FOUNDATIONS FOR A SOUND TAX SYSTEM: SIMPLICITY, CERTAINTY AND STABILITY
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Simplicity, certainty and stability: in ACCAs view these are the three cornerstones of a good tax system. Policymakers should consider them any time they plan to change the tax system. They are also the benchmarks by which taxpayers can assess the effectiveness of government in maintaining and improving tax systems.

Between 2013 and 2015, ACCA published a series of reports on Simplicity, Certainty and Stability in Tax, together with a summary report. This 2020 publication updates the summary report for developments in both the tax arena and the wider social, political and economic environment within which policy makers have to operate while remaining rooted in those original reports.

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Introduction

Tax should exist to create benefits for society, not be a burden upon it

Tax systems are fundamental to society. They are the conduit through which the state gathers the resources it needs to support public spending and are often the direct mechanism for implementing policy. Every citizen is affected by the operation of tax systems, and the efficiency and effectiveness of the system and its administration will have effects far beyond the direct impact of tax collection. Coming to terms with the impact of COVID-19 will intensify the focus on tax systems’ effects, both positive and negative, on economies and societies more broadly.

Just at those economies and societies have grown ever more complex, so have their tax systems. As the world changes around them, tax systems must change to keep up. By the beginning of the 21st century, the arrival of the container, the executive jet and the internet had changed the face of world trade and domestic economies beyond anything previously envisaged. The still greater upheaval of the digitalising economy, transforming not just the way businesses operate but also the fundamental nature of products and consumer demands, highlighted the incompatibility of existing tax systems with social conditions.

The enhanced mobility of goods, people and capital has transformed economies but the importance of tax in maintaining societies remains, and has been highlighted by the shock of the COVID-19 pandemic. As the global economy adapts to the impact of this novel coronavirus, governments will face the prospect of funding increased spending in societies where economic activity overall has declined and much of what remains may take place in very different ways to those envisaged when existing tax systems evolved.¹

The three functions of a tax system (revenue raising, redistribution and regulation of economic behaviour) will be achieved in different ways at different times. As policymakers react to change, and seek to influence it themselves, they will be faced with choices over what to tax, and how to do so.

ACCA has identified three fundamental considerations which every system should strive for, and by which citizens can measure the success of governments and tax administrations in developing laws and processes, and the resources to administer them, for the greatest benefit of society. Regardless of the policies adopted by government, the design of the tax system used to fund or implement them should be optimised to achieve a balance between simplicity, certainty and stability.

1. Simplicity
Understanding and complying with tax legislation should be as simple and straightforward as possible. If taxpayers and their advisers face too complex a tax system and are unclear what is expected of them, this creates the potential for both mistakes and deliberate rule-breaking. Complexity in the tax system distorts the economy, diverting productive energies into non-productive administration.

Why is tax so complicated?
Tax systems can perform multiple roles: raising revenue, redistributing wealth and regulating behaviour (e.g. through excise duty on alcohol or ‘green taxes’). These aims may be achieved in several ways: by taxing spending (e.g. through Value Added Tax (VAT) or Goods and Services Tax (GST)), receipts (personal or corporate income) or capital. Single taxes may be intended to support more than one aim.

Implementing tax also has complexity: even when based on legislation, supplementary guidance or case law may be required to determine how the taxes will operate in practice. Tax authorities, taxpayers and advisers will interpret the rules – not necessarily in the same ways.

In practice, much of the complexity experienced by taxpayers and their advisers stems from policy implementation: confusing paperwork, ambiguous or inconsistent legislation and dysfunctional bureaucratic processes. Additional complexities are created when governments grant exemptions for certain taxpayers or draft anti-avoidance legislation. Anti-avoidance legislation requires taxpayers to keep up to date with targeted rules, or to ‘second guess’ the intentions of the legislature when trying to understand the tax impact of transactions.

Taxes must also be calculated and assessed, which can happen in a variety of ways (e.g. by paper forms or online) and at different periods (e.g. annually, quarterly or on an ad hoc basis). Collection methods also differ. For example, with transactional taxes, it often isn’t the taxpayer who remits the tax to the authorities (e.g. VAT and income tax on employment earnings).

Taxpayers face even more complexity when operating across multiple jurisdictions, which may apply rules in different ways and have different tax rates. Historically, only the largest of businesses tended to operate in more than two jurisdictions, at most, and business models and transactions followed familiar patterns. The digitalisation of the wider economy has created new challenges, as trade and commerce can increasingly operate across the geographic national boundaries that separate tax jurisdictions.

As economic operators supply goods and services in novel ways, which may not even have been contemplated when the tax codes were first written, so tax authorities are faced with fitting new business models into old tax codes. The digitalisation of the wider economy has created new challenges, as trade and commerce can increasingly operate across the geographic national boundaries that separate tax jurisdictions.

What are the advantages of simplification?
ACCA believes that a commitment to achieving simplicity in the tax system will produce the following benefits:

- reduced cost of administration
- greater accountability through clarity and transparency, and
- improved stability, because the potential for unintended consequences and need for counteracting measures are both reduced.

As noted above, reducing the administrative burden on business appears to be more strongly linked with economic growth than cutting tax rates.

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How can greater simplicity be achieved?
Technology can play a part in reducing the administrative burden on business, by enabling online filing, reducing the need for repeated taxpayer input, and even removing the human element from data input altogether. Many jurisdictions now base filings on accounts prepared in XBRL (Extensible Business Reporting Language), which is easily readable by other software.

Simplicity can be encouraged by restricting adjustments to standards-compliant accounting when preparing tax computations. Where adjustments are necessary, these should be specified as clearly as possible.

Drafting simpler tax legislation doesn’t necessarily mean shorter legislation, but it does need to be usable and understandable. This is particularly important in countries where taxpayers self-assess their liability and will be the primary users of the legislation.

The most fundamental driver of simplicity (or complexity) in a tax system is the intended function of the tax. A system designed purely to raise revenue is more likely to be simple, as the only design constraints are neutrality and efficiency. Mechanisms that introduce choices for taxpayers, and taxes designed to influence behaviour, are more likely to increase complexity.

Policymakers should try not to make any one tax do too many things, and should not use too many different taxes to try to achieve the same aim – for example, corporate income taxes become used to raise revenue, to redistribute corporate profits from the wealthy (the business owners who would otherwise ultimately benefit from the surplus), and to regulate business activity, through, for instance, enhanced deductions for installing ‘environmentally friendly’ plant and machinery. Introducing these variously targeted aims inevitably results in complication. And then there is the potential for overlap: direct levies on carbon use or energy consumption have similar aims to the ‘green’ elements of corporation tax. Governments trying to avoid waste and complexity in their tax system need to consider carefully whether they should operate two taxes with the same aim.

Note that the concept of fairness doesn’t necessarily align with simplicity. The simpler and less granular a tax system, the less finely it will be able to differentiate between the circumstances of different taxpayers. A flat tax is theoretically the ultimate in simplicity, but has no ‘progressive’ element.

In general, to encourage simplicity, the number of tax rules, and their ability to interact (or conflict) with each other, should be kept to a minimum. This also applies to international situations. Where a value chain is exposed to tax in a number of jurisdictions, the treatment should be aligned as closely as possible across them all, ideally through formal adoption of common rules and principles.
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2. Certainty

Certainty in a tax system is important because without it neither governments nor taxpayers can effectively budget or plan for their future actions. Yet every system incorporates uncertainty to some degree, and it may even be encouraged.

Benefits of certainty
Policymakers need to be able to base future spending plans on a realistic assessment of expected income. Certainty also benefits taxpayers. It helps them choose between alternative transactions, and to decide whether to proceed with an individual transaction.

Where there is uncertainty over the tax position of a transaction, prudent taxpayers may reserve funds against the potential liability, restricting additional investment and so creating an opportunity cost. Where uncertainty leads to disputes between taxpayer and tax authority, the direct and indirect costs can be considerable.

How uncertainty can arise
Uncertainty can develop at any stage of the tax-assessment cycle – when identifying tax transactions, valuing them and applying tax law to them. The threat of retrospective legislation is particularly devastating, and is generally reserved by governments to counter clear abuse.

Corporation taxes are typically based on an adjusted value of published accounting profit, but calculating that profit may rely on subjective valuations. In addition, the same concept – such as depreciation (gradual writing down of the cost of an asset to reflect its use) – may be applied differently under accounting and tax rules. The same transaction may also have a different tax treatment depending on who makes it. Increasingly, digitalisation is resulting in the development of business models with the ability to create value from activity in jurisdictions where there is no recognised legal presence, and hence no formal accounting for those transactions on which a conventional tax charge can bite. In the absence of a common approach or standards, local interpretations of the functions and structure of the value chain can see multiple jurisdictions asserting taxation rights over the same financial flows.

A purposive interpretation of legislation – where tax law is to be applied in line with its intended purpose – creates uncertainty. This is particularly demonstrated by the general anti-avoidance, or anti-abuse, rule – a principles-based approach designed to protect society from unacceptable tax avoidance, but an inevitable cause of uncertainty.

The involvement of the judiciary in interpreting tax law also has an impact. Judicial precedent can change overnight, while the appeals system and potential for multiple opinions can cause additional uncertainty for taxpayers.

The treaty-based system of international tax (which follows legal form to allocate tax characteristics) has created some uncertainty for international businesses, which leaves opportunities for managers or owners to exploit. But the alternative unitary tax model introduces different uncertainties. Instead of taxing each company's locally accounted profits, such a system taxes a proportion of the whole (global) profits of the business on the basis of the proportion of its sales, assets and labour recorded in the jurisdiction.4

Abuse of uncertainty poses risks to the exchequer. Taxpayers may seek to use it to their advantage when interpreting tax law, while tax officials may also seek an undue advantage, for themselves or the state. Corrupt tax officials could, for example, attempt to impose excessive tax demands in the hope of receiving a bribe.

Extending discretion to tax authorities to ‘do a deal’ poses a further risk to the tax system in the form of undisclosed state aid. Such deals will typically be limited to the largest multinationals or wealthiest individuals, and could give them significant advantages through lower effective tax rates.

Deliberate uncertainty
In some cases, taxpayers seek to introduce uncertainty deliberately, eg through an artificial avoidance scheme based on a tenuous interpretation of the law or facts. In practice, uncertainty usually results from the tax and accounting system’s failure to capture the reality of a transaction clearly.

RESOLVING UNCERTAINTY IS A POOR SECOND BEST TO AVOIDING IT IN THE FIRST PLACE.

Any objectively certain tax regime would have to consider every possible transaction and interaction, making it far too complex. Once governments accept that some circumstance-based uncertainty is unavoidable, they may be tempted to extend the boundaries of uncertainty deliberately. They may expect prudent taxpayers to wish to minimise tax risk and so pay more tax in order to be sure of escaping challenge. Such actions by government are just as open to criticism as actions of taxpayers seeking to exploit uncertainty through aggressive avoidance schemes.

Taxpayers cannot be expected to avoid all such areas of uncertainty. Managers of a business will face a tension between their duties to protect the interests of the owners and other direct stakeholders in the business and their legal and moral duties to wider society. Similarly, governments should consider the potential impact on economic activity of uncertainty.5

What can policymakers do?

Policymakers need to understand the tension that exists between simplicity and certainty. The interests of larger businesses are better served by certainty, while individual taxpayers will require simplicity. The relative importance of simplicity and certainty to smaller businesses will depend on their aims, activities and resources. Designers of tax systems need to reach a compromise between conflicting needs.

LIMITING THE DAMAGE DONE BY UNCERTAINTY SHOULD BE A PRIMARY OBJECTIVE OF TAX SYSTEM DESIGNERS.

Where governments use administrative or judicial discretion in the tax system, clear guidance will be needed. For large businesses, transparent clearance mechanisms allowing taxpayers to discuss proposed transactions in advance could help to address any uncertainties arising when interpreting legislation. Aligning treatment of international value-creation chains will increase confidence when operating across borders.

AGREEING CONSISTENT TREATMENTS FOR CROSS-BORDER TRANSACTIONS IS KEY TO CONFIDENT INTERNATIONAL TRADE.

3. Stability

Stability is closely related to certainty. ‘Certainty’ is about knowing what the answer to a given question ought to be; ‘stability’ is about whether the current answer will still be correct in one, two or ten years’ time. Stability extends to the rates at which calculated values are taxed, and the administrative practices surrounding that process, in a way that certainty does not.

Why stability matters

For taxpayers, stability is essential for effective planning and efficient, sustained compliance. Individuals can budget household income more accurately, while businesses are encouraged to make investment decisions. Businesses would typically prefer to operate in a slightly more imperfect system than in one where incremental improvements are made every year.

STABILITY IS FUNDAMENTAL TO EFFECTIVE PLANNING AND EFFICIENT COMPLIANCE.

IF UNCERTAINTY ABOUT TAX IS GOING TO STAND IN THE WAY OF PROJECTS THAT WOULD OTHERWISE BENEFIT SOCIETY THEN IT HAS FAILED IN ITS OBJECTIVE.

Stability is particularly important for enabling investment in large infrastructure and development projects, as businesses need reassurance that the tax rules won’t change part way through. Concerns about the stability of a tax system will be reflected in the overall risk weighting given to new investments.

Tax rate stability

Across most OECD nations, general consumption taxes (e.g. VAT) and personal income taxes generate most revenue, followed by corporate income taxes. The rates of such taxes need to be moved only minimally to generate a significant revenue impact. The number of changes can be kept to a minimum, and the burden spread across a comparatively wide base. Targeting a smaller population is likely to be more disruptive and divisive.

At a macro level, sudden shifts in tax rates can be bad for business and consumer confidence. When step changes are prompted by major events (e.g. war), the tax burden rarely falls back to its original level. Governments generally find new ways of spending the money.

Tax base stability

Changing the tax rates that affect the tax base has an economic and compliance cost. The more regular the change, the greater the cost. For smaller businesses, in particular, large infrequent changes are generally preferable to successive small ones.

The need for any change should always be considered carefully, as should the mechanics of implementing the change and its interaction with the rest of the tax system. Impact assessments are useful tools for legislators, allowing them to model the outcomes of changes, but policymakers must take account of real-world conditions. The historic UK system of tax credits, for example, had merit as a model, but operational weaknesses.6

The digitalisation of the global economy has presented tax authorities with a new set of challenges, as the external environment in which they operate has changed radically in only a few years. Changing patterns of both production and consumption have radically reshaped international supply chains and value-creation models. It is essential that tax systems adapt to the new conditions, but it will be equally important that changes are made after proper consideration and as infrequently as possible.

Commitment to common rules and standards has the double benefit that changes to the applicable regime will tend to be implemented less frequently and after greater consultation and visibility.

The way forward

Change for the sake of it would be a bad thing in a tax system. Politicians and tax policymakers should always think carefully about whether the tax system is the best way to achieve a desired change in society. The cumulative impact of each change should be considered not just in the context of the tax system but of the wider environment for business and taxpayers.

Some political systems support a consensus model of decision making, which can enable a more stable and predictable tax system. This is particularly important in the developing field of international tax responses to digitalisation. Though politicians may lose some of their discretion to shape tax policy, society may benefit. A measured and well-signposted programme of predictable change represents the optimal, pragmatic compromise.

Tax systems could benefit from some kind of independent oversight of tax policy and the effectiveness and efficiency of the system. This would reassure taxpayers and investors that non-partisan aspects of the tax system are not being compromised for short-term political ends.

Greater consistency in cross-border and internationally applicable taxes would also benefit taxpayers and authorities, reducing scope for disputes and arbitrage. Convergence on common models will improve stability, as each adherent will be less likely to make unilateral changes to their own system.

INVESTMENT IN THE TRAINING AND RETENTION OF STAFF AT EVERY LEVEL SHOULD BE A PRIORITY.

Efforts should also be made to ensure that tax authorities are staffed with well-trained, motivated individuals. This encourages higher-quality tax administration, not least through the maintenance of institutional memory, which can reduce the likelihood of repeated mistakes. The value of an effective tax system for economic growth\(^7\) goes hand in hand with the importance of tax morale,\(^8\) and both will benefit from a stable, properly resourced, domestic tax administration.

MECHANISMS FOR CHANGE ARE AN ESSENTIAL FEATURE OF ANY HEALTHY SYSTEM.

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Today’s world changes faster than most legislatures can update their tax law. The twin challenges of digitalisation and the COVID-19 pandemic have introduced unprecedented external pressures on what governments can tax, and how much revenue they need to raise from doing so. Longer-term factors, such as environmental change and public attitudes towards resource exploitation are also playing a role.

The response to these changes needs to balance speed with effectiveness. Policymakers may need to accept short-term imperfections, while taking a measured approach to implementing genuine structural improvements that meet the principles of simplicity and certainty in a transparent and accountable way.

A good tax system, like a tripod, depends on three ‘legs’ for its strength and solidity. Simplicity, Certainty and Stability. And like a tripod, if any one of the legs is deficient, the whole thing is likely to fall over. The principles to some extent overlap and are interdependent. If the system is not simple, its impact is less likely to be certain creating demand for change and so undermining stability.

Breaking down the analysis of the system methodically is far more likely to create a consistent and coherent outcome that goes at least some way towards achieving the desired aims without any undesirable side-effects.

The balance of the factors will be different in different cases, but perhaps the key is simplicity; once that is in place, certainty and stability will flow as a natural consequence. Use of single taxes with multiple purposes, or of more than one tax with the same objective, runs counter to the objective of simplicity. Policymakers should consider how to avoid waste and complexity in their tax systems.

The importance of the tax system to individuals and society is so great that it should not be treated as a short-term political football, but seen instead as the bedrock of constitutional funding, and recognised as an integral and pervasive element of every business’s and individual’s environment. A good tax system will benefit both governments and their people; a poor one will discomfit individuals and discourage business, with impacts far beyond the tax system itself.