Pasquale Pistone, Jennifer Roeleveld, Johann Hattingh,
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Fundamentals of Taxation

An Introduction to Tax Policy, Tax Law and Tax Administration

IBFD

Fundamentals of Taxation

Why this book?
The main purpose of this book is to promote the dissemination of the basic notions of taxation from a policy, legal and administrative perspective, offering its readers a balanced view of rights and obligations connected with the levying of taxes. The book sets out current principles of taxation from both an economic and legal perspective, explains taxation in different legal systems, outlines considerations for substantive and procedural tax law design and deals with sanctions in tax law.

The book explains the fundamentals of taxation in a simple manner and without reference to a specific legal system. This method allows the book to set out fundamental considerations beyond the boundaries of any actual tax system whilst emphasizing that taxation is always rooted in a legal regime, policy considerations and administrative practice.

The book aims to strengthen awareness of taxation beyond technical circles and was written for the most diversified categories of users in civil society and beyond. People who can benefit from this book may range from university students to tax practitioners or members of civil society from both developed and developing countries who seek a clearer view of current fundamental issues regarding the levying of taxes in a global setting. Furthermore, the book provides basic notions of taxation required for building a theoretically responsible understanding of the operation and challenges of international taxation.

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Production of this Work

This multi-authored book is the result of the scientific cooperation between the University of Cape Town and IBFD. While each author was tasked with the initial drafting of aspects of the book, the book is and remains a collaborative and multi-authored single manuscript.

In the interest of transparency, the initial division of work is recorded as Pasquale Pistone (preface and chapter 5); Jennifer Roeleveld (preface and section 4.3.); Johann Hattingh (sections 2.3., 3.1., and 3.3.-3.4); João Félix Pinto Nogueira (chapter 6); and Craig West (chapter 1 and sections 2.1.-2.2., 3.2. and 4.1.-4.2.).

Peer Review Process and Statement

This statement serves to confirm that the full manuscript of this book was subjected to external peer review at the pre-production stage. For this external peer review, three independent international academic experts in the field were tasked with reviewing the manuscript. In particular, the reviewers were asked to comment on whether the manuscript provides an original analysis based on thorough knowledge of the existing literature on the subject.

Upon receipt of the positive reviews, the manuscript was accepted for publication and the publishing team made the final editorial, stylistic, grammatical, typographical and typesetting amendments.

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Preface

Taxes are an essential component of modern society, since they secure the financial resources through which a given community funds its essential functions.

For long, the world of taxation has been an inaccessible maze of technicalities, confined to a narrow circle of navigated experts and often hard to understand, even for people with a solid legal background.

More recently, taxes have made their way to headline news, raising a growing interest in civil society across the world and a genuine curiosity to understand how taxes in fact work.

Besides being a moral duty, paying taxes is a legal obligation, which each legal system regulates within a positive framework that also establishes the rights arising in connection with such payment.

Often, the revenue-raising function overshadows the legal dimension of taxation. Yet, the latter constitutes an essential component, since it ensures that the levying of taxes complies with the Rule of Law and the principles of civilized nations, which are the fundamental values of each community. Our view is that both are indispensable in a modern tax system.

The main purpose of this book is to promote the dissemination of the basic notions of taxation from a policy, legal and administrative perspective, offering its readers a balanced view of rights and obligations connected with the levying of taxes.

When examining the fundamentals of taxation, this book explains them in a simple manner and without reference to a specific legal system. This method allows the book to set out fundamental considerations beyond the boundaries of any actual tax system whilst emphasizing that taxation is always rooted in a legal regime, policy considerations and administrative practice.

In adopting this fundamental basis method, the authors aim to strengthen awareness of taxation beyond technical circles and reach out to the most diversified categories of users, in civil society and beyond.

The readers of this book can be university students of a tax course, from a developing or developed country, those who come across taxation during their studies or those who are just curious to better understand what taxation is about. People with a solid legal culture or members of civil society without a legal background may use this book to gather a clearer view of the main issues connected with the levying of tax. Furthermore, the book can serve as a starting point to gather the basic notions of taxation that are required for building up a theoretically responsible understanding of the problems of international taxation.

The six core chapters of this book, as well as this preface, reflect the needs of its potential readers, guiding them step by step through the fundamentals of taxation.

A few remarks can help understand how our readers may best use this book.

After a comprehensive overview of the principles of taxation, chapter 2 bundles them together in a context that also takes into account their legal dimension, policy goals and implications.

Since legal systems may affect the actual context in which tax law operates, chapter 3 elaborates on the main features of common law, civil law, mixed and supranational legal systems.

The subsequent chapters focus on substantive tax law and the type of taxes most frequently contained in tax systems (chapter 4), procedural tax law (chapter 5) and sanctions (chapter 6). All of them reflect our approach, which combines the search for effective tax collection and the protection of fundamental rights.

In particular, substantive tax law consists of the rules through which a system imposes taxes. In such framework, chapter 4 addresses the issues connected with the different levels of government at which taxes may be imposed, the impact of the division of powers on the levying and application of taxes, tax law design and the conundrum of rules that determine who and what will be taxed, as well as how and when.

When analysing procedural rules in chapter 5, the book underlines that the power of tax authorities in this context is essential for the achievement of the goals of revenue collection, but also limited by the need to comply with the Rule of Law. In such system, we connect rights and obligations arising for tax authorities and taxpayers.

Chapter 6 elaborates on a thorough analysis of tax sanctions, which addresses them in the light of a preliminary study on the concept and typology of tax infractions. In line with the overall goals of the book, this chapter reconciles the effectiveness of tax sanctions as deterrents proportional to the infractions, also taking into account the effectiveness of legal (also interim) remedies applicable to them.

Because of such features, this book constitutes an experiment for a global study of tax law, which we hope will contribute to raising the awareness of taxation throughout the world. Our wish is that this awareness will be beneficial to civil society, which already fought some centuries ago to combine the obligation to pay taxes with the right to participate in the decision-making that establishes such taxes ("no taxation without representation") and meanwhile may have somehow lost track of the basic features of modern tax systems. Aside from this, we hope that such awareness helps developing countries reach their own understanding of what is good for their own governance.

Since this book is the result of the scientific cooperation between the University of Cape Town and IBFD, the authors would like to thank all the human and financial resources that supported this innovative experiment to serve the international tax community. Our wish is to help the new generations and bright minds of developing and developed nations contribute to a better world by establishing fairer taxation across countries throughout the world.

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Amsterdam and Cape Town, May 2019

Chapter 1

Introduction to Tax Policy

1.1. Fiscal policy and tax policy

Fiscal policy is generally defined as the policy to use government revenue (taxes) and government expenditure to influence the market (the economy). Tax policy is a subset of fiscal policy examining the revenue side of fiscal policy (i.e. the collection of revenue by a state).

Tax policy touches on a number of disciplines, including, but not limited to, economics, behavioural science, political science, accounting, finance and law. Often, these disciplines are intertwined with respect to numerous concepts.

The economics perspective provides the initial broad overview of tax policy, containing both macro and microeconomic aspects. The macroeconomic aspects consider the influence of tax policy on the economy as a whole (unemployment rates, economic growth, consumption levels, etc.). The microeconomic aspects include the impact of tax on individuals, firms and the market.

1.2. The budgetary balance of tax, debt and expenditure in fiscal policy

The levying of taxes has rapidly become the main source of government revenue in most states. There are, of course, exceptions, such as states levying royalties on natural resource extraction. Taxes are used to fund government expenditure, but frequently, government expenditure exceed the amount of taxes collected. This is particularly prevalent when states try to maintain a counter-cyclical budget (i.e. in periods of downturn of the economy, government expenditure is increased despite the lack of tax revenue in an effort to stimulate the economy). However, the shortfall (deficit) between the expenditure and the revenue must be settled. Governments therefore borrow money to fund additional expenditures (usually through the issuance of government bonds).

Taxes, borrowings and expenditures form the three points of the budgetary triangle of government funding. The balance between tax revenue and borrowing must be strictly monitored. Interest charged on the monies borrowed by governments must equally be serviced by the tax revenue collected, and it therefore erodes the tax revenue. When borrowings become excessive, this can lead to a downward spiral in which tax revenues are fully absorbed by the interest charges and the government cannot justifiably increase the tax revenue, rendering government expenditure on the delivery of public goods and services impossible.

Governments must therefore preserve a delicate balance of tax revenue and borrowings to fund its expenditure. This, in long periods of downturn, has prevented governments from successfully applying a perfectly counter-cyclical policy.

The triangle of tax revenue, borrowings and expenditures mean that governments have three mechanisms with which to fund a deficit: (i) raising taxes; (ii) increasing borrowings; or (iii) spending less. Each of these options has a direct impact on the economy. The decision regarding the mix depends on the nature of the fiscal policy of the government and the economic circumstances in which it finds itself.

Examining only the fiscal policy in the absence of other factors, governments tend to either have an expansionary or contractionary fiscal policy. Expansionary policies encourage increasing government expenditure and/or decreasing tax revenue. The intended impact of either of these choices is the stimulation of the economy. Governments in such a cycle are generally trying to decrease unemployment and increase the productivity of the economy (leaving more revenue for reinvestment by the taxpayers rather than extraction through taxes). However, increased expenditure, when coupled with decreased tax revenue, will require the balancing of the budget/funding of the deficit through borrowings.

In contractionary policies, governments decrease expenditure and/or increase taxes. Such actions have the effect of contracting economic activity. Increased taxes take more away from productively generated income, leaving less capital for expansion. Similarly, decreasing expenditure can equally lead to reduced public services (requiring more private investment for such services) and can increase unemployment, shrinking the economy. While contractionary policies may lead to a budget surplus, this assumes that the increased revenue is sufficient to offset the reduced expenditure, but this is not a universal truth. A contractionary policy may still yield a deficit that has to be funded through borrowing.

Increasing taxes can create problems in the economy through increasing deadweight losses, as the increased prices impact the supply-and-demand equilibrium (i.e. increased taxes raise the prices, thereby decreasing demand and increasing deadweight loss). Increased spending by governments or funding a deficit through increased borrowings can crowd out similar spending or borrowing in the private sector in a full-capacity economy, and therefore can be detrimental if not carefully monitored. Increased borrowing can also raise interest rates, reducing the disposable income of households and businesses.

Increased taxes may also generate uncompetitive conditions for multinational entities and be detrimental to the development of small businesses domestically. Decreasing government expenditure can directly affect employment levels and the level of social benefits that may be provided. Increased government borrowing can remove providers of capital from the pool from which the private sector may seek finances.

While it is clear that in designing a tax system, a holistic picture is needed with respect to raising taxes (considering the expenditure by the government, its borrowings, political influences, cultural aspects and interactions with other economic aspects, such as monetary policy), this book considers only issues concerning the levying and collection of taxes raised by states.

1.3. Policy principles for a state to raise taxation

1.3.1. What is a tax?

While the concept of "tax" does not carry a universally accepted definition and therefore is not possible to exhaustively define, it is possible to provide some common identifiers with respect to tax.

It should be noted that most jurisdictions do not define "tax" and that tax should be considered as something different than a levy (which may equally be imposed by a government).

As taxes can be considered a direct violation of the right to property and other constitutional rights, the procedure for governments to introduce a tax is usually subject to some form of special process. In this regard, it should be noted that “levies” are usually not considered taxes and are therefore not subject to discussion here. However, it is important that in the design of any system, taxes are not disguised as levies.

For a government charge to be considered a tax, there are some common traits observable in all taxes:
- a tax is a compulsory charge (i.e. not a voluntary contribution);
- a tax is imposed by legislation (government);
- a tax is to be used for a public purpose; and
- a tax is usually not tied to a specific service to be provided to the individual paying the tax (i.e. the tax may support services to the collective and not the individual).

While these elements are observable, there is no uniformity in application among states. Also, states may well add to the requirements of this list before the charge may be classified as a tax in the particular jurisdiction. Critically, the legitimacy of the tax is found in its creation by legislation.

1.3.2. Theories justifying taxation

In assessing why states raise taxation, the first consideration is the justification for a state to raise tax (i.e. the legitimacy of the tax). This is one of the most neglected issues in defining tax principles. Taxes have become so firmly entrenched in the collective thinking that the more common approach is to ask what governments will do with the tax revenue rather than whether the collection of tax is justified.

In assessing whether tax is justified, numerous theories have evolved over the years, ranging from (i) an emergency levy, to fund particular identified state expenditures; (ii) the benefit theory, which implies that all individuals should contribute to the state from which they receive protection and benefits; (iii) the social contract, according to which all must contribute to the greater good of the community; and (iv) the sacrifice theory, according to which all individuals should contribute in accordance with the wealth they generated (the precursor to progressive tax rates) in order for the state to redistribute (to some extent) that wealth. All of these theories are rooted in the particular circumstances of the time and linked to individual taxpayers rather than corporate entities. As these theories evolved, taxation moved from an emergency measure to a regular levy on individuals. Many of these theories are still quoted today as justification for taxation.

Over the period of development of these theories, taxes rapidly became the main revenue source for modern states, and it is often from the accepted norm that taxes will be levied that the discussion of tax policy begins. However, most of these theories were developed considering the interaction of individuals with the state (either one-on-one or as a collective). Subsequent to these theories and with the advent of legal corporations, further development in the justification of taxes has resulted.

Current writings seem to conflate these theories to justify taxation. This combining of the theories is perhaps representative of a change from considering the individual in a relationship with the state to a wider perspective that includes the state, the economy (including corporations and organizations) and society (representing individuals as a collective). In this triangular relationship, individuals and corporate entities play a role in the economy, being the generators of the economic productive activity that generates income and wealth. The state will generally impose taxes on the productive economic goods of the economy, which returns a portion of the value created within (and implies a nexus with) the state and enables the state to fulfil the purposes for which the taxes were levied. The state may also impose necessary limitations on the economy, but should not overly restrict it, or else it runs the risk of eroding the very productive element that funds it. In this respect, one can see evidence of aspects of each of the earlier theories justifying taxes being present in this interdependent relationship.

There is perhaps a rising fourth element with respect to taxes, and that is the global economy and global society. Taxes are inherently restricted by the bounds of the jurisdiction of the state, but global influences are already directly impacting states, introducing global pressures to conform with respect to various aspects of taxation.

Global conformity is, of course, problematic. Tax systems are inextricably bound to the fiscal and macroeconomic policies of the state and the legal structure in which they are housed (*see* chapter 3). Tax policy is driven by more than idealist values and sound principles, as it is sensitive to political forces, ideologies, lobby groups and international organizations.

Tax culture in a jurisdiction also plays a part in the manner in which tax is imposed in a state and in whether the state will be able to justify the tax to the persons it affects. Numerous forces and social challenges can influence the tax culture in a state. These challenges may range from the level of inequality within the state to whether the government is viewed as legitimate. Similarly, the perception of taxes may equally impact the success of any tax policy. Views may range between seeing all taxes as creating distortions in the market and an unnecessary cost to seeing them as a necessary interventional tool for the state to stimulate and shape the economy (encouraging incentives; *see* chapter 4) or redress inequalities. Within this broad range, many states see taxes as necessary for providing welfare benefits within the state. This speaks to the justification of taxes through the purpose the tax will serve.

All of these factors play a significant role in the balance of the theories for the justification of tax in a particular state.

1.3.3. Justifying taxation through its use

While tax must firstly be created by a legitimate body authorized by the public to impose taxes – which should be accountable to ensure that taxes are not levied that would violate fundamental human rights – justification for tax is regularly provided with respect to the purpose that the tax is meant to serve.

The purposes for which taxes may be levied can be grouped into various categories. The most commonly used categories include (1) providing government functions (also called "state building") such as government infrastructure and military; (2) providing other public goods and services; (3) creating greater equality through redistributive functions; and (4) guiding behaviour in society (as tax can serve to provide guidance as to acceptable and unacceptable behaviour). Categories (2)-(4) are sometimes grouped as elements of state-building or classified as "internal management", which is the nature of what the government is trying to achieve (management of the economy and society). More recently, the influence of the global economy and global society (discussed in section 1.3.2.) can also be perceived as a need for taxation (i.e. revenue is required to respond to these influences), which has been termed "negotiated expansion".

The fact that taxes are raised by the state in terms of the enacted law implies that there should be some limitation to tax as well. Three key principles emerge, namely the following:

– taxes should not erode capital. Erosion of capital will lead to reduced income in the future, which ultimately could destroy the productive economy;

– taxes should not exceed that which is needed to fund the public needs. This implies that taxes should fund service delivery and (efficient) administering of those services; and
– however justifiable the tax may be, if it costs more than what the levied tax would collect, it should not be levied. It is critical that the government service be delivered efficiently, as excessive taxation to fund excessive expenditures or inflated government services cannot be justified.

While the general purpose of taxes should be justified in terms of the common good (public need), ear-marked taxes (taxes levied to fund a particular purpose) may be justifiable, but may equally disrupt the economy by manipulating economic behaviour. However, the objectives that surround public needs may be broadly determined. Depending on the particular country, the redistributive aspects that taxation delivers can form part of the public need (i.e. to achieve greater social equity). Equally, taxes influencing behaviour may be perceived as necessary (environmental taxes, sugar taxes, etc.).

Ultimately, the core of the justification of taxation largely has to do with the (general) purpose for which the tax will be imposed for the benefit of society and represents a blend of the benefit and sacrifice theories and the theory of social contract. Whichever description is used to justify the tax, governments are ideally served by a broad tax base on which taxes are levied that is fair, efficiently administered and responsive to societal challenges and demands. The taxes levied should be levied legitimately and in an environment in which corruption, inefficiencies and inequities are minimized or eliminated. Developing a tax-compliant culture is equally important to tax policy, but this is only realistically achieved when taxes are viewed as justified and the obligations of the state with respect to the delivery of public goods or services are met.

Notes

Notes

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