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A remodelling of Adam Smith's tax design principles

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Abstract

This article examines the principles that are widely used in designing tax systems. It is apparent that the design principles of Adam Smith are still relevant. However, in light of new business practices including the continued evolution of electronic commerce, they are applied slightly differently. An analysis of the principles used by the OECD in its examination of rules governing electronic commerce and principles developed by the American Institute of Certified Public Accountants shed light on their modern usage. From a comparison of the application of these principles this article recommends the adoption of five principles to govern tax design. This will provide both a common understanding and a common approach to tax design.

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Introduction

Dr Johnson once said of an acquaintance, 'Campbell is a good man, a pious man. I am afraid he has not been in the inside of a church for many years; but he never passes a church without pulling off his hat. This shows that he has good principles'.[1]

Take any document proposing or introducing tax reform. Take any critique of the tax system. It will almost invariably make mention of the principles underlying the tax system. However, when reforms are introduced by legislation or changes are made to accounting rules, one might be forgiven for thinking that the authors are a little like Mr Campbell: doffing their hats to Adam Smith in the preliminary paragraphs of an initial report is sufficient to show that the end product has good principles.

This view may be too harsh. Certainly a generation of thesis writers have used the tax principles successfully to analyse different components of the tax system and make effective recommendations for reform. We may live in a tax world reminiscent of Alice in Wonderland – where the tax law vanishes just when it is becoming vaguely familiar, to be replaced by some other extraordinary tangle of concepts and rules – but it is remarkable how the basic principles that should underlie a tax system change very little.

This article examines the use of those principles. It begins by clarifying some issues of definition and putting the use of principles to assess the tax system in context. It then identifies the principles most commonly used in a number of reports over time and across jurisdictions. The major part of the article analyses the content and meaning of the principles adopted in two representative reports from the Organisation for Economic Co-operation and Development (OECD) (applied in Australia) and the American Institute of Certified Public Accountants (AICPA) (considered in the context of their application to New Zealand tax policy). The article concludes with a summary of possible principles and recommends a set of principles that should be used in such reports and analysis in future to ensure consistency and a common understanding of tax design principles.

1 Partington A (ed) *The Oxford Dictionary of Quotations* (4th rev ed, 1996) 372, n 4.

A point of definition

If the principles that should underlie a tax system are so widely accepted, is this article necessary? In 1993, Ken Messere made the telling observation:[2]

> As in other areas where value-judgments and emotions are involved (eg, aesthetics, ethics, politics, psychology) irrationality permeates public finance literature and discussions of tax policy issues, and frequently this is because terms and expressions are used in an inconsistent or ambiguous way.

Even the subject of the article is open to confusion. In this article they are called 'principles'; others call them criteria, goals or objectives.

It is important to note that there can be a distinction drawn between principles in an economic or general sense and legal principles. The more general sense tends to be used when assessing legislative design in the tax context. Some legal theorists argue that the legal definition is more specific. For example, Dworkin would argue that a principle defines and protects an individual right, such as the right to privacy.[3] If this is accepted, it would follow that improving service standards and minimising compliance costs should be seen as collective goals that aim to enhance community welfare. They are policies, not principles. The principle of privacy would 'trump' a policy. In other words, an individual's privacy should not be interfered with simply because the interference would make it easier to minimise compliance costs.

It is clear that the general principles used to provide a basis for reform do not provide a taxpayer with a legally or morally enforceable right. Nor do they require the administration or the executive to act in a particular way. The 'broad taxation principles' are stated generally as goals to be pursued. Once the law is developed based on these principles, legislation will transform some of their content into enforceable rights and obligations.

As Messere points out, the principles themselves are based on value judgments. There is some common core of meaning, but there is also a penumbra of uncertainty,[4] simply because language is so open-textured. Hart argues that,[5] 'uncertainty at the borderline is the price to be paid

2 Messere KC, *Tax Policy in OECD Countries: Choices and Conflicts* (1993 IBFD) 109. Chapter 5, 'Irrationalities', extends the discussion.

3 For example, in Dworkin R, *Taking Rights Seriously* (1978) ch 7 and 12.

4 Hart HLA explored this idea in *The Concept of Law* (1961).

5 Ibid 121-132.

for the use of general classifying terms in any form of communication concerning matters of fact'. Messere argues further that even were the meaning of the commonly used principles agreed, 'there is no unanimity on whether tax policy should be promoting any of these goals'.[6] The fact that they are so commonly used in discussions of reform and analysis of existing laws, suggests that this is an overly pessimistic view. However, it is clear that their content changes depending on the perspective of those setting out the principles. For this reason the analysis of the principles in this article is from the different perspectives of taxpayers and revenue authorities to attempt to give some balance to the recommendations. The analysis will show that there is sufficient commonality of understanding to make the use of generally accepted principles worthwhile in the design and analysis of tax systems.

At the same time it is important to acknowledge that the general principles are not necessarily consistent. Sometimes they are mutually exclusive in their application. It will be the value judgments of those applying the principles that will determine which will carry more weight. This does not make the use of the principles any less worthwhile, for in deciding that one principle should take priority over another, both principles have to be considered and there is transparency in the process.

The principles in context

Arguably, and perhaps simplistically, within any tax system there is the equivalent of a vision, mission and values. The vision constitutes the purpose of taxation. The mission identifies the forms of taxation and the methods of administration, collection and enforcement. The principles equate to the values that underlie the tax system.

The interpretation and content of the principles underlying the system are embedded within the perceived purpose of taxation. It is worth exploring this further to understand the basis for the differences in meaning ascribed to the same principles.

Taxation is a compulsory financial contribution imposed by a government to raise revenue for which the payers of tax receive nothing directly in return. It can be defined as having three purposes:[7]

(a) To provide revenue to finance necessary Government expenditure;

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6 Messere, above n 2, 110.

7 Report of the Taxation Review Committee, Taxation in New Zealand (1967) 13.

(b) To act as an instrument to achieve the economic aims of Government;
(c) To redistribute income on a socially acceptable basis.

Financing necessary Government expenditure

The Government requires revenue to finance its expenditure. In New Zealand, for example, there are three main areas of government expenditure: superannuation, health and education.[8] Taxation is the primary source of funding this revenue. However, there are quite different views as to the rationale for taxation and its use as a policy instrument. These inevitably flow through to the interpretation and application of tax design principles. Take two examples.

For Blackburn, taxation is about revenue generation. Therefore the design of the tax system should cater to taxpayer assumptions that:[9]

1. government does have legitimate revenue requirements and that those can only be met through some form of taxation; and
2. it is the responsibility of the people who benefit from the activities of government to pay individually a portion of those costs as taxes.

He states that taxpayers excluded from the benefits will perceive taxation as unfair. Therefore, Blackburn argues that, 'If the purposes of our government are clearly stated and approved by all who are subject to the payment of its costs, we may stand a better chance of gaining general consent to the taxation that generates the necessary revenue'.[10]

Lerner takes a different view. For him, 'taxation is not a funding operation'.[11] He argues that 'decisions concerning taxation should be made only with regard to the economic effects in terms of promotion of full employment, price stability, or other economic goals, and not ever because the government needs to make money payments.'[12] Lerner suggests the only purpose of taxation is an economic purpose whereby taxation is used

8 Alley C, Maples A, Polson Higgs & Co, & Veal J, *New Zealand Taxation* (1st ed, 2004) 47.

9 Blackburn M, 'Proposal for a Comprehensive Electronic Funds Transfer Tax' (2001). Available at <http://users.ixpres.com/~concepts> [para 5.1] (at 14 April 2005).

10 Ibid.

11 Lerner A, *Economics of Employment*, (1951) 131.

12 Lerner A, 'Functional Finance and the Federal Debt' (1943) *Social Research* 10: 38-51.

to achieve macroeconomic objectives, '[T]axes should NEVER be imposed for the sake of the tax revenues'.[13]

Achieving the economic objectives of Government

Obviously, the economic objectives of governments vary significantly. Although the values or principles underlying the design of the tax system insofar as they use it to achieve those objectives need not change, the colour of their meaning will. The objective of taxation from an economic point of view can be stated thus: [14]

> To reduce private consumption and private investment so that the government can provide social goods and merit goods and subsidise the poor without causing inflation or balance-of-payments difficulties. And of course taxation must not be set so high as to reduce the private activity to such an extent that unemployment results.

A primary purpose of taxation according to Lerner, is 'its effect on the PUBLIC of influencing their economic behaviour'.[15] It happens first through the government's power to determine who is required to pay taxes (they can create sellers who will offer goods and services in exchange for state money). Secondly by the 'way taxation impacts on spending.'[16]

The legislation designed to give effect to these objectives may necessarily conflict with one or more principles of tax design. For example, tax incentives may breach the principles of equity (discrimination between taxpayers), certainty (exceptions lead to rule complexity), and efficiency (increased compliance costs). However, the fact that implementation of economic policy objectives may breach the principles does not obviate the need for them, but ensures that there is a broad benchmark against which variations can be measured and explained.

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13 Lerner, above n 11, original emphasis.

14 Alley et al, above n 8, 49.

15 Lerner, above n 11, original emphasis.

16 Forstater M, 'Functional Finance and Full Employment: Lessons from Lerner for Today,' Working Paper No 272, The Jerome Levy Economics Institute of Bard College (July 1999) Lesson #6: The primary purpose of taxation is to influence the behavior of the public.

Redistributing income on a socially acceptable basis

The impact of the purpose of taxation on the design principles has a significant effect where it involves income distribution. The fact that the redistribution of income is socially acceptable means that breaches of design principles or rewriting their content to take account of socially acceptable exceptions is equally acceptable.

As stated in Alley (*et al*),[17] 'the tax system can be designed to achieve broad social objectives'. A tax can achieve a form of redistribution of income from the wealthy to the poor. This helps to achieve social policy where individuals never fall below a level of income that would deprive them of access to basic food, clothing, housing and education. Progressive taxes are the main method used for redistribution, but low-income rebates, family tax credits and superannuation are further examples of schemes designed to increase the living standards of low-income earners.[18]

Tax intervention in order to redistribute income can limit economic efficiency and freedom of choice. It reduces the freedom and therefore the efficiency of the market.[19] Intervention means, for example, that individuals lack the ability to choose whether they want 'merit goods' such as health or education. Instead they have to pay for them whether or not they use them.

Design principles bring to the attention of governments that use them, occasions of breach. They are then able to consider more carefully the consequences of the relevant policy.

Principles for tax system design

Sawyer points out that '[w]ith the increasing globalisation[20] of business activity, mobility of capital (and to a lesser degree individuals),[21] and the

17 Alley et al, above n 8, 48.

18 Greenheld J, Hopper K, Ritchie K, & Somerfield J, *Tax Policy and Principles: A New Zealand Perspective* (1998) 79.

19 Alley et al, above n 8, 48.

20 Globalisation may be summarised as a metaphor for a way of describing a variety of non-linear processes of change on a global scale; see Walker G, *Introduction, to Globalization And Securities Regulation* (unpublished SJD thesis, Duke University, Draft, 15 December 1958) and Walker G and Fox MA, 'Globalization: An Analytical Framework', (1996) 3 Ind J Global Legal Stud 375.

21 For a discussion on the implications of the mobility of capital, and to a lesser degree, of labour, see Reuven S Avi-Yonah, "Globalization, Tax Competition and the Fiscal Crisis of the State", (2000) 113 *Harv L Rev* 1573.

blurring of jurisdictional boundaries,[22] the setting of domestic tax policy has taken on an increasingly international application.'

In this context, the application of design principles that have common meaning, albeit different application, becomes increasingly important.

Adam Smith in *The Wealth of Nations* published in 1776 outlined four principles of an ideal tax system. These principles are equity, certainty, convenience and economy.[23] If the number of times they are quoted is any guide, they are still relevant to today's tax environment. These principles are important to the creation of tax policy, because it is only when these principles are upheld that effective taxes are implemented in a manner which satisfies the stated purposes of a tax system. The following is a list of some of the principles that have been used in reports over the years. It is selective not comprehensive.

Criteria for an Efficient Tax System[24]

Author	**Criteria**	**Title**
Adam Smith 1776[1]	Equality Certainty Convenience of Payment Economy in Collection	Canons of taxation
Carter Report – Canada 1966[2]	Equity Neutrality Transparency and Accountability Certainty Simplicity Flexibility	The Use of the Tax System to Achieve Economic and Social Objectives
Asprey Report – Australia 1975[3]	Fairness Efficiency Simplicity Growth Stabilisation	Criteria for Tax Systems

22 See eg, Owens J, 'Globalisation: The Implications for Tax Policies', (1993) 14 *Fiscal Stud* 21.

23 Smith A, *An Inquiry into the Nature and Causes of the Wealth of Nations* (selected ed, 1993) p 450.

24 Adapted from Mansor M, Tayib M, Yusof RN, 'Characteristics of An Efficient Tax System – The case of Malaysian Indirect Tax', paper presented at the 6th ATAX International Conference on Tax Administration, 3.

Meade Report – United Kingdom 1978[4]	Incentives and Economic Efficiency Distributional Effects International Aspects Simplicity and Costs of Administration and Compliance Flexibility and Stability Transitional Problems	Characteristics of a Good Tax Structure
HMSO Green Paper Report – United Kingdom 1981[5]	Practicality Fairness Accountability Cost of Administration Fiscal Dimensions Financial Control	Requirement of a Local Tax System
O'Brien Report – Ireland 1982[6]	Equity Efficiency Simplicity Low Administrative and Compliance Costs	Criteria For a Tax System
Ridge and Smith 1991[7]	Administrative Feasibility Economic Efficiency Equity and Accountability	Criteria for Local Tax
Jackson 1994[8]	Equity or Fairness Certainty Convenience of Payment Economy in Collection and Compliance Transparent	Characteristics of an Efficient Tax System
OECD (Ottawa) 1998[9]	Neutrality Efficiency Certainty and Simplicity Effectiveness and Fairness Flexibility	Taxation Framework Conditions (for electronic commerce)
ICAEW Tax Faculty 1999[10]	Statutory Certainty Simplicity Easy to Collect and Calculate Properly Targeted Constant, Consultation Regular Review Fair and Reasonable Competitive	Principles for a Better Tax System

James and Nobes 1997-[11]	Efficiency Incentives Equity Macroeconomic Considerations	Principles of Taxation
American Institute of Certified Public Accountants 2001[12]	Equity and Fairness Certainty Convenience of Payment Economy in Collection Simplicity Neutrality Economic Growth and Efficiency Transparency and Visibility Minimum Tax Gap Appropriate Government Revenues	Guiding Principles of Good Tax Policy

1 Smith A, An Inquiry into the Nature and Causes of the Wealth of Nations (selected ed, 1993) p 450.

2 Canada, Report of the Royal Commission on Taxation ('Carter Report') Vol 2, The use of the tax system to achieve economic and social objectives (1966) ch 1.

3 Taxation Review Committee ('Asprey Report'), Full Report (1975) 13.

4 A Report of a Committee Chaired by Professor Meade JE ('Meade Report'), The Structure and Reform of Direct Taxation (1978).

5 HMSO 1981, Alternatives to Domestic Rates, Cmnd 8449.

6 A Report of a Committee Chaired by O'Brien MH ('O'Brien Report'), 1st Report of the Commission on Taxation – Direct Taxation (1982).

7 Ridge M and Smith S, Local Taxation: The Options and the Argument (1991) IFS: Report Series No 38.

8 Jackson PM, 'Efficient Local Government Finance: The Never Ending Story', in Terry F (ed) Towards Restructuring: The Dimensions of Change in Local Government, (1994) 55-62.

9 Committee on Fiscal Affairs, 'Electronic Commerce: Taxation Framework Conditions' (1998) also at <http://www.oecd.org/dataoecd/46/3/1923256.pdf> (at 14 April 2005) ('Ottawa Taxation Framework Conditions').

10 ICAEW Report 1999, Towards a Better tax System, Tax Faculty: Tax Guide 2/00.

11 James S and Nobes C, The Economics of Taxation: Principles, Policy and Practice (updated 7th ed, 2004).

12 American Institute of Certified Public Accountants, Inc Tax Policy, ('AICPA') Concept Statement 1. 'Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals' (2001) 6.

The table shows a significant overlap of the principles. Some lists are more extended than others. Given the acceptance of the major principles that should underlie the design of a tax system or reforms to an existing system, what is their content and meaning in practice? Two examples provide an insight into the narrow and extended lists, from different perspectives.

Application of the principles: OECD and Australia[25]

One example is found in the OECD work on electronic commerce. Before commencing its major work on the taxation of electronic commerce the OECD members agreed to base it on a broad framework of key taxation principles. The framework principles were endorsed at the 1998 OECD Ministerial Conference in Ottawa: 'A Borderless World – Realising the Potential of Electronic Commerce' ('Ottawa Taxation Framework Conditions').[26] These principles were adopted in member countries in their own reports, including Australia, which provides illustrations of their application.[27]

The principles are generally expressed specifically in reports making recommendations for the reform or design of tax systems. It is important because the legislative process that translates the recommendations of these reports into legislation does not always provide for the articulation of principles.

There are reasons for this. For example, often the translation of proposals into legislation is neither systematic nor necessarily concentrated into a specific piece of legislation. Rather, the process of translation involves lengthy legislation that may be amended significantly in its passage. It is also often scattered throughout the tax law. The nature of legislative amendment means that a bill implementing a reform package may include other amendments that have been waiting for an appropriate amending bill to be included. Determining, therefore, whether major amendments of the tax law meet the principles espoused in the original recommendations is often difficult. In Australia, major reform packages often do provide a rationale for their introduction into parliament in the explanatory memorandum accompanying introduced legislation in a section containing a regulation impact statement. In most cases however, it is necessary to return to the original report to see the over-arching principles behind the reforms.

The reports into the taxation of electronic commerce are chosen here for analysis, because they return to first principles. They clearly identify government and revenue authority thinking on what principles should be used in assessing a tax system at the beginning of the 21st century.

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25 This section was conceived in an earlier form in Bentley D, 'The ATO, Tax and the Internet: The Emperor's New Clothes?' (1999) 9 *Rev LJ*, 99.

26 OECD, above n 33.

27 Tax and the Internet: Second Report – December 1999 ('the 2nd Report') (1999) para 1.3.1.

This is because electronic commerce creates challenges to the existing design of the tax system. Therefore, in reaching solutions to dilemmas raised by electronic commerce, revenue authorities and other interested commentators have reflected closely on the basic principles that underlie the system to an extent that is not usual in tax reform. In comparison, when reports review aspects of the existing system they do not always articulate clearly a complete set of principles. For example, in the Australian Government *Report on Aspects of Income Tax Self Assessment*,[28] there is simply a reference to the principles underlying the income tax system. The report states that, 'tax policy balances potentially conflicting objectives including revenue collection, economic efficiency, equity and other social goals, while attempting to minimise administration and compliance costs', before focusing on an analysis of the meaning of certainty.

The OECD principles are particularly important given that they represent the agreed position of the most powerful economies of the developed countries in the world. Although specific negotiating positions affecting tax matters in the international arena will differ, they will generally fit within this framework. They will impact on positions taken in the World Trade Organisation ('WTO') and on the projects involving tax matters undertaken by the World Bank and the International Monetary Fund ('IMF'). Immediately, this extends the influence of these principles, for, 'whereas the OECD and WTO are concerned with coordinating and shaping the future economic direction of the world's major economies, the IMF and World Bank are concerned with ensuring that other countries follow suit'.[29] This section explores the meaning of these principles, with

28 Commonwealth, 'Report on Aspects of Income Tax Self Assessment' (2004 AGPS) <http://selfassessment.treasury.gov.au/content/report.asp> [65] (at 14 April 2005).

29 Bentley D, 'International Constraints on National Tax Policy' 30 (11) (16 June 2003) *Tax Notes International* 1127, 1133.

reference to associated reports that cast additional light on the understood meaning.[30]

Neutrality

> Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.[31]

The Ottawa Taxation Framework Conditions[32] emphasises neutrality to support its argument that existing tax rules can apply to electronic commerce. The focus is on non-discrimination and the potential for unfair distortion of competition where electronic commerce is treated differently from other forms of commerce. The implication is that to achieve neutrality tax authorities should extend existing tax rules to electronic commerce rather than develop a separate system of tax rules. The principles apply to the tax system generally. Separate rules are more likely to lead to unintended double taxation, non-taxation, and (it is implied) will always lead to differences in interpretation and application because the rules are different.

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30 The OECD provided further interpretation of some principles in its Ottawa Taxation Framework Conditions, above n 33. The European Union ('EU') issued its Communication, E-Commerce and Indirect Taxation, Com (98) Final, 17 June 1998 ('EU Communication'). Some of the principles were central to the US Internet Tax Freedom Act, included as Titles XI and XII of the Omnibus Appropriations Act of 1998, approved as HR 4328 by Congress on 20 October 1998 and signed as Public Law 105-277 on 21 October 1998. See also, Ross J, 'The Internet Tax Freedom Act Finalised' (1999) 1 Tax Planning International e-Commerce 19. The United Kingdom ('UK') Government has also adopted the principles in Inland Revenue and HM Customs and Excise, 'Electronic Commerce: The UK's Taxation Agenda' ('1999 UK Report') <http://www.inlandrevenue.gov.uk/e-commerce/index.htm> (at 14 April 2005).

31 OECD, above n 33, 5.

32 Ibid, 4. See also, Hinnekens L, 'The Challenges of Applying VAT and Income Tax Territoriality Concepts and Rules to International Electronic Commerce' (1998) 26 *Intertax* 52 at 67.

Why are these aspects of neutrality important? From the common law perspective, the Haig-Simons theory[33] suggests that all net accretions to wealth should be taxed. It is based on taxation neutrality, meaning that there should be uniformity of taxation across the tax base and taxation should apply comprehensively. Distortions are thereby limited and, consequently, equity and efficiency within the tax system are possible.[34]

The principle applied to electronic commerce suggests that people in similar circumstances should be treated in the same way. Whether a purchaser goes into a shop and buys a copy of single licence software on a shrink-wrapped compact disc or makes a purchase of the same single licence software via direct download onto her or his computer, the vendor's business profits from the transaction should be treated similarly.

The Australian Taxation Office (ATO) follows this approach and considers the guiding principle for determining the legal and administrative framework for taxation of Internet activities must be tax neutrality.[35] This recognition of the importance of neutrality is seen in its inclusion in all major reports on the taxation of electronic commerce.[36] Although, as discussed, whether the reports mean the same thing by neutrality is another question.

The 1998 Report of the Joint Committee of Public Accounts and Audit in Australia is interesting on this issue generally.[37] It found that application of the concept of neutrality might require adjustment to the substantive law. It also found that the application of neutrality principles would require the ATO to ensure 'the use of best practice processes and requirements for developing and amending legislation and regulations'.[38] The implication is of a presumption that neutrality should apply to all legislation and subordinate legislation. It suggests that the legislature may

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33 See the original contributions by Haig RM, 'The Concept of Income – Economic and Legal Aspects' in Musgrave RA and Shoup CS (eds) *Readings in the Economics of Taxation* (1959); Simons HC Personal Income Taxation (1938); and Carter Report above n 26. For a very useful discussion, see Head JG, 'Capital Gains Tax and Capital Income Taxation' (1987) 4 *Australian Tax Forum* 35.

34 Head, ibid 38. See also, Head JG, 'Capital Gains Taxation – An Economist's Perspective' (1984) 1 *Australian Tax Forum* 148.

35 2nd Report, above n 39, para 1.2.3.

36 The 2nd Report, ibid, describes it as 'virtually universal support' and provides a number of examples at fn 5, para 1.2.4.

37 Report 360: Internet Commerce – To buy or not to buy? (1998) at para 4.25 ff.

38 Ibid para 4.37.

have a wider view of the meaning of neutrality than has the executive arm of government.

Neutrality has remained the single most important principle in the international discussion of the taxation of electronic commerce. The European Union ('EU') emphasised neutrality and non-discrimination between different forms of commerce in its EU Communication.[39] It highlighted the need to use international co-operation and, where appropriate, co-ordination to prevent distortion of competition. The third EU guideline spoke of ensuring neutrality, and focusing on unfair competition to EU businesses which are taxed on electronic commerce transactions, where their competitors making supplies from outside the EU are not.[40] This principle underlies the Council Directive on VAT on electronically supplied services.[41] Non-EU suppliers of certain electronic services within the EU must now charge VAT. To prevent non-EU suppliers from having to register in all EU Member States to which they make supplies there is a special registration scheme set up under the Directive to allow registration in a single Member State. This concession is also based on an attempt to maintain neutrality.[42]

Similar arguments are widely canvassed in determining the appropriate tax treatment of foreign investment. Questions of capital import and capital export neutrality do raise the issue of how to deal with cross-jurisdictional taxation, as by definition it is impossible to create complete neutrality while there are different tax systems.[43] It is an issue that vexes the European Union as it grapples with the difficulty of introducing tax rules that are neutral between Member States.

On the one hand, capital import neutrality requires that both foreign and domestic investors are treated in the same way and that all business activity

39 EU, above n 42, 2.

40 For a discussion of the neutrality of taxation between states, see Hinnekens L, 'International Taxation of Electronic Commerce: An Emerging Framework' (1999) *Intertax* 440.

41 Council Directive 2002/38/EC of 7 May 2002 applicable to VAT on radio and television broadcasting services and certain electronically supplied services.

42 For an analysis of the application of the Directive, see Lejeune I, Joostens M and Mesdom B, 'VAT on electronically supplied services: The rules are known – what is the reality?' (2004) 2(1) *Tax Planning International Indirect Taxes* 9.

43 See Easson A, *Taxation of Foreign Direct Investment* (1999) 36 and 180, Easson A, *Tax Incentives For Foreign Direct Investment* (2004) ch 3, and Graetz MJ, 'Taxing international income: Inadequate principles, outdated concepts and unsatisfactory policies' (2001) 26 *Brooklyn Journal of International Law* 1357.

in a jurisdiction is taxed at a similar level. This would require, among other things, alignment of tax systems, exemption of foreign-source income and no layering of taxes with the imposition of withholding taxes.

On the other hand, capital export neutrality requires that the investment decision should be the same whether the investment is made at home or abroad. This would require, among other things, alignment of tax systems, a credit for foreign taxes paid (which should not exceed home taxation) and no deferral of taxation on either active or passive income.[44]

Elements of both capital import and capital export neutrality principles are upheld in the development of international tax rules and negotiation of double tax agreements that ensure some reduction in double taxation, double non-taxation and tax avoidance. As a policy goal, Easson argues that capital import neutrality and the application of the source principle is preferable:[45] to keep the rules simple; because the problem of under-taxation of foreign direct investment income is 'more easily tackled at source';[46] because encouraging direct investment and the free movement of capital without the distortion of taxation is thereby more easily achieved; and as many of the goals of capital export neutrality are met using this approach.

In the context of the taxation of electronic commerce, the focus has been on ensuring that current tax rules do not discriminate between different forms of transaction. The revision of the commentary on Article 5 of the OECD Model Tax Convention on Income and on Capital[47] definition of permanent establishment to cover, for example, web servers, provided the

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44 The OECD, in *Studies in Taxation of Foreign Source Income: Controlled Foreign Company Legislation* (1996) notes that the decision to implement controlled foreign company legislation CFC depends on whether a country has a policy of capital export neutrality. Australia has moved towards CFC rules that exempt most active business income (limited capital export neutrality), whereas New Zealand has tended towards the "complete elimination of all tax deferral arising from foreign investment as compared to domestic investment", 12, (full capital export neutrality). Adopting capital import neutrality in this context has become more difficult since OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998), as recommendations 1-3 adopt a capital export neutrality approach in an attempt to curb harmful tax competition.

45 Easson, *Taxation of Foreign Direct Investment*, above n 55, 182.

46 Ibid.

47 OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (1992) (updated looseleaf).

basis for rules that satisfy elements of either or both capital import and capital export neutrality.[48]

The US, in its *Internet Tax Freedom Act* provided for neutrality between different forms of commerce. It barred discriminatory taxation of electronic commerce.[49] The Act's focus was primarily internal and attempted to bring the indirect tax and tariff systems of individual states and local governments into line with overall US policy. The Act bars taxes on Internet access, multiple taxation of electronic commerce, and the extension or imposition of new taxes or tax reporting duties on Internet transactions.[50] However, it also forms part of the US foreign and trade policy. Congress receives annual reports on the existence and removal of foreign barriers to US electronic commerce.[51] The Act also requires the President to pursue bilateral, regional and multilateral agreements to remove tariffs and discriminatory foreign taxes from electronic commerce.[52] The States themselves have recently followed the EU lead in pursuing neutrality between in-state and out-of-state suppliers. More than forty states have formed the Streamlined Sales Tax Project to create uniform definitions for sales tax and to pursue collection of sales tax on sales to residents by companies that do not have a physical presence in their states.[53] Again, neutrality in the treatment of suppliers is seen as vital to shore up revenue collection.

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48 For a broader discussion see RL Doernberg, L Hinnekins, W Hellerstein and J Li, *Electronic Commerce and Multijurisdictional Taxation* (2001) 3.1 and 4.3.1.3.

49 §1104. The original Advisory Commission on Electronic Commerce <http://www.ecommercecommission.org> (at 14 April 2005) was set up by Congress, under the Internet Tax Freedom Act to study the impact of federal, state, local and international taxation and tariffs on transactions using the Internet and Internet Access. The Commission recommended repeal of the 3% federal excise tax on telecommunications services, simplification of states' sales and use taxation systems, a prohibition on taxes on Internet access subscription charges, extension of the current Internet Taxation moratorium on multiple and discriminatory taxation, clarification of the nexus standards for collection and remittance of state and local taxes on remote transactions, for tax administration of e-commerce to minimise disclosure of consumers personal information and to contain sufficient security to protect that information, and exploration of privacy issues associated with the collection and administration of taxes on e-commerce. The moratorium on certain internet taxes was extended for four years in 2004.

50 §1101 and §1104.

51 §1202.

52 §1203.

53 See Buresh J, 'US: Impact of Sales Tax Developments' (2003) 1(6) *Tax Planning International Indirect Taxes* 16.

The 1999 UK Report took a slightly different view of neutrality. It stated that 'the taxation of e-commerce should seek to be technology neutral so that no particular form of commerce is advantaged or disadvantaged'.[54] The UK principle is more limited in application than that of the US in that it is neither prescriptive, nor a required element of its national and international policy. It is broader in that it is a basic principle that the authorities should take into account in all matters affecting electronic commerce.

Efficiency

> Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.[55]

The Ottawa Taxation Framework Conditions defines efficiency narrowly in terms of minimisation of compliance and administration costs through improving taxpayer service and tax administration.[56] The same approach is taken in both the EU Communication[57] and the 1999 UK Report.[58]

Because minimising taxpayer compliance costs and making compliance easier is thought to improve revenue collection, it is a prime focus for tax authorities.[59] So, too, is any reduction in the cost of administering the tax system. It is in these areas that most can be done in the short-term to improve co-operation between jurisdictions. Although it is a narrow view of efficiency, potentially it could have the most impact on the widest number of taxpayers.

Revenue authorities are naturally defensive when claims are made about the high costs of compliance. However, the adverse publicity does place pressure on governments and revenue authorities to consider compliance costs in formulating and implementing tax policies. This is especially important where the potentially high costs of administering and monitoring the taxation of electronic commerce provide a significant incentive for governments to shift those costs to taxpayers and third parties. Adopting the principle that compliance and administration costs should be minimised provides a framework for negotiation between the different

54 Above n 42, 2.9.

55 OECD, above n 33, 5.

56 Ibid 8.

57 Above n 42, 7.

58 Above n 42, 2.9.

59 For a wider discussion and details of the literature, see Bentley D (ed) *Taxpayers Rights: An International Perspective* (1998) ch 1. See also 1999 UK Report, above n 42, 49.

stakeholders to determine a fair allocation of responsibilities and associated costs.

This is increasingly the position in Australia, where extensive consultation took place to try and ameliorate some of the costs of compliance placed on taxpayers with the implementation of major reforms in 2000.[60] Consultation and communication also makes it easier for the revenue authorities to gain acceptance for electronic compliance and delivery of services. Taxpayers can see the ATO, for example, as keeping in touch with the latest developments, but also as assisting taxpayers to take advantage of electronic communication.[61] This will remain a major focus for the ATO and Treasury, reflected in the *Report on Aspects of Income Tax Self Assessment*, which stated categorically that, 'The main aim of the system of tax administration is to collect … revenue with minimum administration and compliance costs.'[62]

Certainty and simplicity

> The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.[63]

Certainty and simplicity are two of the most favoured, yet most elusive, qualities of any tax system. The EU Communication stated that there 'should be certainty about the rules and compliance should be made as simple as possible to avoid unnecessary burdens on business'.[64] The 1999 UK Report stated that, 'the rules for the taxation of e-commerce should be clear and simple so that businesses can anticipate, so far as possible, the tax consequences of the transactions they enter into'.[65]

It is interesting that the EU Communication favours certainty of rules, but simplicity of compliance. Perhaps it recognises the difficulty in making rules simple. The OECD and UK approach is for the rules

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60 During the Review of Business Taxation process chaired by John Ralph, which released a number of papers including, A Strong Foundation: Discussion Paper (1998), A Tax System Redesigned (1999), A Platform for Consultation: Discussion Paper 2 Building on a Strong Foundation (1999).

61 ATO, above n 39.

62 Commonwealth, above n 40, 2.

63 OECD, above n 33, 6.

64 Above n 42, 7.

65 Ibid 2.9.

themselves to be both clear and simple. Even if simplicity is confined to making the rules simple to understand, it is a difficult task. The rules governing the taxation of electronic commerce are an excellent example of the difficulties of translating complex transactions into simple rules, as the rules will necessarily follow the nature of the transaction. They are often so complex that governments struggle to make them certain, let alone simple. An admirable aim is to draft the rules clearly, using simple language. It will aid certainty. Even then, the rules will only become certain over time, as they are interpreted and applied. During a period of change, as the rules are adapted to cope with the transactions they govern, it is inevitable that they will appear complex. They will be new and there will be different interpretations of their meaning.

Recent developments in Australia bring a new slant to the implementation of the principles of certainty and simplicity. From 1 July 2002, drafting tax legislation was moved from the ATO to the Department of the Treasury (Treasury). Part of the rationale was that, as Treasury was responsible for formulating tax policy, it should have more input into the translation of that policy into legislative design. Bringing policy and legislative development together aimed to produce a strategic alignment between Government policy and its implementation in legislation.

On 16 December 2004, the Australian Government issued its *Report on Aspects of Income Tax Self-Assessment*.[66] It identified the conflict between certainty in the law and simplicity in the drafting of the law:[67]

> During the 1980s and 1990s the tax legislation set out in increasing detail how the law applied in a variety of fact situations. This was seen as desirable because taxpayers naturally want a high level of certainty as to whether and how the law will apply in their particular circumstances. While the 'detailed' approach to law does provide certainty where a taxpayer's circumstances are specifically addressed by a rule, laws designed in this way can never anticipate all the relevant circumstances for every taxpayer.
>
> As factual circumstances vary greatly, covering a wide range of circumstances in detail is likely to result in law that is long and complicated. Complex circumstances are not easily clarified through elaboration in the law, at least not without generating

66 Commonwealth, above n 40.

67 Ibid 66.

> legislation of inordinate length. Indeed, by introducing more boundaries between the legal concepts, potentially there is increased scope for ambiguity and uncertainty. Long and detailed law can also make it harder to find the underlying policy intent and thus increase the risk that the courts will interpret the legislation in a way unintended by Parliament. When a statute is cast in a very specific way, new circumstances can generate loopholes or inequities, requiring further specific legislation and so on.

Instead, it suggests that Treasury will move towards a principle-based approach to drafting of tax legislation.[68] There are also indications that there may be a re-write of the complete tax legislation using this approach to bring together the simplified 1997 *Income Tax Assessment Act* and the remaining elements of the 1936 *Income Tax Assessment Act*, which operate in tandem following the demise of the Tax Law Improvement Project.[69]

The benefits are theoretically that the law will be simpler and shorter, more flexible, more stable, more certain, and because the draft law will be conceptually simpler, it will apparently provide a better basis for consultation. It is probably a futile exercise to attempt to make the rules substantively simple.[70] However, the aim is in line with the EU definition of simplicity as keeping the burden of administration and compliance costs to a minimum.

It is appropriate to consider certainty and simplicity together because so often there is a conflict between them, both in terms of legislative drafting and taxpayer compliance. The more certain are the rules, the less simple they usually are to understand. The simpler the rules, the less simple they usually are to either comply with or administer.

Effectiveness and fairness

> Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised

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68 Ibid.

69 Commonwealth of Australia Board of Taxation 2003, 'The Board of Taxation 2002-03 Annual Report (2003) <http://www.taxboard.gov.au> (at 14 April 2005).

70 See Prebble J, 'Why Is Tax Law Incomprehensible?' (1994) *Br Tax Rev* 380, Cooper GS, 'Themes and Issues in Tax Simplification' (1993) 10 *Australian Tax Forum* 417 and the analysis in Gale WG and Holtzblatt J, 'The Role of Administrative Factors in Tax Reform: Simplicity, Compliance and Enforcement' (22 February 2000 *SSRN Journal*) <http://papers.ssrn.com/sol3/results.cfm> (at 14 April 2005).

> while keeping counter-acting measures proportionate to the risks involved.[71]

This definition of effectiveness and fairness is from the tax administrators' perspective. Fairness to the taxpayer is presumably inferred from the statement that only the right amount of tax will be collected at the right time. In most systems based on the rule of law, it would not be open to administrators to collect more than the right amount of tax and to collect it earlier than the prescribed due date. The last sentence mentions proportionality, but then refers to the risks involved. That is more a question of efficiency in the allocation of resources than a statement that the measures used against a taxpayer should be proportionate to the amount of tax or level of avoidance involved. The term 'fairness' usually falls within the principle of equity.

From the taxpayer's perspective, fairness or equity usually means an equitable distribution of the burden of taxation.[72] The Carter Commission saw this as the primary objective of a tax system. It stated that, 'Unless a tax system is generally accepted as fair, the fundamental purpose of taxation is lost'.[73] This embeds within it the OECD definition, but incorporates the wider perspective needed at the design stage. Here is where tax policy and implementation diverge and effectiveness and fairness mean different things depending upon which stage of the process is in question.

The 1999 UK Report does not mention fairness, but in its definition of effectiveness it does state that 'the tax rules should not result in either double or unintentional non-taxation'.[74] Perhaps when fairness is coupled with effectiveness, it refers to the preference that there should be no double taxation.

The principle of effectiveness is specifically included to emphasise the importance that revenue authorities place on collecting the full amount of tax due to them. It is particularly sensitive given the potential for avoidance and evasion through electronic commerce. Although many of the concerns about general non-payment of taxes may have been exaggerated, there are still substantial risks to the revenue.

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71 OECD, above n 33, 6.

72 Carter Report above n 26, 17.

73 Ibid.

74 Above n 42, 2.9.

From the taxpayer's perspective, where fairness equates to equity, there are two major requirements for an equitable tax.[75] It should treat people in similar circumstances in the same way: this is horizontal equity. It should ensure that tax is allocated fairly between people in different circumstances: this is vertical equity. There are the caveats set out in the Asprey Report that measuring equity is not easy.[76] Notwithstanding the difficulties, the principle is generally accepted.

Interestingly, the new members of the EU seem to be following the Irish example of tax rate reduction to ensure both neutrality and horizontal equity.[77] 'Slovakia set the regional benchmark last year with a 19% flat rate for income tax, corporate tax and VAT'.[78] The issue of vertical equity must then be addressed in other ways.

In the same vein, the Australian Asprey Report[79] in 1975 argued that a failure to tax capital gains at the same rate as income causes a tax system to fail on grounds of both vertical and horizontal equity. Capital gains tax was introduced in Australia after significant debate in 1985. Over the years, the coverage of the tax has been whittled down, so that in addition to various exemptions not applicable to ordinary income, capital gains are discounted for individuals by 50% and for long-term small businesses by 100%. The argument for this apparent breach of the principle would state that the principle stands but is modified by a particular social policy tool to shape investment behaviour to meet broader government economic goals. It is important that the government offers incentives to encourage savings and investment, particularly to boost the retirement income of small business owners. Without the incentives, the argument goes, the government would not meet its long-term policy objectives.[80]

Vertical equity has historically been an essential part of the tax system through progressive taxation. In Australia, as elsewhere, the arguments over the appropriate marginal rates of income tax for individuals, indexation, reduction and other adjustments are canvassed regularly. As with horizontal equity, the principle is fundamental to the tax system, but can be sacrificed on the altar of policy necessity. The benefits of a GST outweighed its

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75 Asprey Report, above n 27, 14.

76 Ibid.

77 'Reaping the European Harvest', *The Economist* (8 January 2005) 42.

78 Ibid 43.

79 Asprey Report, above n 27, ch 23.

80 For extensive discussion along these lines of a range of initiatives, see Review of Business Taxation, *A Tax System Redesigned* (1999).

regressive nature. The electorate accepted the associated package of benefits combined with exemptions for what were seen as the basic necessities of food, health and education as recompense for the lack of progressive taxation.

Another equally difficult equity concept is that of inter-nation equity, or the equitable division of tax revenue between countries. As this essentially concerns the allocation of taxing rights it is a significant point of debate. Picciotto provides a history of the process that led to the development of general international principles.[81] The tax treaty system has been supplemented by generally agreed approaches within the OECD in certain areas, such as transfer pricing and harmful tax competition.[82] The extensive international discussion in the context of electronic commerce is an attempt to overcome the perceived threat to inter-nation equity, as there is concern that it could undermine source taxation.[83] However, the fundamental issue is whether tax systems should favour residence or source based taxation supported by different versions of economic allegiance and derivation of benefits theories.[84] Inter-nation equity relies on bilateral negotiation between nations, sometimes under the auspices of frameworks agreed in international organisations. While there is no solution, the principle of equity and fairness suggests it is important to take inter-nation equity into account.

Flexibility

> 'The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments'.[85]

The flexibility principle is not specifically taken up in other major reports, with the exception of the Carter Report, which refers to it in the context of federal-provincial relations.[86] The tenor of any report on electronic commerce is usually that the rules should be modified or adapted where necessary to ensure that electronic transactions are taxed in the same way as

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81 S Picciotto, *International Business Taxation* (1992).

82 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) and OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998).

83 Doernberg et al, above n 60, 3.1.3.

84 Discussed further in Easson, above n 57, 39.

85 OECD, above n 33, 6.

86 Carter Report, above n 26, 16.

other forms of commerce. This preserves neutrality. The Carter emphasis is similar. It suggests that a tax system must be flexible enough to cope with changing needs and aspirations of different jurisdictions. Flexibility is therefore accepted as a given. It should be, as it is integral to the efficiency of the system.

Ten Principles of Good Tax Policy Related to New Zealand

The American Institute of Certified Public Accountants (AICPA) provides the second example of an extended list of principles that are relevant to the creation of good taxes, calling them 'the ten guiding principles of good tax policy.'[87] These principles include Smith's four principles as well as six others, 'simplicity, neutrality, economic growth and efficiency, transparency and visibility, minimum tax gap and appropriate Government revenues.'[88] These principles are considered in the context of their application to New Zealand tax policy.

Equity and Fairness

Contributions by taxpayers should be in proportion to their ability to pay according to income and 'similarly situated taxpayers should be taxed similarly'.[89] 'The subjects of every State ought to contribute towards the support of the Government, as nearly as possible in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the State.'[90] The equity principle is often perceived to be the fairness principle, ie, what people view as fair they will view as equitable. 'Many people view a tax as fair if taxpayers with the greatest ability to pay have the highest tax burdens.'[91]

The AICPA principle of equity is predicated on the traditional division of 'horizontal equity and vertical equity'[92] where horizontal equity is when 'individuals earning the same amount of income pay the same amount of tax.'[93] If an accountant and a lawyer both earn an annual income of

87 AICPA, above n 36, 6.
88 Ibid 43.
89 AICPA, above n 36, 11.
90 Smith, above n 23, 451.
91 AICPA, above n 36, 11.
92 Ibid.
93 Greenheld, above n 18, 87.

$100,000 they should pay the same income tax. If the accountant pays $20,000 tax and the lawyer $30,000 this is horizontally inequitable and perhaps the lawyer should get the accountant to do his annual tax return. Vertical equity is achieved when the 'amount of "hurt" is equal among all taxpayers.'[94] This means that an individual with 'the greater ability to pay should be paying more tax.'[95] If a carpenter earns an annual income of $40,000 and pays $8,000 in income tax and a doctor earns $80,000 and pays $8,000, this is vertically inequitable because the doctor earns twice as much as the carpenter. The idea of the progressive tax system implemented in New Zealand is to achieve horizontal and vertical equity. People earning the same income pay the same tax and those with a greater income pay more tax and frequently at a higher marginal tax rate.

Horizontal Equity

'The New Zealand income tax system does not always adhere to the principle of horizontal equity.'[96] Greenheld *et al* give reasons for this:

- 'Persons who derive capital gains generally receive preferential treatment'.[97] New Zealand does not have a capital gains tax. That is, it does not have a separate statute setting out the requirements and rules for a tax which applies to the gains made on the capital held and/or sold by a taxpayer.[98] 'Currently, a person earning a salary of $50,000 will pay tax at 19.5 percent and 33 percent while a person who sells their house and makes an equivalent gain will pay no tax.'[99]

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94 Ibid.

95 AICPA, above n 36, 11.

96 Greenheld, above n 18, 89.

97 Ibid

98 New Zealand may not have a specific capital gains tax, but it still taxes certain capital gains by specifically targeting them in the taxation system and classifying them as taxable income. This is achieved by classifying income received from capital transactions as received in the course of carrying on a business.

Some provisions of the taxation system also target particular transactions that produce capital gains. These provisions include:

- Land transactions [s CB 5 to s CB 20] Personal property [s CB 2 to s CB 4],
- Calculation of foreign investment fund income or loss [s EX 38, 39, 42, 44, 47, and 57, and s CQ 5],
- Restrictive covenant and exit inducement payments [s CE 10].

99 AICPA, above n 36, 51.

- In previous years certain industries received tax incentives but the gradual removal of these incentives has increased horizontal equity.[100]
- Individuals are able to deduct expenditure incurred in deriving investment or business income but such a deduction does not exist for employment income. This inconsistent treatment is not compatible with the principle of horizontal equity.[101]
- Family tax credits distort horizontal equity in that they only provide credits for taxpayers with children.[102]
- The self-assessment income tax system present in New Zealand enables potential for tax evasion and as such erodes horizontal equity. The amount of tax collected depends on the honesty of taxpayers and the ability of the New Zealand Inland Revenue Department (IRD) to validate returns filed.[103] Taxpayers 'receiving source deduction payments and resident withholding income have no opportunity to evade tax because tax is deducted at source.'[104] This is inequitable treatment of differing taxpayers with the consequence that an increase in the amount of tax avoided and evaded will increase the burden on those who are taxed at source.[105]

Vertical Equity

In New Zealand the progressive tax rate for individuals is designed to achieve vertical equity where people with higher incomes pay tax at a higher rate. Vertical equity is also reinforced by the low income rebate, transitional tax allowance and family tax credit which lower the amount of tax paid by low income earners. However the extent the rebates achieve vertical equity is limited because the amount of hurt still appears to be greater for low and middle income earners.[106]

It is argued that GST legislation 'is contrary to the principle of vertical equity because those on higher incomes have the ability to save and

100 Greenheld, above n 18, 89.
101 Ibid.
102 Ibid.
103 Ibid.
104 Ibid.
105 Ibid 90.
106 Ibid 87-88.

therefore as a proportion of their income pay less GST.'[107] Greenheld suggests 'there is some evidence that many large companies undertake arrangements that are tax-driven, the temptation to avoid tax being largely due to the reluctance of the New Zealand Courts to invoke New Zealand's general anti-avoidance provisions.'[108] This further undermines the principle of vertical equity.

Achieving an Equitable Tax Policy

Different individuals have differing views of what they perceive to be 'fair'. For example:

> [A]n income tax system may be considered fair if:
> 1. All taxpayers are taxed at the same tax rate (a flat tax), because those with higher incomes will pay more than taxpayers with lower incomes.
> 2. Taxpayers with higher incomes pay tax at higher rates than lower income taxpayers (a progressive tax).
> 3. Many different types of income are taxed the same (meaning, for instance, that few or no types of income are excluded from taxation).[109]

The 'integrity of the tax system depends on the public perception of how equitable the system is.'[110] If taxpayers perceive the tax system to be inequitable and hence 'unfair' they are more likely to avoid and evade tax, resulting in those who pay higher taxes bearing the tax burden, with perhaps the result that they incur higher tax rates to cover the deficiency.[111] The current penalties regime and the increase in allocation of resources to the IRD to police this may help encourage horizontal equity, by encouraging people to be diligent in filing their tax returns.

A study carried out by Tan[112] indicated that taxpayers perceive New Zealand's tax system, as a whole, to be fair. Middle income earners were perceived as being hardest hit by the tax system as compared to those in

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107 AICPA, above n 36.

108 Greenheld, above n 18, 89.

109 AICPA, above n 36, 11.

110 Greenheld, above n 18, 90.

111 Alley et al, above n 8, 53.

112 Tan LM, 'Taxpayers' Perceptions of Fairness of the Tax System – A Preliminary Study' (1998) 4(2) *New Zealand Journal of Taxation Law and Policy*, 59–71.

higher and lower income groups. For this reason a progressive tax rate was perceived to be fairer than a flat or regressive tax rate.

Adam Smith's definition of equity is based on 'ability to pay' and 'an issue that continues to trouble economists is how to measure ability to pay.'[113] Should the ability to pay be based on 'income, wealth a composite of the two or some other measure'?[114] Any measure of ability to pay may not necessary produce equitable taxation, for example, two taxpayers each earning the same income may be in quite different economic positions.[115] One may have no dependants while the other may have a wife and three children. However, if this income is over the relatively low threshold for family support the tax paid will be the same for both.

Under the current New Zealand tax rules an investor who buys shares directly is taxed differently from an individual who buys them indirectly through an investment manager, such as a unit trust. 'This is because dividends and capital gains are taxable for those in the business of investing, with most professional funds managers falling into this category.'[116] If an individual investor were to make similar investments directly, they would typically not pay tax on those capital gains.

Similarly, there is inequity when income from investments made in New Zealand is treated differently from those made offshore:

> For offshore investments, special tax rules, known as the 'grey list' exemption, apply to investments in entities resident in Australia, Canada, Germany, Japan, Norway, the United Kingdom and the United States. Investments in those countries can be taxed more favourably than comparable investment in New Zealand or countries that are not on the grey list…The unintended effect is that incentives are created to invest directly and in offshore assets for tax purposes. This can disproportionately affect lower and middle-income savers because they are unlikely to have sufficient funds to invest directly and get diversified returns.[117]

113 Alley et al, above n 8, 52.

114 Ibid.

115 Ibid.

116 A government discussion document *Taxation of investment income. The treatment of collective investment vehicles and offshore portfolio investments in shares* Policy Advice Division of the Inland Revenue Department, (Wellington) June 2005, para 1.5.

117 Ibid para 1.9 and 1.10.

In June 2005 a government discussion document was published by the NZ Policy Advice Division of the Inland Revenue Department.[118] The proposals outlined in this discussion document aim to resolve these inconsistencies and the distorting inequity they have on investor decision-making.

In designing a tax system, policy makers need to take administrative and compliance problems into account to achieve equity, because it is fairness, by encouraging voluntary compliance, that holds the system together and keeps it running at minimum cost.[119]

Certainty

'The tax rules should not be arbitrary and should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined'[120] or as Adam Smith states,[121] 'The tax which the individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought to be clear and plain to the contributor and to every other person'. Certainty generally comes from clear statutes as well as timely and understandable administrative guidance readily available to all taxpayers.[122]

Certainty in tax legislation is difficult to achieve due to the complexity of tax law. As a result tax legislation is often incomprehensible and appears unclear and ambiguous. Frequent changes to tax legislation due to changing Government tax policy leads to further uncertainty. In New Zealand, the IRD attempts to achieve some certainty by publishing easy to understand guides with step by step instructions. But these guides reflect the Inland Revenues' interpretation of the legislation and do not address some of the more complex issues.[123]

Some certainty is achieved in New Zealand tax legislation in that it is set in statute and is not at the discretion of individual IRD officers.[124]

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118 A government discussion document *Taxation of investment income. The treatment of collective investment vehicles and offshore portfolio investments in shares* Policy Advice Division of the Inland Revenue Department, (Wellington) June 2005.

119 Ross S and Burgess P, *Income Tax: A Critical Analysis* (2nd ed, 1996) 26.

120 AICPA, above n 36, 11.

121 Smith, above n 23, 452.

122 AICPA, above n 36, 12.

123 Greenheld, above n 18, 90.

124 Alley et al, above n 8, 54

Certainty is also achieved by the *Income Tax Act* and *GST Act* stating the applicable rates of tax and the manner and time of payment.[125]

However, the income tax legislation lacks certainty in other respects. For example it 'does not provide exhaustive list of items subject to income tax.'[126] The writing of the legislation is complex, with the inclusion of catch-all provisions, leading to further uncertainty. Certainty is also undermined by taxpayers and IRD having different objectives. This often leads to different interpretation of the Acts, as each reflects their own objectives.[127] This results in problems 'as ambiguity in tax law also gives potential for loopholes to be devised and exploited.'[128]

The IRD and Courts have attempted to remove uncertainty, by rulings and precedent. By using a purposive approach Courts have been able to give meaning to words such as 'income', where such definitions are not found in the statutory provisions. The Binding Rulings regime is another step to remove uncertainty. The regime gives the Commissioner of the IRD the ability to issue private, public, status and product rulings which bind the Commissioner and therefore help eliminate the uncertainty by not allowing the Commissioner to change his view.[129] The rulings also provide certainty to taxpayers by enabling taxpayers to 'have certainty on the tax implications of a transaction before entering into it.'[130]

Certainty is required by the taxpayer, the IRD and also by the Government. Allan[131] refers to two types of certainty in this respect. The first is certainty of incidence, being the degree of certainty with which the tax authority can accurately predict the incidence of a tax. The person who is intended to bear the tax and the person who does ultimately bear it may not always be the same. The second type of certainty Allan calls fiscal marksmanship, being 'the certainty with which the [taxing] authorities can predict the revenue which will fall due to be paid in the year in question'.[132] A useful discussion on this second type of certainty appears in the AICPA principle 'Appropriate Government Revenues', which follows.

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125 Ibid.

126 Greenheld, above n 18, 91.

127 Ibid.

128 Alley et al, above n 8, 54.

129 Ibid 55.

130 Ibid.

131 Allan CM, *The Theory of Taxation* (1971) 39.

132 Ibid 40.

Certainty is important to both the taxpayer and the enforcing authority due to its relevance to the overall tax system. It is certainty which helps to improve compliance with the rules and increase respect for the system. Certainty is closely related to simplicity, because if the rules are complex it is more likely the legislation will lack certainty.[133]

CONVENIENCE OF PAYMENT

> A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer... For example, a tax upon the purchase of goods should be assessed at the time of purchase when the person still has the choice as to whether or not to buy the goods and pay the tax. Convenience of payment is important in helping to ensure compliance with the tax system. The more difficult a tax is to pay the more likely that it will not be paid. Typical payment mechanisms include withholding (such as the withholding of income taxes from employee paychecks) and periodic payments of estimated tax liability.[134]

The self-assessment regime implemented in the New Zealand tax system means taxpayers have to determine their own tax liability, but there are also some taxes collected at source. Therefore the convenience of collection varies depending on the type of tax.[135]

Compliance costs also reduce the convenience of the income tax system. Such costs include collecting information, obtaining advice from tax experts and preparation of returns. 'Various studies (eg, Sawyer and Hite, 1997) have estimated that taxpayers incur between $1.5 and $2 billion annually in compliance costs. This suggests that the New Zealand tax system is not convenient for taxpayers.'[136] However, since this study, for most individuals receiving salary, wages, interest or dividends, the tax system has become very convenient.[137] These taxpayers no longer have to file an IR 5, individual tax return; their tax liability is determined by an income statement issued by the IRD.[138] For other individuals the tax system may not be so convenient,

133 AICPA, above n 36, 12.

134 Ibid.

135 Greenheld, above n 18, 92.

136 Ibid.

137 An October 2001 Income Tax Amendment Act with application to the 2002-2003 and subsequent income years.

138 Alley et al, above n 8, 56.

with small business owners 'having a number of tax obligations including filing GST and FBT returns, deducting PAYE from employee wages and filing an annual income tax return.'[139] Other individuals are 'also charged with the collecting of tax at source', for example banks collecting resident withholding tax.[140]

Compliance costs are being addressed in current Governmental policy evidenced by the report released in September 2003 titled *Making Tax Easier for Small Businesses* where the Government 'proposes a number of changes to make tax collection more convenient such as aligning payment dates for provisional tax and GST payments and basing provisional tax payments on GST turnover.'[141]

Economy of Collection

'Every tax ought to be so contrived as to take out of the pockets of the people as little as possible, over and above that which it brings into the public treasury of the State.'[142] The costs to collect the tax should therefore be kept to a minimum. Such costs include the 'compliance costs incurred by the taxpayer' and 'administrative cost to the Government.'[143]

Taxpayer compliance costs are defined by Sandford and Hasseldine[144] as 'those costs incurred by taxpayers in meeting the requirements laid on them by tax law, over and above the payment of tax, and over and above any distortion costs inherent in the nature of tax.' Such costs include monetary, time and from stress and anxiety associated with preparing tax returns.[145] Different taxpayers face different levels of compliance costs. As explained under the principle of Convenience above, salary and wage earners have minimal compliance costs in meeting their taxation obligations whereas business taxpayers have significant compliance costs.[146] It is a current New Zealand Government policy objective to address compliance costs especially for small businesses.

139 Ibid.

140 Ibid.

141 Ibid 57.

142 Smith, above n 23, 452–453.

143 AICPA, above n 36, 12.

144 Sandford C and Hasseldine J, *The Compliance Costs of Business Taxes in New Zealand* (1992) 5.

145 Alley et al, above n 8, 58.

146 Ibid.

Administrative costs are defined as 'costs incurred by the public sector to collect tax.'[147] With the advent of new technologies and greater reliance on technology the IRD has been able to significantly reduce the administrative costs.[148] However various types of taxes have different compliance and administrative costs and 'arguably each tax has its own political or economic justification for its existence' and cannot be avoided.[149]

The loss of efficiency that results when tax distorts economic behaviour is also a significant cost, relating to both administrative and compliance costs.[150] Economy of taxation also relates to the principle of simplicity. 'The more complex a tax, the greater the costs for the government to administer it and the greater the compliance costs for taxpayers to determine their tax liability and report it.'[151]

Simplicity

Simplicity outlines the need for tax law to 'be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.'[152] This is important both to taxpayers and revenue authorities. It is essential in formulating tax policy that the drafted legislation is kept simple as 'complex rules lead to errors and disrespect for the system that can reduce compliance.'[153]

This principle is very closely aligned with the principle of certainty. If tax law is simple it will be more certain, which will improve the compliance process and enable taxpayers to better understand the tax consequences of transactions in which they engage in or plan to engage.

A policy objective of the New Zealand Government is to achieve greater simplicity of the tax law. The Tax Simplification Consultative Committee[154] was set up to reduce the complexity of the tax legislation. This was attempted through the rewrite of core provisions of the *Income Tax Act*.[155] However it has been suggested that the 'simplified legislation

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147 Ibid.

148 Ibid 59.

149 Greenheld, above n 18, 92.

150 Alley et al, above n 8, 59.

151 AICPA, above n 36, 12.

152 Ibid 12.

153 Ibid 12.

154 Tax Simplification: Final Report of the Consultative Committee (1990).This was preceded by the Consultative document on tax simplification (1989).

155 Alley et al, above n 8, 55.

is often at least as complicated as the original version'[156] and with similar 'past attempts at simplifying legislation has been largely unsuccessful.'[157] Richardson and Sawyer concluded that the reorganisation of the tax legislation and the rewrite of the core provisions of the ITA 1994 had 'resulted in a significant reduction in average sentence length'.[158] However, at that stage (1998) the rewrite process had failed to have a substantial impact on the understand ability of the legislation.[159]

A process of further simplification in New Zealand is evidenced by the following reports:

More time for business – tax simplification for small business, A Government discussion document (May 2001) and *Making Tax Easier for Small Businesses*, A Government discussion document (September 2003). Examples from these reports include: consolidating payments and reporting systems for employer taxes, reducing unnecessary tax forms, reducing record keeping requirements, covering part of the cost of using payroll agents, improving the timing and frequency of tax payments, provisional tax based on GST turnover, a discount for individuals starting a business and electronic tools to answer questions on employment and residence status.

As stated by Randolph Paul,[160] 'A spirit of humility is not amiss in dealing with the problems of simplification of our tax law. The subject is vast. Many have tried and no one has conquered.' Surrey and Brannon[161] define simplicity as the 'characteristic of a tax which makes the tax determinable for each taxpayer from a few readily ascertainable facts.' Cooper states: [162]

> in much of the literature, not only is it assumed that simplicity is a self-evident good, so also the assumptions are made that there is only one route to achieve it and that we all intuitively know what that solution is. All of these assumptions, once stated, are obviously disclosed to be false, but they are implicit in the literature.

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156 Tan LM & Tower G, 'The Readability of Tax Laws: An Empirical Study in New Zealand' (1992) 9 *Australian Tax Forum*, 370–372.

157 Greenheld, above n 18, 91.

158 Richardson M and Sawyer AJ, 'Complexity in the Expression of New Zealand's Tax Laws' (1998) 14 *Australian Tax Forum* 352.

159 Ibid.

160 Randolph EP, *The Simplification of Federal Tax Laws* (1994), quoted in Cooper, above n 82.

161 Surrey S and Brannon GM, 'Simplification and Equity as Goals of Tax Policy' (1968) 9 *William & Mary Law Review* 915.

162 Cooper, above n 82, 421.

For example, according to Boucher[163] and Nolan,[164] redrafting the income tax into clearer language, which is the most commonly suggested simplification, is a limited objective with correspondingly limited benefits. Cooper[165] states 'they are right. Redrafting a rule to make an application clearer does not necessarily make it (let alone the entire system) easier to administer or comply with. Nor would it solve the problem of unnecessary complexity in the systems chosen to give effect to policy'. He also states 'If defining simplicity is difficult, measuring it is an even more intrepid exercise'.[166]

Cooper[167] states the best strategy for simplification might be to prevent complexity from arising. Slemrod[168] suggests that every proposed tax reform should be accompanied by a Resource Cost statement – which details the total compliance and administration costs of the proposal. This requirement would complement the more common and expected analysis of the equity and efficiency consequences of the proposal. Presumably, the revenue estimates of the proposal would then have to be adjusted to take into account these additional costs so as to give the government an estimate of the net social benefits from the proposal.

The Ralph Committee in its Final Report[169] states 'Complexity is one consequence of continually building the business tax system upon a foundation deficient in policy design principle'. This statement reinforces the need for a clearer set of principles to be referred to and applied when any changes to taxation laws are being considered.

Neutrality

Neutrality requires that 'the effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a

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163 Boucher T, 'The Simplification Debate: Too Simplistic?' (1991) 26 *Taxation in Australia* 277.

164 Nolan B, 'Modernisation of the Income Tax Law, the Third Dimension', unpublished address to the ATO, 18 June 1992.

165 Cooper, above n 82, 425.

166 Ibid.

167 Ibid 459.

168 Slemrod J 'The Return to Tax Simplification: An Econometric Analysis' (1989) *Public Finance Quarterly* 3. Revenue Impact statements have been introduced in Australia in an attempt to achieve this.

169 Review of Business Taxation Final Report, *A Tax System Redesigned: More Certain, Equitable and Durable* (July 1999) p 106.

transaction should be kept to a minimum.'[170] This means that an individual should not be making business decisions based solely on tax considerations. Taxpayers should not be encouraged or discouraged from entering into certain transactions due to the advantages or disadvantages of tax law.[171] 'Neutral taxes collect revenue without disturbing the market's invisible hand; they don't alter choices among goods, between spending and saving, or between work and leisure.'[172] Tax incentives specific to a particular industry undermine the neutrality of the tax system. A decision to buy one product as against another should not be determined by tax considerations.[173] In this sense New Zealand's GST is, with some exceptions, neutral as it applies to most goods and services consumed in New Zealand.[174]

Balancing neutrality of onshore and offshore taxation of investment is complicated. Different tax outcomes can arise depending on whether the investment is in a New Zealand company or a foreign one. One reason is that New Zealanders pay tax on their domestic investments through the tax paid by the companies that they invest in.

> The company tax system levies tax on the earnings of companies even if they do not pay dividends, which provides a measure of tax on investments, even though rises in share price may not be directly taxable. In other countries, some companies pay a similar level of tax, while others pay little to no tax. Further, some offshore investments pay regular dividends, as most New Zealand companies do, while others rarely if ever do so. As a result, finding one tax treatment that suits all offshore investments and does not leave some offshore investments significantly under-taxed is a challenge.[175]

The New Zealand government discussion document *Taxation of investment income* proposals are aimed at improving the alignment between the tax treatment of direct and indirect investment in New Zealand shares,

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170 AICPA, above n 36, 13.

171 Ibid.

172 Veseth M, *Public Finance* (1984) 181.

173 Ross and Burgess, above n 131.

174 Alley et al, above n 8, 60.

175 A government discussion document *Taxation of investment income. The treatment of collective investment vehicles and offshore portfolio investments in shares* Policy Advice Division of the Inland Revenue Department, (Wellington) June 2005, para 1.11.

and ensuring that a reasonable level of neutrality is maintained in the tax payable on offshore portfolio share investments.

The neutrality principle is based on the assumption that the 'primary purpose of a tax is to raise revenue for governmental activities, rather than to influence business and personal decisions.'[176] However this is not always the case; taxation can also be used to further social and economic objectives and as such certain types of taxes are designed not to be neutral.[177] New Zealand examples include imposing a tax on tobacco to discourage consumption.[178]

Economic Growth and Efficiency

> The tax system should not impede or reduce the productive capacity of the economy.[179]

That is it 'should neither discourage nor hinder national economic goals, such as economic growth, capital formation and international competitiveness.'[180] This principle 'is achieved by a tax system that is aligned with the economic principles and goals of the jurisdiction imposing the tax.'[181] For example, New Zealand tax rules should not pose competitive disadvantages for New Zealand companies relative to foreign companies. Policy formulators need to consider the potential impact tax changes have on the economy before implementation.

> Economic growth and efficiency is impeded by tax rules that favor a particular industry or investment thereby causing capital and labor to flow to such areas for reasons not supported by economic factors which can potentially harm other industries and investments, as well as the economy as a whole.[182]

This principle is related to the principle of neutrality in that tax rules that distort taxpayer behavior may hinder economic efficiency.

176 AICPA, above n 36, 13.
177 Alley et al, above n 8, 60.
178 Ibid.
179 AICPA, above n 36, 13.
180 Ibid.
181 Ibid.
182 Ibid.

Transparency and Visibility

> Taxpayers should know that a tax exists and how and when it is imposed upon them and others.[183]

This enables individuals and businesses to know the true cost of transactions and to see what their total tax liability is and how the money supplied to the government in the form of taxation is being utilised.[184] An understanding of what their money is being used for may remove to some extent the negative perception of tax and may help increase compliance. It may be politically convenient for a government to retain or raise a tax when it is not visible as there will be little, if any, awareness among taxpayers of the effect on them.

Allan refers to the notion of 'evidence', being 'the extent to which the taxpayer is made aware of his [or her] tax payments'.[185] Woellner *et al*[186] note that in a democratic society citizens should have complete information about the impact of various taxes so they can decide the extent to which they support a government's programmes and objectives. Excise taxes (eg, taxes on tobacco, alcohol and petrol) are one form of tax that is not readily visible to taxpayers, compared to income taxes (such as PAYE deducted from earnings and detailed on pay slips) where most taxpayers are all too aware of what they pay.[187]

Transparency is facilitated by individuals and businesses being able to give feedback on new policy initiatives before they become legislation. New Zealand has an impressive record of tax policy discussion documents being issued to the public inviting direct comment and feedback.[188]

Transparency and visibility are closely related to certainty and simplicity. The more complex a tax system is, the less transparent it tends to be. Complexity obscures how, when, and on whom a tax is imposed, which increases confusion, frustration, and the perception that the tax is unfairly imposed.[189]

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183 Ibid.

184 A roadmap to achieve tax law transparency is given in AICPA Tax Policy Concept Statement 3, *Guiding Principles for Tax Law Transparency* (September 2003).

185 Allan, above n 143, 40.

186 Woellner RH, Barkoczy S, Murphy S, Evans C, *Australian Taxation Law 2002* (12th ed, 2002) 37.

187 Alley et al, above n 8, 60-61.

188 See <http://www.taxpolicy.govt.nz> for lists of these documents.

189 AICPA *Tax Policy Concept Statement* 3, above n 192, p 7.

Minimum Tax Gap

> A tax should be structured to minimise non-compliance.[190]

This principle identifies the tax gap as: [191]

> the difference between taxes that are owed and taxes that are voluntarily paid. A tax gap exists with any tax for a variety of reasons, such as intentional errors (non-filing, underreporting of income, overstating of deductions, and omission of transactions) and unintentional errors (math mistakes and lack of understanding of the rules).

If the principles of convenience, certainty and simplicity are not achieved, complexity of tax legislation may encourage non-compliance. Procedural rules are generally required for all tax systems in order to encourage compliance. Rules to encourage compliance might include mandatory withholding of taxes at the source and penalties for noncompliance. Generally, compliance measures need to strike a balance between the desired level of compliance against the costs of enforcement and the level of intrusiveness of the tax system.[192]

An effective tax system will be facilitated where the tax gap is minimised.

New Zealand has a system of taxing income at source for wages, salaries, interest and dividends which has meant that most salary and wage earners who do not have other business, rental or large investment income are no longer required to file a tax return. They therefore have little opportunity to minimise their tax burden or avoid paying taxes. However, a system of penalties for noncompliance introduced in 1996 has proved over-zealous and has needed modification.[193]

Appropriate Government Revenues

'The tax system should enable the government to determine how much tax revenue will be collected and when.'[194] Tax policy must consider the ability

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190 AICPA, above n 36, 13.

191 Ibid.

192 General Accounting Office ('GAO') Reducing the Tax Gap – Results of a GAO-Sponsored Symposium (June 1995) GAO/GGD-95-157, 13.

193 See the *New Zealand Tax Administration Act 1994*, Pt IX Penalties and the many amendments that have been necessary since the introduction of this legislation.

194 AICPA, above n 36, 13.

of potential taxes to raise revenue requirements, because this is ultimately the overriding purpose of taxation. If a tax does not meet the revenue needs of the government it should be seriously reconsidered.[195] Typically, a mix of taxes provides a more stable tax base because different types of taxes are affected differently by changes in the economy. Governments need assurance that tax revenues will be stable so that required spending can occur.[196] The use of the Goods and Services Tax in New Zealand has decreased the Governments reliance on income tax but in recent years a timely collection of tax revenue has not been a problem as each quarter the revenue received has far exceeded the estimates.[197]

A tax system will be effective if it raises appropriate funds to sustain the level of public services demanded by citizens and policy makers.

Comparison of tax principles

In Tabular form, the two lists of tax criteria examined appear somewhat different and more expansive than those used by Adam Smith. They are set out below with their definitions for comparison.

Adam Smith (1776)	OECD (1998)	AICPA (2001)
Equity Contributions should be in proportion to the ability to pay according to income	**Effectiveness & Fairness** Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved	**Equity & Fairness** Similarly situated taxpayers should be taxed similarly. The concepts of horizontal and vertical equity

195 Alley et al, above n 8, 60.

196 AICPA, above n 36, 14.

197 See for example, *NZ Herald*, 25 September 2003, 'The Government's operating surplus for the year ended June 30 came in at $1.966 billion, $605 million more than the forecast made in the May...' <http://www.nzherald.co.nz/index.cfm?ObjectID=3525412> (at 14 April 2005), or *NZ Herald*, 30 June 2000, 'The Government looks like banking a higher Budget surplus for the current year than it last forecast. Financial statements for the nine months... 13 May 2000'. <http://www.nzherald.co.nz/index.cfm?ObjectID=137098> (at 14 April 2005).

Adam Smith (1776)	**OECD (1998)**	**AICPA (2001)**
Certainty Taxes should be certain and not arbitrary	**Certainty & Simplicity** The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted	**Certainty** The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined
Convenience Taxes should be levied in a manner convenient for the taxpayer		**Convenience of Payment** A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer
Economy Taxes should be no more than required	**Efficiency** Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible	**Economy in Collection** The costs to collect a tax should be kept to a minimum for both the government and taxpayers
	Neutrality Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation	**Neutrality** The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum
	Flexibility The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments	

Adam Smith (1776)	OECD (1998)	AICPA (2001)
		Simplicity The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner
		Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy
		Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others
		Minimum Tax Gap A tax should be structured to minimise non-compliance
		Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when

A recommended set of principles

A common understanding is important in searching for a framework of principles that can be used to consistently analyse the ongoing changes to tax rules, types of tax and tax systems. The greater the level of specificity the less likely the principles are to be implemented. From the above analysis and examples of the application and meaning of each principle, it appears that several of the principles in the extended lists simply reflect a greater level of detail within the principles on the shorter lists.

We recommend that the following principles be adopted with the accompanying definitions. They represent a common understanding of the goals for a 'good' tax system. Commissions of enquiry, legislators, policy-makers, administrators and taxpayers may have more detailed goals that they wish to see achieved in any reform or change process. Where such goals will affect the principles they are better included not as additional principles but within the ambit of the existing principles.

For example, the AICPA list can comfortably be contained in this way. Today, economy in collection and convenience of payment both relate to efficiency of compliance and administration costs and should be assessed under the same heading of efficiency. Simplicity, transparency and visibility are usually seen as important elements in ensuring certainty. There should be neutrality of the tax system so that economic growth and productive capacity of the economy will not be impeded. Effectiveness extends to minimising the tax gap and ensuring appropriate government revenues.

EQUITY AND FAIRNESS

- Taxation system design should take account of horizontal and vertical equity.
- It is important that the public perceives the tax system as fair.
- Inter-nation equity should be considered for international elements.

CERTAINTY AND SIMPLICITY

- Tax rules should not be arbitrary.
- Tax rules should be as clear and simple to understand as the complexity of the subject of taxation allows, so that taxpayers can anticipate in advance the tax consequences of a transaction including knowing when, where and how the tax is to be accounted.
- There should be transparency and visibility in the design and implementation of the tax rules.

EFFICIENCY

- Compliance and administration costs should be minimised and payment of tax should be as easy as possible.

NEUTRALITY

- The tax system should not impede or reduce the productive capacity of the economy.

- Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- Capital import neutrality and capital export neutrality should be considered.

Effectiveness

- The system should collect the right amount of tax at the right time without imposing double taxation or unintentional non-taxation at both the domestic and international levels.
- The system should be flexible and dynamic to ensure a match with technological and commercial developments.
- The potential for active or passive non-compliance should be minimised while keeping counter-acting measures proportionate to the risks involved.

These principles will always compete and overlap with each other. The art of taxation design is to balance the principles most effectively in achieving the intended purpose. Vertical equity, for example, is often sacrificed to achieve other principles. As the Carter Commission put it: [198]

> We realize that some of the objectives are in conflict, in the sense that movement toward one goal means that others might be achieved less adequately. Simultaneous realization of all the goals in some degree will constitute success if, as we hope, our choices as to the appropriate compromises adequately reflect the [informed] consensus…

The broad content of these recommended principles is set out in the analysis of the OECD principles (Application of the principles: OECD and Australia) and AICPA principles (Ten Principles of Good Tax Policy Related to New Zealand). However, the detail will always remain the subject of debate, disagreement and ultimately negotiation between the different influencers of tax system design. Ideally a 'Tax Policy Concept Statement' should be written for each as is being undertaken by the

198 Carter Report, above n 26, 17.

AICPA.[199] This is beyond the scope of this paper but certainly a desirable development and objective of a future paper.

Conclusion

As the pace of change continues unabated, it is inevitable and advantageous that reports into tax design are founded on fundamental tax design principles. In the interests of common understanding and consistency, it is useful to have a set of principles such as those of Adam Smith that are widely applied. At the same time and in light of modern business practices including the ongoing development of electronic commerce it is suggested that Smith's principles need modernising.

Most reports adopt a variation of Smith's principles. As the variations become fractured, it will be useful to return to a common starting point: most importantly because they will also provide the basis for analysis of a wide range of international rules, such as those governing the taxation of electronic commerce. The principles recommended in this article reflect the principles used in most reports, but draw them together using widely accepted and understood terminology. As tax law design becomes increasingly international in perspective and countries look to contemporary tax design in formulating their own tax systems, it would be very useful if the recommended framework of principles was widely adopted and used.

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199 The Tax Division of the American Institute of Certified Public Accounts has published three Policy Concept Statements:
Tax Policy Concept Statement #1 — Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals
Tax Policy Concept Statement #2 — Guiding Principles for Tax Simplification
Tax Policy Concept Statement #3 — Guiding Principles for Tax Law Transparency
These can be obtained from the following website:
https://www.cpa2biz.com/ResourceCenters/Tax/ConceptStatements.htm