devoted to taxation is very limited.

Understandably, there is a tendency in some of these textbooks that where taxation is considered at all it is with respect to the institutional arrangements in just one country. Buckley et al. (1998) take a European perspective but have relatively little on taxation. These textbooks also tend to see taxation mainly as a technical matter rather than a strategic one. An exception is Haugen (2001) who has a chapter on the effect of taxes on investment strategy and this is an approach that seems worth developing more widely. Decisions relating to corporate finance and investment often have long-term implications, and taxation and likely changes and trends in taxation should be incorporated as a factor in developing strategy.

A much more international dimension is, of course, present in textbooks on multinational finance such as Buckley (2000); Eiteman, Stonehill, and Moffett (2001); and Shapiro (2003). However the coverage of taxation is variable and there is often considerable scope for developing a more strategic approach.

Textbooks often have specific gaps involving taxation and business strategy. An important one across the range of such books is that most of them lack a thorough coverage of issues specifically affecting small businesses. Most businesses are small businesses. Furthermore, for a range of reasons, small businesses might have a lower awareness than large corporations of the importance of strategic tax considerations and less access to specialist

advice. Another gap in many textbooks is the lack of discussion regarding the management of pensions. Again this is something that has tax implications including issues in employee remuneration.

One of the few books in this area that is devoted to matters raised in this chapter is Scholes et al. (2002) *Taxes and Business Strategy: A Planning Approach*. Although this is a specialist text it does show how the subject of taxation and business strategy might be usefully included in mainstream strategy and finance textbooks.

### 9.3 Developing Business Strategy Including Taxation

#### 9.3.1 An Approach

There is also no reason why taxation cannot be effectively included in developing business strategy in practice. In this context the issue is not so much quantitative techniques of economic modelling or forecasting but more general techniques of positioning an enterprise and its output in its competitive environment. To take the most general level of such activity, one method is to construct plausible scenarios of likely economic and social developments which can then be used to develop strategies (Schwartz 1998). Another approach is to take a wide view on a multidisciplinary basis as, for example, is done by Northcote (1991) but without relying on a single technique. A commonly used method that seems to offer a useful and systematic analysis in this context is known as STEP analysis in which the relevant Social, Technological, Economic, and Political factors are examined in turn as laid out, for example, by Mercer (1992). There are alternative formulations of this approach such as the 'PEST' analysis by Johnson and Scholes (1999: 104–107). This approach has also been used to develop a strategic analysis of the tax environment itself (James 1997, 1999).

Many of the relevant issues of financial tax planning are summarized in Chapter 10 (Microeconomic Approaches to Tax Research). These include moving income and costs to take advantage of different tax rates. This can be done from one time period to another, between different jurisdictions, and to take advantage of particular economic incentives. The issue of taxation and capital structure is also a standard issue in finance—that interest payments servicing debt finance may be deducted against gross revenue but dividend payments to shareholders may not. Other issues are raised in Chapter 14 (Taxation and Capital Markets).

However, there are certain areas that might bear further examination in developing the tax aspects of an overall business strategy. These include economic, accounting, and legal aspects following on from the discussion in the chapters in the first part of the book and also multinational business strategies, political aspects, and dynamic tax planning.

### 9.3.2 Economic Costs

The economic effects of taxation are examined in Chapter 3 but there is a particular application with respect to the case for making taxation an integral part of the process of developing business strategy.

Tax systems have the effect of altering the costs and benefits of different economic decisions. Sometimes the differential tax treatment of different activities arises as an incidental result of taxation. Sometimes it is intentional and the tax system is used deliberately to affect commercial behaviour—for example, in offering investment incentives because the government wishes to encourage investment. An enterprise may well be able to take advantage of favourable tax provisions, whether they are intentional or not, and be better off. However, incorporating taxation into more general business strategy may allow the company to evaluate more easily whether acting in such a way would be in its wider and longer-term interests. There have been cases, for example, where companies have responded to regional tax and other incentives to locate in areas that would not otherwise have been commercially suitable and this has been a factor in the eventual failure of some of these businesses.

Another aspect of economic outcomes relates to tax incidence. This is a particular area where taxation can have results that are unexpected by those who fail to take account of the implications of tax provisions.

### 9.3.3 Tax Incidence

The topic of tax incidence is described in Chapters 2 and 3 but it has some specific applications to business strategy. One is what Scholes et al. (2002) describe as ‘implicit taxation’. Generally a tax on one good will increase its price but it is also likely to shift demand to substitute goods and services and so increase their prices as well. In this context investments that have

tax advantages are likely to be more sought after as a result. Therefore their prices would be higher and their net returns lower than they would be if other investments were not taxed. Similarly investments that are fully taxed will be less attractive and have a lower price and a higher gross return than if they were not taxed. In the case of bonds, for example, it is the difference in the rates of return of fully taxable bonds and the lower gross return of tax favoured bonds that might be described as an implicit tax and some studies into such effects are discussed in Chapter 10. The process of adjusting to the tax system will continue until after tax returns are equalized across all investments, after taking account of the degree of risk attached to different assets and so on.

However, such effects are not limited to the investments but extend also to the investors. Not all economically active entities face the same tax rates. At one end of the scale is the large charitable sector that often faces zero tax rates. Even commercial enterprises face different rates. For instance in the United Kingdom there is a lower 'small companies' rate which is withdrawn by a tapering arrangement as profits increase. There are also differences between corporations subject to corporate income taxes and unincorporated enterprises subject to personal taxation. Faced with the implicit tax phenomenon described in the previous paragraph it is easy to see that the allocation of investment depends on the tax status of the investor as well as that of the investment. Thus enterprises subject to high rates of taxation will gain from investing in investments with tax breaks and organizations which face low or zero rates of tax might do better to favour taxed investments since they can benefit from higher gross rates of return.

### 9.3.4 Financial Reporting and Taxation

Sometimes accounting figures might be manipulated simply to reduce tax liability. Nevertheless any such gains to be made in this way may have other costs since possible conflicts arise between financial reporting and tax matters. This has been made very clear in a different context in a case before the US Supreme Court, *Thor Power Tools Company v. Commissioner of Internal Revenue*.<sup>1</sup> The case was concerned with matters related to inventory accounting procedures and additions to bad debt reserves, and that accountants might be more conservative for commercial reasons than was appropriate for the assessment of tax. It was stated that:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major

responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets'. In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

Further discussion of these matters is presented in James (2002). It is possible, of course, that such figures might be conservative for tax as well as commercial reasons. However, investors and analysts often use accounting figures to price both debt and equity. Reporting lower income figures to reduce tax liability could have disadvantages in terms of causing share prices to be lower and the cost of capital—whether debt or equity—to be higher than it might otherwise be.

### 9.3.5 Legal Aspects

A basic knowledge of legal aspects of taxation is also an important matter in business strategy and legal research is examined in Chapter 2 above. Legal considerations add further weight to the theme of this chapter that issues of taxation should not be addressed separately but as part of mainstream business decision making.

There are several judicial doctrines that indicate that transactions should have an underlying business purpose if they are likely to be acceptable to tax authorities. One is the 'substance over form doctrine' in Anglo-Saxon countries and there is a similar 'abuse of law' doctrine in a number of Western European civil law countries. The basic point is that the substance of a transaction rather than its legal form may be held to be the most important consideration in tax matters. Another device is the 'business purpose' test by which arrangements that reduce tax may be ignored if they do not serve a 'business purpose'. Increasingly specific anti-avoidance provisions have been developed in many countries. These are sometimes general provisions preventing taxpayers arranging their affairs 'artificially' to avoid tax or specific provisions relating to particular tax havens or tax avoidance devices.

The Australian anti-avoidance provisions (embodied in Part IVA of the legislation) provide a relatively clear example. Briefly a tax benefit may be denied by the Commissioner of Taxation if the following apply:

- There has to be a ‘scheme’
- This gives a ‘tax benefit’
- The scheme started after 27 May 1981
- The dominant purpose of the scheme was to obtain a tax benefit.

The conventional distinction between legal and illegal manipulations for tax purposes is relatively well known. Both tax evasion and tax avoidance reduce tax payments but the former does so outside and the latter inside the law. However tax avoidance can be a more complex and uncertain exercise than some might imagine. To denote the blurred distinction between tax avoidance and tax evasion, in his discussion of the subject Arthur Seldon (1979) coined the term ‘avoision’. Some of the pitfalls in these areas might be avoided if decisions are made on a sound commercial basis rather than as a separate exercise designed largely to avoid tax.

### 9.3.6 The Organizational Form of an Enterprise

It has already been suggested that the situation of small businesses is relatively neglected in the relevant textbooks. One issue of particular relevance to them is the organizational form they should take and this is examined further by Channon, Edwards, and James (2002). There are reasons to suppose that small businesses have different characteristics than larger ones. Clearly they are more likely to take the form of a sole trader than larger enterprises and personal tax considerations might play a larger part in business strategies. Furthermore there are often more favourable tax regimes for smaller business that should also be taken into account.

There are three basic organizational forms of enterprise—sole traders, partnerships, and corporations—and there are some other variations. Taxation is not the only consideration in choosing the most appropriate organizational form for a particular enterprise but it can be an important one. Sole traders and partnerships are subject to personal taxation each year in the normal way but incorporated enterprises are separate legal entities. They are therefore subject to taxation in their own right. This can mean that income is taxed once at the corporate level and again to personal taxation when profits are distributed to shareholders. Corporations however

have a basic advantage in that reinvested profits are not subject to personal income tax until they are distributed to shareholders. Which organizational form has the most tax advantages for any particular enterprise depends on a range of factors not least of which is the relative taxation of corporate and personal income.

### 9.3.7 Multinational Business Strategies

A particular dimension relates to multinational activities and, of course, enterprises that operate internationally have considerable scope for arranging their affairs to take advantages in the different tax systems and rates applying in different jurisdictions.

Taxes, quotas, and other explicit non-tax barriers to trade are not the only matters to consider.

As with domestic strategies, an international tax strategy should not be considered in isolation. There may be important tax factors that have implications not only for selecting which countries to target, but also for the methods used to penetrate foreign markets. Exporting is possibly the most straightforward way of trading in other countries but, of course, there are alternatives. A company could set up a production facility of its own in another country or allow production by another firm under licence. There could be some sort of joint venture. There may be decisions to be made about service and distribution facilities. There are many important factors including taxation that should be taken into account in deciding which and how different countries might be targeted.

### 9.3.8 Political Aspects

One possibility is that by minimizing its tax liability an enterprise might attract unwelcome political attention and interference. This might be particularly true, for example, of a high-profile multinational corporation operating in a country that is not necessarily sympathetic to free-enterprise. In such circumstances it might be a sound business decision not to go to excessive lengths to avoid taxation and such matters are discussed further in Shapiro (2003).

A related consideration applies to countries where there are perceived to be more serious political risks to its operations—in extreme cases even the

possibility of expropriation. A multinational corporation might be willing to take such risks for a high return, but prefer to transfer profits to a safer jurisdiction, even if that results in a higher rate of taxation.

### 9.3.9 Dynamic Tax Planning

A general aspect that is often overlooked is the dynamic nature of strategic planning. The future, of course, is uncertain and possible changes are incorporated into development strategies. This should also include tax matters. There may be changes in tax rates or other aspects of taxation and it may be possible to anticipate some likely developments in these areas. There may also be changes in the interpretation of tax law by the courts. As financial and investment strategies can be costly to change at a later date, there may be considerable advantages in adopting strategies that allow for future flexibility at low cost.

## 9.4 The Future

Possible future trends in taxation have been analysed elsewhere—for example, by James (1999). Among other things, increasing complexities in the socioeconomic environment are likely to increase the complexity of the tax systems that have to accommodate them. Technological developments including e-commerce will provide challenges to tax systems in the future and will have implications for business strategy. Increasing globalization and international competition will also affect tax systems. One school of thought is that tax systems will have to respond to such changes by becoming more closely aligned. The concept of ‘tax competition’ describes economic benefits some countries feel they might gain by offering tax concessions to attract businesses and individuals to locate in their areas. The ability of other countries to maintain different tax systems is therefore limited by possible economic outflows to countries that offer a more competitive tax environment.

Nevertheless, there seem to be considerable pressures that encourage countries to maintain significant differences in their tax systems and therefore scope for business and tax planning. For example, the European Union (EU) has had a policy of encouraging tax harmonization for many years (James 2000) but considerable differences in taxes remain. Taxes that have

**Table 9.1.** Corporate income tax and VAT rates in the EU

<i>Country</i>	<i>Corporate income tax rates %</i>	<i>VAT standard rates %</i>
Austria	34	20
Belgium	39	21
Denmark	32	25
Finland	29	22
France	33.33	20.6
Germany		16
Retained income	40	
Distributed income	30	
Greece	40	18
Ireland	24	21
Italy	37	20
Luxembourg	30	15
Netherlands	35	17.5
Portugal	34	17
Spain	35	16
Sweden	28	25
United Kingdom	30	17.5

*Note:* There are also other differences in these taxes in the different countries.

*Source:* Kesti, J. (2000). *European Tax Handbook*. Amsterdam: International Bureau of Fiscal Documentation.

been the subject of perhaps the greatest attention regarding European harmonization are Value Added Tax (VAT) and corporate income taxation but considerable variations in rates remain, as shown in Table 9.1.

Table 9.1 gives the normal rate of VAT in EU Member States. This varies from 15 per cent in Luxembourg and 16 per cent in Germany and Spain to 25 per cent in Denmark and Sweden. However the differences between countries are even greater than indicated by the different main rates of tax. For example, Member States have a variety of arrangements for reduced rates of VAT on certain items. The United Kingdom has a special rate of 5 per cent on domestic fuel and power. Spain has a super-reduced rate of 4 per cent for some basic necessities and another reduced rate of 7 per cent for food, transport, tourism, etc. In Sweden there is a reduced rate of 6 per cent for newspapers, periodicals, concert, and cinema tickets and another reduced rate of 12 per cent for foodstuffs and services related to tourism. Denmark has no reduced rate at all.

However, the differences also extend to the structure and administration of taxation. Taking the example of corporate taxation, the committee of tax

experts chaired by Ruding (1992) recognized that there were obstacles to complete harmonization for corporation tax. Hence there continue to be significant differences in the nature of corporate tax systems with respect to whether they are classical or imputation systems, their tax bases, and tax reliefs. The definition of taxable income for corporate taxation varies from country to country. In some countries taxable income is closely related to accounting profit and therefore varies according to different countries' accounting rules. In other countries there are significant differences between accounting profit and taxable income and these differences vary between countries. For example, in Germany tax rules give the maximum depreciation rates for particular assets and these are based on the expected useful lives of such assets. In the United Kingdom depreciation is published in financial statements according to custom and accounting standards. The tax treatment of depreciation is quite separate from accounting depreciation and dealt with as capital allowances. These are a standardized version of the amounts allowed and are also used as investment incentives.

Further differences in European tax systems are to be found in Kesti (2000) but the point is clear, that even with a positive policy of tax harmonization, it is very difficult to reduce differences in tax systems. Therefore there is likely to remain considerable scope for business strategies to take account of such differences.

## 9.5 Conclusions

There is evidence that taxation is a relatively neglected input into the development of business strategy. However, there are considerable advantages to including taxation in the process of developing business strategy since it is an important factor in determining profitability. This is not a technical tax exercise, though of course the relevant expertise is needed. Rather it is a process of incorporating tax considerations regarding present and likely future tax developments along with all the other relevant factors in strategic business decision making.

## NOTE

1. 58L Ed. 2d. 785 at 802 (1979).

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## Microeconomic Approaches to Tax Research

*Alan Macnaughton and Amin Mawani*

### 10.1 Introduction

Academic researchers studying the impact of taxation on the economy have tended to focus on changes in real—that is to say, non-financial—economic behaviour such as saving, labour supply (hours worked), investment, location decisions of firms, and charitable donations. The types of behavioural change recommended by tax practitioners in articles about tax planning—changes in business form, changes in the timing of transactions, and changes in financial structure—have been given much less attention. This weakness in the academic literature was noted by Slemrod (1990), who proposed a hierarchy of behavioural changes to taxation in which these tax-planning responses were considered to be the most frequently observed, while the changes in real economic behaviour were considered to be the least frequent.

A major reason for this failing in the literature has been the interdisciplinary nature of the problem. Economists and finance researchers have had a traditional aversion to institutional detail and cannot easily read articles by tax practitioners, while academic accountants and lawyers have until recently not had the graduate-level economics training required to produce the required theoretical and empirical studies.

These barriers have been broken down somewhat in recent years. Prominent in this process is Scholes and Wolfson (1992), a 600-page text on tax planning arising out of a course taught to MBA students at Stanford

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University in the United States.<sup>1</sup> The chief contribution of the Scholes–Wolfson book to academic tax research in accounting was to identify certain common features that tend to be shared by all tax-planning strategies. Their framework (not a new theory or methodology) seeks to explain the role and influence of taxes in organizations in a positive and predictive approach. Tax strategies of firms are deemed to be predictably rational, and differences in tax strategies among firms can be explained by differences in their economic positions.

Current research of the type exemplified by Scholes and Wolfson has become known in the academic accounting literature as ‘the microeconomic approach to tax planning’.<sup>2</sup> Similar research in economics such as Stiglitz (1983, 1985) has not yet acquired any particular label.

The link between microeconomics and tax planning is an obvious one. A common theme of microeconomics is that each economic agent is assumed to be maximizing an objective function subject to constraints. Taxes are one component of this problem, since almost any business is required to pay taxes. Investigating this aspect of behaviour with the tools of modern finance and economics brings tax-planning research into the company of the more familiar fields of applied microeconomics such as consumer behaviour, production economics, international trade, principal–agent behaviour, and public finance.

Unlike most economic research on tax, Scholes and Wolfson concern themselves only to explain tax-planning behaviour in terms of economics without drawing any normative conclusions. Thus, there is no discussion of deadweight losses, horizontal equity, progressivity, or optimal tax rates; in fact there is almost no discussion of tax policy at all (Sims and Sunley 1992).

The purpose of this chapter is to provide a brief review of the literature on the microeconomic approach to tax planning. For a fuller treatment, see Shackelford and Shevlin (2001), who offer a comprehensive overview of the major developments in microeconomic-based, empirical tax research in accounting over the last fifteen years. Their major areas of focus include research on coordination of tax and non-tax factors, effects of taxes on asset prices, and taxation of multijurisdictional commerce, but they also discuss research design issues such as model specification, data limitations, and measurement error. Related work in finance is surveyed in Graham (2003).

This survey has the same weaknesses as the literature it describes. Thus, the focus is mainly on American research, although Canadian work is also reviewed. The focus is also almost exclusively on empirical work because there has been only very limited theoretical work on tax planning.<sup>3</sup> However, there is much room for theoretical research in this area, and such work may be appealing in some European jurisdictions where publicly available firm-level data may be limited.

Collins (1998) has summarized in one sentence the key lessons emerging from the microeconomic approach: effective tax planning consists of 'allocating income or deductions across tax pockets' so as to 'maximize wealth', 'given all relevant tax and non-tax considerations'. The key elements of this definition are the phrases in quotation marks, which we examine in turn below under three main headings:

1. 'Allocating across tax pockets' relates to the allocation of income and expenses across time periods, jurisdictions, means of financing (equity versus debt), etc.
2. 'Maximizing wealth' relies on measurement of the marginal tax rate applying to each pocket, since wealth is maximized by allocating income to the pocket with the lowest marginal tax rate and allocating deductions to the pocket with the highest marginal tax rate.
3. The 'relevant tax and non-tax considerations' are non-tax costs, all parties, and all taxes.

As each of these topics are discussed, it is important to keep in mind that the insights derived are generally not new to sophisticated tax planners. The new information is most often the empirical documentation of the degree to which the tax-planning strategies are carried on, and the weighting of the different factors affecting the design of the optimal strategy. Essentially, this literature makes explicit the intuitive judgement of the sophisticated tax planner. Although it would be wonderful if the microeconomic approach to tax planning could develop to the point at which it could influence tax practice in the way that academic finance research has influenced finance practice (particularly in the derivatives area), this goal has not yet been realized.

## 10.2 Types of Tax Pockets

### 10.2.1 Time Periods

*Ceteris paribus*, firms can be expected to try to shift income to adjacent periods with lower marginal tax rates and expenses to adjacent periods with higher marginal tax rates. Scholes, Wilson, and Wolfson (1992) document that firms shifted income by managing their gross margins and selling, general, and administrative expenses in response to anticipated lower statutory tax rates announced in the 1986 US Tax Reform Act. Identifying the means of shifting is important, since certain income and expenses are easier to shift than others. Scholes, Wilson, and Wolfson (1992) document that larger firms undertake more intertemporal income shifting. Shifting of certain income

and expenses may also trigger non-tax costs in the form of financial reporting costs (see below), as well as impose potential tax consequences to other contracting parties. For example, Guenther (1994a) finds that while larger firms shift more income across time periods, those with higher leverage (or higher financial reporting costs) are more reluctant to report lower income. It is also important to understand and control for non-tax motivations for shifting income and expenses, and thereby isolate tax reasons for shifting across time periods. Since pre-shifted incomes are not observable, Scholes, Wilson, and Wolfson (1992) use control firms that are not subject to statutory tax rate reductions in the same quarters for statistical comparison. Lopez, Regier, and Lee (1998) document that income-shifting firms are also more likely to have been aggressive in their tax reporting in prior periods. Any new major tax reform in any country will likely create new research questions that will need to be addressed by similar intertemporal experiments.

Maydew (1997) found that firms shifted income to subsequent periods to increase their NOLs (net operating losses—the US term for tax losses) in 1987–9, since NOL carry-backs from the pre-1990 high tax rate period were worth approximately 12 per cent more than NOLs arising from the post-1989 low tax rate period. The control sample consisted of NOL firms from earlier and later periods when firms did not have the same opportunity to carry back their NOLs to a high tax rate period.

Other studies of intertemporal shifting have focused on firm-specific reasons for variations in marginal tax rates rather than on variations induced by tax law changes. For example, Beatty, Chamberlain, and Magliolo (1995) document that realized gains and losses on securities as well as provisions for loan losses and loan charge-offs differed among banks with NOLs and banks without NOLs. Collins, Shackelford, and Wahlen (1995) document that realized gains and losses on securities as well as provisions for loan losses and loan charge-offs are a function of municipal bond holdings, for which the interest is tax-exempt federally in the United States. It is important to note that within a US multinational organization, the presence of US NOLs or municipal bond holdings provide information about the US tax position only, and not the global tax position.

### 10.2.2 Jurisdictions

Multinational corporations have reasonable opportunities to allocate their reported income and expenses, as well as shift real economic decisions in order to achieve favourable tax treatment at the consolidated level. For example, the 1986 decline in US statutory tax rates triggered US multinationals

to shift reported incomes into the United States (Harris 1993; Klassen, Lang, and Wolfson 1993). Collins, Kemsley, and Lang (1998) document income shifting between the United States and foreign jurisdictions of US multinationals from 1984–92 depending on the relative magnitudes of US and foreign statutory tax rates. To control for any changes in real strategic decisions within and across jurisdictions, researchers should focus on intrafirm transfers across jurisdictions, and not on reported incomes by jurisdiction.

Newberry (1998) reports that firms facing foreign tax credit (FTC) limitations react by reducing their debt and increasing their common and preferred equity. Newberry and Dhaliwal (2000) document that US firms are more likely to issue debt through their foreign subsidiary in a higher tax rate jurisdiction if the parent has NOL in the United States, and if the FTC limitation is binding. Olhott (1999) reports that larger multinationals undertake more income shifting across jurisdictions, while Collins, Kemsley, and Lang (1998) document the impact of cross-jurisdictional income shifting on earnings and potential valuation.

Income shifting may also occur across subnational jurisdictions if the variation in tax rates is sufficiently large. For example, Klassen and Shackelford (1998) show income shifting among US states and Canadian provinces in response to subnational tax rates. Subnational studies have an advantage of being able to control an important non-tax factor, namely political risk.

Tax rate variations across jurisdictions also affect real decisions. For example, Kemsley (1998) shows that firms choose between exporting from the United States or manufacturing in the foreign jurisdiction depending on their FTC position. Hines (1996) shows that US state taxes affect foreign investment, particularly by firms from countries that do not offer home country credits for US federal and state income taxes. Single (1999) surveys tax executives' responses to a case study to evaluate the relative importance of taxes in the location decision.

### 10.2.3 Taxes and Capital Structure

All jurisdictions offer a tax shield for debt, but not for equity (that is to say, interest payments are deductible but dividend payments are not). This has an effect on firms' capital structure as shown in Graham, Lemmon, and Schallheim (1998), Trezevant (1994), and Dhaliwal, Trezevant, and Wang (1992). The tax effect varies across firms and periods depending on firms' marginal tax rates, NOLs, pension plans, and FTC positions. For example, Dhaliwal, Trezevant, and Wang (1992) show the choice of debt or equity to be dependent on firms' NOL status, while Collins and Shackelford (1992)

show the use of preferred stock to be a function of NOLs and FTC positions. Dhaliwal, Trezevant, and Wang (1992) also document that firms rely on leverage as a tax shield much more when they have exhausted their other tax shields such as depreciation. Engel, Erickson, and Maydew (1999) document that the tax benefits of leverage can be extremely large in selected cases. There are several important issues to keep in mind when researching the effect of taxes on capital structure. First, a firm's capital structure depends to some extent on historical decisions, since changing capital structure at frequent intervals is costly. Thus, firms may carry suboptimal capital structure on their balance sheets (at a given point in time) from a tax perspective because the non-tax costs incurred in changing it may outweigh the benefits. Second, Scholes and Wolfson (1992) assert that, 'financing decisions cannot be made without simultaneously considering the tax characteristics of the assets' side of the firm's balance sheet' (p. 8). Third, debt is not the only source of tax shields. Maydew (1996) points out that substitutes include depreciation and investment-related shields, as well as expenditures such as advertising and bad debts. In the absence of non-tax costs, \$1 of advertising deduction is a perfect substitute for \$1 of interest deduction for tax purposes. Of course, non-tax costs such as financial reporting costs are not the same across such different tax shields. Furthermore, firms have different degrees of freedom in adjusting different tax shields to changes in marginal tax rates.

Finally, Graham (1996a) shows that examining *levels* rather than *changes* to test for the effects of tax on financing choices can lead to erroneous conclusions about the relationship between capital structure and taxes. For example, suppose a firm finds itself with a high marginal tax rate (MTR) and low debt, and decides to acquire more debt. It is possible that the act of increasing debt obligation may lower the firm's expected MTR (by increasing the probability that the firm will pay no taxes). The sample data could therefore include firm-years with high-MTR/low-debt and low-MTR/high-debt. Regressing the ratio of debt to assets of this firm on MTR may generate a negative coefficient, and therefore an incorrect inference. Other ways of expressing the same concern include justifying which variables are endogenous and which are exogenous, as well as clarifying the direction of causality in the relationship between taxes and debt.

### 10.3 Maximizing Wealth

Taxes clearly influence firm behaviour through the deductibility and inclusion provisions of the income tax laws. Such provisions offer tax-induced

economic incentives or disincentives to the firms undertaking the decisions. To the extent that such decisions are undertaken at the margin (for example, income shifting, compensation, financing, and investment), the appropriate tax rate that captures the tax-induced economic incentive or disincentive facing the firm is the corporate marginal tax rate. The gain in shifting income or expenses between tax pockets (time period, jurisdiction, type of income, etc.) is the difference between the marginal tax rate applying in the two pockets. Thus, much research has focused on the proper measurement of marginal tax rates, particularly in the presence of tax losses.

To reflect the objective function of multiperiod wealth maximization in the microeconomic approach to tax planning, the marginal tax rate is defined as the present value of extra tax savings (liability) when taxable income decreases (increases) by \$1. If the change in income due to the economic decision undertaken at the margin is large, it could be worthwhile to compute an 'interval' marginal tax rate that takes into account the actual change in income. For example, Clinch and Shibano's pension reversion study (1996) measures interval effective marginal tax rates due to the large amounts involved in pension reversion decisions.

All jurisdictions have income tax systems that are not symmetric in their treatment of income and losses: an immediate income tax is imposed on the former, while the latter does not necessarily generate an immediate refund. Tax provisions allow firms to carry back any operating losses and offset against any positive taxable income (before loss carry-overs) in the legislated carry-back period, resulting in an immediate refund to the extent that taxes were actually paid in this carry-back period. Operating losses can also be deducted from positive taxable income in the carry-forward period. However, there is no impact on cash flows until the year in which the losses are actually used, and then only to the extent that taxes would otherwise have been payable in that year. It is this asymmetric tax treatment of income and losses that can result in marginal tax rates differing substantially among firms.

Shevlin (1990) and Graham (1996*b*) describe their simulation methodologies in estimating firm-specific corporate marginal tax rates that incorporate the impact of operating loss carry-overs. They simulate taxable incomes before loss carry-overs over the carry-forward period, and apply existing and projected operating losses against the simulated income series on a first-in, first-out basis. Hence, both prior and future years' taxable incomes can influence the current year's effective marginal tax rate. The simulated MTR seems to be theoretically the most appropriate, since it incorporates *all* different types of tax shields, including those anticipated in the future. Just examining one type or component of tax shield and ignoring others in determining firms' tax rates at the margin seems inappropriate.

Other proxies for firms' marginal taxpaying status have included statutory tax rates, average tax rates, a binary variable for the existence of NOLs, a binary variable for positive taxable income, a trichotomous variable for the existence of NOLs and/or taxable income, FTC position, and several others. These are defined and compared in Graham (1996*b*). Omer and Shaw (1991) describe other practical concerns in estimating tax rates and computing the corresponding tax benefits and costs.

## 10.4 Relevant Tax and Non-tax Considerations

The microeconomic approach considers efficient tax planning as an integral part of business planning, and vice versa. By treating taxes endogenously, firms are not presumed to simply minimize their taxes but rather pursue a broader objective that considers other business costs and benefits, as well as taxes paid by other stakeholders with which the firm contracts. This perspective has helped to shape our thinking about how taxes influence business decisions, and how tax benefits may be shared among stakeholders. In any business transaction, effective tax planning explicitly seeks and considers *non-tax costs*, identifies and considers *all parties* or stakeholders, and emphasizes *all taxes*.

### 10.4.1 Non-tax Costs

In a broader context of business planning, the benefits of a particular tax-planning strategy may be outweighed by incremental non-tax costs or reduced non-tax benefits. Incorporating non-tax costs and benefits into cross-sectional studies enhances our understanding of how and when firms trade-off between pursuing tax benefits and avoiding non-tax costs. Since tax-minimization strategies can affect other organizational objectives, this strand of research offers an explanation of why firms may not be minimizing their taxes.

The most common non-tax issue addressed by accounting researchers is financial reporting cost. Financial reporting costs occur whenever a tax-minimization strategy has an adverse effect on the company's financial statements and thereby influences the perceptions of suppliers of debt and equity capital. Given the similarity of accounting and tax treatments for many reporting issues,<sup>4</sup> firms often face a conflict between wanting to

appear profitable to their capital suppliers, while preferring to appear poor to the government. If a reduction in book income leads such capital suppliers to regard the firm less favourably, the firm may have to lower the price on a new equity issue, face a higher interest rate on its debt, or face restrictions on growth and expansion plans imposed by such capital suppliers. Firms thus often have to bear the 'financial reporting costs' that result from pursuing tax-minimization strategies. Studies that document firms trading off tax benefits for accounting earnings include Beatty, Chamberlain, and Magliolo (1995), Collins, Geisler, and Shackelford (1998), and Maydew, Schipper, and Vincent (1998).

The importance of financial reporting costs may vary across different types of firms. Wolfson (1993) has argued that financial reporting costs should be lower in private corporations as well as closely held public corporations since the principal shareholders are usually actively involved in the business, and thus have independent sources of information with which to supplement the information provided in financial statements. Cloyd, Pratt, and Stock (1996) found that while 56 per cent of public-firm managers in the United States preferred a hypothetical investment that produced net income a year prior to the associated cash flow, only 18 per cent of private-firm managers made this choice. Klassen (1997) finds that closely held public companies divest operating units at greater losses (or smaller gains) relative to their widely held counterparts.

Agency costs are another non-tax factor that often needs to be incorporated into research designs. A manager may prefer to forego tax strategies that reduce book income if such strategies also reduce her accounting-based bonuses. Johnson, Nabar, and Porter (1999) examined firm responses to the 1993 new legislation that denied tax deduction for compensation in excess of \$1 million that was not performance related. Full deductibility could be preserved by making the compensation performance-based, or by deferring until a deduction was available. Johnson, Nabar, and Porter (1999) found that firms' decisions to preserve their tax deduction was directly linked to the magnitude of the tax benefit otherwise foregone, and negatively related to agency benefits otherwise foregone. Balsam and Ryan (1996) also found that firms' decision to retain the deduction was influenced by its agency costs.

Tax shelters and partnership forms constitute other settings that are motivated by agency costs. Shelley, Omer, and Atwood (1998) examine the capital market reaction to announcements of business restructurings into publicly traded partnerships. Advantages of these restructurings include flow-through taxation and reduced information asymmetries about growth opportunities, while disadvantages include agency and record-keeping

costs. Shelley, Omer, and Atwood (1998) find announcement period returns to be positively associated with the proxies for the advantages, and negatively associated with the proxies for the disadvantages cited.

Other non-tax costs and benefits that may need to be weighed against tax costs and benefits include liquidity, regulatory capital, and valuation. For example, Collins, Kemsley, and Lang (1998) show that US multinationals often command a higher price-earnings ratio for their foreign earnings compared to their domestic earnings. As a result, any income shifting from the high tax rate foreign jurisdiction to the low tax rate US jurisdiction comes at a valuation cost. Other studies that document firms trading off tax benefits for valuation benefits include Ayers (1998) and Miller and Skinner (1998).

Essentially, non-tax costs are in evidence where a taxpayer who could save taxes by implementing a strategy chooses not to do so. The size of these non-tax costs can vary substantially. For example, in their study to predict tax-motivated child support strategies in Canada, Feltham and Macnaughton (1997) show that controlling for non-tax costs results in significantly lower predicted behavioural responses that better reflect actual data. While Gelardi's (1996) Canada-UK study on the timing of marriages does not explicitly deal with non-tax costs, it does describe the non-tax costs that caused only a small proportion of taxpayers to take advantage of the tax rules.

It may be important to note the subtle shift in the literature as it moved from investigating the 'trade-off' between tax and non-tax costs, to investigating the 'coordination' of tax and non-tax factors. Shackelford and Shevlin (2001) point out that only a subset of firms face trade-offs between tax and non-tax costs, while almost all firms face the problem of coordinating taxes and non-tax factors. For example, if a decision choice being investigated reduces both taxes and accounting income (non-tax factor), then Shackelford and Shevlin (2001) show that firms may fall into one of the four categories in Table 10.1.

**Table 10.1.** Decision choices—taxes and accounting income

		$X_1$	
		<i>Low tax (0)</i>	<i>High tax (1)</i>
$X_2$	Low book income (0)	A	B
	High book income (1)	C	D

Source: Shackelford and Shevlin (2001).

It is important to note that only firms in D face a trade-off between taxes and financial reporting costs. Firms with accounting losses (in A and B), for example, may not face the dilemma of pursuing both tax minimization and accounting-income maximization. Since financial reporting cost is often measured as deviation of actual reported income from some target income, researchers may need to recognize that trade-offs between taxes and accounting income are not symmetric in positive or negative deviations from target income. For example, firms that experience a significant positive deviation from target income may be able to pursue the tax-saving strategy without the dilemma of incurring financial reporting costs. Klassen and Mawani (2000) is an example of a study that recognizes these different motivations and therefore codes firms' deviation from target income with two independent variables: those with positive deviation from target income, and those with negative deviation from target income. These two subsets yield statistical results that are different for some of the hypotheses. In some cases, merging firms with different motivations into one coded independent variable may dilute the average impact, and not allow researchers to statistically detect their developed hypotheses.

Shackelford and Shevlin (2001) also point out that simply finding both tax ( $X_1$ ) and non-tax ( $X_2$ ) factors to be statistically significant does not necessarily imply that firms face a trade-off between the tax and non-tax factors. A statistically significant regression coefficient on a tax or a non-tax factor simply captures the incremental effect of that factor, holding everything else constant. Hypothesizing trade-offs means firms consider both factors simultaneously, and it can be statistically detected only by incorporating an interaction term ( $X_1 * X_2$ ) into the regression model.

Non-tax costs are prevalent and require researchers to broaden their scope of investigation. More non-tax costs need to be identified and documented.

#### 10.4.2 All Parties

Effective tax planning may require managers to consider the tax position of not only the firm itself, but also the tax positions of all parties with which it contracts—customers, suppliers, employees, and shareholders. Since many business decisions involve transactions with external parties, firms that consider only their own tax positions may find it difficult to transact or contract with other parties. A firm's tax-minimizing strategy for a given decision may be unacceptable to the firm with which it wishes to transact or enter into a contract. Restructuring the transactions may

improve the positions of all contracting parties at the expense of the government (Scholes and Wolfson 1992). Analysing tax strategies through such a multilateral framework often results in finding ways of reducing non-tax costs, while preserving all or most of the tax benefits.

Compensation schemes serve as an ideal context for research based on this framework, since they can be viewed as a partnership contract between the employer, the employee and the (uninvited) government or taxing authority. The objective is to structure the compensation transaction in a way that reduces the government's share, thereby allowing the remaining two partners to competitively share the rest of the pie. An excellent example of this kind of research is Matsunaga, Shevlin, and Shores (1992). They examine disqualifying dispositions of incentive stock options that result in tax benefits to corporations while imposing tax costs on employees. After quantifying the costs and benefits of disqualifying, the study finds that disqualification is more likely to occur when corporate tax benefits are large enough to offset employee tax costs and corporate financial reporting costs. In contrast, Austin, J. Gaver, and K. Gaver (1998) find that after controlling for unsystematic risk and firm size, corporate tax variables are not statistically significant in explaining option choice. In another context, Erickson (1998) examines the tax and non-tax factors influencing corporate acquisitions from the perspectives of all the contracting parties—acquirer, target, and target shareholders.

Similar tax-planning choices with respect to stock options arise in other countries, although the terminology and detailed rules may be quite different. Mawani (2003*a,b*) describes a Canadian strategy of obtaining an employer tax deduction through cancelling the stock option and substituting a cash payment. Egginton, Forker, and Grout (1993) note that in the United Kingdom the cost of shares purchased on the open market and given to the executives upon exercise of options is deductible to the firm, while no deduction is available for the opportunity cost of shares issued from the treasury upon exercise of options. Hence, there may be an opportunity for an empirical study on stock option choice in the United Kingdom.

Note that to demonstrate that both parties are indeed better off, the exact method by which the benefits will be shared between the parties must be explicit. If this is left implicit, it is possible to derive erroneous conclusions about the benefits of one tax-planning strategy versus another. Therefore, considering the tax positions of all parties needs to be done carefully by keeping one party indifferent, and then comparing the costs or benefits to the other party. There are few published studies in this area of tax research since it is difficult to get data for more than one party to a transaction.

### 10.4.3 All Taxes

An investor's demand for any particular investment is determined by its risk and after-tax return. If some forms of returns are taxed more favourably, then investors will bid up their prices relative to tax-disfavoured assets, thereby reducing their pre-tax returns. Scholes and Wolfson (1992) term the difference in pre-tax returns of assets that are of equal risk but taxed differentially an 'implicit tax'. Explicit taxes paid to the government may include taxes paid by other contracting parties, and therefore the multilateral perspective remains applicable. Rational investors consider both explicit taxes paid to the governments, as well as implicit taxes incurred in the form of lower pre-tax returns when making their investment choices. This is familiar from the economics literature on the theory of tax incidence. In the capital markets literature, accounting and finance researchers have been interested in the extent to which stock prices impound taxes.

Accounting studies that have detected and documented such implicit taxes include Shackelford (1991), Guenther (1994*b*), and Erickson and Maydew (1998). Shackelford (1991) shows that banks charged different rates on their employee stock ownership plan (ESOP) loans based on whether they were able to exclude half of their interest income from the tax base. However, the after-tax returns to the banks were not equal for these two pre-tax rates charged for ESOP loans. The competitive banking industry allowed ESOP borrowers to enjoy approximately 75 per cent of the tax benefits (in the form of lower borrowing rates) from the interest exclusion available to banks. Guenther (1994*b*) documents that pre-tax yields on treasury bills reflect changes in statutory tax rates. Erickson and Maydew (1998) document lower than expected price declines (representing the implicit tax) of high-dividend yielding stocks upon announcement of an anticipated unfavourable tax legislation proposal, while Engel, Erickson, and Maydew (1999) show that asset prices were only marginally affected by taxes.

In the market for business acquisitions, the research questions have revolved around whether the tax characteristics of the target firms are adequately reflected in the acquisition prices, and how such price differentials are shared between acquirers and sellers. Ayers, Lefanowicz, and Robinson (2000) find that firms qualifying for goodwill amortization deductions are able to yield higher selling prices, with target shareholders retaining approximately 75 per cent of the tax benefits from goodwill deductibility. For the same law change, Henning and Shaw (2000) also find that tax deductibility of goodwill increases the amount of purchase price allocated to goodwill, increases the purchase price of the business, and improves

after-tax returns of both acquirers and target shareholders (that is to say, the tax benefits of goodwill deductibility are shared by both the sellers and the buyers). Thus the tax characteristics of both the acquiring and target firms seem to affect the price as well as the structure of the acquisitions.

The extent to which taxes on dividends are impounded into stock prices has been examined by Harris and Kemsley (1999), Harris, Hubbard, and Kemsley (2001), and Collins and Kemsley (2000). Based on the Ohlson (1995) residual-income valuation model, these papers find that investors value the book value of other assets higher than that of retained earnings (the source of future dividends), and therefore conclude that stock prices are discounted to reflect taxes on dividends received or receivable.

The extent to which capital gains taxes are impounded into stock prices has been investigated by Shackelford and Verrecchia (1999), Lang and Shackelford (2000), and Blouin, Raedy, and Shackelford (2000). Shackelford and Verrecchia (1999) document that investors sell their stocks at higher prices if they do not qualify for the lower long-term capital gains tax rates. Lang and Shackelford (2000) show that stocks that did not pay dividends enjoyed a market premium of about 6.8 per cent (compared to dividend-paying stocks) during May 1997 when US legislation to lower long-term capital gains tax rate was approved. Blouin, Raedy, and Shackelford (2000) document that the three-day cumulative abnormal returns from 1983–97 are an increasing function of short-term capital gains tax rates.

The extent to which implicit taxes are capitalized into asset prices depends on the competitiveness of the industry. Owners of monopolies and oligopolies may be able to retain some of the benefits of tax-favoured treatment, while owners of competitive firms may see the tax benefits conferred on them evaporate in the form of lower pre-tax returns. With differentially taxed assets and differentially taxed investors, it is extremely difficult to empirically assess the magnitude of the implicit tax rate that equates the different asset values. Detecting implicit taxes by comparing after-tax rates of returns is also complex due to risk differences across assets.

## 10.5 Conclusion

The microeconomics approach to tax planning is comprehensive in the sense that it views tax planning as an integral component of business planning, and vice versa. By treating taxes endogenously, firms are not presumed to simply minimize their taxes but rather pursue a broader objective that considers taxes as well as other business costs and benefits. This perspective

has helped to shape our thinking about how taxes influence business decisions, and has brought about an interesting multidisciplinary research agenda that spans the fields of microeconomics, finance, accounting, and taxation.

By emphasizing that efficient tax planning is not simply tax minimization, the microeconomics approach has pushed tax researchers to seek tax as well as non-tax institutional knowledge. This broader and more integrated scope makes it an exciting field for research and teaching. It is no longer sufficient to address the agency aspects of compensation in isolation, or teach it in one class, and address the tax aspects of compensation in another area of research or teaching. If decision makers in practice consider both issues simultaneously, then so should researchers and teachers. The brief review of the microeconomics framework and related literature in this chapter will hopefully motivate economics and finance researchers to consider more tax institutional details in their work, and motivate tax and accounting researchers to incorporate the microeconomics framework in their work.

In the past, tax planning has been regarded as a subject for research by tax practitioners rather than those with social science training. As a result, researchers studying the impact of taxes on the economy have not studied tax-planning behaviour, while tax planners have not generalized the common features of their strategies and empirically documented them for large sample studies. This omission is in the process of being rectified by research using a microeconomics-based approach. This microeconomics approach not only documents the influence and importance of taxes, but also explains and predicts firms' behaviour in different contexts.

## NOTES

1. An updated version which contains more information on empirical studies is Scholes et al. (2002).
2. Shevlin (1999) puts the microeconomic approach to tax planning in perspective by providing an overall review of tax research in accounting, which he divides into three categories: tax policy, tax planning, and tax compliance. For example, a major paradigm in tax compliance research is judgement and decision making, based on the foundation field of psychology.
3. Two exceptions are Macnaughton (1992) and Feltham and Macnaughton (2000).
4. For accounting-method choices, there is usually a book-tax trade-off only if there is conformity between the accounting methods used for the two purposes. In most countries, conformity between the tax and accounting books is the rule rather than the exception (Cummins, Harris, and Hassett 1995).

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# International Transfer Pricing

*Jamie Elliott*

## 11.1 Introduction

Transfer prices represent the prices at which goods, services, or intangibles are transferred/provided by one enterprise to an associated enterprise. International Transfer Pricing (ITP) concerns cross-border intragroup transfers. The magnitude of these transfers is apparent when considering the importance of foreign direct investment (FDI) to the world economy. UNCTAD (1997*a*) shows that as at the mid-1990s there were about 44,500 multinational enterprises (MNEs) worldwide with over 275,000 foreign affiliates. UNCTAD (1997*b*) also stated that the value of goods and services of foreign affiliates is now greater than exports and such affiliates appear to be the principal means for delivering goods and services to foreign markets. The value of foreign affiliates' worldwide assets were \$8.4 trillion in 1994.

### 11.1.1 A Taxation Focus

Although (domestic) transfer pricing has been a much studied, problematic area for many years (e.g. Camman 1929), the Organization for Economic

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Cooperation and Development (OECD) Transfer Pricing Guidelines (OECD 1995) explain why the growth in MNEs has put the spotlight on ITP:

The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context.

These issues arise primarily from the practical difficulty, for both MNEs and tax administrations, of determining the income and expenses of a company or a permanent establishment that is part of an MNE group that should be taken into account within a jurisdiction, particularly where the MNE group's operations are highly integrated (OECD 1995: Preface paras 1 and 2).

The OECD and the majority of fiscal authorities use the 'arm's length principle' (ALP)<sup>1</sup> to determine an arm's length price, resulting in a fair and acceptable division of business taxes between different tax jurisdictions.<sup>2</sup> In the last decade, the House Ways and Means Committee (the US Congress's tax-writing body) has voiced concerns that foreign-owned MNEs operating in the United States were benefiting from tax underpayments by understating US taxable profits. The huge sums of money passing between affiliates and the perceptions that ITP is purely a tool for minimizing taxes have shaped the US transfer pricing regulations. This focus on tax take has led the United States to tighten its rules and regulations on international transfer pricing. In turn, the transfer pricing rules adopted by many other tax jurisdictions around the world (including Australia, Canada, Korea, and now the United Kingdom)<sup>3</sup> have been designed to protect the national corporate tax revenues of the tax authorities in those jurisdictions. The impetus for the more onerous regime in the United States is explained by Laster and McCauley (1994: 44):

the scant profit of foreign firms operating in the United States has emerged as one of the biggest puzzles in international finance. That 4.7 million workers using \$1.8 trillion in assets to generate sales of \$1.2 trillion could fail to turn a profit strikes many as unbelievable. Could foreign companies have paid \$316 billion in the past decade for firms earning \$10.7 billion in the year before acquisition only to lose money overall on their holdings in 1992—a year in which US-owned firms earned record profits?

The ALP is explained in Art. 9 of the 1979 (revised and updated in April 2000) OECD Model Taxation Convention on Income and on Capital. The basis of the ALP is that the result of an intercorporate transaction should be similar to the result of a transaction which would have taken place between unrelated parties in similar circumstances. If the transfer prices are not deemed to be at arm's length by a fiscal authority (i.e. that fiscal authority

believes that the taxable profit on related party transactions is too low) then it is possible for the 'aggrieved' fiscal authority to make an adjustment to the corporate profits such that corporate tax is calculated on a higher level of taxable profits. In turn, these adjustments might result in double taxation where a company is subsequently required to pay tax on the same taxable income on two different jurisdictions. Where double tax treaties<sup>4</sup> exist, a mutual agreement procedure is usually available under the terms of the treaty under which the tax authorities of two countries will attempt to resolve by mutual agreement any instances of double taxation.

### 11.1.2 A Wider Focus

A wider focus acknowledges that international transfer pricing is an interdisciplinary issue and impacts on a range of factors including tariffs, efficient allocation of resources, performance evaluation, and cash management (Abdallah 1989; Choi and Mueller 1992). This wider focus accepts the argument that transfer pricing policies are not a function of tax minimization alone but embrace other considerations such as the strategy of the group. Ogley (1993) puts the transfer pricing policy into perspective: 'In reality, the transfer pricing arrangements of the majority of multinationals have evolved, as the businesses have grown either organically or by acquisition in response to a number of competing and often conflicting commercial considerations. The minimisation of direct tax is only one such consideration'.

## 11.2 Theoretical Literature

There are a number of very good articles (Abdel-Khalik and Lusk 1974; Grabski 1985; McAulay and Tomkins 1992) and books (Rugman and Eden 1985; Giovannini, Hubbard, and Slemrod 1993; Emmanuel and Mehafdi 1994; Eden 1998) which review the domestic/international transfer pricing literature and position it within the MNE literature. McAulay and Tomkins (1992) suggested a series of variables impacting on transfer pricing: external characteristics, corporate characteristics, administrative characteristics, individual group characteristics, and transfer characteristics. Leitch and Barrett (1992) divided the factors affecting transfer pricing into broad categories based on MNE and FDI theory and a number of

empirical studies. These factors were behavioural, economic, sociopolitical, government intervention, taxation, international financial markets, and operational.

Some of the relevant theoretical literature is considered below.

### 11.2.1 Theoretical Models

Hirshleifer (1956, 1957) studied transfer pricing using a marginal cost–revenue approach. This has led to much subsequent research which has attempted to refine/improve the economic models (see Rugman and Eden 1985 for examples).<sup>5</sup> Economic research into ITP is wide-ranging: the standard argument considers the potential for MNEs to minimize taxes and the resulting tax competition between fiscal authorities (see Copithorne 1971; Horst 1971). Recent research has considered the design and optimality of a set of transfer pricing rules and regulations from different perspectives (e.g. a single country; two countries, when one country imposes the rules; coordinated rules between two countries). Halperin and Srinidhi (1987, 1991, 1996) have also carried out a number of theoretical studies. Alternatives to the economic models have included mathematical programming and accounting approaches but their theoretically efficient transfer prices tend to ignore market imperfections (e.g. differentials in a country's labour cost, proximity to transport, and markets for intermediate and final products).

### 11.2.2 Organizational Approach

Eccles (1985) acknowledged that managers must deal with all aspects of a problem when determining transfer prices and cannot conveniently ignore key variables discarded by a particular theory. Eccles concluded that 'policies that are highly recommended in economic theory, mathematical programming and accounting theory are almost completely absent in practice' (1985: 41). Consequently, Eccles used inductive reasoning to develop a transfer pricing framework—Managers' Analytical Plane (MAP)—based on the MNE's degree of vertical integration and diversification.

Following the research by Watson and Baulmer (1975) and Swierenga and Waterhouse (1982), Spicer (1988) incorporated the markets and hierarchies framework (see Coase 1937; Williamson 1975, 1979) to develop nine interrelated hypotheses of which three linked the transfer pricing policies to dimensions

of intrafirm transactions between specific subunits. Subsequently, Colbert and Spicer (1995) have extended this research by developing a theory of the transfer pricing process (in terms of transaction costs) and then tested this theory using a multicase research design investigating internal transfers in four high-technology electronics firms using multiple case studies. The rationale for conducting case study research was the need to investigate internal transactions at the subunit level (rather than concentrating on the MNE in totality) and that transaction costs are determined by the dimensions of that transaction. Three dimensions are identified: asset specificity, uncertainty, and the frequency and volume of transactions.

Although the majority of these organizational studies consider domestic transfer pricing, there are few studies that apply these approaches to an ITP environment (Elliott and Emmanuel 2000).

### **11.3 FDI and MNEs**

Foreign direct investment in the world economy represents a very important part of public policy decisionmaking. Many different theories have been suggested to explain FDI and MNE activity (Dunning and Pearce 1995). Dunning's eclectic approach (Dunning 1981, 1988) is one of the dominant paradigms on the conditions which determine the degree to which MNEs engage in or increase overseas production. It argues that to overcome the disadvantages of competing with a local firm in its local market (e.g. little specialist knowledge of the local market conditions, additional costs such as transportation costs), a firm engaged in international production must be able to rely on a set of advantages which are not available to the local firms (referred to as ownership–location–internalization (OLI) advantages).

### **11.4 Empirical Research**

#### **11.4.1 Empirical Research: Database Studies**

There are two main impediments to conducting positivist studies investigating international transfer pricing issues. First, in many countries, it is difficult to access confidential tax data. The United States, however, appears to be an exception to this rule. For instance, Grubert and Mutti (1991) gained access to 1982 tax data on a cross-section of thirty-three countries to

address several international taxation issues, including whether MNEs take advantage of tax-planning opportunities by shifting taxable income to low-tax countries. Collins and Shackelford (1998) examined the effects of taxes on cross-border payments of dividends, interest, royalties, and management fees, between US MNEs' foreign affiliates. The study used 1990 tax return information (based on Form 5471)<sup>6</sup> for the largest 7,500 foreign subsidiaries (by total assets). Using this data, the authors claim that their study 'presents the most direct evidence to date that US multinationals coordinate their non-US activities to mitigate foreign taxes' (1998: 172). They claim that the results support this assertion for cross-border payments of dividends, interest, and royalties, but not management fees.

Second, in many countries the accounting standards have limited segmental disclosure requirements. The information disclosed in the financial accounts often lacks the consistency and content to facilitate a meaningful study. However, again accounting data in the United States contains more geographic segmental information than is typical in other countries which in turn allows large database analysis of income shifting and transfer pricing issues to be conducted (Harris 1993; Klassen, Lang, and Wolfson 1993; Jacob 1996). For instance, Klassen, Lang, and Wolfson (1993) studied geographic income shifting by 191 US multinationals in relation to the worldwide changes in corporate tax rates between 1984 and 1990 and using regression analysis found that 'US multinational firms shifted income to the United States from Canada and from the United States to Europe in 1985 and 1986, consistent with increasing Canadian rates and decreasing rates in Europe'.

#### 11.4.2 Empirical Research: Questionnaire Surveys

Mehafdi and Emmanuel (1997) review over seventy transfer pricing studies (mostly survey-based and mostly domestic transfer pricing) over a forty-year period. They also review seventy-nine PhD dissertations, mainly at US universities, and conclude that this research 'only adds or refines theoretical (mathematical) models' (1997: 9). The paper concludes that 'transfer pricing research is too complex to lend itself to survey research methods' and offers some suggested research methods with which to tackle transfer pricing, such as a grounded theory approach using in-depth exploratory and explanatory case studies with pluralistic data collection methods. Some of the more recent international transfer pricing studies include Al-Eryani et al. (1990), Borkowski (1990, 1992, 1997), Cravens and Shearon

(1996), Ernst & Young (1997), and Tang (1993). Ernst & Young (1997) surveyed 393 parent companies in the Global 1000. This study comments on the range of profiles of transfer pricing within organizations: 'Transfer pricing is viewed as a compliance exercise in some organisations while in others it has made the move to the boardroom, where it is considered as part of corporate strategic planning' (1997: 762).

### **11.5 International Transfer Pricing: The Approach of Selected Tax Authorities**

Deloitte Touche Tohmatsu (2002) summarizes the current transfer pricing position for selected countries as of June 2002 in 'Strategy Matrix for Global Transfer Pricing: Comparison of Methods, Documentation, Penalties, and Other Issues'. Table 11.1 reproduces selected extracts for the OECD, Australia, Japan, United Kingdom, and the US.

### **11.6 Specific Considerations—The Emerging Literature**

One of the driving forces behind the emerging literature on ITP is the fact that it is so multidisciplinary. Mehafdi (1990) noted the multidisciplinary nature of transfer pricing and argued that it is necessary to have a framework that recognizes the 'particularities and peculiarities of companies'. This requires an understanding of the internal and external factors that influence and are influenced by internal transactions.<sup>7</sup>

Numerous objectives, including tax minimization, have been identified and these objectives are often contradictory. The existence of confounding theories, objectives, and evidence is noted by Leitch and Barrett's (1992: 67–68) review of the transfer pricing literature:

MNEs often have many objectives whose achievement depends on situation-specific factors . . . . The majority of these factors are motivated by MNE, FDI and organisational theory. Because they are often so closely interrelated . . . many of these objectives conflict and are difficult to rank in spite of what surveys may indicate. These difficulties are indicative of the complexity surrounding the multinational transfer-pricing element.

Leitch and Barrett (1992) argue that surveys, economic models, and traditional linear and goal-programming approaches all offer some benefits

**Table 11.1.** Transfer pricing issues in selected countries

	<i>OECD</i>	<i>Australia</i>	<i>Japan</i>	<i>UK</i>	<i>US</i>
<b>Tax authority</b>	Not applicable	Australian Tax Office (ATO); Division 13 part of III, Income Tax Assessment Act 1936 (Effective 1982)	National Tax Agency (NTA); Special Taxation Measures Law (STML), Art. 66-4 [Effective for tax years beginning on or after 1 April 1986]; Enforcement orders 39-12, Enforcement ordinance 22-11.	Inland Revenue; Main legislation in Section 770 & Schedule 28AA, Income & Corporation Taxes Act 1988. APAs covered in Sections 85–87 Finance Act 1999.	Internal Revenue Service (IRS); IRC 482 [Latest amendment effective for tax years beginning after 31 December 1986.]
<b>Regulations, rulings, guidelines</b>	Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations <sup>a</sup>	Final Rulings (TR 92/11, TR 94/14, TR 95/23, TR 97/20, TR 98/11, TR 98/16, TR 1999/1, TR 1999/8, TR2000/16) Draft Rulings (TR 2001/D11) <sup>b</sup>	Circular 66-4 (1)–66-4 (7)-2. TP Commissioner's directive (guideline), issued on 1 June 2001. [Circulars and directives are not law. They provide guidance to administrative agencies on the interpretation of laws.]	Inland Revenue Tax Bulletin Issues 31 (European Arbitration Convention), 37 (transfer pricing rules), 38 (penalties), 43 (APAs), 46 (non-resident landlords). Inland Revenue Press Release 13 Nov 2000 (Mutual Agreement Procedure and US/UK treaty).	Reg s1.482 Reg s1.6662-6
<b>Documentation requirement</b>	Pricing decisions should be documented in accordance with prudent business practices. Reasonable for tax authorities to expect taxpayers	Document pricing decision in accordance with prudent business practices. Must include specific documents. ATO ruling TR 98/11 recommends contemporaneous documentation to	No statutory requirements, but strongly recommended for audit defence. No contemporaneous obligation.	Taxpayers should keep records and complete return. In practice, burden shifting to taxpayer to demonstrate reasonable pricing. Contemporaneous documentation is expected. [Effective	Must include certain specific documents as well as supporting documents. Contemporaneous documentation required. [Effective tax years beginning after 31 December 1993.]

	to prepare and maintain such material. No contemporaneous obligation.	reduce risk of audit.		tax-years ending on or after 1 July 1999.]	
<b>Tax return disclosures</b>	Should be limited to information sufficient to allow tax administration to determine which taxpayers need further examination.	Schedule 25A requires disclosure of types of transactions, dollar amounts, countries involved, documentation maintained, and methodologies used.	Schedule 16-4: Detailed Statement Concerning Foreign Affiliated Persons.	No separate disclosure required (i.e. on signing tax return, taxpayer will be implicitly confirming compliance with arm's length standard).	Forms 5471 and 5472 require disclosure of detailed information on controlled transactions with foreign entities.
<b>Acceptable methods</b>	CUP, Resale Price, Cost Plus, Profit Split (e.g. Contribution Analysis or Residual Analysis), TNMM	CUP, Resale Price, Cost Plus, Profit Split (e.g. Contribution Analysis or Residual Analysis), TNMM	CUP, Resale Price, Cost Plus, Profit Split (Residual Profit Split, Comparable Profit Split) other methods. Modified Resale Price and Modified Cost Plus (like CPM) are effectively used in practice of bilateral APA and CA cases.	CUP, Resale Price, Cost Plus, Profit Split (e.g. Residual Analysis), TNMM	CUP, Resale Price, Cost Plus, Comparable Profit Split, Residual Profit Split, CPM
<b>Priority of methods</b>	Reasonable method. Transaction-based preferred over profit-based.	Most appropriate method. Transaction-based preferred over profit-based.	Transaction-based preferred over profit-based.	Most reasonable method or methods. Transaction-based preferred over profit-based.	Best method

<sup>a</sup> OECD: various chapters published in July 1995, March 1996, and October 1997.

<sup>b</sup> Australia: all draft and final rulings have retrospective effect to 1982.

Source: Deloitte Touche Tohmatsu (2002).

to understanding transfer pricing but all suffer limitations. Consequently, they advocate that:

a new search process is needed to help the decision maker formulate criteria for optimising organizational objectives. Managers must have the ability to study and learn more about the environment and the tradeoffs between objectives and constraints before they can intelligently manage their transfer-pricing and related ownership, location, and internationalisation decisions. (1992: 85)

Spicer has argued that 'an organizational theory of the transfer pricing process requires a wider consideration of relationships among a firm's diversification strategy, its intra-firm transactions, its organisation structure and its management accounting and control systems' (1988: 304).

A summary of emerging themes is provided as follows.

#### 11.6.1 What are the Important Variables?

If a contingency framework is to be used, it is important to ensure that the contingent factors are not misspecified and no important contingent factors are excluded—this is problematic because of the multidisciplinary nature of ITP. A number of different techniques have been experimented with to try and identify the important factors. Borkowski (1996) used meta-analysis of previous studies ('marginally successful, at best'). Case-based reasoning (CBR)—an inductive approach—has also been used as a potential medium for learning or to improve understanding about transfer pricing decision making within an organization (Curet and Elliott 1997).

#### 11.6.2 ITP in its MNE Context

The context of ITP needs to be better understood. How does an MNE approach ITP? What is the corporate structure of the MNE? What are the strategies of the MNE? There have been empirical studies (Cravens 1997) and economic studies (Schjelderup and Sorgard 1997) which have considered the importance of strategy. In the latter case, they incorporated the delegation of authority and strategic interaction with local firms into their model. Cravens and Shearon (1996) believe that for transfer pricing research it is essential to understand how the transfer pricing method fits into the decision making process.

### 11.6.3 The Influence of Taxation

One of the common findings in previous survey research is that taxation is an important variable in the consideration of ITP. One standard comment is that ITP is used to minimize a group's tax liability. However, the global trend by fiscal authorities is to 'tighten up' the tax regulations and requirements relating to ITP (see Table 11.1). This means that there is a greater onus placed on MNEs to comply with national requirements and document this compliance adequately. For example, the United Kingdom has introduced a new transfer pricing regime as part of Corporate Tax Self Assessment (see Elliott 1998) whereby when submitting their annual tax return, corporate taxpayers are signing that the related party dealings underlying their tax computations are at arm's length or have been adjusted to ensure that they are at arm's length. A Deloitte & Touche LLP review of various countries' transfer pricing enforcement policies and regulating schemes has found that the number of tax authorities aggressively auditing transfer prices has grown from two to twelve since 1994 (Tax Management 2000).

### 11.6.4 Future ITP Research

The way in which ITP is researched might be reconsidered, as suggested by Emmanuel and Mehafdi (1998), in terms of three criteria:

*Transactions which are considered.* Colbert and Spicer (1995) have investigated domestic transfer pricing transactions at the divisional and sub-unit levels, shifting the focus from a group viewpoint to the consideration of specific transactions. This focus could also be adopted for cross-border transactions.

*Research methods which are used.* Mehafdi and Emmanuel (1997) have argued that: 'To redress the balance in transfer pricing research, we believe that a grounded theory approach using in-depth exploratory and explanatory case studies with pluralistic data collection methods is the way forward. To give an encompassing account of transfer pricing change within single companies the case studies will need to be longitudinal' (1997: 31). Elliott (1999) is one example of a longitudinal grounded theory case study which considers a series of international intragroup transactions for one MNE at the subunit level.

*The MNE's organizational context within which the transfer pricing transactions operate.* Meer-Kooistra (1994) carried out case study research

in four Dutch MNEs leading to a greater in-depth knowledge about how transfer pricing systems function. This research reiterates the need for more attention to context:

Research into the functioning of transfer pricing systems has to take full account of the processes of change and adaptation, or the dynamics of the phenomenon. We need to remember that we are researching a real situation that has developed over the years due to decisions with long-term influence on the activities. Moreover, researching the formal regulations will not suffice. In addition, research into the real procedures is necessary. (1994: 150)

## 11.7 Conclusion

The influence of taxation on international transfer pricing becomes more and more persuasive as an ever increasing number of fiscal authorities introduce transfer pricing rules for the first time; or refine the existing rules to place a greater responsibility on taxpayers to demonstrate arm's length pricing; or implement additional specific legislation for cross-border related party transactions (e.g. Advance Pricing Agreements).<sup>8</sup> In addition, the cross-border transactions themselves are becoming more complex as many industries undergo mergers and realignment (e.g. pharmaceuticals); as there is convergence in technology standards (e.g. telecommunications); and as technology allows more cross-border trade (e.g. global trading in banks).

Perhaps the most important research findings relate to recommendations about potentially suitable and unsuitable research methods and methodologies. Questionnaire surveys and database studies fail to improve our understanding of the richness and variety of corporate practices because there is a definite gap between theory and practice in relation to international transfer pricing.<sup>9</sup> Therefore this researcher emphasizes the importance of longitudinal case study based studies for conducting ITP research and helping to test existing theories or generate meaningful theories.

## NOTES

1. Picciotto (1992) provides a very good historical account of ITP with particular emphasis on the emergence of the arm's length standard.
2. See Table 11.1 for accepted methodologies.
3. See Elliott (1995) for some commentary on US concerns about foreign-owned MNEs, and the tensions between the USA and the OECD regarding the evolution and revision of ITP legislation.

4. Double tax treaties aim to eliminate the double taxation of income or gains arising in one country and paid to residents of another country.
5. See also Halperin and Srinidhi (1987, 1991, 1996).
6. US MNEs are required to file a separate Form 5471 to the IRS for each foreign subsidiary. This form discloses information on cross-border payments of dividends, interest, royalties, and management fees (but the precise recipient/payer of the flows is not identified).
7. Tang (1993) considers the multidisciplinary nature of transfer pricing in relation to its interfaces with selected disciplines: marketing, behavioural science, business policy, international business, economics and finance, law, taxation, and accounting.
8. An advance agreement that determines an appropriate set of criteria for the determination of the transfer pricing for specified controlled transactions over a period of time.
9. Quoting Colbert and Spicer (1995: 453) 'most surveys of practice are of limited value, firstly because they tend to abstract from industry and organisational context and, secondly, because they are wrongly directed at the level of the firm as a whole rather than at the subunit level where internal transactions actually take place'.

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## Tax Compliance Costs

*Jeff Pope*

### 12.1 Introduction

Compliance costs simply expressed are those costs that taxpayers incur as a result of meeting their taxation obligations over and above the payment of the tax itself. The burden of the compliance costs of taxation is now widely recognized throughout many countries in the world, particularly where research studies have taken place. This understanding and acceptance of this burden has not occurred overnight, or been easily achieved. Tax authorities in several countries in the world, including the United Kingdom and New Zealand, now include compliance cost assessments (variously designated) when assessing new taxation policies or amendments. The significance of developments in this topic may be considered from two perspectives. First, the contribution of particular research studies to methodology and knowledge in the field and secondly the development of the topic in specific countries, with ensuing studies in other countries. Rather than treat these two perspectives separately, an integrated approach is adopted. The development of the topic of tax compliance costs has five main themes or phases (Pope 1993: 71–73): identification and theoretical recognition; measurement; government recognition in taxation mission statements (lip-service); effective government policy to reduce or minimize compliance costs; and continual monitoring and the use of tax impact statements.

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## 12.2 Early Recognition by Adam Smith and Subsequent Neglect

Adam Smith (1776) first recognized the importance of the compliance costs of taxation in his four famous maxims or canons of taxation, summarized as the principles of equity, certainty, convenience, and economy. It is not often appreciated that two of the four maxims are concerned wholly with compliance costs, whilst a third includes compliance costs and contains a vivid statement of the psychological costs of tax compliance.<sup>1</sup> In the decades that followed Smith's inspiring work, economists placed great emphasis on the equity and efficiency aspects of taxation, particularly the deadweight loss<sup>2</sup> aspects, to the almost total exclusion and neglect of the compliance costs. Even today, most public economics and finance texts reflect this attitude, although more recent texts are starting to recognize the importance of compliance costs.

## 12.3 Early Attempts at Measurement

The 'pioneering expedition into this unexplored territory' was undertaken in the United States by Professor R. M. Haig (1935), with subsequent work by Martin (1944), who recognized the fundamental characteristic that 'there is evidence of considerable (compliance) cost which does not vary significantly in size of the tax bill'. Martin also stressed the difficulty of what in economics is termed a joint cost, namely identifying compliance costs accurately and separating them from ordinary business expenses and planning costs.

Other notable studies in the United States included those by Yocum (1961), Muller (1963), and Wicks and Killworth (1967). The first Canadian study appeared by Bryden (1961), sponsored by the Canadian Tax Foundation.

These early North American studies are characterized by an emphasis on business compliance costs. They established a number of key characteristics, particularly that compliance costs are not directly proportional to tax liability or taxable income and that they are regressive in nature—economies of scale are likely to occur. For countries with a federal system of government, they also established that multistate business operation is associated with high costs, particularly where states use different definitions of the tax base. The important trade-off of administrative and compliance costs had also been emphasized.

About the time interest in compliance cost research seemed to be waning in North America, it was beginning in Europe. The first European study was

in West Germany by Strümpel (1966), who quantified the compliance costs of small businesses and recognized their psychological burden, albeit theoretically.

## **12.4 The Pioneering Work at the University of Bath, UK**

The early 1970s saw the beginnings of a series of compliance cost studies initiated by Cedric Sandford at the Centre for Fiscal Studies, University of Bath, UK. This culminated in the seminal publication by Sandford, Godwin, and Hardwick (1989)—an essential initial reference for anyone new to the field. It includes a history of the topic, including a summary of previous studies up to 1989, definitions and concepts, and methodology of measurement, essentially a questionnaire survey technique. A copy of the questionnaires used in particular studies is included in an Appendix. The major part of the book analyses and discusses the major studies undertaken by Sandford, Godwin, and Hardwick on a tax-by-tax basis. The final part estimates the administrative and compliance costs in the United Kingdom for the year 1986–7, analysing their size, distribution, and effective incidence. Three measures of the importance of compliance costs were used, namely absolute money terms, as a percentage of tax revenue, and as a percentage of GDP. This precedent has been followed by nearly every other study where the overall magnitude of compliance costs is estimated. The book concludes by discussing the policy implications of the research.

It should be stressed that Sandford had the support and cooperation of the UK's Inland Revenue and HM Customs and Excise in his research. The UK government has led the world in requiring the revenue departments, as part of a more general deregulatory policy, to produce compliance cost assessments (or tax impact statements) for all tax changes affecting business. Since 1986 when the policy was first established, the assessment methodology has been refined and improved (see Evans and Walpole 1999 for discussion in an international context).

## **12.5 More Recent North American Studies**

In the mid-1980s Slemrod made significant advances to the estimation of compliance costs in the United States, particularly for personal taxpayers (Slemrod and Sorum 1984).<sup>3</sup> Slemrod later revisited this area in order to

ascertain the impact of the Tax Reform Act of 1986. The key finding (Blumenthal and Slemrod 1995*a*) was that the Act did not lower the costs of compliance, as was the declared intention of policy makers. This second study did not attempt to gross up the results nationally as the earlier study had done; estimates were made at the disaggregate level. A significant development by Slemrod in this field was the much greater use of regression analysis to identify significant variables in contributing to the level of, and changes in, compliance costs.<sup>4</sup>

A major US study in the early 1990s adopted a rather different emphasis to that of other countries. While countries such as the United Kingdom and Australia seem particularly concerned with the effect of compliance costs on small business, US policy makers were more interested in the compliance costs of the large corporations (Slemrod and Blumenthal 1996). Other important studies comprised the cost of itemizing deductions in the US income tax (Pitt and Slemrod 1988) and the compliance costs of foreign-source income (Blumenthal and Slemrod 1995*b*).

The other notable research in the United States during the 1980s and 1990s was a study for the US Treasury (Arthur D. Little Corporation 1988). The major goal was to develop a methodology for estimating the 'paperwork burden' on taxpayers of the federal income tax. Interestingly, this burden was measured solely in terms of time (hours in 1993). This addresses the difficult problem of converting non-work time into money terms, which is the approach generally followed in other studies, but not very happily. There is no unanimity among researchers on the most appropriate method for doing so. Four major methods have been used: each individual's reported value, possibly subject to some maximum rate; the sum that taxpayers would pay to be rid of all compliance costs (a hypothetical concept which most respondents find very difficult to handle); the before tax wage rate; and the after tax wage rate.<sup>5</sup>

In Canada, Vaillancourt (1995) estimated the compliance costs of individuals for both personal income tax and payroll taxes for the year 1986. A distinctive feature was the inclusion of relevant questions in face-to-face interviews conducted by a national commercial polling organization in an omnibus survey. Erard (1997) has undertaken a study of big business in Canada similar to the Slemrod and Blumenthal study for the United States.

Several studies, commissioned by either Revenue Canada or the Department of Finance, Canadian Federal Government, have been undertaken regarding the compliance costs of the politically controversial Goods and Services Tax (GST or Value Added Tax), notably, Plamondon (1991), who used an interesting and ingenious interview procedure to obtain the data, and Plamondon and Associates Inc. (1995).

An issue of concern for federal systems of government is whether a single tax collection agency would be preferable to a combination of federal and provincial/territorial/state tax administrations. A Canadian study (Public Policy Forum, 1997) estimates the magnitude of compliance and administrative costs of Canada's tax systems, and the impact of a single tax administration. The key finding is that such a single agency would be beneficial and produce significant cost savings.

## 12.6 More Recent European Studies

While the topic of compliance costs has developed most rapidly in English-speaking countries, particularly in the last two decades, studies in other countries, particularly Europe, should not be ignored. Important compliance cost studies have taken place in the Netherlands, Spain, and Sweden (with English versions of the research available).

One of the most important methodological developments has been made by Allers (1994) of the Netherlands. Critics of compliance cost postal questionnaire surveys, such as Tait (1988), invariably raise the question of non-response bias. Basically, they argue that respondents have higher compliance costs than non-respondents because those with higher compliance costs are more motivated to reply. Thus studies tend to overestimate the true value of compliance costs. Allers' innovation was simple yet effective. On the basis that many non-respondents can be persuaded to answer just one question, Allers included a postcard for non-respondents to return. The one question it contained asked for an estimate of the respondent's compliance costs relative to other similar firms on a five-point low to high scale. Exactly the same question was asked on the full survey questionnaire. Allers was then able to compare the perception of relative costs for respondents and non-respondents and also assess the accuracy of respondents' perceptions against recorded costs. The key finding was that the results of the business survey were biased downward by non-response rather than upwards as theoretically argued by the critics.

This approach, relying on the validity of non-respondents' answers to one question, may be seen as simplistic and ambitious by critics. However, the Allers method has subsequently been used successfully in an Australian study by Evans et al. (1996: 37; 1997) who concluded that non-response bias was not a major issue in their surveys.

Another very important aspect of the Allers research was his investigation of transfers between the public and private sectors in the Netherlands.

His study thus included social insurance contributions, social security benefits, and subsidies as well as taxation. Thus in many ways the Allers study of transfers in the Netherlands is the single most comprehensive study to date anywhere in the world.

The Spanish study (Diaz and Delgado 1995) investigated the compliance costs of personal income tax in 1990, while the Swedish study (Malmer 1995) assessed the effects of tax reform during 1990–1 on the level of compliance costs.

## **12.7 Studies in Australia, New Zealand, and the Asia-Pacific Region**

A series of five major studies was undertaken in Australia by Pope and Fayle in the late 1980s and early 1990s, culminating in estimates for the whole federal tax system for the year 1990–1 (Pope 1995). This pioneering research, supported by the Australian Tax Research Foundation, was made against a backdrop of political sensitivity to the topic and independently of the Australian Taxation Office (ATO).<sup>6</sup> Compliance cost estimates of the Australian state payroll tax system were also made (Pope, Fayle, and Chen 1993).

Taxpayer costs of compliance for the tax year 1994–5 by Evans et al. (1996, 1997) in an ATO sponsored study have also been published. The authors state that ‘the findings are the result of the largest single survey into compliance costs conducted anywhere in the world’, namely 10,000 personal and business taxpayers in 1995 and 1996. The 1997 report gives a very useful international comparison of results from the major studies in Australia, New Zealand, the United Kingdom, and the United States.

In New Zealand, a comprehensive study of the compliance costs of business taxes for the 1990–1 tax year was undertaken with the assistance of the New Zealand Inland Revenue Department (Sandford and Hasseldine 1992). This included findings on the then recently introduced GST.

Four pioneering studies in the Asia-Pacific region over the period 1995–8 comprise the compliance costs of corporate income taxation in Singapore, Malaysia, and Hong Kong (Ariff and Pope 2002). A limitation of these studies is that grossing-up of results to produce aggregate compliance cost estimates was not possible, mainly because of insufficient detail in published tax authority statistics. All these studies utilized the mail questionnaire approach, with the style of questionnaires and ensuing analysis being adapted to the tax regime, culture, and available tax statistics of the appropriate country. In that sense, studies in Asian countries are particularly commendable, in so far as

either less tax data is published for public dissemination or it is simply not collected. A new study of small and medium size businesses is being undertaken in Malaysia (Ariff and Pope 2002). Ariff and Pope also discuss the relative importance of tax compliance costs vis-à-vis other tax policy issues in developing Asian countries.<sup>7</sup>

## 12.8 Major Methodological Issues

The academic, community, and government interest in research and estimates of tax compliance costs in many of the world's leading and most prosperous countries in the 1980s and 1990s was largely uncoordinated, with each country's research developing independently. The topic was sufficiently small and specialized for researchers to monitor each study (e.g. Sandford, Godwin, and Hardwick 1989). A significant advance to knowledge and the literature in the field was instigated by Sandford, who organized a closed conference on compliance cost measurement and policy issues in 1994. Leading academic researchers, together with senior tax administration and government officials, from throughout the world reviewed the methodologies of the major studies and assessed their value to policymakers. Moreover, the proceedings (Sandford 1995) provide a valuable reference source in English and summary of compliance cost research in eight countries.<sup>8</sup>

The two major survey methodologies used by compliance cost researchers to date are evaluated, namely large-scale surveys of taxpayers (particularly the postal questionnaire survey technique, sampling methods, and grossing-up procedures) and depth surveys of taxpayers and tax professionals (with studies from Australia, Canada, New Zealand, and the United Kingdom cited). Sandford (1995: 375–401) critically evaluates the methodologies and suggests ways of improving them, as well as analysing many of the key questions raised by critics, such as non-response bias, sampling difficulties, and the reliability of response estimates. Perhaps the greatest value of this ex-post review was the interaction of policymakers with researchers, the outcome being a much clearer picture of the next steps in the development of the topic (Sandford 1995: 402–413).

A second closed conference, organized by Sandford, Evans, Hasseldine, and Pope, was held in April 2000, with similar benefits arising from the interaction of policymakers and researchers. There was a marked emphasis on a much greater role for estimation methodologies other than, or alongside, large-scale questionnaire surveys, essentially in order to improve the quality of taxpayer data. Theoretical developments, estimation studies, and

modelling particularly noteworthy (and not discussed elsewhere in this chapter) include Hasseldine (2001), Cordova-Novion and De Young (2001), and Poutziouris, Chittenden, and Michaelas (2001), respectively. The key findings and emerging research trends from this timely conference are discussed in Evans, Pope, and Hasseldine (2001). Both the 1994 and 2000 conference proceedings are essential reading for students and scholars new to the area.

## 12.9 Key Findings Worldwide

The compliance cost studies undertaken to date in various countries throughout the world nearly all demonstrate three key findings:

1. Compliance costs are high, whether measured in absolute money terms, as a percentage of tax paid, as a percentage of GDP,<sup>9</sup> or by comparison to administrative costs (the costs to the revenue authorities).
2. Compliance costs are very regressive, especially for GST.<sup>10</sup> The level of compliance costs is a major concern to small business,<sup>11</sup> unless exemptions or special arrangements for compliance exist which mitigate the comparative disadvantage of small business.
3. Research into compliance costs and ensuing publicity 'puts compliance costs on the political agenda'. They have played a significant role in the development by governments of the evaluation of the compliance costs of tax regulations; also they have influenced the introduction of Taxpayers' Charters which, among other things, stress the duty of the tax authorities to minimize compliance costs subject to other objectives.

Although international comparisons are fraught with difficulty, a very useful analysis of the reasons for international compliance cost differences is presented in Sandford (2000: 134–137).

## 12.10 Likely Further Developments

The next major phases in the development of compliance costs research are likely to be:

1. For countries where major studies have already been undertaken, identification of specific 'hot spots' where compliance costs are particularly

high. In-depth studies, probably using interview or focus group methods, would identify small, marginal tax policy changes which might lead to a significant reduction of the difficulties and ensuing cost levels. Government would be made aware of 'where the shoe pinches'. There may also be more sophisticated international comparisons, although this area remains fraught with difficulties.

2. The countries which have undertaken compliance cost studies to date are heavily dominated by those with high GDP per capita, as well as a predominance of English-speaking/Anglo-Saxon countries. The next phase should see further compliance cost studies in the richer countries of the Asia-Pacific region, for example, Malaysia and Singapore, and also in developing countries, for example, India (Chattopadhyay and Das-Gupta 2002a,b,c).
3. Psychological costs. This important area has been theoretically recognized in nearly all studies since Adam Smith first gave expression to them in 1776, but then generally consigned to the 'too hard basket'. The Spanish study (Diaz and Delgado 1995) attempted to get a feel for the psychological costs of filing tax returns but did not attempt to put a figure on them. This difficult area is being tackled by a study in Australia (Woellner et al. 2001), using focus groups.
4. The extension of compliance cost studies into related fields, which has already begun on a small scale, such as tax (incentive) expenditures (Gunz, Macnaughton, and Wensley 1995) and subsidies (Allers 1994).
5. For countries with a federal system of government, such as Canada and Australia, the issue of tax harmonization and a single collection agency and the effects on compliance costs remain a long-term issue. The work of Plamondon (Public Policy Forum 1997) may be further developed. Research on the impact of European Union (EU) tax regulations on compliance costs is also likely to be of increasing importance (National Audit Office 1994: 25, especially table 4; Verwaal and Cnossen 2001). The EU itself is currently undertaking a study on the administrative and compliance costs of corporate tax harmonization.<sup>12</sup>
6. The effect of technology and on-line returns and transfers in reducing tax compliance costs (CFSUB 1998), especially in newly introduced tax systems, such as Australia's Goods and Services Tax from 1 July 2000 (Pope 2001).
7. The estimation of start-up compliance costs, an area where there is yet to be a reliable study anywhere in the world. Australian tax reform affords such a rare opportunity (Pope 2001; Rametse and Pope 2002).

## 12.11 Concluding remarks

Research into the compliance costs of taxation, a topic practically unheard of two decades ago, seems to be going from strength to strength in many of the leading and richer countries throughout the world. Governments in these countries are not only becoming increasingly aware of the political importance of compliance costs but specifically incorporating compliance costs into their tax policy decisionmaking processes. Other countries are slowly following. A recent and significant development is recognition of the topic's importance by both the OECD and the EU.<sup>13</sup> From an academic perspective, the importance of compliance costs vis-à-vis deadweight losses is beginning to be recognized within the economics profession as a whole.

## NOTES

1. The psychological costs of tax compliance are also known as anxiety costs. Smith (1776) identifies the possible 'unnecessary trouble, vexation and oppression' to people arising from 'the frequent visits and odious examination of the tax gatherers' (from canon IV, as cited by Sandford et al. 1989: 25).
2. Welfare losses arising from changes in businesses' and individuals' decision-making and behaviour because of taxation. Also known as the excess burden.
3. The key points of this study are summarized in Blumenthal and Slemrod (1995a).
4. Sandford used regression analysis to identify which factors affected compliance costs significantly in his personal income tax study (1983–4 tax year). Refer to Appendix B, Sandford, Godwin, and Hardwick (1989: 234–238).
5. This issue is fully discussed in Pope (1995: 114–118) and Evans et al. (1997: 9–12).
6. The ATO did provide useful data and advice, but refused to cooperate with the sampling frame.
7. Similar discussion is being held in emerging countries elsewhere in the world, for example, in Croatia (Ott and Bajo 2001).
8. The United Kingdom, Australia, New Zealand, the United States, Netherlands, Canada, Spain, and Sweden. This chapter has usually cited this as a reference source in preference to either a series of original references (e.g. five Pope et al. studies in Australia) or non-English original references (e.g. Spain and Sweden). Researchers interested in these more specific and detailed sources should refer to the references given at the end of the relevant chapter as cited in Sandford (1995). The same principle applies to studies in Ariff and Pope (2002).
9. For example, the compliance costs of the tax system are estimated to be around 1% of GDP in the UK and 2% of GDP in Australia (Evans et al. 1997: 83).
10. For example, in New Zealand, 1990–1, mean GST compliance costs for the smallest businesses were 2.7% of turnover, compared with 0.005% for the largest businesses (Hasseldine 1995: table 6.6), a factor of 540 times greater.

11. Average estimates of total compliance costs for firms with 1–499 employees range from between 1.3% and 7% of Business GDP in eleven OECD countries (Cordova-Novion and De Young 2001: table 4); See also Poutziouris et al. (2001).
12. Philippe Cattoir, Tax Policy, European Commission, Brussels (private communication, October 2000).
13. OECD (2000), Cordova-Novion and De Young (2001); private communication for EU research, respectively.

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# European Law of Taxation

*Tom O'Shea*

## 13.1 Introduction

The European law of taxation (EC tax law) is a body of law, distinct both from international tax law and from the taxation laws of the Member States of the European Community (EC). Its importance is growing,<sup>1</sup> and its impact on domestic tax systems is clearly visible. Research in this area often requires an interdisciplinary approach because of the interlocking nature of EC institutions and the political and economic issues which gave rise to them and which result from them; the fiscal impact of all EC policies; the nature of EC laws and legislative instruments; the jurisprudence of the European Court of Justice (ECJ); the limits placed on how Member States may operate their domestic tax systems; and the interaction between domestic tax law, EC tax law, and international tax law.

The tax researcher may endeavour to find answers to research questions by looking at history and spotting developments and trends, or by adopting a comparative approach. The tax policy traditions of the various Member States will differ and it may be interesting to investigate how this impacts on EC tax law developments. Equally, many research topics in EC taxation will involve empirical solutions anchored in economics or tax policy. Enlargement of the Community will impact on all EU policies and cause

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particular problems for decision making in the taxation arena.<sup>2</sup> Budgetary implications and political decisions pervade every aspect of the host of EC policies.<sup>3</sup> Often, the tax researcher is drawn into an interdisciplinary approach if answers to research questions are to be found.

There are several EC textbooks that may prove useful. For a good general grounding on European Union (EU) law and issues try Weatherill and Beaumont (1999), *EU Law*. This is a comprehensive work and gives an insight into the workings of the EU together with detailed sections on taxation. The best UK introductory work on EC tax law is written by Williams (1998), *EC Tax Law*. Another excellent textbook on EC tax law is Terra and Wattel (2001), *European Tax Law*. This covers most of the key tax issues and is a standard textbook in the field. An earlier work that might be useful is Easson (1993), *Taxation in the European Community*.

The question is ‘where does one begin?’ It can be a daunting task for anyone who does not have a European law background. To what extent is tax regulation a competence of the European Community or of the Member States? The aim of this chapter will be to provide an answer. Interesting areas of EC tax law will be highlighted and future research topics will be considered against, first, an outline analysis of the EU institutional structure and, then, an overview of the defining legal agreements of the EU—the Treaty of Rome (ECT) and the Treaty on European Union (TEU).

### 13.2 The EU Institutional Framework

An interesting place to start is to consider the institutional framework of the EU and to see how taxation fits into that structure. The key players are the Council of Ministers, the European Council, the Commission, the European Parliament, and the ECJ. In the legislative process, each of these institutions plays a role, but the European Council’s involvement is limited to launching key political initiatives and to finding political solutions at the highest possible level (Art. 4 TEU). It has no ‘legislative’ functions within the European Community.

The *Council of Ministers*<sup>4</sup> is the most important legislative body in the EU institutional framework. It comprises Government Ministers from each Member State. A Commission representative usually attends each Council Meeting. The Commission is actively involved in the Council because it is generally the initiator of legislative proposals. The Council can pass legislation in three ways: unanimously, by ‘Qualified Majority Vote’ (QMV)<sup>5</sup> (Art. 205 ECT), and by a ‘simple majority’ vote. Usually, the Council can amend

legislative proposals, made by the Commission, only by a unanimous vote (Art. 251 ECT). This creates a balance in the legislative creation process, as the Commission can amend its own proposals at any time, which can be helpful in reaching a consensus or a compromise deal. At present, if direct taxation is to be harmonized, it is the Council, which must act with unanimity.

The *European Council* comprises the Heads of State or Government of the Member States, together with the President of the Commission.<sup>6</sup> It must be distinguished from the Council composed of the Heads of State or Government, which has been given certain decision making powers by the Treaty.

The *European Commission* is a unique international institution. It performs a number of roles within the EU institutional framework. These include those of law enforcer, legislator and initiator of legislation, mediator, and Community civil service. It also has certain executive roles to play, particularly in the sphere of competition law. The Commission obtains much of its legislative power by delegation from the Council, with day-to-day decisions being delegated to the Commissioner responsible for that particular policy area.

While the Commission usually initiates European legislation, it is the Council (on a proposal from the Commission and after consulting the European Parliament) which usually adopts it. The Parliament plays only a consultative role in tax matters (Arts. 94 and 300 ECT). A Commissioner represents the Commission in the Council. The Commission wields considerable influence at European level because of its powers to initiate legislation and to amend proposed legislation in such a way as to obtain agreement in the Council. If, for instance, the Council is intent on introducing a piece of legislation, the Commission may be able to make suitable amendments which will secure sufficient votes in Council for the legislation to be passed. The Commission is therefore a key player in the introduction, drafting, negotiation, and design of the final legislative product. It has considerable legislative powers to pass delegated legislation. Also, it has power to conduct infringement proceedings against Member States for failing to fulfil EC law obligations. In the areas of competition policy, and in the administration of EU structural funds, the Commission has considerable executive powers, which extend to spending-control over certain parts of the EC budget.

The *European Court of Justice* (ECJ) plays a significant role in the EC taxation area. Its decisions are binding; it interprets European law and determines the legality of European 'secondary legislation'. It has created a number of 'judge-made' general principles of law.<sup>7</sup> It can depart from its

earlier decisions. This power to reinterpret the law gives tremendous flexibility to national courts/tribunals involved in EC tax law matters. They have the option to accept an existing decision of the ECJ or they can refer the matter back to the ECJ in the hope that it will change its previous ruling. An interesting research topic would be a study of how far the ECJ can actually go, before one might say, that it is 'lawmaking', in the 'legislative' rather than in the 'judicial' sense. This is the concept of 'judicial activism'.

The jurisdiction of the ECJ is limited by the powers given to it in the ECT, but it has been expanded by the jurisprudence of the ECJ. The *Fundamental Freedoms* in the ECT (defined and discussed below) give it the power to determine whether or not Member States have infringed the Treaty. To ensure uniformity of EC law, the ECJ renders interpretative rulings under a 'Preliminary Ruling' procedure (Art. 234 ECT). This procedure is important because it allows even the lowest Court or Tribunal in a Member State to request the opinion of the ECJ on the interpretation of European law. This procedure makes every national Court a part of the European judicial framework. Judicial review of EC legislative acts is available and might be used, for example, if procedural requirements or general principles of law are infringed, or if a matter is beyond the scope of the ECT. The ECJ also has competence to hear actions against Member States brought by the Commission or another Member State where it is alleged that they have failed to fulfil their obligations under the Treaties.

The ECJ has significant powers that it has used to promote taxation changes at European and domestic level. The power to adopt a new piece of legislation (positive integration) rests with the Member States or with the Council if it has been given the necessary competence. However, the ECJ can often achieve similar results by interpreting Community law in such a way that national tax rules have to be altered or changed in order for the Member States to comply with their Community obligations under the ECT (negative obligation).<sup>8</sup> For example, international tax law distinguishes between resident taxpayers who are taxed on their worldwide income, and non-resident taxpayers who are taxed on income arising in a source state. Sometimes, under EC law, this distinction amounts to a hidden or covert discrimination based on nationality or place of incorporation. The jurisprudence of the ECJ is, therefore, significant, and it continues to have an increasing impact on the tax systems of the Member States.<sup>9</sup>

An 'Advocate General' is used by the Court as a preliminary means of investigating all the issues involved in the case, either raised by the parties or considered relevant by the Advocate General. The Opinion of the Advocate General is very persuasive, but is not binding on the ECJ. It can accept or reject it. It can also dip into the Opinion and take out what it considers relevant and discard the remainder.

The ECJ decided in *Costa* (1964) that EC law was supreme over the domestic laws of the Member States. Therefore, Member States will be in breach of their Community law obligations if they pass laws, or agree international treaties, which are contrary to EC law. It may be worthwhile to study the impact of ECJ judgements on the tax systems of the Member States. How has the jurisprudence altered their design and modus operandi? Are the Member States complying with the Court's rulings, or are they simply redesigning their tax systems and finding alternative means to enforce similar tax rules? A key area of future tax research will be the evolving jurisprudence of the ECJ in tax matters. This will be dealt with briefly below, after the building blocks of the EU—the ECT (as amended) and the TEU (as amended)—have been examined.

### 13.3 Treaty of Rome (ECT)—Overview

'The Consolidated Version of the Treaty Establishing the European Community' is a piece of 'primary legislation'.<sup>10</sup> A brief overview of its key Articles, relevant to the tax sphere may be useful.

The early Articles set out the tasks, activities, and common policies of the Community. They continue by describing the limits on the powers of the Community and introduce the concept of 'subsidiarity'. The institutional framework of the Community is outlined, a loyalty provision requiring Member States to fulfil their obligations under the Treaty is included, and any discrimination on grounds of nationality is prohibited (Arts. 2–12 ECT).

The *fundamental Treaty freedoms* include free movement of goods; free movement of workers; freedom of establishment; freedom to provide services; and free movement of capital and payments (Arts. 23–31, 39, 43, 49, and 56 ECT). The 'negative integration' rules, comprising the four fundamental freedoms, the prohibition against any discrimination on grounds of nationality (Art. 12 ECT), and the competition rules<sup>11</sup> specify what Member States and Community nationals are not allowed to do.<sup>12</sup> They are enforced by the ECJ and are interpreted in a very wide manner and together help create the European Internal Market (EIM).

Title VI is entitled, '*Common Rules on Competition, Taxation and Approximation of Laws*' (Arts. 81–97 ECT). State aids are outlawed in certain circumstances. Tax can become entangled in the 'state aids' arena when the Member State grants tax subsidies to certain businesses. A tax subsidy may be an 'indirect' state aid. Article 90 prevents Member States from imposing internal indirect taxes on the products of other Member States in excess of that imposed on that State's similar domestic products.

The Council is given *power to harmonize indirect taxes* (Art. 93 ECT) to the extent that such harmonization is necessary 'to ensure the establishment and the proper functioning of the internal market'. It has a further power, under Art. 94 ECT to issue directives for the 'approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market'. Note that each time it has to act unanimously: thus, each Member State has a 'fiscal veto'.

Article 293 ECT is important because Member States are required to enter into negotiations with each other 'with a view to securing for the benefit of their nationals'—the '*abolition of double taxation* within the Community' among other things.<sup>13</sup>

Finally, there is a *residuary power* (Art. 308 ECT) that confers competence upon the Council (acting unanimously) if action by the Community is necessary to attain a Community objective and such power is not otherwise provided for in the Treaty.

### 13.4 EC Instruments of Law

Part Five of the ECT describes the powers and functions of the EC institutions and their respective roles in the EC institutional framework (Arts. 189–267 ECT). Article 249 ECT outlines the main instruments of law used by the Community (a Regulation, Directive, Decision,<sup>14</sup> Recommendation, or Opinion<sup>15</sup>).

#### 13.4.1 Regulations and Directives

These are the two main instruments of EC 'secondary' legislation. They differ significantly. A Regulation is binding on all Member States without further action on their part. An example is the Common Customs Code,<sup>16</sup> which is uniform throughout the EU.<sup>17</sup> A Directive is only binding on Member States as to the result to be achieved. How that result is achieved is left up to individual Member States. A Directive accords a certain degree of flexibility to the Member States, which a Regulation does not. Directives are implemented into domestic law by national laws. For example, the Community's Value Added Tax (VAT) regime applies in each Member State, and the Sixth VAT Directive<sup>18</sup> is transposed into English law by the Value Added Tax Act 1994

(VATA 1994).<sup>19</sup> Each Member State has its own VAT legislation, similar to, but different from, the VATA 1994. Note that certain provisions of a Directive can have ‘direct effect’<sup>20</sup> in a Member State without further national laws being introduced, although this does not remove the obligation to introduce such laws.

### 13.4.2 Implementation of Directives

The implementation of Directives in the domestic laws of Member States often leads to either incorrect or incomplete implementation. This causes problems for States and businesses, particularly when cross-border activity occurs. The tax researcher can profit from such turmoil. An interesting research study might involve a reflection on the ‘pros and cons’ of implementing European tax legislation via Directives. It might consider why Directives rather than Regulations are preferred, and how the transposition of Directives can differ across the various Member States, leading to distortions and compliance problems for businesses operating across the EU.

In *direct taxation*, there has been little legislative activity. This has been mainly due to the ‘fiscal veto’, and its requirement of unanimity in the Council. Some direct tax legislation has been passed. Two important Directives include the Merger Directive (Council Directive 90/434/EEC) and the Parent–Subsidiary Directive (Council Directive 90/435/EEC). Exploring how Member States have implemented (or non-implemented) these two Directives should be of interest to researchers given the increase in European merger activity in recent years. More recently, the Member States have agreed on a Code of Conduct on Harmful Tax Competition<sup>21</sup> and a Taxation of Savings Directive is in the pipeline.<sup>22</sup>

The *Merger Directive* postpones or defers the tax charge when certain company reconstructions take place in an intra-EC setting. The exact scope of the Directive remains unclear and its implementation into national law has also proved problematical because of its complexity.

While the Merger Directive looks at the tax cost involved in setting up a cross-border relationship, the *Parent–Subsidiary Directive*<sup>23</sup> addresses the ongoing tax costs involved when income is received from the subsidiary. Dividends paid to a qualifying parent are not subjected to withholding taxes and double-tax relief is received in the Member State where the Parent company is resident. Tax researchers might find the anti-abuse provisions in Art. 1 of interest, together with an examination of how the Directive has been implemented in Member States.<sup>24</sup>

At present, the only 'European entity' that exists is a form of European partnership with a legal personality called a European Economic Interest Grouping (EEIG) (Regulation 2137/85). The recently adopted *European Company Statute* does not come into effect until 2004. How do/will these entities impact on the European and domestic tax sphere? The extent to which these vehicles are, or will be, used for cross-border economic activity and cooperation, their limitations and strengths, and perhaps, how their use could be expanded should also be of interest to a tax researcher.

Two other pieces of secondary tax legislation should be noted—*The Arbitration Convention*, and the *Mutual Assistance Directive* (MAD).

The MAD<sup>25</sup> allows, and encourages, the exchange of tax information between the competent authorities of the Member States. It has limitations. An interesting study would be an investigation of the interaction between the MAD, domestic law, and bilateral tax treaties as it seems clear that the MAD cannot always require a company resident in one Member State to participate in an enquiry initiated by another Member State.<sup>26</sup>

The Arbitration Convention (Convention 90/463/EEC) is an attempt to resolve some of the problems encountered by multinational groups in the transfer pricing sphere. The Convention uses the 'arm's length' principle. Perhaps, the key research question in this area is whether this principle is the right choice, or whether some type of formulary apportionment<sup>27</sup> should be used. Equally, it would be interesting to know how the Convention works in practice, the extent of its use among multinationals, and the impact of 'e-commerce' in this area.

### 13.4.3 The ECJ and its Tax Jurisprudence

The case law of the ECJ in taxation matters includes cases involving VAT. These might involve an interpretation of the Sixth VAT Directive; a consideration of how the VAT Directives have been implemented into national law; arguments over the 'right of deduction'; and numerous other questions. It is a very fruitful area for a tax researcher. Member States have implemented the VAT directives very differently and this has led to confusion, controversy, and litigation.

An interesting area of research into the Court's jurisprudence might be an examination of how the ECJ has expanded the application of the 'fundamental freedoms' into the tax arena. This represents a type of encroachment by the Community into the competence of the Member States<sup>28</sup> because it is the ECJ that determines when EC law applies in the direct tax sphere.<sup>29</sup> Over

the years, the demarcation line has moved considerably. The interesting research question is—where will the Court draw the line in the future?

In relation to the residency of companies,<sup>30</sup> the Member States use different criteria to establish the nexus for taxation purposes—act of incorporation, seat, head office location, location of ‘central management and control’, etc. Meanwhile, the ECT has included a variety of criteria in its freedom of establishment rules.<sup>31</sup> The interaction between these two sets of rules—the nexus for taxation of companies and the freedom of establishment rules, using a branch or a subsidiary format—has led to litigation dating back to 1986 and the ‘*Avoir Fiscal*’ or French Tax Credits case (1986). Problems continue to occur because the Treaty, and Double Tax Treaties,<sup>32</sup> provide for non-discrimination of branches or ‘permanent establishments’,<sup>33</sup> even though they are not separate companies, and are merely part of another ‘entity’.

Certain frontier workers have prospered from the Court’s jurisprudence<sup>34</sup> while others have not been so fortunate.<sup>35</sup> Similarly, in the area of cross-border services,<sup>36</sup> the jurisprudence of the ECJ continues to evolve and creates repercussions for national tax systems.<sup>37</sup> The question for the tax researcher is how far can the ECJ actually go? Will a single, uniform tax system have to be agreed by the Member States?<sup>38</sup> How does the EIM differ from other single markets such as the United States, Australia, Switzerland, or free trade areas, such as NAFTA (North American Free Trade Association), from a taxation point of view?

## 13.5 Some Key Areas of Future European Tax Law Research

### 13.5.1 Economic and Monetary Union

The arrival of the Euro and EMU will have a profound impact on the tax laws of all fifteen Member States, even though only twelve Member States have currently signed up for the Euro. EMU is intrinsically linked with the taxation policies of the Member States.

### 13.5.2 Taxation as an Economic Tool of Government

Fiscal independence is an important tool for the Member States, particularly if they have given competence in economic and monetary policies completely to the Community. Taxation can be used as an instrument of

Government to slow down or speed up an economy. Giving up control of taxation means that the political control of the national economy moves to the European level. While, one might argue, that this is good from the EIM point of view, and for businesses throughout the Community, this may not be an acceptable strategy for a particular Member State at a given point in time. This topic brings into play a host of disciplines—economics, social policy, tax policy, politics, and the concepts of ‘statehood’ and the ‘nation-state’—and triggers a multitude of interdisciplinary research opportunities.

### 13.5.3 Tax and Other EU Policies

The interaction between tax policy and other EU policies should not be forgotten. We have already seen how tax can impact on a number of EU policies, such as, environment, energy, and regional policies, and in the social policy sphere when taxation of occupational pensions is considered.<sup>39</sup> Elimination of tax obstacles to the provision of cross-border services will continue to be significant as the single market develops.

### 13.5.4 Tax Policy and Tax Coordination

Another area of interest is the entire field of tax policy and tax coordination throughout the EU. Each Member State has its own tax system and its own ideas about how taxation should be used, charged, and spent. Unless some ground rules can be agreed at a political level, economic operators will invariably face fifteen different tax systems (or more, as new states join), with different compliance criteria, different tax rates, different taxes, and tax bases. Community law and international tax law will increase the complexity, costs, and administrative burdens encountered on cross-border transactions.

In the tax area, the Commission has been active in terms of proposing legislation. This has been very effective in the sphere of indirect taxes but not so successful in the sphere of direct taxes. This latter log-jam has occurred because of the division of powers. Competence in tax matters is retained by the Member States except insofar as such competence has passed to the European Community institutions. However, the tax systems of all Member States must comply with EC law.

An interesting research study would be to see how far the tax systems of the Member States are moving closer together. How far do they need to be harmonized, and why should harmonization take place? Do indirect taxes need to be harmonized more than direct taxes?<sup>40</sup> It may be of interest to explore the nature of harmonization and its relationship with 'coordination' or 'approximation' initiatives. What roles could each play? It might also be useful to investigate the categories of 'harmonization', such as, harmonization via legislation, harmonization as a result of regulatory competition, and harmonization as a consequence of other less formal pressures, such as, the EU Code of Conduct on Harmful Tax Competition.

### 13.5.5 Interaction Between Domestic Tax Law, EC Law, and International Tax Law

The jurisprudence of the ECJ is constantly trying to find compromises in this area.<sup>41</sup> Frontier workers,<sup>42</sup> companies providing cross-border services,<sup>43</sup> and businesses operating across the EU<sup>44</sup> and international borders, may regularly come into situations of conflict involving national tax rules, EC law, and international tax rules. Conflicts occur because the rules of international tax law allocate the residence of individuals or enterprises to a particular country.<sup>45</sup> The country of residence is allowed to tax all of a person's income (worldwide taxation). This comes into conflict with 'source' countries that are given the limited power to tax certain income arising within their territories (limited taxation). The outcome is very often double taxation.

### 13.5.6 Double Tax Treaties

The international community has developed bilateral treaty solutions based on the OECD Model Tax Convention (Baker 1994). The residence country will relieve double taxation, to a certain extent, either by using a 'credit' method or an 'exemption' method. However,<sup>46</sup> such double taxation is not, always, completely avoided.<sup>47</sup>

So, for the avid tax researcher, there is plenty of scope for attempting to find solutions in this complex area. For instance, should all EU countries operate a single credit or exemption system?<sup>48</sup> Should bilateral tax treaties be changed to a single multilateral tax treaty for EU Member States? Is the concept of 'virtual resident' justifiable? Should all residents of EU Member

States have a 'European' residence? What will be the impact of the European Company in this area?

### 13.6 Conclusion

The European Law of Taxation has immense research opportunities both for the pure legal jurist and for the interdisciplinary tax researcher. It will continue to impact on the tax systems of the Member States, affect the negotiation and terms of international tax treaties, and the ECJ will continue to develop its own jurisprudence. While the Member States abstain from their political responsibilities of agreeing European tax legislation, it is likely that the ECJ will continue to try to fill the gaps and find solutions to European tax problems.

### 13.7 Postscript June 2004

Since writing this chapter, EC tax law has developed at a rapid pace. ECJ jurisprudence in the area of the Community freedoms and EC tax legislation has continued to evolve and interact with Member States' national tax rules. New EC tax rules have been adopted and the European Company is due to become a reality soon. This brief update can only give you a taste of some developments that have occurred in the past three years.

I will flag some of the most important cases since November 2001. The full references to the cases, which are a 'must read' in this area, are included in the end of chapter case list. You will find most of them in Van Raad (2003). *Danner* (2002) re-runs the infamous *Bachmann* (1992) case with different results on similar facts—'cohesion of the tax system' is elevated from the level of the taxpayer to the level of international agreements. *Commission v Germany* (2002) is the most important of the 'Open Skies' judgments of the ECJ. The significance of this judgment, in the air transport sphere, for Member States' Double Tax Conventions has yet to be determined. *Überseering* (2002) deals with interaction of Community freedoms and Member States' company law systems and the German 'seat' doctrine. *Lankhorst* (2002) deals with interaction of Community law and national thin capitalization rules. *Skandia* (2003) addresses the interaction of Community freedoms and cross-border pension and life assurance policies. *Bosal Holding* (2003) concerns the interaction of the freedom of

establishment with cross-border loss relief provisions. *Oce* (2003) addresses the concept of withholding tax under the Parent-Subsidiary Directive. *Inspire Art* (2003) is a case in which the freedom of establishment and national company law rules (*Centros* 1999) are revisited. *Barbier* (2003) concerns the free movement of capital and national tax rules in the inheritance tax area. *Collins* (2004) deals with workers and EU citizenship, especially social security matters. The substantive concern of *GIL Insurance* (2004) is VAT and insurance premiums, and in particular the case addresses the issue of state aid.

There is also considerable Internet information that is now available on EC tax matters. In this section I summarize sources of information about recent important EC tax developments. There are a number of Commission and Council documents worth further investigation. A survey on the European Company (SE) may be found at <[europa.eu.int/comm/taxation\\_customs/publications/reports\\_studies/taxation/societas\\_europea/survey.pdf](http://europa.eu.int/comm/taxation_customs/publications/reports_studies/taxation/societas_europea/survey.pdf)>. The Commission communication relating to tax obstacles in the Internal Market (COM (2003) 726 final) is available at <[europa.eu.int/eur-lex/en/com/cnc/2003/com2003\\_0726en01.pdf](http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0726en01.pdf)>. The Council Directive amending the Parent-Subsidiary Directive is reproduced at <[europa.eu.int/eur-lex/pri/en/oj/dat/2004/l\\_007/l\\_00720040113en00410044.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l_007/l_00720040113en00410044.pdf)>.

The amendments to the proposed Interest and Royalties Directive 2003/49/EC are available: COM (2003) 841 final at <[europa.eu.int/eur-lex/en/com/pdf/2003/com2003\\_0841\\_en01.pdf](http://europa.eu.int/eur-lex/en/com/pdf/2003/com2003_0841_en01.pdf)> and COM (2004) 243 final at <[europa.eu.int/comm/taxation\\_customs/taxation/company\\_tax/docs/miscel/royalties\\_en.pdf](http://europa.eu.int/comm/taxation_customs/taxation/company_tax/docs/miscel/royalties_en.pdf)>. The Commission's communication on dividend taxation of individuals in the Internal Market (COM (2003) 810 final) may be found at <[europa.eu.int/eur-lex/en/com/cnc/2003/com2003\\_0810en01.pdf](http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0810en01.pdf)>. Its communication concerning a Code of Conduct on implementation of the Arbitration Convention (90/436/EEC) (COM (2004) 297 final) is located at <[europa.eu.int/eur-lex/en/com/cnc/2004/com2004\\_0297en01.pdf](http://europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0297en01.pdf)>.

Further documentation may be found on the Commission's web-pages dealing with Taxation—the Index page is <[europa.eu.int/comm/taxation\\_customs/taxation/taxation.htm](http://europa.eu.int/comm/taxation_customs/taxation/taxation.htm)>. A useful starting page for your search of the Europa website is <[europa.eu.int/index\\_en.htm](http://europa.eu.int/index_en.htm)>. Another very important page is the ECOFIN Press Releases at <[ue.eu.int/cms3\\_applications/Applications/newsRoom/loadBook.asp?target=2004&bid=93&lang=1&cmsld=350](http://ue.eu.int/cms3_applications/Applications/newsRoom/loadBook.asp?target=2004&bid=93&lang=1&cmsld=350)>.

European Parliament matters can be found at <[www.europarl.eu.int/home/default\\_en.htm](http://www.europarl.eu.int/home/default_en.htm)>. ECJ judgments and Opinions of Advocates General from 1997 to the present time may be found at <[curia.eu](http://curia.eu)>.

int/jurisp/cgi-bin/form.pl?lang = en>. This is another important page worth bookmarking and checking on a frequent basis. Enlargement of the Community information and further details can be found at <europa.eu.int/comm/enlargement/index\_en.html>.

A very useful web-page with a UK focus is <www.parliament.uk/useful/ul\_eu.cfm>. From the UK's point of view it should be noted that two very interesting cases are in the pipeline which may significantly impact upon UK tax rules: the first is *Marks and Spencer* (2003) and the second is *Cadbury Schweppes* (2004). ECJ decisions in these cases will be given in 2005 and 2006. *Marks and Spencer* concerns cross-border loss reliefs when a subsidiary is liquidated and *Cadbury Schweppes* concerns controlled foreign company rules and the freedoms of establishment.

## NOTES

1. See Communication from the Commission COM (2001) 260 final: 'Tax policy in the EU—Priorities for the years ahead'.
2. Unanimity is currently required for many decisions in the tax field. This will become even more difficult to achieve after enlargement. Consequently, new decisionmaking procedures will have to be introduced to prevent stagnation. One proposal is to make use of the enhanced cooperation procedures provided in the Treaty of Amsterdam and due to be extended by the Nice Treaty. See COM (2001) 260 final (paragraph 4.4).
3. <<http://europa.eu.int/pol/index-en.htm>>.
4. There are different Councils for different aspects of Government, for instance, transport, agriculture, etc.
5. Article 205(2) Treaty of Rome (ECT). QMV allows legislation to be passed with a specified majority of the 'weighted' votes in the Council. As a corollary, it allows legislation to be blocked if a certain number of 'weighted' votes in the Council can be mustered. QMV has become the normal way that most voting in the Council occurs. It is expected that QMV will assume even greater importance when further enlargement of the EU takes place. Currently, it appears that the larger Member States with two Commissioners will trade-off increased 'weighted' voting powers in the Council, for a reduction in their number of Commissioners (to one each).
6. Assisted by their respective Ministers for Foreign Affairs and by a Member of the Commission.
7. For example, the doctrine of 'direct effect'. Certain provisions of (say) a Directive can confer rights upon individuals and legal persons if the Directive has not been transposed correctly into national law. The provision has to be clear and unambiguous, and be intended to confer rights. An individual or legal person can apply to a domestic court for a remedy using the Directive as a legal basis for the claim.
8. A good example of these powers can be seen in *Schumacker* (1995), where the ECJ was faced with a frontier worker paying more tax in Germany simply because he was not resident there.

9. Examples include, French 'tax credit' legislation, UK tax legislation relating to 'repayment supplement' on overpaid tax, and Greek tax legislation relating to the taxation of bank branches.
10. To complete the primary legislation picture, one must pay a quick visit to the TEU which created the 'European Union' (EU) (see Art. 4 TEU). It sets out the objectives of the EU. From the tax researcher's point of view, Art. 6 TEU is interesting because it states that the EU shall respect 'fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms ... as general principles of Community law'. This creates a growth area for tax research: tax and 'fundamental rights'.
11. Articles 81–89 ECT relating to rules on competition, and Arts. 90–93 ECT relating to tax matters.
12. For example—Art. 23—prohibition of customs duties and charges having equivalent effect; Art. 39(2)—abolition of any discrimination based on nationality between workers; Art. 43—restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited; restrictions on freedom to provide services within the Community shall be prohibited; Art. 56(1)—restrictions on the movement of capital (Art. 56(2) covers 'payments') between Member States and between Member States and Third Countries is prohibited.
13. The ECJ has said in *Gilly* (1998) that this Article does not have direct effect. It is about negotiation of double tax treaties, that is, involving international law, not EC law.
14. A decision is binding on the persons to whom it is addressed.
15. Recommendations and Opinions are not binding, but do create 'soft-law'. 'Soft law' is non-binding, but is persuasive, particularly if used by the ECJ as an aid in interpreting a Directive, etc. An example of 'soft-law' is the Code of Conduct in relation to harmful tax competition in the EU. It is non-binding, but the Member States have signed up to it. So there is considerable political force and 'peer pressure' behind it. As such, it adopts the appearance of law—'soft-law'. Similarly, if a recommendation is made, this might be followed by the Member States, but is not binding on them. 'Soft-law' is particularly important in the field of direct taxes, where unanimity is required. See COM (2001) 260 final (paragraph 4.3).
16. Regulation (EEC) 2913/92 and Regulation (EEC) 2454/93.
17. This can be contrasted with the Community's Value Added Tax (VAT) regime, implemented by Directives, which differs in each Member State.
18. Sixth Council Directive 77/388/EEC of 17 May 1977.
19. VATA 1994 consolidated earlier UK VAT legislation.
20. Directives can create rights for natural or legal persons who are disadvantaged by the non-implementation or improper implementation of a Directive. Such rights can be enforced against the Member State in national courts. The use of Directives has led to a considerable amount of litigation in the tax sphere.
21. COM (97) 495 final. <[http://europa.eu.int/comm/taxation\\_customs/french/publications/official\\_doc/com/taxation/com495\\_oct1997/en.pdf](http://europa.eu.int/comm/taxation_customs/french/publications/official_doc/com/taxation/com495_oct1997/en.pdf)>.
22. <<http://europa.eu.int/scadplus/leg/en/lvb/l31040.htm>>.
23. See De Hosson (1990) for a review of the Parent–Subsidiary Directive.
24. For example, Greece has had particular problems with the definition of Greek 'company', that is, to benefit from the Directive (Nikolopoulos 2001).

25. Council Directive 77/799/EEC as amended by Council Directive 79/1070/EEC.
26. The MAD has become increasingly important since it was extended to VAT. See Regulation (EEC) 218/92.
27. Formulary apportionment might be used to notionally divide the total income of a multinational among the States in which it operates. Tax would be applied to the profits by a predetermined 'formula'. To date, the OECD (Organisation for Economic Co-operation and Development) countries have avoided using such an apportionment, but there may be considerable advantages for the EU countries to adopt such a system internally.
28. Member States retain competence in direct tax matters subject to Community law.
29. *Schumacker* (1995) and *Metallgesellschaft* (2001). See also *Eurowings* (1999) (paragraph 32).
30. Look at *Daily Mail* (1988), *Avoir Fiscal* (1986), *Halliburton* (1994), *ICI v. Colmer* (1998), *St. Gobain* (2001), *Royal Bank of Scotland* (1999), and *Hoechst* (2001).
31. Article 43 ECT prohibits restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State. This extends to restrictions on the setting up of agencies, branches, or subsidiaries by nationals of any Member State established in the territory of any Member State.
32. For example, Art. 24(3) of the OECD Model Tax Convention provides that the taxation of a permanent establishment in a state 'shall not be less favourable than taxation of residents of that state'.
33. The ECT provides for branches to be treated in the same way as residents through the application of the non-discrimination principle. If freedom of establishment occurs through the opening of a branch in a Member State, such a branch must be treated in a similar way to residents of that state if they are objectively in the same situation. For a good example, see *Royal Bank of Scotland* (1999).
34. *Biehl* (1990), *Schumacker* (1995), *Wielockx* (1995), *Asscher* (1996), and *Terhoeve* (2001).
35. *Werner* (1993), *Gilly* (1998), and *Gschwind* (1999).
36. *Bachmann* (1992), *Safir* (1998), and *Vestergaard* (1999).
37. *Safir* (1998).
38. See COM (2001) 260 final, for the Commission's thoughts on this.
39. See COM (2001) 214 final.
40. See paragraph 3.1 COM (2001) 260 final.
41. For example, see *Wielockx* (1995), *Asscher* (1996), and *Gilly* (1998).
42. For example, *Schumacker* (1995).
43. For example, *Vestergaard* (1999).
44. For example, *Hoechst* (2001).
45. Article 4 OECD Model Tax Treaty.
46. *Gilly* (1998). See also Hedemann-Robinson (1999).
47. This happens depending on the interaction between the domestic tax laws involved (different tax rates and bases, and no harmonization of direct taxes at EU level). Sometimes, it depends on an exemption method or credit method being used. Very often, it can depend on exactly what was agreed bilaterally in the appropriate Tax Treaty. See Avery-Jones (1996).
48. The UK Inland Revenue has produced an interesting report in this general area. See Inland Revenue website <[www.inlandrevenue.gov.uk/consult/dtrc.pdf](http://www.inlandrevenue.gov.uk/consult/dtrc.pdf)>.

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*British Tax Review; Bulletin of the Institute of Fiscal Documentation; Common Market Law Review; EC Tax Journal; EC Tax Review; European Law Review; European Taxation; Intertax; Legal Issues in European Integration; Taxation (UK); The Tax Journal (UK); Tax Notes International; VAT Monitor; Yearbook of European Law.*

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# Taxation and Capital Markets

*Kevin Holland*

## 14.1 Introduction

Taxes are often a major component of ‘transaction costs’ and therefore have the potential to affect every aspect of the functioning of capital markets. Their influence could extend far beyond the prices at which assets are traded to include the nature of the securities traded, the timing of the transactions, and even the physical location of the markets.

These research issues have provided a rich setting for primarily quantitatively orientated researchers for over forty years. These studies have frequently provided conflicting results and, in an attempt to obtain a greater understanding, research design is becoming more focused. A detailed understanding of tax legislation will be critical.

In the relationship between taxation and capital markets the former has traditionally been the dominant party. More recent developments suggest that the balance in the relationship is changing. Asset flows associated with capital markets can have a significant effect on the level and structure of taxation. Increasing integration of capital markets has led to a greater mobility of capital, giving rise to the potential for increased tax competition. This has subsequently led to attempts at increased cooperation between nation-states on taxation. Capital markets now influence tax legislation to an unprecedented degree.

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This chapter will consider both directions of influence. References will be made to research papers and as far as possible these will be contemporary references. While this will provide the reader with knowledge of the more recent papers, researchers should also refer to seminal papers. Frequently these will provide a fuller description of the issues under discussion and can be a more fruitful source of ideas for future research.

A number of excellent review and synthesis papers have been published recently and provide an excellent access to the vast literatures in this field; see, for example, Graham (2003), Maydew (2001), and Shackelford and Shevlin (2001). A number of journals regularly publish work in this area; *Accounting and Business Review*, *International Tax and Public Finance*, *Journal of Accounting and Economics*, *Journal of Accounting Research*, *Journal of the American Taxation Association*, *Journal of Business Finance and Accounting*, *Journal of Banking and Finance*, *Journal of Finance*, *Journal of Financial Economics*, *National Tax Journal*, and *The Accounting Review*. In addition to standard texts on taxation, two specialist texts should be of interest to researchers new to this field, *Taxes and Business Strategy: A Planning Approach* (Scholes et al. 2002) and *Financial Markets and Capital Income Taxation in a Global Economy* (Roberti 1998a).

The collection of papers edited by Roberti (1998a) provides an excellent starting point in considering the influence of capital markets on taxation. The papers cover a range of topics including ‘the challenges of capital market globalization’, ‘tax distortions and international market pressures for national tax system conformity’, and ‘the growing need for tax cooperation’.

## 14.2 Influence of Taxation on Capital Markets

### 14.2.1 Asset Returns

An obvious question is whether investor level taxation affects the prices at which securities are traded. To the extent that a security’s price is determined by the magnitude and timing of the cash flows expected to accrue to its owner, one would expect the tax treatment of those cash flows to influence the price. In fact, in a perfectly competitive market, *ex ante* after tax risk-adjusted returns of all securities should be identical. This implies that variations in the rates of taxation across securities will lead to differences in their pre-tax rates of return. Scholes et al. (2002) refer to this tax induced variation in pre-tax rates as an implicit tax (when applied to pricing rather than the level of return the concept is referred to as ‘tax capitalization’).

In theory a security's implicit tax rate can be found by comparing its pre-tax rate of return with a benchmark return, that is, the pre-tax rate of return on a fully taxable security of similar risk (the explicit tax burden is found by applying the appropriate marginal tax rate to the taxable return). When combined, the implicit and explicit tax burdens should result in an equalization of the *ex ante* risk-adjusted after tax returns across all securities. Any unfavourable tax treatment afforded the returns will therefore be priced into the asset at the appropriate marginal rate of tax for the marginal investor (Scholes et al. 2002).

In practice calculating an implicit rate can be problematical. If the tax treatment of a security's return can vary by type of investor, for example, exempt pension fund or taxable private individual, the theoretical level of implicit taxation is unclear (Engel, Erickson, and Maydew 1998). As the identity of the marginal investors who set the market clearing price cannot be identified readily, the existence and magnitude of implicit taxes becomes an empirical issue.

Differential tax treatments of dividend and capital gains provide a setting in which to observe taxation effects on price. The tax capitalization/implicit taxes debate in the United States arises because dividend income relative to capital gains is typically subject to a higher explicit tax rate. Therefore equity that has a relatively high dividend payout ratio would attract a higher explicit tax burden. One would expect therefore, that the risk adjusted pre-tax return on such equity would be higher than that on equity with a lower dividend payout ratio, that is, a yield-related tax effect. (Brennan (1970) derives an after-tax version of the Capital Asset Pricing Model (CAPM) which predicts a positive relationship between the dividend yield and *ex ante* pre-tax return.)

Using UK data Chui, Strong, and Cadle (1992) concluded, 'taxes significantly affect the equilibrium relationship between returns and dividend yields'. In another UK study Ang, Blackwell, and Megginson (1991) observed the changes in the relative price levels of the equity of dual class investment trusts. These investment trusts had two classes of equity: one that paid only a scrip (stock) dividend, the other only a cash dividend. As the tax treatment of scrip dividends relative to cash dividends changed over time the relative prices of the equity changed, a result consistent with the view that taxation influences gross yields.

Though finding evidence of a positive relationship between dividend yield and equity returns, Morgan and Thomas (1998) dispute the validity of a tax-based explanation. They cite evidence (Ashton 1991) that the UK tax system favours dividends over retentions, the reverse of the situation in the United States. They suggest that dividend signalling effects and a delayed related price reaction could account for their findings.

A critical problem in comparing relative returns and dividend yields is the requirement to control for variations in risk between securities. The following papers attempt to overcome this problem. Froot and Dabora (1999) examined the prices of three 'twin or dual' stock companies.<sup>1</sup> In each of the three cases a special charter fixes the division of equity cash flows between each 'twin'. With fully integrated markets each set of twin's stock prices should move together. However, they found prices were more highly correlated with the relative stock market index of the country where the stock is most actively traded than with the other twin. The authors tentatively attributed this observed lack of co-movement to, in part, tax-induced investor heterogeneity induced in part by tax treaty provisions. (Since 1 January 1994, the double tax treaty between the United States and the Netherlands led to US pension funds having a tax induced preference for (the Amsterdam based) Royal Dutch Petroleum over (the London based) Shell Transport and Trading.) If pension funds constitute the marginal investors, a difference in price between the two companies would be expected. However, a problem in interpreting such studies stems from markets also differing in ways other than taxation.

Guenther (1994) compared US Treasury stock of varying maturities. Assuming a constant statutory tax rate, pre-tax yields on US treasury stocks maturing either side of a 31 December year-end should differ only marginally (to the extent of the present value of the taxes on the January maturing bill being less than that of the December bill's and the term structure of interest rates being positive). If however the tax rate differs between the two years, then yields would be expected to vary by a greater amount. The empirical evidence was consistent with a pricing difference that reflected the variation in tax rates. Erickson and Maydew (1998) adopt a similar approach in comparing each security to itself before and after an unexpected change in the taxation of dividends. Their results confirm the existence of implicit taxes in the pricing of 'preferred' stock.

Shackelford and Shevlin (2001) summarize what is termed 'dividend capitalization', that is, the concept of investor level tax capitalization when applied to shares, as producing three schools of thought: the traditional view where any additional tax costs of paying dividends are offset by a reduction in agency and other non-tax costs; the irrelevancy view (Miller and Scholes 1978) where the marginal investor is tax exempt and would therefore not be prepared to bear taxes through a tax induced reduction in the share price; and the 'new view' (or full dividend tax capitalization) where shareholder taxes are capitalized fully in share prices at a level which, controversially, is independent of the timing of the dividend payments. Collins, Harris, Hubbard, and Kemsley have developed and tested the 'new

view' in a series of recent papers, the latest of which is Harris, Hubbard, and Kemsley (2001). The papers' results have been described as 'implausible' (Shackelford and Shevlin 2001), the underlying assumptions 'shaky' (Maydew 2001), and overall 'controversial' (Shackelford and Shevlin 2001).

Harris, Hubbard, and Kemsley (2001) also report results for Australia, Japan, Germany, and the United Kingdom consistent with the capitalization of shareholder level dividend taxes into equity prices. However, Dhaliwal et al. (2003) among others question the validity of some of the underlying assumptions, for example, that all retained profit must be distributed to shareholders in the form of taxable dividends, and the inconsistency of the theory's implications with the existence of dividend clientele and the apparent absence of widespread dividend capture trading. After examining different settings and revised models they fail to replicate the finding of tax capitalization.

#### 14.2.2 Tax and Dividend Clientele

Completely contrary to the implications of full dividend capitalization is the existence of 'dividend-clientele'.<sup>2</sup> If dividends are taxed more highly than capital gains then firms with high-expected dividend payout ratios would attract shareholders with low marginal income tax rates and vice versa. In effect firms can ignore the tax preferences of their shareholders; it is the shareholders who make the adjustment by investing in firms with payout ratios consistent with their tax preferences. In contrast to the number of tax capitalization studies there are relatively few focusing on the documentation of tax clientele. Dhaliwal, Erickson, and Trezevant (1999) find that when firms initiate a dividend the proportion of the equity held by institutional investors who have tax induced preference for returns in the form of dividend, increases. However, in the United Kingdom, Lasfer (1996) found evidence inconsistent with the dividend clientele argument. Instead firms appear to consider their shareholders' tax position in forming dividend policies. The absence of dividend clientele may arise because of the existence of significant non-tax factors outweighing the tax benefits.

#### 14.2.3 Ex-day Effects

When share prices change from *cum-divi* to *ex-divi* any resulting price change can provide information about the influence of taxation. For example,

in the absence of transaction costs and taxation, it would be reasonable to expect the price of a share on turning ex-dividend to fall by the amount of the forthcoming dividend. Earlier empirical studies have however consistently found that the ex-dividend price change is typically less than the dividend.

Elton and Gruber (1970) attributed this finding to taxation. Critically, assuming that shareholder clientele do not change around the ex-dividend date, they predict that when dividend income is subject to a higher marginal tax rate relative to capital gain, a negative relationship between the dividend yield and the ex-dividend price change holds. They then used the observed relationship to impute shareholders' marginal rates of taxation.

Miller and Scholes (1982) among others have questioned Elton and Gruber's analysis primarily because it ignores arbitrage opportunities. In buying equity *cum-divi* and selling *ex-divi* short-term traders, that is, those without differential marginal rates of tax on income and capital could earn 'above normal profits'. (The tax benefit of the anticipated resulting loss may however, be denied through anti-avoidance legislation. See the annual *Butterworths UK Tax Guide* for a relatively accessible guide to UK tax legislation.) Miller and Scholes (1982) put forward a 'short-term traders/ transactions cost hypothesis', where the *ex-divi* price change is attributed to the presence of transaction costs. Consistent with short-term trading, Athanassakos (1996) found significant levels of 'abnormal' trading volume around *ex-divi* days using Canadian data.

Murray and Jagannathan (1998) removed the influence of taxation by examining Hong Kong equity prices but found a result similar to that in taxed regimes, that is, the fall in the share price was less than the expected dividend. Their evidence tends to suggest that the ex-dividend price change is not attributable to taxation, but possibly transaction costs. However, Lasfer (1996) using size as a proxy for transactions costs concluded that the *ex-divi* price change is not related to transactions costs.

Bali and Hite (1998) offer another non-tax based explanation. They consider that *ex-divi* price changes are on an average less than the dividend because although dividends are essentially continuous, share prices are constrained to discrete 'tick' multiples. They find that though the average price drop is less than the dividend it is within a 'tick' of the dividend and with the presence of transaction costs potential arbitragers are unwilling to pay the full value of the dividend.

A more recent paper by Green and Rydqvist (1999) again suggests an underlying tax explanation. They display great ingenuity in identifying tradable Swedish lottery bonds as a setting in further examining ex-day price behaviour. Cash distributions or interest in the form of prizes on

Swedish lottery bonds are tax-exempt while any capital gains are taxable. Consequently, holders have a preference to cash distributions over capital gains, the reverse of the normal case with equity and bonds. Therefore if previously documented ex-day price behaviour is tax induced then one would expect the ex-day price drop to be greater than the coupon in the case of the lottery bonds—this is confirmed by empirical finding of average price decreases of 130 per cent of the cash distribution. (This specific institutional setting also reduces the potential biases resulting from the presence of dealers and short-term arbitragers who are taxed symmetrically on cash distributions and capital.)

#### 14.2.4 Seasonalities

A consistent finding in studies of market efficiency has been the existence of seasonality in equity returns. Clare, Psaradakis, and Thomas (1995) found evidence in the United Kingdom of significant price increases in December, January, and April and significant decreases in September. They attribute the January and April effects to the influence of the US January effect<sup>3</sup> and tax-induced selling in the United Kingdom, respectively.<sup>4</sup> Investors holding shares trading at a loss relative to their original purchase price may have an incentive to sell those shares prior to the tax year-end in order to crystallize the loss (Badrinath and Lewellen 1991).

In a further UK study, Baker and Limmack (1998) detect January and April effects that may in part be attributable to a tax-loss selling hypothesis. In the United States, Jones, Lee, and Apenbrink (1991) tested the 'tax-loss selling hypothesis' by examining returns before and after the 1917 introduction of income tax in the United States. They found that significant seasonality occurred only after its introduction.

#### 14.2.5 Product Innovation

Taxation has had a significant influence on innovation in capital market contracts in the last twenty years. For example, the growth of the Eurobond Market followed the imposition by the United States of a 30 per cent withholding tax on interest payments on bonds sold in the United States to overseas investors (Miller 1986). Similarly, the growth in the early 1980s of the use of deep discount or zero coupon bonds has been attributed to

taxation. Miller (1986) describes how a flaw in the US legislation and a 'blunder' by the Japanese authorities fuelled their popularity. He comments, 'No single innovation epitomises so neatly the many strange and often unplanned elements that come together to produce a significant financial innovation'.

Grinblatt and Longstaff (2000) explore a more recent example of financial innovation. Under the Separate Trading of Registered Interest and Principal of Securities (STRIPS) programme in the United States, holders of qualifying treasury bonds and notes can elect to have the underlying principal and coupon payments split into two separate securities (conversely, previously split components can be reconstituted into a single security). They concluded that the observed differences in prices of 'stripped' and 'unstripped' treasury notes and bonds could in part be influenced by tax. There may, however, be non-tax explanations. Indeed, Grinblatt and Longstaff (2000) attribute part of the demand to investors wishing to create or synthesize securities of a particular maturity, that is, make markets more complete.

Aside from changes in legislation, innovation has also been driven by the potential of 'electivity of tax treatment' (Warren 1993). For example, within the United Kingdom the differing treatment between the taxation of contingent claims and fixed claims, that is, the realization and yield-to-maturity approach, respectively motivated the practice in the early 1980s of 'coupon stripping' using deep discount (or zero coupon) bonds. 'Coupon stripping' was the practice of offsetting against interest received from holding interest bearing securities, the discount arising from a related issue of zero coupon bonds. As the holder of the deep discount bonds was assessable to tax only when these bonds were redeemed, a deferral of tax could be achieved (legislation in the 1988 Taxes Act had the effect of cancelling this tax advantage).

### **14.3 Influence of Capital Markets on Taxation**

The remainder of this chapter looks at how the activities of capital markets can influence the actions of tax legislators. The popularity of deep discount bonds referred to above, provides an excellent example of this process. To counteract the tax deferral benefits of coupon stripping, legislation was passed which neutralized the benefits. Through product innovation, capital market participants can dictate the timing and form of legislative changes. Concerns have been raised as to whether legislation can keep pace with such innovation: 'tax authorities have found it impossible to keep

pace with developments in the market place; tax legislation now lags a long way behind commercial developments' (Organization for Economic Cooperation and Development (OECD) 1992). A partial response may be a continual change in tax legislation in an attempt to 'blunt' the effectiveness of previously successful strategies (Miller 1986).

Increased mobility of capital brought about by technological developments and associated deregulation of capital markets has the potential to increase the allocative efficiency of capital markets and therefore welfare. However, this same increased mobility can lead to a decrease in welfare if in response to tax competition, tax revenue falls. A loss in welfare occurs if as a consequence the level of publicly provided services falls from a previously optimum level. In the absence of a coordinated response to a reduction in global tax revenues, states may unilaterally revise their domestic legislation precipitating a further round of tax competition in the form of reductions in tax rates and changes in the tax bases, 'the race to the bottom' (Roberti 1998*b*).

Technological change has also permitted 24-h trading or 'globalization' of capital markets. Global trading can result in parties from several jurisdictions being stakeholders to a single transaction. This raises the issue of how any profits are to be allocated to the various interested parties. In the absence of tax coordination there is a risk that the transaction may be subject to either double- or, less likely, under-taxation. The OECD is currently considering whether it is feasible to reach a consensus on how global trading should be taxed (OECD 1997).

This arena provides two avenues of research: a specific approach that focuses on a particular product or market innovation, and a general approach that focuses on, for example, institutional responses to the allocation of globally organized transactions. The former is a potential area where tax and marketing specialists could collaborate in order to examine the process of product innovation. Chapter 5 'Taxation Research as Political Science Research' provides an indication of potential areas of research in the latter more general arena.

## 14.4 Conclusion

Despite the length of time taxation and capital markets have coexisted, there is still a lack of a general consensus as to the effects of taxation on the operations of capital markets. This may be due to the dynamic nature of tax legislation that provides a constantly changing tax environment and/or the

failure to control for variations in institutional factors that vary both over time and across jurisdiction. While the field is a researcher's paradise with a rich variety of settings it must be frustrating for policymakers wanting to know the answers to apparently straightforward questions! After listing notable exceptions Erickson and Maydew (1998) comment that, 'Despite decades of research ... , no consensus has been reached about whether or how taxes affect the pre-tax returns of stocks'. And in a similar vein, Fama and French (1998) state that, 'despite the importance of the issue, there is little convincing evidence on how taxes affect the pricing of dividends and debt'.

## NOTES

1. The three sets of companies were: Royal Dutch Petroleum and Shell Transport and Trading PLC; Unilever NV and Unilever PLC; and SmithKline Beecham (formed by the merger of SmithKline Beckman and the Beecham Group). An interesting question is the prevalence of UK–Netherlands alliances.
2. Although frequently referred to in connection with dividends, the concept of 'tax clientele' is obviously not restricted to dividends; see, for example, Shackelford (1991) for evidence that lenders to Employee Share Options Plans are high tax-paying banks.
3. The January effect in US markets describes the general fall in share prices in December followed by a general price increase in the following January (after the 31 December US tax year-end).
4. A possible explanation of the UK September effect was the demand for liquidity from companies in order to settle corporation tax liabilities which were due nine months after the end of the year. With the new quarterly tax payment basis applying to larger companies, the September effect may lessen or even disappear in the future.

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## Taxation in an Electronic World

*Andrew Lymer*

### 15.1 Introduction

The development of global communications media, such as the Internet, is revolutionizing the lives of many people. The ways in which business is conducted has been affected by these changes. While this revolution has not had significant effects on everyone and every business, it has now reached a critical mass in most developed economies and also has had a significant impact on many developing countries. Many commentators suggest, however, that we are only just seeing the beginning of this communications revolution (e.g. in the area of accounting, Elliott 1992 and Wallman 1997).

What is the 'electronic world' and why is its taxation an important subject for interdisciplinary tax research? The 'electronic world' has been given a number of names including 'the information superhighway', 'cyberspace', and generically, 'the Internet'. These terms all refer to a non-physical or virtual 'space', created by the use of technology, which participants can use to interact with each other. This leads to the creation of a 'virtual world' in which people in different physical locations can meet, interact, engage in private, or do business with each other. The name 'e-business' or 'e-commerce' is used to describe this process of doing business in the electronic world.<sup>1</sup>

Direct taxation of business is largely focused on the business activity of profit or value generation. If a business engages in electronically mediated

activity in generating profits, this will potentially be liable to taxation in the same way as non-electronic-based activity. In the same way, indirect taxation will be levied on consumption of products and services whether these are provided electronically or physically (i.e. in person).

The taxation of e-commerce is an appropriate topic for tax research as the 'electronic world' is becoming an important feature of the wider societies within which people operate, which are themselves supported and influenced by taxation systems. The electronic world will therefore affect and be affected by tax systems and these influences need to be understood in order to develop suitable tax systems to operate in this new environment, and in the environment where the physical and virtual worlds interact. Our current tax systems were designed to operate in a mostly physical environment in which the majority of transactions are documented in writing, and the place where taxable transactions occur or taxable income arises can be pinpointed easily. The vital transaction focused features of a tax system designed to suit this physical domain may, or may not, be equally well suited to a non-physical or partly non-physical environment.

One report (Deloitte and Touche 1997) which examined the issues raised in this chapter, emphasized the important interrelationship between electronic and physical worlds for tax policy creation in the following way:

The greatest challenge to a tax regime is its ability to adjust and adapt to a changing world. The coming of the age of electronic commerce, the increased mobility it brings to business and the greater flexibility it offers to the way that transactions and communications are made is the latest and perhaps the most demanding of these challenges. (p. 1)

The current body of research supporting the development of tax systems specifically addressing electronic activity is limited. At present fiscal authorities and other interested parties are attempting to shape the debate over how best to tax the electronic world and, therefore, the following commentary reflects a debate at an early stage of development rather than one based on the distillation of thought over many years (James 1999). Many issues of this discussion reflect the difficult issues that have characterized debates over the development of existing tax systems for many years. For example, issues of international tax harmonization, international tax jurisdictions (and corresponding collection rights and methods), and the appropriate extent of various tax bases. However, a number of new issues have also been created as a direct result of wider electronic activity.

This chapter outlines the nature of the debate currently occupying tax professionals and researchers as it relates to taxation of e-commerce activity. It then provides some examination of why these issues pose specific research

and policy creation problems and provides a literature review of existing materials illustrating the current state of development of international plans to tax e-commerce. The final section of the chapter aims to illustrate the richness of the electronic world as a subject for future tax research.

## 15.2 Nature of the Current Debate

Historically the study of taxation has been largely a parochial issue. It has focused, in the main, on national concerns. This perspective mirrored that of the main disciplines of study from which tax researchers were drawn—namely law, public policy/economics, and accounting—as we have seen outlined in the first part of this book.

More recently the rapid development of globalization has created a whole new ‘industry’ of international taxation. However, even when an international perspective has been necessary, such as when concerning the taxation of truly multinational enterprises, it is still most often approached as an aggregation of national perspectives rather than by adopting a truly international (i.e. non-jurisdictionally focused) one.

Current approaches to the subject of taxation of the electronic world, however, are breaking with this aggregation tradition by adopting a more international perspective than is usually the case. The Organisation for Economic Co-operation and Development (OECD) has accepted the role of international coordinator to encourage, as far as possible, an international debate on how to deal with the issues raised by e-commerce. While this may be an effective way to proceed, it is a process with which national fiscal authorities have relatively limited experience compared to their more usual parochial approach to tax reform. This international, cooperative approach will be tested for problem-solving effectiveness as the output from the international discussions are brought home by fiscal authorities for local debate and rule changes. This began to occur in early 2001 and will continue for some time.

An interdisciplinary approach to creating tax systems for cyberspace is a necessary complement to an international perspective for policy formulation. Developing effective solutions will require the combination of skills offered by economists, lawyers, and accountants, as well as the technical skills and understanding of computer professionals.

Research on the role and operation of taxation in an electronic world to inform the policy creation debate must therefore be undertaken in an international and interdisciplinary fashion if it is to yield useful insights

into the nature of a successful tax system for cyberspace, the 'real' world, and where they interact.

### 15.3 Is the Taxation of the Electronic World a Special Issue?

The taxation of the electronic world is unlikely to result in radical overhauls of national tax systems (Joint Committee of Public Accounts and Audit (JCPAA) 1998). However, it has forced fiscal authorities to return to a number of old, but currently inadequately resolved, issues. It also provides them with a number of new problems. The reasons for this situation include those discussed below, presented in no particular order of importance and with illustrative, not exhaustive, intent.

#### 15.3.1 Location of Activity

Electronic-commerce operates outside of a geographically constrained environment (i.e. an environment defined by a physical dimension). This creates practical difficulties for important fundamental tax principles such as, permanent establishment or location of transaction events. The creation of permanent establishments, and therefore the liability to tax, can be more difficult to determine than would previously have been the case in a solely physical business case as less physical evidence will exist to provide the required proof of a jurisdictional right to tax. (See OECD 2000*b,e*, 2001*b* for a discussion of the recent changes to Art. 5, Permanent Establishment definition.)

The increased mobility of labour, finance, and intangible resources made possible by cyberspace technology could lead to the erosion of some (particularly developed country) national tax bases. For example, improved labour mobility makes it easier to operate virtual organizations whose 'presence' can be moved from a more expensive to a cheaper tax environment. Such mobility also makes jurisdictional claims to tax based on 'place of control' of businesses much harder to establish with any reliability (OECD 2001*c*).

Taxation changes in one jurisdiction may affect the free flow of trade around that jurisdiction and thereby have 'knock on' effects on other countries' tax incomes. This becomes a particular concern when the traditional use of permanent establishment rules break down, as may be the case with increasing e-commerce activity, as tax revenue is shifted from source

countries to residence countries. (A fuller discussion of income shifting due to e-commerce activities can be found in IFAC 1999.)

### 15.3.2 Tax Havens and Offshore Banking

Technology offers opportunities to manage the location of taxable activities in ways not easily achievable where normal physical constraints are found. This provides increased flexibility for tax planning as nationally focused tax systems will become easier to circumvent. It therefore raises critical issues for national jurisdictions such as the wider use of tax havens and the effects of harmful tax competition. (OECD 1998*a*, 2000*g* provide a fuller examination of issues of harmful tax competition/practices.)

### 15.3.3 Income Source Manipulation

Adequate assessment of the multiple income sources that may be used to move value between tax jurisdictions is an important feature of effective tax systems. The use of different business models due to the presence of e-commerce may result in different income types being generated. For example, the presence of e-commerce elements in a business may result in changes to the nature of a taxable supply bringing into question the definitions of what constitutes a good rather than a service for indirect tax purposes (OECD 2001*d*). Further, a matter less directly a result of e-commerce, but nonetheless an issue of significant magnitude influenced by the wider use of e-commerce, is the changing income distribution practices involving dividends, royalties, and license fees. (See IFAC 1999 and OECD 2000*d* for wider discussion of these issues.)

### 15.3.4 Identification and Record Keeping

Practical problems exist when attempting to relate the virtual activity that occurs in the electronic world to the real entities behind those activities. For example, audit trails can become harder to examine as, for example, paper documentation may not be produced, ownership or liability issues become harder to determine, and anonymity becomes easier to achieve.

(The ATO First Report 1997, provides an interesting discussion on this issue. See also OECD 2001e.)

### 15.3.5 Tax Collection

Efficient collection of tax payable can become more difficult. For example, larger scale use of virtual business arrangements increases the possibilities for self-employment or the use of multiple, as opposed to single, employers, either of which make tax collection more difficult to achieve efficiently (OECD 2001e).

### 15.3.6 Disintermediation

A common feature of a move to electronic activity is disintermediation or reintermediation. Removal of existing intermediaries and/or their replacement with different intermediaries requires changes to current tax systems, particularly in the area of tax collection and tax compliance auditing, as business intermediaries are often used as convenient tax collection points in many tax systems. (Fuller discussion of disintermediation effects associated with e-commerce can be found in ATO 1997.)

### 15.3.7 Special Tax Concessions

Use of *de minimis* rules, and other tax concessions, in conjunction with easier international trade brought about by e-commerce, may result in unacceptable growth in tax revenue loss. (See OECD 2001d and JCPAA 1998 for an extensive examination of *de minimis* rules in relation to indirect taxation and import rules.)

### 15.3.8 Electronic Payment Systems

Use of electronic money and barter-based means of exchange could develop into international currencies that escape national taxation systems. (See, for example, ATO 1997; OECD 2000c,d, 2001a for discussion of alternative payment systems made possible by e-commerce.)

### 15.3.9 Other Issues

The presence and growth of the electronic world does not, however, just present problems for fiscal authorities. It provides opportunities to improve taxpayer service and to reduce tax evasion and inappropriate avoidance. This may be achievable through market changes that some argue could result from e-commerce such as 'massification'. In this case, a market develops in such a way that it results in the presence of fewer large organizations, many very small organizations, and few businesses of intermediate size. If such a market change occurred, a fiscal authority would be able to target the bulk of the tax revenue due from a marketplace by dealing with very few of the organizations that actually make it up. (The concept of massification is outlined and developed in more detail in JCPAA 1998.)

While these issues are causing policy development and tax administration concerns for the national fiscal authorities, the tax related activity of the taxpayer is also being influenced by e-commerce. Existing problems with adequate data sourcing and management for tax compliance are extended and a number of new problems are created. These include:

1. Adequately tracking the flow of capital and creation of profit in their growing organizations.
2. Compliance costs of producing returns that are acceptable to the increased number of fiscal authorities with which the organization needs to deal.
3. Increasing costs of providing a defence in tax disputes.
4. Difficulties of matching the ability of true globalization made possible by technology with the increasingly artificial, nationally geographically constrained, tax systems. These problems include producing increasingly artificial transfer pricing strategies that bear looser and looser resemblance to business reality.

## 15.4 Literature Review

### 15.4.1 Pre-Ottawa 1998 Debate

Prior to an OECD conference held in Ottawa, Canada in October 1998, the literature that referred explicitly to taxation of the electronic world largely consisted of governmental position papers prepared for domestic or

international conferences on the subject, and commentary on those documents. These papers originate from the United States, Australia, the United Kingdom, Japan, and Canada, as well as from the European Union (EU) and the OECD. In the pre-Ottawa conference period very little was written from a taxpayer perspective.

Specific literature on this subject first appeared in the United States at the end of 1995 and explored how individual states could tax Internet services as a new tax base (Newman 1995). A US federal debate commenced at the end of 1996 with the publication of a paper by the US Treasury that called for a reexamination of the 'source versus residency' balance of cross-border taxation and emphasized the importance of neutrality when contemplating any tax changes for electronic trade (US Department of the Treasury 1996). A formal framework of principles on the subject followed this document (Clinton Administration 1997). The framework suggested a moratorium on new taxes for e-commerce should be introduced across the world. While no response was forthcoming to this call across much of the rest of the world, a moratorium was brought into place in the United States with the introduction of the Internet Taxes Freedom Act in 1998.

In 1996 the Australian Tax Office (ATO) formed a project team to consider the implications on Australian tax policy of e-commerce. A report was published by this team in August 1997 detailing the implications of the Internet and electronic cash on taxation in Australia. This report became known as the ATO First Tax and Internet Report (ATO 1997). This document emphasized the idea that neutrality was critical to successful adjustment of a national tax system to deal with e-commerce. It also made several practical suggestions to deal with other concerns over e-commerce activities such as the use of business registration numbers on websites to aid identity of income recipients.

A second report related to this area was produced in Australia in June 1998, on this occasion by the Joint Committee of Public Accounts and Audit (JCPAA) for the Parliament of the Commonwealth of Australia (JCPAA 1998).<sup>2</sup> This report reviews a number of advantages and disadvantages of other approaches to the taxation of international activity, such as the Vann (1991) apportionment proposal in the context of taxing cross-border e-commerce activity. The report suggested, however, that major alternative proposals to existing accepted international tax practice such as introducing apportionment will not gain favour in the near future even with the tax issues raised by e-commerce. It did, however, propose that such radical proposals might become more popular as the full potential of e-commerce activity is reached and measurable impacts on national tax bases become visible. (This view was also supported in an International Federation of Accountants study in the following year—IFAC 1999).

The JCPAA report also considered the 'customs screen-free limit', which allows for low valued imported goods to be received by consumers in Australia without addition of sales tax (now GST) or other duties. The potential for increased use of this limit to import untaxed goods from abroad in direct competition to domestically taxed goods was considered to be one possible impact of increased electronic trade. The JCPAA, however, found no evidence of significant tax revenue loss from this electronic activity at the time and therefore proposed no change to the (then) level of AUS\$50 for this limit.

This report concluded with the suggestion that they foresaw no 'appreciable impact on tax collections in the next one to two years. Beyond this point it is difficult to make predictions'.

In Europe a debate began in 1996 about the possibility of a tax on the flow of information passing over the Internet. This was to be called the 'BIT' tax (see Cordell and Ide 1994; European Commission High Level Expert Group 1996; Soete and Kamp 1996). The idea of a new tax of this kind was, however, not supported in some parts of Europe, and received almost no support at all outside of it. In April 1997 it was effectively removed from the agenda as a possibility for the short-term future (European Commission High Level Expert Group 1997), although its advocates continued to present a case in its favour (e.g. Cordell 1998; Soete and Weel 1998).

A European Ministerial Conference, held in Bonn in July 1997, identified barriers to the development of an electronic world. In suggesting ways to overcome these barriers, they called for tax neutrality and for legal certainty for electronic transactions (Global Information Networks Ministerial Conference 1997*a*). The papers for this conference also suggested that the territorial concepts underlying direct tax systems (i.e. residence and source principles) needed to be re-examined in the light of the growth of an electronic world and that a role would exist in the future for the OECD and World Trade Organization (WTO) in coordinating international tax in this area (Global Information Networks Ministerial Conference 1997*b*).

In Canada a report was released that supported the case for a truly international solution to be applied to the taxation of cyberspace to overcome problems that would otherwise be caused by greater double taxation in the future (Report to the Minister of National Revenue 1998). The report also supported the US advocacy of a free market solution as the way forward rather than the imposition of further taxes and other regulation and constraint.<sup>3</sup>

Towards the end of this period (late 1997) the focus of the discussion of a suitable international tax system(s) to deal with the electronic environment moved from the domain of nation-states to the OECD. This body brought together the major national fiscal authorities on several occasions from the

start of 1997 to discuss this issue. Other interest groups, such as business representatives, were included in these meetings. The first two rounds of discussion were held in London (OECD 1997*a*) and Turku, Finland (OECD 1997*b,c*). A further round of discussions took place in Ottawa, Canada in October 1998. Prior to this meeting a large number of position papers were issued (including, for example, Chartered Institute of Taxation (UK) 1998; Doyle, Ferguson, and Morris 1999; Inland Revenue 1998).

Following this conference in Ottawa, a joint declaration was made by the members of the OECD on how taxation of e-commerce was going to be developed (OECD 1998*b,c*). This declaration emphasized, first, the potential benefits that new technology offered, such as simplification of tax systems and enhancement of taxpayer service, and, second, that the taxation framework for e-commerce should be guided by the same principles that guide governments in relation to taxation of conventional commercial activity (namely efficiency, neutrality, certainty, simplicity, effectiveness, fairness, and flexibility). It concluded that no new forms of taxation would be needed for e-commerce but that existing international agreements (such as double tax treaties) would need to be reviewed and clarified in the light of future developments.

#### 15.4.2 Post Ottawa 1998 Activity

##### 15.4.2.1 Activity by the OECD

The October 1998 OECD conference in Ottawa provided a natural break in the development of global thinking in this area. The Ottawa conference was the last global conference that the OECD organized before launching its more subject specific working groups and Technical Advisory Groups (TAGs) to continue the debates specifically outlined following the Ottawa conference. These TAGs reported back to the OECD in December 2000 (see details in OECD 2000*e,f*, 2001*a,d,e*).

Five TAGs were created at the Ottawa meeting covering income characterization, business profits, consumption tax, technology, and professional data assessment.<sup>4</sup> The output of these groups then began a process of consideration at national level by OECD member and observer countries who had acted as the participants in these groups. Given the wide inclusion of countries from across the world in these groups, it was hoped that their recommendations will be efficiently translated into national policies. The

general availability of the working papers of these groups as they progressed was also aimed at minimizing the development of potentially contradictory national policies while the international consensus was being discussed.<sup>5</sup>

Specific outputs of the TAGs included a paper providing clarification on the application of the Art. 5 Permanent Establishment definition in the context of e-commerce, (OECD 2000e),<sup>6</sup> discussion of how payments for different categories of e-commerce related transactions should be characterized for tax treaty purposes (OECD 2001a), work on compliance and taxpayer service issues with the development of best practice principles for identifying and countering anticompliance, and audit of the electronic world (OECD 2000a, 2001c,e).

The OECD called a further global gathering of tax administrations in Montreal, Canada in June 2001. This meeting reviewed the output of the TAGs and resolved to continue the work of these specialist groups as joint efforts towards further development of tax solutions in this area.<sup>7</sup>

#### 15.4.2.2 Activity by the United States

At the same time as the international work was being coordinated by the OECD a number of national initiatives were also ongoing. The major national initiative in this area over the time that the TAGs were in operation was the Advisory Commission on Electronic Commerce (ACEC) set up by the US Congress to discuss the future viability of their three year tax moratorium on Internet activity imposed by the Internet Tax Freedom Act (ITFA) 1998.<sup>8</sup>

During its operation the ACEC organized physical, mostly open, meetings in various places around the United States. In addition to input from concerned individuals, companies, and lobbying bodies, the Commission also received presentations from the EU and the OECD.<sup>9</sup>

The Commission completed its work with a report to Congress on 12 April 2000. While it looked as if the Commission would not reach the necessary two-thirds majority in support of any one plan to recommend to Congress, support for the continuation of the moratorium was finally agreed. The agreement was reached despite strong opposition from the state participants on the Commission who were keen to see the ability to raise local revenue from the Internet given back to them, citing the possibility of significant future tax revenue loss through cross-state Internet transactions that are untaxed. The commercial lobby, who naturally favoured the maintenance of the moratorium, eventually proved more dominant.

The report was accepted by Congress in May 2000. This has resulted in the extension of the moratorium for a further five years to October 2006,

and also the removal of the federal telephone tax (then 3 per cent) to further reduce the tax burden on the use of the Internet.<sup>10</sup>

#### 15.4.2.3 Activity by the United Kingdom

The United Kingdom played an active role in the TAGs and Working Groups of the OECD and was therefore reluctant to engage in specific work of its own during the two year TAG operation period that might have limited the introduction of internationally agreed principles in due course. However, the UK Government had been keen to create a positive environment within the United Kingdom to ensure that Internet-related businesses did not leave the country.

The UK Inland Revenue and HM Customs and Excise jointly issued a position paper in November 1999 outlining their current policies towards taxation of electronic activities over the Internet (Inland Revenue 1999). This document provided little in the way of new policy guidance, although made a number of measurable targets for use of the Internet for tax administration over the subsequent few years. For example, it promised that all dealings with the UK Government will be possible electronically by 2008 (later revised to 2005 by the Prime Minister).

At the same time as the development of this document, the UK fiscal authorities also established an Electronic Commerce Consultation Forum that included members from various interest bodies.<sup>11</sup> This Forum was split up into subgroups reflecting similar focuses to those of the OECD TAGs. They also set up a specific team within the Inland Revenue to develop e-commerce related policy in the future.

#### 15.4.2.4 Activity by Australia

The Australian Tax Office has been one of the most active fiscal authorities in the world in its consideration of taxation of the electronic world. As discussed in the previous section, it was one of the first to issue a discussion paper in this area (ATO 1997). They followed up this paper with a further detailed paper in December 1999 (ATO 1999).

The second report adopted a similar style to the UK report produced at around the same time, suggesting that international cooperation was central to all its ongoing considerations in this area. However, it went beyond the UK report in outlining some interesting, innovative approaches to solving tax problems caused by the growth of the electronic world. These included suggestions to treat e-commerce income derived by Australian controlled foreign entities located in preferential tax regimes as 'tainted' for tax determination purposes, the monitoring of the developments of

electronic money around the world, and reporting on the growth in low value consignments arriving in the country.

The December 1999 report also outlined the plans to establish a Consultative Committee (similar to that already set up in the United Kingdom and with a wider membership than the original project team they had established in 1996) and also gave details of the ATO's plans for adaptations to the tax administration system to more adequately deal with e-commerce problems.

#### 15.4.2.5 Non-governmental debate

With the creation of the ACEC in the United States, and the start of the development of tangible proposals in this area from the activities of the OECD, much wider interest in this subject has been generated. For example, the lobbying of the ACEC was undertaken by many interest groups including the e-Freedom coalition, the AICPA, and a large number of commercial concerns.<sup>12</sup>

A taxpayer perspective on the taxation of e-commerce was explicitly adopted in a report from the International Federation of Accountants released in May 1999 (IFAC 1999). This report suggested that, while the issue of tax base protection and collection efficiency were important to fiscal authorities, it is the taxpayer who will eventually bear the cost of any changes to the tax code as a result of e-commerce, either directly in their tax payments, or indirectly through changes to the costs of their tax compliance. This report pointed out that the perspective of the taxpayer on the issues then being debated by fiscal authorities was quite likely to lead to different conclusions to those being proposed by the authorities. Taxpayers, they suggested, were looking for more flexibility to be built into the tax systems of countries in which, and with which, they traded to support the continuing development of globalization. They were also calling for reductions in artificial national constraints that are imposing heavy compliance costs for no direct business benefit.

The IFAC report also asked that tax authorities de-emphasize tax returns and increase the emphasis on withholding similar taxes especially in replacement of existing indirect tax systems.

### 15.5 Policy and Other Research Problems to be Addressed

Having illustrated how the existence of an electronic world is causing fundamental rethinking by national fiscal authorities and international

bodies such as the OECD, the question of a role for tax research then arises. This section addresses both policy, and other related, research problems that are yet to be satisfactorily resolved. It attempts to suggest how various research questions may be formed to examine issues raised by the debate outlined in the previous section.

The issues of how to tax an electronic world reflect many of the problems fiscal authorities currently have to deal with in connection with distance selling and mail order. Examination of existing tax rules in these areas may give some foundations for appropriate policies for e-commerce related tax proposals. However, the difficulties addressed by distance selling rules are magnified given the potential scale—both in frequency and numeric value—of electronic world activities that may be undertaken. This therefore increases the importance of establishing an appropriate tax system to deal with this activity; current distance selling regulations are merely minor parts of legislation mainly focused on physical, face-to-face transactions.

Research questions can be derived from three broad areas: ‘What should be taxed?’, ‘Who should be entitled to tax?’, and ‘How should tax operate for electronic commerce?’ In each case, a number of possible researchable issues are outlined as examples.

### 15.5.1 What Should be Taxed?

Should all aspects of ‘trading’ be subject to tax, or can some types of transactions be excluded? Existing tax systems differentiate between transactions by type but, as the nature of a product or service can change when digitized, the tax treatment of the product or service could also change. This could offer opportunities for tax manipulation. Research addressing the extent to which the manipulation is occurring as a direct, or indirect result of e-commerce would be of interest to fiscal authorities.

This particular issue has caused some disagreement between the USA/OECD and the EU. The position of the United States and OECD at present on definitions of goods versus services is that the mode of delivery should not affect the definition. However, the EU proposes that products supplied electronically should be considered the provision of a service not of a good; the treatment of electronic supply would disregard the treatment of the same product delivered as a physical product (IFAC 1999). While this issue is likely to be resolved in the future, it illustrates the potential

difficulty that is encountered in achieving fundamental tax policy changes in an international context.

It should be recognized that many forms of electronic trading are already taxed under existing tax systems. The banking sector, for example, relies heavily on electronic funds transfer technology for its activities and these flows are already taxed under existing regulations. In the United Kingdom, for example, such taxes include, stamp duty on the movement of funds into shares and tax deducted at source by banks on interest payments when made electronically to customer accounts. It is important to understand the impact of these existing electronic taxes and how they might be useful in aiding the development of more general policies, and research in this area would be useful in developing this understanding.

### 15.5.2 Who Should be Entitled to Tax?

How will jurisdictional boundaries for the right to collect tax be established when the conventionally used physical criteria are no longer so easy to apply and enforce? For example, the permanent establishment rules determine the right to collect tax in many jurisdictions but the permanency of an electronic 'presence' can be difficult to establish.

How will the balance between source and residency for right to tax be changed? This debate has been fuelled from the earliest discussions by the US proposal of an increased role for residency based systems, but the issues have yet to be more fully explored as a research topic.<sup>13</sup> Further assessment of the tax gain/loss implications of such a move is needed.

How will international arbitration over issues such as double taxation disputes be organized? In the EU at present an agreed arbitration procedure exists for settlement of disagreements over jurisdictional rights to tax between Member States. Such agreements may need to be created on a more global scale to deal with the increased volume and value of jurisdictional disputes at this wider level as a result of e-commerce. A study on the motivation and implication of a system of formal arbitration resolution could usefully be undertaken.

What are the implications for establishing and maintaining double tax treaties in a more dynamic business environment made possible by technology? In addition to the current international debate over possible amendments to the permanent establishment definition, other model treaty articles could also require adjustment to continue to be effective.

### 15.5.3 How Should Tax Operate in this Area?

Examples of researchable issues in this area could include:

1. How will security concerns over the transmission of potentially sensitive or private information be dealt with (as outlined in JCPAA 1998)?
2. How will the auditing and monitoring of activity be achieved given the global concerns over money-laundering possibilities and the ability to physically store records of activity offshore?
3. What will be the taxation effects of disintermediation or their replacement with new intermediary business? Research addressing alternative tax collection strategies could usefully support policy development in this area (ATO 1997; IFAC 1999).
4. How will the balance of direct to indirect taxation be affected (IFAC 1999)?
5. How will intangibles be taxed in the future given that they may be particularly susceptible to manipulation and dynamic management by electronic means?

It will also be important to monitor and analyse any changes made to tax systems to describe their effect and effectiveness in dealing with the issues such as those raised above.

## 15.6 Conclusion

It is likely that the continuing development of an electronic world will change the nature of national tax systems, at the margins in the short term, and possibly more fundamentally over time. It is also possible that these developments may lead to some integration of national tax systems in some areas to form an international tax system or systems.

It is unlikely, however, that new taxes will be enacted specifically to tax general electronic trade (in contrast to non-electronic trade), as the political will is very much against this option at present. The principle of tax neutrality between physical and e-commerce activity was clearly expressed at the OECD meeting in Ottawa in 1998, and more powerfully in the accepted recommendations of the Advisory Commission on e-commerce in the United States in 2000. Given the current dominance of the United States in the electronic world, the rest of the (physical) world is unlikely to depart too far from the stance of this major player as the threat to international competitiveness this would entail would be too politically unacceptable in

the near future. This may change, however, if the dominance of other trading blocks, such as the EU, continues to grow; then, a more effective challenge to the position of the United States might be viable. A foretaste of this possible future is seen in the recent changes to Value Added Tax (VAT) legislation in Europe where the EU has imposed greater jurisdictional rights over indirect taxation collection to avoid tax free sales of services to non-registered customers by non-EU based companies (Commission of the European Communities 2000; Hardesty 2000).<sup>14</sup>

The presence of an electronic world will, however, have a far-reaching impact on many aspects of tax management and compliance for individuals, businesses, and governments. Such a fundamental change will bring with it numerous opportunities for research addressing important questions of concern for all levels of society.

The Industrial Declaration from the Global Information Networks Ministerial Conference (1997*b*) provides an appropriate challenge with which to conclude this discussion of research possibilities in connection with the taxation of the electronic world: 'The technological advances that are driving e-commerce are not compatible with existing tax rules, and technology rather than tax policy will likely determine the tax rules of the next century'.

## 15.7 Chapter Postscript October 2003

The period of time following the reporting of the OECD TAGs in early 2001 has seen much less public debate of issues of taxing e-commerce than in the immediate run up to that time. The internationally agreed upon principles elaborated in these TAGs have, during this time, been taken back to national level for discussion and debate and for bringing into national legislation where appropriate. A reduced number of the TAGs continue to operate under the oversight of the OECD and are due for the next round of reporting at the end of 2003 on their ongoing remits.<sup>15</sup> Little information on the interim progress made by these new TAGs has been made public in the last two years; however, other, non-OECD mediated, activity has occurred in a number of areas of which readers should be aware. These could have an impact on the approach to tax research adopted by a researcher seeking to develop a tax angle in this domain. These include: readdressing the US moratorium; adjustment of VAT legislation in Europe; and the streamlined sales and use tax project. This brief update is concluded with some pointers to other tax developments that have been influenced or motivated by e-commerce.

### 15.7.1 Readdressing the US Moratorium

The extended US moratorium on new Internet related taxes was discussed in section 15.4.2.2 above. Initially the moratorium was to be extended to October 2006; however, this was shortened in the process of enacting the legislation to October 2003. Further debate has therefore occurred in the United States on the value and nature of a continued moratorium in this area over the period we are reviewing. It has now been proposed that a permanent moratorium should be enacted in this area when the current moratorium act expires in November 2003. It is an interesting research question whether Internet access, and other online activity captured by this act, should indeed justify this special status—particularly given this status is not common in other countries.

### 15.7.2 Adjustment of VAT Legislation in Europe

An important change to VAT legislation in Europe was enacted in July 2003. Prior to this time, services were taxed on the basis of the location of the supplier, not the customer, whether the customer was registered or not. This required EU companies to charge tax on all their electronic services wherever their customers were based (once outside of their own country) and whatever their VAT status. However, non-EU companies who traded within the EU were not required to collect VAT on their transactions with EU customers. This was in part corrected by the reverse charge scheme registered traders are required to operate, but did mean sales to non-registered customers who escaped VAT.

The new legislation<sup>16</sup> sought to address this imbalance. It required non-EU companies operating in one or more European countries, and trading at turnover levels over the threshold limit for VAT registration, to register for, and charge, VAT when selling electronic services to non-registered customers. This move was not widely welcomed outside of the EU, especially in the United States as a major supplier of electronic services into the EU; however, EU officials argued this action was necessary to prevent continued unfair competition. The fall out of this explicitly international application of intra-EU rules related to the resolution of an electronic-world-created problem is being watched with interest as one of the first new pieces of legislation created explicitly to deal with e-commerce-created problems outside of a normal national jurisdiction. It will test the boundaries of international approaches to e-commerce taxation resolution.

The 'opposite side of the coin' to this legislation is that EU suppliers no longer have to charge VAT on most electronic services (as deemed by the EU to be most electronic sales) to customers that are outside of the EU.

Research opportunities exist to examine both of these key legislation changes and their impact on taxpayers and tax authority activity. For example, interesting issues arise related to compliance and carrying out effective enforcement when requiring non-resident companies to comply with tax legislation in this way.

### 15.7.3 Streamlined Sales and Use Tax Project

The example of the streamlined sales and use tax project<sup>17</sup> in the United States is worth highlighting as a major project that has received significant impetus because of the tax issues associated with e-commerce activity. This major revision to the operation of sales and use taxes in the United States has been ongoing for many years but is now almost approaching the point where it will take national effect—this point will be reached when 20 per cent of the population of the states that impose a sales tax have enacted the new agreement legislation at the state level. This point has almost been reached as this piece is written.<sup>18</sup> A key motivation for the successful agreement of the necessary number of states to the required changes in the sales and use tax regulations was the impact of e-commerce on cross-state transactions where some states were becoming significant losers.

Examination of this legislation and the process by which it was negotiated, will provide interesting insights into the way in which e-commerce activity is changing indirect taxation policy and practice.

### 15.7.4 Other Tax Developments with E-commerce Implications

A large number of tax legislation changes have been enacted around the world in the period since this article was drafted. In many cases, the examination of the implications of the new legislation on and for e-commerce activity has now become commonplace.<sup>19</sup>

A further area of significant development related to Internet/e-commerce presence has been the changing 'face' of the Revenue authorities via their websites. This has included not only significantly increased opportunities

for online filing, and other compliance focused ventures by the tax authorities, but also large steps forward in the provision of a wider range of taxpayer services in many tax authorities. The associated back-office, and 'mind-set', changes this is bringing about in both the taxpayer and the tax authorities would be an interesting and rich ground for behavioural research with an IT aspect to it.

## NOTES

1. These terms can be considered to refer to different aspects of trading in the electronic world; however, for this chapter they will be used interchangeably.
2. This report suggests it was the first parliamentary study on this subject in the world where previous reports had been authored by revenue authorities (JCPAA 1998: paragraph 1.35).
3. This report also incorporated an excellent summary of the then current governmental work to date (chapter 3).
4. For details of the remit of each TAG see <[www.oecd.org/daf/fa/e\\_com/tag.htm](http://www.oecd.org/daf/fa/e_com/tag.htm)>.
5. For a view on the work of the TAGs prior to completing their assignments in December 2000 see the Report to the 2000 Ministerial Conference (OECD 2000a).
6. The consensus that was developed on this subject was that a website, or the hosting of a website, will not in itself create a permanent establishment, but the placing of a server may, under certain circumstances do so (although calls for more fundamental changes were also being made, for example, Maugham 2000).
7. To view details of the resolutions made at this meeting, visit the conference website at <[www.ae-tax.ca](http://www.ae-tax.ca)>.
8. Full details on the Advisory Commission can be found at <[www.ecommercecommission.org](http://www.ecommercecommission.org)>.
9. For details of the individual proposals submitted during the operation of the Advisory Commission, see Lymer and Singh (2000).
10. The press release from the ACEC <[www.ecommercecommission.org/releases/aceco517.htm](http://www.ecommercecommission.org/releases/aceco517.htm)> summarized the resolutions of the Commission accepted by Congress.
11. See <[www.inlandrevenue.gov.uk/e-commerce/ecom4.htm](http://www.inlandrevenue.gov.uk/e-commerce/ecom4.htm)> for details.
12. See Lymer and Singh (2000) or the ACEC website for full details of all submissions made to the Commission <[www.ecommercecommission.org](http://www.ecommercecommission.org)>.
13. See Pinto (2002).
14. This legislation became effective in Europe from July 2003.
15. For further details, see the OECD website at <[www.oecd.org/document/7/0,2340,en\\_2649\\_33741\\_1900871\\_119660\\_1\\_1\\_37427,00.html](http://www.oecd.org/document/7/0,2340,en_2649_33741_1900871_119660_1_1_37427,00.html)>.
16. An extension to the Sixth Directive was proposed in June 2000 and confirmed in February 2002—Council Directive 2002/38/EC (IP/02/673)—see <[http://europa.eu.int/comm/taxation\\_customs/taxation/ecommerce/vat\\_en.htm](http://europa.eu.int/comm/taxation_customs/taxation/ecommerce/vat_en.htm)>.
17. For further details, see the official website of the project at <[www.streamlinedsalestax.org](http://www.streamlinedsalestax.org)>.

18. An excellent source of details on the ongoing streamlined sales and use tax project is <[www.ecommercetax.com](http://www.ecommercetax.com)>.
19. For an examination of some cases where non-standard rules have been brought into effect related to e-commerce activity, see 'E-Commerce Taxation Around the World' by David Hardesty, 24 November 2002 <[www.ecommercetax.com/doc/112402.htm](http://www.ecommercetax.com/doc/112402.htm)>.

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PART

# IV

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## INTERDISCIPLINARY RESEARCH IN TAXATION

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## Producing Good Taxation Research

*Margaret Lamb and Andrew Lymer*

### 16.1 Introduction

The main objective of this book is ‘to guide and encourage readers to produce more good taxation research’ (Section 1.2). We have made clear our view, shared with our co-authors, that ‘taxation research will be enriched if multi-disciplinary perspectives are complemented by interdisciplinary perspectives’ (Section 1.5). What do we mean by ‘good’ taxation research? How might a difference of perspective alter the approach that a researcher might take to produce good taxation research? To answer these questions we need to (1) summarize some general characteristics of ‘good’ research; (2) explain why we believe every tax researcher should recognize and nurture ties to a ‘home’ discipline; (3) describe the characteristics of a ‘single-disciplinary approach’; (4) explain what we believe is involved in doing interdisciplinary research; and (5) suggest how the taxation research eclecticism, that has been noted as a positive feature of taxation research by several chapter authors in this book, reflects a trend in research practice more broadly defined.

### 16.2 ‘Good’ Research

‘There is no such thing as perfect research and “you cannot please all of the people all of the time”’ (Denscombe 2002: 3). Many guides to research and doctoral study, like Denscombe’s guide to social research, have been written to chart the intellectual journey from identification of the research idea to a publication that may be judged to be successful and fit for its purpose.

It is this judgement at the end of the research process that tells us most definitively whether the research knowledge produced is 'good' or not.

By 'social research', Denscombe means 'research in areas like education, health, business studies, social work, housing and media studies that draws on a number of disciplines, such as sociology, psychology, economics and politics' (2002: 1). It is a broad research spectrum, therefore, and embraces the subjects and disciplines discussed in this book. Denscombe notes what the contributors of chapters to Part II of this book have also found: clear guidelines about the nature of good research 'have not been easy to find because social research is a "contested" area with plenty of controversies and disagreements among the experts' (ibid.).

### 16.2.1 Ground Rules

'Behind the apparent divisions and diversity', it is possible, Denscombe argues, to identify 'certain expectations about social research that tend to be accepted across a wide spectrum of disciplines and approaches' (2002: 2). He schematizes these expectations in the form of ten 'ground rules for good research':

To qualify as social research an investigation needs to:

1. have clearly stated aims [*purpose*], that are
2. related to existing knowledge and needs [*relevance*], and that are
3. investigated within limitations imposed through time, money and opportunity [*resources*].

Research needs to:

4. contribute something new to knowledge [*originality*], using
5. precise and valid data [*accuracy*],
6. collected and used in a justifiable way [*accountability*],
7. to produce findings from which generalizations can be made [*generalizations*].

The research needs to adopt an attitude and approach that is:

8. open-minded and self-reflective [*objectivity*],
9. recognizes the rights and interests of participants [*ethics*], and is
10. cautious about claims based on the findings [*proof*]. (Denscombe 2002: 4)

Although there is likely to be widespread acceptance that these rules summarize at a very general level what is needed to underpin the production of good research, there is bound to be variation in interpretation and

emphasis from discipline to discipline. This may be the case over rules relating to 'rigour' and 'relevance'.

### 16.2.2 'Rigour' and 'Relevance'

We have already said that it is assessment at the *end* of the research process that confirms the quality label 'good' or otherwise. 'Rigour' and 'relevance' are key concepts of research quality assessment. Each can be defined in terms of particular disciplines and may be said to represent the traditional values of 'scholarship'. In many disciplines rigour is recognized by contribution to theory. Relevance, too, can be partly defined by reference to existing theories and the sorts of problems that the discipline is accustomed to examining. In Chapter 3 of this book, James discusses an economic approach to taxation research in terms of the types of problems that would typically be examined. Most often it is the doyens of the discipline who make judgements of relevance and decide when new theories and problems should be recognized. In the context of academic disciplines, Kuhn's (1970: viii) phenomena of 'paradigms'—'universally recognized scientific achievements that for a time provide model problems and solutions to a community of practitioners'—emerge from such a process of academic judgement.

In a more applied field, rigour still tends to be defined and recognized by its senior practitioners. Theory will be important, but the definition of problems to be examined may be more fluid, reflecting the iterative processes of theory modification and approximation in practical application. Relevance is recognized in a more holistic manner, either by reference to theory, implementation, or the problems of the applied field. The academic discipline of accounting is like this, as Lamb discusses in Chapter 4 of this book. In such fields, it is not just the senior academic practitioners of the discipline who articulate judgements of relevance, but also the non-academic implementers of theories and practices. This is the primary double hurdle of research quality—academic quality and relevance—widely recognized in management research (Pettigrew 1997, 2001).

As applied and hybrid fields of research and practice have grown, 'relevance' has come to be defined less by any one scholarly community on its own and more by stakeholders inside and outside academia. Communities of practitioners, research funding bodies, and governments take important roles in setting research agenda and making judgements about the relevance of proposed research. In Britain, we see this in the ways that private

sector organizations define what would be valuable research from their perspectives.<sup>1</sup> This process is reflected in the way British research councils<sup>2</sup> and government<sup>3</sup> define research criteria. In the field of management, the debate over the nature of the ‘relevance gap’ and how best to address it has spawned a stream of published literature and reports (see, for example, the 2001 special supplement to the *British Journal of Management*). In this context, many academics ‘endorse a research policy based upon the double hurdle of *academic* rigour and *managerial* relevance, embedded in both the social science canons of best practice and the worlds of policy and practice’ (Starkey and Madan 2001: S8; emphasis added).

### 16.2.3 Levels of Research Quality Assessment

Research quality assessment and sorting takes place at various levels. Within university departments, academics make judgements about whether particular research is ‘good’ (or ‘good enough’) for the award of a doctorate, to offer employment, or to secure promotion. Journal editors and their nominated referees judge whether particular papers are acceptable for publication and, according to some commentators (e.g. Lee 1995), may act as ‘gatekeepers’ for their related discipline. Research funding bodies ask referees to judge if research proposals reach threshold standards of quality for funding in a competitive market of ideas. Quality assessment and accreditation bodies may ask peer referees to classify individuals and their research according to quality criteria before awarding a quality classification or kite-mark to the academic institution. This is what occurs in the periodic Research Assessment Exercises conducted within the British university system (discussed in this book by James in Section 3.9 and Lamb in Section 4.2).

The preceding examples refer to external assessors of research quality. We have to pay attention to the ways in which external assessors express their quality standards and preferences. However, if we read the external signs slavishly in planning our own research, we risk being unsettled by changing standards, fashions, and standard-setters. Production of ‘good’ research requires individuals to follow their interests and internalize appropriate standards of quality. We argue that it is best to work to standards that we as individuals choose as ‘good’ and then strive for excellence in those terms. If these standards are well chosen, then they will usually be a reliable guide to how to produce research that is ‘good enough’ in someone else’s eyes for a particular purpose.

### 16.3 The 'Home' Discipline

'Disciplines' are 'the recognizable communities of scholars that develop conventions governing the conduct of research and its adjudication' (Salter and Hearn 1996: 20). Recognition of boundaries between disciplines often varies according to local institutional arrangements, for example, definitions of university departments. The nature of the discipline can also vary from place to place, depending on national or institutional histories and cultures. The chapters of Part II of this book illustrate these points.

Affiliation with a particular discipline will, like citizenship, usually be a matter of birth. It will, however, be 'birth' as the creation of a research-ready academic. 'Readiness for research' is one among many learning objectives that undergraduate degree programmes often claim. A master's-level degree course often involves a more substantive preparation for research. In either case, academic qualification in a particular subject will create a familiarity with and familial tie to a particular discipline. We refer to this as an individual's 'home' discipline. This is the discipline to which the researcher feels the closest sense of affiliation by academic training, outlook, or practice (see Lamb and Lymer 1999). Occasionally, the home discipline will need to be chosen from among several possibilities. This would be the case when a researcher has trained in more than one academic discipline. It would also be the case when a practitioner—with an academic qualification in one discipline and professional qualification in another—begins to follow an academic research career.<sup>4</sup>

Disciplines are not simple groupings of people who share the same body of knowledge; they are also institutions for the 'disciplining' of individuals over how the system of knowledge will be used (Hoskin and Macve 1986; Knights and Wilmott 1997; Panozzo 1997). Day-to-day power of the discipline *to discipline* may be benign and positive in the sense of encouraging scholarly rigour. Nonetheless, the exercise of disciplinary power can be reflected in a relatively narrow set of research subjects, methods, and publication outlets that are particularly encouraged and rewarded within the discipline.<sup>5</sup> The core of a discipline may be carefully defined and well understood, but the research outside the core may be less carefully defined or less well understood. This concentration of interest and specialization at the core may be explicable given the social construction of disciplines. However, it may also be seen as an unnecessary narrowing of scope and vision that inhibits the creativity and renewal of the discipline.

We argue that every tax researcher should recognize and nurture a home discipline. We believe this should be the case whether the researcher follows

a single-disciplinary approach to taxation research or not. Our recommendation is based both on our acknowledgement of the power of academic disciplines in practice, and also a recognition of the scholarly benefits of working closely with colleagues who undertake analogous research with familiar theories and background in mind and 'tool kits' to hand. Once the home discipline is clear, the tax researcher would need to ensure that his or her research projects maintained a link with that discipline. Nurturing this link will involve keeping focused on suitable research objects, defined in disciplinary terms, and attentively tracing links between the tax research and core research areas of the discipline.

#### **16.4 Single-disciplinary Approaches to Taxation Research**

Single-disciplinary research 'is discipline-based and carries a distinction between what is fundamental and what is applied; this implies an operational distinction between a theoretical core and other areas of knowledge such as the engineering sciences, where the theoretical insights are translated into applications' (Gibbons et al. 1994: 19). In single-disciplinary research, projects are conducted 'with like-minded colleagues who share considerable common knowledge and skills' or by lone researchers who work within a research community similarly defined (Evaluation Associates 1999: 4). In this context, individuals 'will often specialise in particular sub-fields or methodologies' (ibid.). In this mode of research: (1) 'any knowledge is validated by the sanction of a clearly defined community of specialists'; and (2) 'the term paradigm is used to denote a provisional consensus among the relevant set of practitioners' that is 'the result of a particular mode of organisation, and . . . denotes a way of seeing things, of defining and giving priority to certain problem sets' (Gibbons et al. 1994: 22).

In her chapter on legal traditions of taxation research, Freedman (Chapter 2, Section 2.1) describes single-disciplinary legal research as black letter (an attempt to fit the cases and legislation into a rational framework, pointing out the internal inconsistencies and supposed principles) but comments that the best legal research, although grounded in this legal technique, goes through it to the policies. James (Chapter 3) indicates that an economic approach to taxation research would focus on 'how the necessary tax revenue to support the public sector can be raised in the most efficient and equitable way'. Lamb (Chapter 4, Section 4.1) characterizes accounting research as focused on the accounting 'processes of calculating, valuing,

reporting, and evaluating financial transactions, performance, and events', 'their outputs, and the institutions created around them'.

Even when researchers choose a single-disciplinary approach to taxation research, they face choices within the boundaries of their disciplines. Freedman (Section 2.3) refers to the 'pluralistic tradition and flexibility' of British tax law research. James (Section 3.9) notes 'trends towards more technical and mainstream work' but the existence of economists who take alternative approaches to their subject. Lamb (Section 4.3.2) describes accounting researchers as having different ontological understanding of their research subjects as well as epistemological divergences. What is important, we suggest, in adopting single-disciplinary approaches to tax research is, first, to understand the hallmarks of research in the particular disciplinary tradition, and, second, to adopt a research approach shared with at least some talented specialists in the recognizable core of the discipline.

## 16.5 An Interdisciplinary Approach to Taxation Research

A research environment in which single-disciplinary approaches predominate can be described as 'multidisciplinary' and is populated with various autonomous disciplines (Gibbons et al. 1994: 28). Multidisciplinarity, it is argued, 'does not lead to changes in the existing disciplinary and theoretical structures. Cooperation consists in working on the common theme but under different disciplinary perspectives' (ibid.). Interdisciplinarity, by contrast, reflects a very different approach by individual researchers and can lead to different forms of interaction between the academic disciplines. Interdisciplinarity can be regarded as a research approach that complements single-disciplinary approaches rather than competes with them. This is the approach that we, as well as other authors of this book, have adopted with respect to interdisciplinarity.

Salter and Hearne (1996) combine a theoretical examination of 'disciplinarity' and 'interdisciplinarity' as forms of knowledge production and organization with advice on how to conduct interdisciplinary research in practice. They argue that interdisciplinary research represents exemplary high quality research:

[Interdisciplinarity] is seen to represent the best efforts of researchers not only to focus on societal issues but to explore the social and practical aspects of their expertise. . . . [R]esearch is interdisciplinary because many research problems cannot be easily addressed from within the confines of particular disciplines. They

require the concerted efforts of many people, each reflecting a different perspective. (p. 3)

This characterization of the power of interdisciplinary research reflects what other authors have described as 'an emerging view that researchers addressing the complex problems of the modern world need to collaborate more frequently to draw upon the knowledge, skills and techniques of a range of disciplines' (Starkey and Madan 2001: S18). Interdisciplinary research can 'produce an outcome that is more than the simple sum of the parts. At its best, and most creative, interdisciplinarity produces transcendent insights that were previously not perceived by the individual disciplines working alone . . .' (Professor Gordon Conway, Vice-Chancellor of the University of Sussex, 1995, quoted in Starkey and Madan 2001: S18).

Interdisciplinary research may be and is done as a team effort or by a lone researcher (Evaluation Associates 1999: 4). Salter and Hearn (1996) argue that the essence of interdisciplinary research is how the researcher positions himself or herself with respect to the research subject. An 'instrumental' approach sees interdisciplinarity as consisting, ' . . . for the most part, of borrowing methods and tools from across the disciplines in an effort to address needs dictated by the specific problem at hand' (ibid.: 30). The complexity and interconnectedness of tax problems would justify instrumental interdisciplinary approaches. In contrast, 'conceptual interdisciplinarity' adopts an interdisciplinarity dependent on disciplinarity (ibid.: 30–37). It is this approach that underpins our notion of an interdisciplinary approach for the tax researcher. Our approach acknowledges both the home discipline's strength—the embodiment of a stable epistemic community which has reached a consensus over what it recognizes as research excellence—and its weaknesses—'exclusivity, self-containment, and the setting of strict paradigm controls' (ibid.: 33). We think of an interdisciplinary approach as research activity with the potential to enrich the home discipline by compensating for its weaknesses.

All 'interdisciplinary inquiry concentrates on the nexus between two or more disciplines [and] researchers must have competence in each area. They must consciously reflect upon the purview of each discipline, its questions, its methodology and its unique potential' (Cluck 1980: 69 quoted by Salter and Hearn 1996: 33). In either case, Salter and Hearn argue that interdisciplinary researchers must pay close attention to differences in 'register' between academic disciplines because concepts, language, and ways of thinking about a problem may differ, even if—superficially—they appear to be the same. By 'register' they mean the discourse or 'the manner in which information is understood, arguments are marshalled, and issues are discussed' which reflect the common reference points and the prevailing

epistemological assumptions of each academic community (*ibid.*: 22–23). To compensate for this problem of different registers they describe interdisciplinary research as circling around a problem: first, to see how it has been dealt with by other researchers in other disciplines, and, then, to double-check understanding of the various ‘registers’ involved (*ibid.*: 55). They also emphasize the importance of finding someone across the disciplinary lines to talk to when formulating the research problem.

‘As a mode of research, interdisciplinarity extends the boundaries of academic knowledge, enabling complex practical problems to be solved and fomenting the creation of networks of experts. However, the organizational structure of most institutions of higher education has historically favoured a more monodisciplinary research culture’ (Starkey and Madan 2001: S19). Adoption of an interdisciplinary approach to taxation research requires some diplomacy in how the interdisciplinary researcher maintains his or her relationship with the home discipline. Interdisciplinary approaches may be seen as challenges to the power of established disciplines, especially to ‘the premises that have long supported [disciplinary] research and a critique of the organization of knowledge into disciplines . . . within the university’ (Salter and Hearn 1996: 3–4). The interdisciplinary researcher may advocate different, (arguably) better methods. Even limited innovation may be perceived by someone as radical change. In these circumstances the interdisciplinary researcher may need to exercise diplomatic courtesy, a willingness to explain with clarity, and a certain modest persistence. Fortunately, the positive benefits and research challenges of interdisciplinarity are acknowledged in many influential parts of the academic community.<sup>6</sup> Interdisciplinary researchers can find powerful supporters.

In summary, we argue that a sound interdisciplinary approach to taxation research involves: (1) recognition of the interdisciplinary object of research, which may be a problem best studied in the round; (2) the recognition of and nurturing of connections to a ‘home’ discipline; (3) familiarity with (an)other discipline(s), including the matter of differences in ‘register’; and (4) adoption of research methods that are drawn appropriately from the methods used and that are well developed in the relevant disciplines.

## **16.6 Variation of Research Approach as a Virtue in a Problem-centred World**

In this book several authors have noted the eclectic character of tax research. Both Freedman in Chapter 2 and Lamb in Chapter 4 present this eclecticism as a positive feature. Here, we suggest that such research diversity

reflects a trend in research practice more broadly defined. Academic researchers have spent the last decade debating the role of academic and university research in broader societal processes of 'knowledge production' and diffusion (see, for example, Gibbons et al. 1994; Salter and Hearn 1996; Starkey and Madan 2001). The conclusions of these social researchers suggest that the problems of our complex world require that traditional multidisciplinary research should be supplemented with something new. The supplement 'has evolved out of the disciplinary matrix of [traditional research] and continues to exist alongside it' (Gibbons et al. 1994: 17). The supplement is described in various ways, but often the label 'transdisciplinary' is applied:

Transdisciplinarity . . . corresponds to a movement beyond disciplinary structures in the constitution of the intellectual agenda, in the manner in which resources are deployed, and in the ways in which research is organised, results communicated and the outcome evaluated. . . . In the production of transdisciplinary knowledge, the intellectual agenda is not set within a particular discipline, nor is it fixed by merely juxtaposing professional interests of particular specialists in some loose fashion leaving to others the task of integration at a later stage. Integration is not provided by disciplinary structures—in that regard the knowledge process is not interdisciplinary, it cuts across disciplines—but is envisaged and provided from the outset in the context of usage, or application. . . . Working in an application context creates pressures to draw upon a diverse array of knowledge resources and to configure them according to the problem in hand. (Gibbons et al. 1994: 27)

Aram and Salipante (2003) attempt to adapt this research approach for individual researchers in a way that would 'meld rigour and relevance'. They identify the 'characteristics of bridging scholarship' (*ibid.*). The first characteristic is that it is 'problem initiated': 'The framing of the problem is a critical point . . . [as is] identifying the scholarship's intended audiences, those communities of practice to whom . . . the problem . . . is meaningful and relevant' (pp. 201–202). The second characteristic is that it 'transcends epistemological dichotomies' and is, therefore, 'epistemologically eclectic' (p. 202). The goal of bridging scholarship 'is to combine elements that other research sees as dichotomous. . . . [It] combines a commitment to contextualism with a reaching for the general. It denies neither experience nor theory, examining both in a process of iterative interplay . . .'. The third characteristic of bridging scholarship is 'a concept of validity that rests on utilization of the knowledge in the world of practice . . .' (p. 203). There is much scope for 'bridging scholarship' in taxation research. Indeed, this is an approach that we already see used by some taxation scholars who have adopted interdisciplinary research approaches.

The management scholar Pettigrew (2001: S62) argues 'that the complexity and uncertainty of the knowledge production process demand of us the exploration of many different types of knowledge production, user engagement and mechanisms of impact'. He adopts Morgan's (1983) approach of 'conscious pluralism' as 'the only sensible way forward'. The need, he argues (p. S69) is 'for holistic thinking and action'. The desirability of 'conscious pluralism' in research approach is very much what we, as well as authors of other chapters in this book, have argued. The potential for the production of more good taxation research will improve if alongside single-disciplinary approaches to tax research there are interdisciplinary approaches that are rigorous, relevant, and well grounded in the specialist academic knowledge and techniques of more than one academic discipline.

## 16.7 Conclusions

Our book has considered how disciplinary-based approaches to tax research have developed in law, economics, accounting, political science, and social policy. Topical studies provide bibliographic surveys of specific areas of tax research. Throughout, we have drawn attention to interdisciplinary approaches to tax research problems. In this chapter, we have explained what we mean when we say that we hope researchers will produce more 'good' taxation research and how we think that an 'interdisciplinary research approach' can complement a 'single-disciplinary approach'.

Our aim has been to produce a book that offers an innovative introduction to tax research. We have done so by presenting readers with a broad survey of taxation research and by encouraging single and interdisciplinary approaches to scholarship which take strength and creativity from the existing eclecticism of taxation research. We have explored the challenging problems that arise in connection with taxation. We hope that readers can begin to see and understand the dominant themes and patterns in this field of study. In this book tax researchers have explained what they find compelling about the study of taxation. Each author has made clear how the tax research problems that he or she finds interesting are linked to other tax research problems and perspectives within their own discipline and in other disciplines. We have argued that this interlinking approach is one way to ensure that the study of taxation is seen to be a relevant and rigorous area of research and to demonstrate why good tax researchers should be regarded as valuable contributors to the core of their own research disciplines and academic departments.

We hope that this book will assist researchers, especially researchers new to the tax field, to orient themselves in the academic tax research terrain that we have begun to map. We have posted many signs and suggested directions to new tax researchers who wish to make their own contributions to tax research. Our compendium of existing research and the approaches adopted will assist these researchers in the early stages of their research and help them to make connections between their findings and those of earlier research. This growing network of research connections across disciplinary boundaries will enrich national and international study of taxation as well as continue the processes of mapping and facilitate new developments in interdisciplinary tax research.

## NOTES

1. For example, the Centre for Business Performance of the Institute of Chartered Accountants in England & Wales 'promotes high quality research of relevance to the accountancy profession and the wider business community'. Its 'goal is to encourage thought leadership in consideration of performance-related issues with an emphasis on their financial aspects'. The quotations are from [www.icaew.co.uk/cbp/](http://www.icaew.co.uk/cbp/) (seen on 10 February 2004).
2. The Economic and Social Research Council (ESRC), one of the leading British funding councils, makes clear that relevance is an important criterion for research funding: 'We aim to provide high quality research on issues of importance to business, the public sector and government. The issues considered include economic competitiveness, the effectiveness of public services and policy, and our quality of life'. The quotation is from [www.esrc.ac.uk/](http://www.esrc.ac.uk/) (seen on 10 February 2004).
3. The British government encourages 'evidence-based' and 'policy relevant' research. See, Starkey and Madan (2001: 510) for a general discussion and, as a specific example, the website of the 'Adding It Up' project to improve analysis in the public sector. Its Evidence-based Policy Fund concentrates 'on research, which should provide timely and policy relevant results'; the quotation is from [www.addingitup.gov.uk/ebpf/ebpf\\_overview.cfm](http://www.addingitup.gov.uk/ebpf/ebpf_overview.cfm) (seen on 10 February 2004).
4. The case of the practitioner-turned-academic is not unusual in taxation research. In such cases, the former practitioner has to acquire knowledge and understanding of the theories, philosophies of research, and methods in the new academic field, as well as make sense of his or her personal experience of practice from this new academic perspective. Often this process is structured through doctoral training that permits the individual to rethink previous experiences of practice in the context of a formal induction into the research ways of the new academic discipline.
5. Knights and Wilmott (1997) emphasize the power relationships within disciplines:

All forms of research and teaching involve an exercise of power over those who seek admission to, recognition by, and identification with a particular

discipline. . . . [C]areer systems, the internal management of departments, publication outlets, and research funders exert a tendential effect of reinforcing such discipline. Conformity with disciplinary norms, standards, procedures and methods of carrying out projects provides a secure framework through which to select from the infinite variety of topics and approaches to . . . research activity. Sustaining or advancing a disciplinary cause presents an obvious means of gaining recognition and support from colleagues. (p. 21)

6. General support for interdisciplinary research is provided by Higher Education Funding Councils (1999) and Scottish Higher Education Funding Council (1997). In management, the argument is made by Gibbons et al. (1994), Starkey and Madan (2001), and Pettigrew (2001). For the merits of interdisciplinary taxation research done across the fields of accounting, finance, and economics, see Shackelford and Shevlin (2001) and Slemrod (2003).

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# APPENDICES

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# I

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## Journals with a Tax Research Focus

*John Hasseldine and Andrew Lymer*

### AI.1 Introduction

This appendix is intended to provide readers with a brief overview of the range of journals that are available as either a source of research material or indeed as a publication outlet. Information listed includes the publisher, a description of the type of research published and/or the stated objectives of the journal, the current editorial address, and website (where applicable).

### AI.2 Listing of Journals

*Advances in Taxation* <[www.elsevier.com](http://www.elsevier.com)> is a book series published by Elsevier Scientific Publishers. This annual welcomes articles on any aspect of federal, state, local, or international taxation including, but not limited to, compliance, computer usage, education, law, planning, and policy. Acceptable research methods include any analytical, behavioural, descriptive, legal, quantitative, survey, or theoretical approach.

Editor:

Tom Porcano

Department of Accountancy

R. T. Farmer School of Business Administration

Miami University

Oxford, Ohio 45056

USA.

This appendix was updated in October 2003 and worldwide web addresses were checked in June 2004.

*Asia-Pacific Journal of Taxation* <[www.af.polyu.edu.hk/about\\_journal\\_apjt.html](http://www.af.polyu.edu.hk/about_journal_apjt.html)> is a quarterly refereed journal published jointly by the Taxation Institute of Hong Kong and the Hong Kong Polytechnic University. It welcomes research papers, commentary notes, and book reviews that address significant taxation issues of relevance to the Asia-Pacific region. Research papers should be analytical and may be empirically or theoretically based. Studies of comparative practices or international research reports are encouraged.

Editor:

Editor, *Asia-Pacific Journal of Taxation*  
Department of Accountancy  
The Hong Kong Polytechnic University  
Hung Hom, Kowloon  
Hong Kong.

*Asia-Pacific Tax Bulletin* <[www.ibfd.nl](http://www.ibfd.nl)> is published by the International Bureau of Fiscal Documentation. It welcomes articles dealing with taxation and related matters of interest to readers in the Asia-Pacific region.

Editor:

c/o IBFD  
PO Box 20237  
1000 HE Amsterdam  
The Netherlands.

*Australian Tax Forum* <[www.taxinstitute.com.au](http://www.taxinstitute.com.au)> is published quarterly by the Taxation Institute of Australia. It provides a forum for the discussion of issues in tax policy, law, and reform.

Editor:

Cynthia Coleman  
c/o Publication Coordinator  
Taxation Institute of Australia  
7th floor, 64 Castlereagh Street  
Sydney NSW 2000  
Australia.

*Australian Tax Review* is published by the Law Book Company (part of Thomson Legal and Regulation Ltd.). Articles containing a legal analysis of Australasian tax law are invited.

Editor:

A. H. Slator QC  
c/o Production Editor  
LBC Information Services

50 Waterloo Road  
North Ryde, NSW 2113  
Australia.

*British Tax Review* is published by Sweet & Maxwell <[www.smlawpub.co.uk](http://www.smlawpub.co.uk)>. It seeks to provide a forum in which current developments and problems in all areas of revenue law can be considered and analysed by practitioners and academics. Articles between 3,000 and 12,000 words are welcomed and shorter pieces such as current notes and case notes, and longer pieces will also be considered.

Editors:

David Oliver, Judith Freedman

*British Tax Review*

Sweet & Maxwell

100 Avenue Road

London NW3 3PF

United Kingdom.

Papers for consideration should be sent to:

Judith Freedman

*British Tax Review*

Worcester College

Oxford OX1 2HB

UK.

*Bulletin for International Fiscal Documentation* <[www.ibfd.nl](http://www.ibfd.nl)> is published by the International Bureau of Fiscal Documentation based in Amsterdam. It welcomes articles which are of interest to an international readership of tax professionals, executives, and scholars.

Editor:

Editor, *Bulletin for International Fiscal Documentation*

PO Box 20237

1000 HE Amsterdam

The Netherlands.

*Canadian Tax Journal* <[www.ctf.ca](http://www.ctf.ca)> is published by the Canadian Tax Foundation. Its objective is to be a forum for the dissemination of research in and informed comment on taxation and public finance, with particular reference to Canada. Manuscripts may be written in English or French.

Editor:

Neil Brooks, Editor, *Canadian Tax Journal*

Canadian Tax Foundation

595 Bay Street, Suite 1200  
Toronto M5G 2N5  
Canada.

*eJournal of Tax Research* <[www.atax.unsw.edu.au/ejtr/](http://www.atax.unsw.edu.au/ejtr/)> is published by the Australian Taxation Studies Program (ATAX) at the University of New South Wales. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. The journal emphasizes the interdisciplinary nature of taxation.

Editors:

Rodney Fisher and Binh Tran-Nam  
ATAX, Faculty of Law  
University of New South Wales  
Sydney 2052, NSW  
Australia.

*European Taxation* <[www.ibfd.nl](http://www.ibfd.nl)> is published by the International Bureau of Fiscal Documentation based in Amsterdam. It welcomes articles providing coverage of key legal and policy developments affecting taxation and investment throughout Europe.

Editor:

c/o IBFD  
PO Box 20237  
1000 HE Amsterdam  
The Netherlands.

*Fiscal Studies* <[www.ifs.org.uk/publications/fiscalstudies/](http://www.ifs.org.uk/publications/fiscalstudies/)> is published by the Institute for Fiscal Studies. The journal reflects a broad interpretation of fiscal studies; articles are concerned with the whole range of ways in which government action affects the private sector of the economy. Papers, preferably no more than 7,500 words, are encouraged from individuals working on applied problems whose results have topical policy application.

Editors:

David Miles, Gareth Myles, and Helen Simpson  
Managing Editors, *Fiscal Studies*  
Institute for Fiscal Studies  
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*International Tax and Public Finance* <[www.kluweronline.com/issn/0927-5940](http://www.kluweronline.com/issn/0927-5940)> is published by Kluwer. It publishes research on theoretical

and empirical aspects of tax policy, broadly interpreted to include expenditure and financial policies. Both articles on open economy issues and single country tax reform analyses are published. Each issue includes a special section called the International Policy Watch that discusses a current policy issue or reviews some recent tax development.

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*International Tax Journal* is published by Fordham University. It is a refereed journal that publishes a variety of articles relating to international taxation.

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*International Transfer Pricing Journal* <www.ibfd.nl> is published by the International Bureau of Fiscal Documentation in Amsterdam. It presents worldwide views on transfer pricing for corporate tax purposes.

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*International VAT Monitor* <www.ibfd.nl> is published by the International Bureau of Fiscal Documentation based in Amsterdam. It welcomes articles on Value Added Tax (VAT) and also shorter contributions for 'VAT around the world' which are of interest to an international readership of tax professionals, executives, and scholars. Manuscripts are subject to a review process by the editor and an editorial board.

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*Intertax* <[www.kluwerlawonline.com](http://www.kluwerlawonline.com)> is published by Kluwer Law International (now part of Aspen Publishers Inc.). It provides practical up-to-date, high-level international tax information and covers all aspects of international tax issues.

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*Journal of Australian Taxation* is published by Monash University <[www.buseco.monash.edu.au/depts/blt/journal\\_tax.php](http://www.buseco.monash.edu.au/depts/blt/journal_tax.php)>. The journal publishes a mix of applied research, taxation policy research, and empirical research. It encourages submissions from overseas jurisdictions that are of relevance to an Australian and international academic audience.

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*Journal of the American Taxation Association* <[www.atasection.org](http://www.atasection.org)> is published by the American Taxation Association. Articles accepted include legal research, quantitative research, theoretical research, and descriptive pieces dealing with tax topics. Educational studies should contain evidence that they have been classroom tested and students have profited from the experience.

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including taxation. Critiques of current practices, general purpose solutions to problems through tax models, and applied research findings of interest both to academics and to practitioners are all appropriate.

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*National Tax Journal* <[www.ntanet.org](http://www.ntanet.org)> is published by the National Tax Association. The journal aims to present a broad spectrum of professional subject matter dealing with government finance and taxation to those concerned with public sector finance and policy. It publishes contributions to knowledge, whether institutional, empirical, or analytical; a new methodological or administrative development; an evaluation of the pros and cons of a currently relevant policy problem; or a speculative and reflective treatment of an unsettled issue in government finance.

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*New Zealand Journal of Taxation Law and Policy* <[www.brookers.co.nz/](http://www.brookers.co.nz/)> is published by Brookers. Articles published include legal and policy analyses of the New Zealand tax system.

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*Revenue Law Journal* <[www.bond.edu.au/law/rlj/index.htm](http://www.bond.edu.au/law/rlj/index.htm)> is published by the School of Law at Bond University. Articles of a tax policy or technical nature that are concise, analytical, and clearly written are welcomed.

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*Tax Executive* <[www.tei.org/pubs.html](http://www.tei.org/pubs.html)> is published by the Tax Executives Institute, Inc. Articles are welcomed on aspects of federal, state and local, Canadian, international, and tax management issues.

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*Tax Law Review* <[www.law.nyu.edu/programs/tax/review.html](http://www.law.nyu.edu/programs/tax/review.html)> is published by the New York University School of Law. The journal publishes articles containing legal and policy analysis on a variety of tax issues.

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*Tax Notes* <[www.taxanalysts.org](http://www.taxanalysts.org)> is published weekly by Tax Analysts. It is designed as a publication on current tax issues within the United States,

and includes special reports on various research findings, reports on progress on Congressional Bills, IRS news, commentary, and issues of practice.

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*Tax Notes International* <[www.taxanalysts.org](http://www.taxanalysts.org)> is published weekly by Tax Analysts. It is designed as a publication on major aspects of international taxation and investment. It is the international sister publication to *Tax Notes*. It invites articles from tax experts and its listed correspondents.

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*Tax Adviser* <[www.croner.co.uk](http://www.croner.co.uk)> is the journal of the Chartered Institute of Taxation and Association of Taxation Technicians. It publishes practical articles on aspects of UK tax law and practice.

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# II

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## Academic Tax Research Organizations

*John Hasseldine*

### AII.1 Introduction

This appendix is intended to provide readers with a brief overview of the *academic* tax research organizations that exist throughout the world. The current administrative address is shown, and website listed (where appropriate). Although it is sometimes difficult to distinguish between organizations largely comprised of tax academics and those geared to tax professionals, an attempt has been made here to list organizations of interest to tax academics.

### AII.2 Listing of Organizations

*American Taxation Association* (ATA) <[www.atasection.org](http://www.atasection.org)> was founded in 1974, and since 1978 has been a section of the American Accounting Association (AAA). Membership is open to persons with an interest in tax education and research. Membership includes a subscription to *Journal of the American Taxation Association* (JATA) and a regular newsletter. The Association has an annual meeting each August, in conjunction with the AAA annual meeting, and also has a mid-year meeting (often with a JATA conference). Participation in the ATA is encouraged and there are numerous committees and subcommittees (e.g. the Tax Manuscript Award

This appendix was prepared in October 2003 and worldwide web addresses were checked in June 2004.

Committee, Concerns of New Tax Faculty Committee, International Tax Policy Subcommittee, etc.). The ATA has also published several monographs relating to tax research methodologies and tax databases.

Address:

c/o American Accounting Association  
5717 Bessie Drive  
Sarasota, FL 34233-2399  
USA.

*Australasian Tax Teachers' Association* <[www.orange.usyd.edu.au/atta/](http://www.orange.usyd.edu.au/atta/)> is a network of academics, writers, and administrators from Australia and New Zealand with a common interest in tax who have the goal of improving the standard of tax teaching across Australasia. The Association has an annual conference where papers are presented on topical tax issues.

Address:

Mr Colin Fong, Secretary  
ATAx, Faculty of Law  
University of New South Wales  
Sydney 2052, NSW  
Australia.

*Canadian Tax Foundation* <[www.ctf.ca](http://www.ctf.ca)> is an independent tax research organization. The purpose of the Foundation is to provide Canadian governments and taxpayers with the benefit of expert, impartial research into current taxation problems in order to establish the most equitable tax system possible. The Foundation publishes the *Canadian Tax Journal* and holds a number of conferences each year, providing a forum for the interchange of ideas among business and professional people, academics, and government officials.

Address:

Canadian Tax Foundation  
595 Bay Street, Suite 1200  
Toronto M5G 2N5  
Canada.

*Institute for Fiscal Studies* (IFS) <[www.ifs.org.uk](http://www.ifs.org.uk)> is a politically independent non-profit educational charity promoting research and informed discussion of fiscal affairs. Members receive a free subscription to *Fiscal Studies*, reductions on other IFS publications and conferences, and a Newsletter. The IFS employs directly about thirty staff in London and the research staff are divided into various sectors. Outputs include reports, conferences, seminars, a newsletter, and the publication of *Fiscal Studies*.

## Address:

7 Ridgmount Street  
 London WC1E 7AE  
 UK.

*International Bureau of Fiscal Documentation* <[www.ibfd.nl](http://www.ibfd.nl)> is a non-profit apolitical organization which gathers information concerning taxation for all countries of the world and makes it available to interested parties. The Bureau maintains a professional staff of accountants and lawyers, a large library, and has a number of key publications—including journals, loose-leaf services, and books. One of these is the *Bulletin of International Fiscal Documentation* which publishes articles of interest to subscribers from around the world.

## Address:

International Bureau of Fiscal Documentation  
 PO Box 20237  
 1000 HE Amsterdam  
 The Netherlands.

*International Fiscal Association* <[www.ifa.nl](http://www.ifa.nl)> is an organization founded in 1938. Its aim is the study and advancement of international and comparative law in regard to international and comparative fiscal law and the financial and economic aspects of taxation. It promotes scientific research, holds regular international congresses, and is closely linked with the International Bureau of Fiscal Documentation.

## Address:

IFA General Secretariat  
 c/o World Trade Center  
 Beursplein 37  
 PO Box 30215  
 3001 DE Rotterdam  
 The Netherlands.

*International Institute of Public Finance* <[www.iipf.net](http://www.iipf.net)> is an organization with an international membership of public finance economists. Its main activity is to run an annual international conference.

## Address:

Birgit Schneider  
 IIPF General Secretariat  
 University of Saarland  
 PO Box 15 11 50  
 D 66041 Saarbrücken  
 Germany.

*National Tax Association* (NTA) <[www.ntanet.org](http://www.ntanet.org)> is a non-political, non-profit organization based in Washington DC, the purpose of which is to educate and benefit its members by promoting the scientific study of taxation, by encouraging research, organizing conferences, and by appointing committees to investigate special problems. The NTA publishes the *National Tax Journal*.

Address:

725 15th Street, Suite 600  
Washington DC 20005  
USA.

*Tax Analysts* <[www.tax.org](http://www.tax.org)> is a non-profit organization based in Virginia. It publishes *Tax Notes* and *Tax Notes International*. It has an extensive Internet site and operates over twenty Internet discussion groups including tax history, tax practice, tax policy, and international tax issues.

Address:

6830 North Fairfax Drive  
Arlington, VA 22213  
USA.

*Tax Research Network* (TRN) <[www.trn.org.uk](http://www.trn.org.uk)> is an informal network that was set up in 1992. Each year a late summer tax conference has been held and the TRN enables researchers to share work in progress by providing a venue for presentation and feedback. The TRN uses an email distribution list and the Internet to publicize details of upcoming conferences and research opportunities.

Address:

Dr Lynne Oats  
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University of Warwick  
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# III

## Empirical Sources for Tax Research

*Kevin Holland, Amin Mawani, and Andrew Lymer*

In this appendix we outline a variety of databases, references to databases, and papers on tax research resources that provide empirical sources that may be of use to tax researchers. No attempt has been made to order these resources using any specific importance criteria.

### AIII.1 UK and European Tax Research Databases

#### AIII.1.1 Commercial Databases

All of the following vendors offer products which cover, to varying degrees, UK company related information. The various products include: financial accounting information; market data including share price and volume data; merger and acquisitions news; equity and debt issues etc.; and analysis of ownership.

*Thompson Financial (including Datastream, Extel, Worldscope, Global Access and I/B/E/S)*—<[www.thomson.com/financial/financial.jsp](http://www.thomson.com/financial/financial.jsp)>.

Also see the following link for full list of products: <[www.thomson.com/financial/financial\\_products\\_az.jsp](http://www.thomson.com/financial/financial_products_az.jsp)>.

*London Business School (London Share Price Data—LSPD)*—<[www.london.edu/ifa/Risk\\_measurement/LSPD/lspd.html](http://www.london.edu/ifa/Risk_measurement/LSPD/lspd.html)>.

*Bureau van Dijk Electronic Publishing (BvD) (including Financial Analysis Made Easy—FAME)*—<<http://www.bvdep.com>>.

These resource references are correct as at the time of production of this appendix (July 2003) but may be subject to change over time. Worldwide web addresses were checked in June 2004.

*Mergent. Inc (Financial Information Services—FIS online)—*  
 <www.fisonline.com>.

### AIII.1.2 Free Data Sources

The Institute of Fiscal Studies and the Inland Revenue both provide data on current and past tax rates and allowances etc.:

*Institute of Fiscal Studies:* <www.ifs.org.uk>.

*Inland Revenue:* <www.inlandrevenue.gov.uk>.

*London Stock Exchange (LSE):* contains aggregate and firm specific information on the population of firms listed on the LSE and the Alternative Investment Market (AIM), <www.londonstockexchange.com>.

*The House of Commons Information Office:* publishes a list of budget dates since 1900 and other useful information concerning budgets, <www.parliament.uk/faq/faq.cfm#bud>.

## AIII.2 North American Tax Research Databases

### AIII.2.1 Commercial Databases

*The Individual Tax Model File (ITMF).* A database containing a sample of individual US Federal Income Tax returns filed (unaudited) in a given year. This database is useful for cross-sectional simulations of the administrative and revenue impact of tax provisions, and to provide descriptive statistics of taxes paid by individuals by type of income. Described in Enis (1991). See the Office of Tax Policy Research for further details of this database <www.otpr.org>.

*Statistics of Income (SOI) panel of individual returns.* A database containing panel data of a large sample of taxpayers over time. Useful for research questions requiring the tracking of the same taxpayers over time—for example, to assess the impact of a change in tax law. Described in Crum (1991) and available from the Ernst & Young/University of Michigan Tax Research Data Base <www.otpr.org>.

*Taxpayer Compliance Measurement Program (TCMP).* A database of a randomly selected sample of individual and corporate taxpayers with taxes filed, taxes assessed (by Internal Revenue Service—IRS), and the tax gap or difference. Used by IRS to distinguish compliers and

non-compliers, and for identifying potential non-compliers. Discussed in Ricketts (1992).

*Survey of Taxpayer Opinions File.* A database of taxpayer demographics, attitudes towards the IRS and the tax system, and self-reported information on tax compliance behaviour. Useful for exploring associations between demographics, attitudes, and compliance. Discussed in Ricketts (1992).

*Survey of Tax Practitioners and Advisers.* A database on tax practitioners' attitudes towards the IRS, and their evaluation of IRS services. Discussed in Ricketts (1992).

*Compustat.* Database on annual (and quarterly) financial, statistical, and market related data on a large number of North American companies for many years. The corporate text file includes full text of the Annual Reports, 10Ks, 10Qs, 20Fs, and Proxy Statements. Available from Standard and Poor's on PC and mainframe versions. Discussed in Hollingsworth and Rich (1992). See <[www.compustat.com](http://www.compustat.com)>.

*Corporation Source Book of Statistics of Income.* An annual database with detailed line-items from corporate tax returns categorized by industry and size. Data is not firm-specific. Available from the University of Michigan, Office of Tax Policy Research. Discussed in Hollingsworth (1992). See <[www.otpr.org](http://www.otpr.org)>.

*Statistics Canada's Social Policy Simulation Database and Model (SPSD/M).* A database containing a sample of individuals and households with information on demographics, education, family structure, income receipts (by type), occupation, housing characteristics, tax variables, and expenditure data. Useful for computing marginal tax rates. Discussed in Macnaughton (1992). See <[www.statcan.ca](http://www.statcan.ca)>.

*Taxation Statistics, Corporate Taxation Statistics, Corporation Financial Statistics, Statistics Canada Labour Force Annual Averages.* Published annually by Statistics Canada. Discussed in Macnaughton (1992). See <[www.statcan.ca](http://www.statcan.ca)>.

*University of Chicago Center for Research in Security Prices (CRSP).* Coverage restricted to US markets though may be useful re data on UK firms listed on US exchanges. <[gsbwww.uchicago.edu/research/crsp/](http://gsbwww.uchicago.edu/research/crsp/)>.

### AIII.2.2 Free Data Sources

*New York Stock Exchange (NYSE)*—contains firm-specific information of all firms listed on the NYSE <[www.nyse.com](http://www.nyse.com)>.

*US Securities and Exchange Commission (Electronic Data Gathering, Analysis, and Retrieval System—EDGAR)*—allows access to listing documents, 20Fs etc. of all firms with a US listing (including international firms). See <[www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml)>.

*World Tax Database*—project of the Office of Tax Policy Research (part of the University of Michigan Business School). It has current and historical data on the tax systems of the world. See <[wtodb.org/index.html](http://wtodb.org/index.html)>.

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