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Tax Avoidance and Two Aspects of the Rule of Law

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ABSTRACT

Tax avoidance disputes present a conflict between preventing tax schemes that frustrate public policy and the rule of law. When considering the connection between taxation and the rule of law, it is helpful to distinguish between two aspects of the rule of law. The narrow-scope rule of law concerns whether disputes are decided according to legal norms that are general, prospective and impartial. The wide-scope rule of law concerns whether the government rules through law or through some extra-legal method and whether the government respects existing legal entitlements. Although closely connected, the two aspects of the rule of law are distinct: a violation of the rule of law in one sense does not necessarily have significant implications for the aspect of the rule of law. Tax disputes implicate both aspects of the rule of law. Tax adjudication violates narrow-scope rule of law when it ignores established law, appeals to legal norms that are not known in advance or renders judgments on grounds of personal partiality. Taxation violates wide-scope rule of law when used to expropriate politically unfavoured parties, confer benefits on politically favoured parties, or regularly shift tax burdens in arbitrary and unpredictable ways. This understanding of the rule of law does not yield any straightforward argument in favour of more formal methodologies of statutory interpretation or against anti-abuse rules. If the applicable legal norms are known in advance, it is not a violation of the narrow-scope rule of law to decide cases according to principles rather than rules or economic substance rather than legal form. Less formal, more purposive forms of adjudication tend to rely more on sound judgment by judges. In a legal system with a skilled and impartial judiciary, anti-abuse rules are not inherently threatening to the rule of law. They are less desirable in polities with wide-scope rule of law deficits. When tax disputes are highly politicised and the impartiality of the tax authorities and judiciary is open to question, it may be preferable to adopt more formal methods of adjudication that rely less on abstract reasoning about tax policy and that are easier to monitor for signs of bias. Tax law methodology should be calibrated to political context. Approaches that might be best suited for politically stable polities with highly skilled impartial judiciaries might be ill-suited for other contexts.

INTRODUCTION

Adjudication of tax disputes presents a conflict between the state's interest in preventing tax avoidance schemes that frustrate tax policy and taxpayers' interest in being able to rely on tax statutes. This implicates values of distributive justice and economic efficiency on the one hand and the rule of law on the other. The extent to which courts can curtail tax avoidance schemes using anti-abuse rules, anti-abuse doctrines and purposive interpretation without infringing upon the rule of law is a question of both theoretical importance in drawing the boundaries of the rule of law and practical importance in resolving tax disputes.

This chapter takes a new perspective on what is well-travelled territory. It does so by distinguishing between two types of rule-of-law considerations and using the relationship between them to consider the interplay between the law of tax avoidance and the rule of law. Evaluating compliance with the rule of law is complicated by the multi-faceted nature of the concept and by the tendency of different authors to appeal to differing conceptions of the rule of law. This is caused not only by conceptual disagreement about the concept, but also by

disagreements about broader political and moral values that underpin the proper function and aims of the legal system.[1]

To disentangle the different kind of considerations that are sometimes discussed under the heading of the rule of law, it is helpful to distinguish between two senses of the term. One sense of the rule of law, which I will call narrow-scope rule of law, concerns whether disputes are decided according to legal norms that are general, prospective and impartial. For the most part, narrow-scope rule of law is a question of whether the government follows the existing legal rules. It is especially concerned with the conduct of adjudicative bodies of government, although it has implications for other parts of government as well. The other, which I will call wide-scope rule of law, concerns whether a society is governed through law or through some other means. The wide-scope rule of law is implicated by whether political authorities respect existing legal entitlements rather than conferring benefits and burdens on an ad hoc basis. Wide-scope rule of law is a matter of whether the government rules through law or governs through some extra-legal method. Whereas narrow-scope rule of law focused mainly on legal adjudication and on the formal properties of law and law-making, the wide-scope rule of law concerned with the substantive role of law in politics and society. Analysis of the rule of law in legal theory are mostly, although not exclusively, concerned with the narrow-scope rule of law. Discussion of the rule of law in the social sciences and by international organisations such as the World Bank and the United Nations is mostly, although not exclusively, concerned with the wide-scope rule of law. Although distinct, the two senses of the rule of law are closely connected. A violation of the rule of law in one sense will very often undermine the rule of law in the other. Resolving legal disputes in ways that are not in accord with pre-existing, publicly accessible legal norms tend to undermine a law-based political order. And a lawless political order will, over time, tend to corrupt a precise and well-functioning legal system.

Tax disputes implicate both narrow-scope and wide-scope rule of law. Tax adjudication violates narrow-scope rule of law when it ignores established law, appeals to legal norms that are not knowable in advance or renders judgments on grounds of personal partiality rather than legal entitlement. Tax disputes implicate wide-scope rule of law concerns when taxation is used to expropriate politically unfavoured parties or confer benefits on politically favoured parties. Violation of narrow-scope rule of law principles is one way of infringing wide-scope rule of law principle, but not the only way. Public policy that undermines settled expectations based on existing legal entitlements may threaten wide-scope rule of law even if adjudication scrupulously follows the new legal norms. Likewise, a violation of narrow scope rule-of-law may not impinge greatly on the wide-scope rule of law if it only involves isolated instances of unfairness to individual taxpayers and has no systemic implications.

Narrow scope and wide scope rule of law considerations are both relevant to interpretation of tax statutes. In what follows, I will consider statutory anti-abuse rules, judicially created anti-abuse doctrines and purposive interpretation of tax statutes. Purposive interpretation on the one hand and specific anti-abuse rules and doctrines on the other raise different methodological issues. However, because general anti-abuse rules often apply when the purpose of a transaction is tax avoidance and when the results of the transaction are not in accordance with the purposes of the relevant tax statute, purposive interpretation and anti-abuse rules have a complementary and interdependent relationship in this context.[2] I will argue that anti-avoidance doctrines and interpretive methodologies for tax statutes must be evaluated in light of both narrow-scope rule of law considerations and wide-scope rule of law considerations, and that the relationship between the two is dynamic. Legal norms that allow

[1] See generally J Waldron, 'The Rule of Law' in EN Zalta and U Nodelman (eds) *The Stanford Encyclopaedia of Philosophy* (Fall 2023 Edition). Available at: https://plato.stanford.edu/archives/fall2023/entries/rule-of-law/.
[2] V Thuronyi, K Brooks and B Kolozs, *Comparative Tax Law* (Alphen aan den Rijn, Kluwer Law International 2016) 158–59.

revenue authorities and judges a great deal of scope to combat abusive tax schemes may not infringe upon the narrow-scope rule of law if they are carefully drafted and faithfully applied but may be inadvisable in contexts where the wide-scope rule of law is fragile. The first section will explain the narrow scope rule of law and its implications for tax avoidance disputes. The second section will introduce the wide scope rule of law and differentiate it from the narrow scope rule of law. The third section argues that the advisability of anti-abuse rules depends in part on whether the political and legal systems of a polity show strong commitment to the rule of law. The final section concludes.

NARROW-SCOPE RULE OF LAW: FOLLOWING THE RULES

The narrow-scope rule of law is the primary focus of most work on the rule of law in legal theory. This is natural since it is the aspect of the rule of law that is most closely connected to the operation of the legal system. Although Lon Fuller's and Joseph Raz's multifaceted analyses of the rule of law have implications for both aspects of the rule of law, the narrow-sense conception is foregrounded.[3] For this reason, it makes sense to briefly consider the theories of each theorist with the caveat that the focus will be on points of commonality rather than on the important differences between the two. In *The Morality of Law*, Fuller identifies eight necessary attributes of law: generality, publicity, prospectivity, intelligibility, consistency, practicability, stability, and congruence.[4] A system of rules that entirely fails to exhibit any one of these features is not a system of law, according to Fuller, but at most is a failed attempt to create law. For the analysis here, we need not decide whether these are necessary attributes of law or merely features of a legal system conducive to the rule of law. The point is that insofar as rules fall short in one of these ways, this is a rule of law shortcoming.

Joseph Raz provides a non-exclusive list of principles of the rule of law. His principles include attributes of legal norms such as that the law should be 'prospective, open, and clear', 'relatively stable' and that the making of laws 'should be guided by open, stable, clear, and general rules'. However, they also include attributes of legal institutions and procedures such as an independent judiciary, 'open and fair hearings', absence of bias in adjudication, judicial review of conformity with the law, accessible courts, and impartial exercise of prosecutorial discretion.[5] As the focus of this analysis will be on substantive tax law rather than tax procedure, it makes sense to focus on the first category of Raz's principles which also happen to be those with the greatest overlap with Fuller's.[6] Both Fuller and Raz agree that the rule of law requires that laws be clear and publicly accessible in advance to those expected to comply with them.[7] They also agree that great instability in the rules in force at any given time is a threat to the rule of law and that laws should, in some minimal sense, be general.

Because the generality criterion will be especially important to questions concerning tax avoidance, it is worth exploring in slightly more detail to avoid potential misunderstandings. Both Fuller and Raz suggest that the generality criterion should be read narrowly to require that legal norms have formal significance across the legal system but not as putting substantial constraints on the substance of the law. Fuller notes that generality does not rule out laws naming particular individuals, although such laws might violate 'external' considerations of fairness that are not part of the 'law's internal morality'.[8] Raz emphasises

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[3] J Raz, 'The Rule of Law and its Virtue' in *The Authority of Law* (Oxford, OUP, 1979) 214, 226; L Fuller, *The Morality of Law* (2nd edn, New Haven, Yale University Press, 1969) 156–57.
[4] Fuller, *The Morality of Law* ibid 39.
[5] Raz, 'The Rule of Law and its Virtue' above n 3, 214–18.
[6] For analysis of the relationship of the rule of law to tax administration, see Daly, Chapter 2 in this volume.
[7] For detailed analysis of the prospectivity requirement, see Gillis, Chapter 4 in this volume.
[8] Fuller above, n 3, 47.

that the requirement that laws be general in nature does not bring with it any sort of anti-discrimination norm and that substantively objectionable discrimination may be compatible for the rule of law.[9] The generality criterion on Fuller's and Raz's understanding therefore should not be seen as a barrier to targeted anti-abuse rules or as significantly limiting the form that general anti-abuse rules can take.

Both Raz in his earlier work and Fuller suggest that a common attribute of most aspects of the rule of law is that they are required for the law to be action guiding.[10] Citizens cannot follow law that is secret, contradictory, incomprehensible, retrospective, or requires actions that are impossible. It is difficult for citizens to follow or officials to enforce law that changes too frequently or is not sufficiently general in character. Incongruency between the law as enacted and the law as applied frustrates attempts to comply with the law and subjects people to inconsistent standards. Raz's procedural aspects of the rule of law can be seen as supporting the action guiding function of law by making it more likely that the substance of the law will be applied consistently and accurately.

In more recent work, Raz expressed reservations about his earlier formulation and in particular about the contention that the action guiding nature of law provides sufficient scope for explaining the conceptual unity and moral significance of the rule of law.[11] He proposed that the formal principles of the rule of law should instead be seen as aimed at preventing arbitrary government, which 'is the use of power that is indifferent to the proper reasons for which power should be used'.[12] The proper end of government is the promotion of the interests of the governed, as opposed to, for example, the private interests of the rulers.[13] Conformity to the rule of law requires action 'with manifest intention to serve the interests of the governed, as expressed by the law'.[14] This is consistent with well-intentioned incompetence or honest mistakes about the interests of the governed. Therefore, the rule of law does not require that government actually advance the interests of the governed but merely that it acts in a way that aims to do so.[15] And although Raz's new account is somewhat thicker than his old account, it sharply differentiates the rule of law from other virtues of a legal system such as democratic legitimacy, human rights, or substantive equality before the law.[16] It is not clear that it makes a difference for the topic of tax avoidance which of Raz's two formulations of the rule of law one selects. A tax judgment that violates the rule of law typically undermines both higher level interests protected by the rule of law. It does not provide sufficient guidance to taxpayers about how they can comply with the law and is arbitrary from the perspective of the conception of the public interest implicit in the tax statute. The second formulation, perhaps, frames the issue with greater clarity since the law of tax avoidance seems to involve a tension between two ways in which a tax decision may be arbitrary: a tax may be arbitrary in the sense of going beyond what is authorised by statute or arbitrary in the sense of contradicting the policy implicit in the tax statute.

Raz's conception of the rule of law (and to a lesser extent Fuller's) is thin in the sense that it seeks to avoid incorporating substantive values such as freedom, democracy, equality, or human rights in the concept of the rule of law.[17] Some readers will doubtless find this thin conception of the rule of law unsatisfying. Other approaches to the rule of law imbue the

[9] Raz above n 3, 215–16.
[10] ibid 214, 226; Fuller, above n 3, 156–57.
[11] J Raz, 'The Law's Own Virtue' (2019) 39 OJLS 1, 5.
[12] ibid 5.
[13] ibid 7.
[14] ibid 7–8.
[15] ibid 14.
[16] ibid 8–10.
[17] T Bingham, *The Rule of Law* (London, Allen Lane, 2010) 67.

concept with substantive values such as freedom, equality, or human rights.[18] I believe that this is undesirable for several reasons. First, it does not serve conceptual clarity to combine what are analytical distinct values in a single concept. This kind of unclarity encourages arguments that seem to rely upon the rule of law but, upon closer inspection, actually turn on a different substantive value that could be analytically separated from the rule of law and is only connected to it by the particular thick conception of the rule of law adopted. Second, thick conceptions of the rule of law encourage unproductive arguments between partisans of different substantive values over which substantive values should be included in the definition of the rule of law. It is far better to argue over substantive values directly (e.g. the relative priority of freedom and equality, the value of private property, etc.) rather than conducting this debate in a covert form. Third, the more substantive political values are incorporated into its definition, the more difficult it is to understand what is uniquely important about the rule of law or secure agreement on its normative significance. This is especially unfortunate since it is sometimes possible to achieve argument on rule of law values between people with deep substantive disagreements on the merits of free market capitalism, the nature of democracy, the meaning of equality and other 'thick' rule of law values. Finally, it is somewhat doubtful that a thicker concept of the rule of law would change many of the conclusions below. The basic conflict between legal certainty for taxpayers and alignment with the substantive aims of tax legislation can be drawn without a thicker conception of the rule of law. Why use a complex concept when a simple one will do?

Even working with a thin conception of the rule of law, the connection between the rule of law and other values is controversial. Raz emphasises the degree to which aspects of the rule of law are necessary for the law to be efficacious. If the function of the law is to guide behaviour, then the law fails to perform its function if it is not capable of providing guidance.[19] It is a contingent matter whether, all things considered, this is a good thing: a wicked government that acts more efficaciously is not, thereby, a good government but is only more effectively wicked. Of course, a more efficacious legal system may be desirable for all sorts of instrumental reasons since it tends to make life more predictable for citizens and to encourage trust in government and perhaps social trust more generally. If the function of the legal system is to advance the interests of the governed by creating and applying law, then the legal system fails to perform its function if it does not aim to promote the interests of the governed as expressed by the law.[20] This is a failure of law, qua law, and usually, but not always a bad thing in itself. But since the law sometimes does not, in fact, serve the public interest, it is a contingent matter whether complying with it is a good thing. Fuller takes a different view, arguing that the law has an internal morality such that violation of the rule of law is not merely instrumentally bad but intrinsically so. This difference is connected to a long-running debate between positivists such as Raz who believe that the content of the law has no necessary connection to morality and depends instead on social facts and anti-positivists such as Fuller who believe that the content of the law depends on moral value as well as on social facts,[21] although both positivists and anti-positivists might embrace a great range of theories of the rule of law. For our present purposes, there is no need to resolve such debates as the sorts of procedural fairness interests implicated by interpretation of tax statutes will likely have instrumental moral significance, at least in minimally just states, even if they do not have intrinsic moral significance.

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[18] ibid; FA Hayek, *The Constitution of Liberty* (Chicago, The University of Chicago Press, 1960).
[19] Raz, above n 3, 226.
[20] Raz, 'The Law's Own Virtue' above n 11, 7–8.
[21] L Green and T Adams, 'Legal Positivism' (*The Stanford Encyclopaedia of Philosophy*, 17 December 2019). Available at: https://plato.stanford.edu/entries/legal-positivism/ (last accessed 22 November 2023).

Several things follow from this analysis of the narrow-scope rule of law. First, compliance with the narrow-scope rule of law is a graded property, one that comes in degrees.[22] Some violations of the rule of law are more serious than others either because a violation infringes against more attributes of the rule of law or because it infringes on a given set of attributes more severely. The rule of law has both intrinsic value in its protection of procedural fairness and instrumental value in the improved effectiveness of government and trust in government. The latter values are sensitive to the degree to which government pursues desirable ends. Second, perfect conformity with the rule of law is neither possible nor desirable. No set of legal norms can provide guidance for all possible circumstances without any trace of vagueness or ambiguity and, even if this were possible, it would be inferior to a system in which certain questions were left open for resolution by those better informed about future circumstances. Third, the rule of law must be balanced against other values.[23] There is no assurance that it will not conflict with other important objectives. When it does, the relevant considerations must be weighed to determine which value will give way. Fourth, because the rule of law has multiple aspects, these sometimes come into conflict with one another.

The internal conflict between different aspects of the rule of law can be found in the law of tax avoidance. For example, there is tension between clarity and stability in tax law. On the one hand, anti-abuse doctrines and general anti-abuse rules introduce potential uncertainty in the law as they require two levels of analysis rather than one. It is often somewhat uncertain whether they will apply to particular transactions. In this sense they reduce the predictability of law relative to a more formalistic mode of interpretation that considers statutory provisions in isolation. On the other hand, if courts uphold transactions that subvert statutory purposes this encourages frequent legislative changes in the law to close perceived loopholes. This decreases legal stability relative to a system in which courts use a set of relatively stable anti-abuse principles to prevent results that subvert statutory purposes. Reasonable minds may differ as to the relative priority of stability and clarity in tax law. It is likely that the best approach will consider both virtues and reflect a compromise between the two.

This tension has a particular bite because clarity in tax law might be less valuable than in other areas of law. For most areas of law, it is preferable if those subject to the law change their behaviour to conform to it. We usually prefer that citizens uphold contracts, avoid torts, respect the property rights of others, comply with environmental, financial, public health and traffic regulations and avoid perpetrating crimes. The position of tax law is more complicated. Ex post certainty is desirable because this provides taxpayers with certainty about how much they must pay the government. Ex ante certainty is not necessarily advantageous from the perspective of the public good. For taxes aimed primarily at raising revenue, it is typically undesirable for taxpayers to change their behaviour in response to the law since this creates economic inefficiencies and reduces tax revenue. Some economists have even argued that imposition of taxes at random rates known only at the close of the tax year would be most efficient since they would raise more revenue with less deadweight loss.[24] This means that the value of legal certainty is more limited and depends, in part, on whether greater certainty encourages or discourages behaviour that is undertaken for tax reasons. As a result, it is difficult to say whether greater knowledge of tax laws aimed at raising revenue improves welfare and if so when.[25] For Pigouvian taxes, by contrast, it is desirable that taxpayers are aware of the tax

[22] Raz, above n 3, 222.
[23] ibid 228–29.
[24] J Stiglitz, 'Utilitarianism and Horizontal Equity: The Case of Random Taxation' (1982) 18 *Journal of Public Economics* 1.
[25] D Weisbach, 'Is Knowledge of the Tax Law Socially Desirable?' (2013) 15 *American Law and Economics Review* 187, 210.

and change their behaviour in response to it.[26] Minimising externalities requires taxpayers to take notice of the law whereas collection of tax revenue is most effective when taxpayers do not. Because most taxes aim primarily to raise revenue rather than changing taxpayer behaviour, clarity may be something of a mixed blessing: serving the rule of law by giving citizens notice of their legal obligations but making the law less efficacious by reducing tax revenue.

A second internal tension in tax law involves conflict between clarity and generality as legal virtues. Clarity is better served by formal principles of statutory interpretation that prioritise plain meaning and bright line interpretive rules even at the expense of policy coherence. However, doing so will make the most salient high-level norms in the tax law less general as outcomes depend more heavily on the particular circumstances of each taxpayer and less on the overarching principles (e.g. as more taxpayers avoid tax the effective tax rate deviates from the statutory tax rate more often). Generality, therefore, provides a reason to favour application of anti-abuse doctrines that can be used to bring outcomes for individual taxpayers in line with the general norms underlying tax statutes. It is difficult to say how significant this aspect of the generality is for the rule of law. As noted above, Fuller and Raz favour a narrow reading of generality on which a legal provision that effects only a few taxpayers is, in some sense, general if all taxpayers are formally subject to it. However, it is obviously possible to draft laws in such a way that they are formally general, but foreseeably impact only a few taxpayers. In extreme cases, this might be thought to undermine the rule of law, for example when legislators decide to target personally identifiable politically disfavoured parties. On balance, it seems that anti-abuse rules only contribute modestly to the generality of law in the sense that is important to the narrow scope rule of law. The most egregious instances of political favouritism are not likely to run afoul of anti-abuse rules since they are clearly intended by the legislature. The connection between anti-abuse rules and the politicisation of the tax system raises questions that go beyond the theories found in Raz and Fuller and will be addressed below in connection with the wide-scope rule of law.

The narrow-scope rule of law has implications for both the substantive and procedural tax law. It requires that the law be publicly accessible, prospective, clear and internally consistent. There are two central concerns with anti-abuse rules from the perspective of the rule of law. One is that a rule may not be sufficiently clear to provide guidance to taxpayers who wish to understand their legal obligations before receive instruction from the tax authorities or a ruling from a court. A second concern is that an anti-abuse rule may be applied inconsistently across taxpayers or in a way that is biased in favour of the tax authorities so that the rule as a practical matter grants discretion to the tax authorities unfettered by any judicial oversight. The analysis in this section will focus on the former concern. The issue of systemic bias will be considered below in the context of wide-scope rule of law.

A sufficiently vague or open-ended anti-abuse rule might flout the rule of law by providing insufficient guidance for taxpayers, tax authorities and courts. For example, a rule that states ‘A taxpayer shall pay an amount of tax that is fair’ without any further specification of how to understand fairness in this context would raise serious rule of law concerns as it appears nearly impossible to understand a taxpayer’s obligations before they are pronounced upon by a court. Likewise, a rule that transactions may be recharacterised if they appear to be structured by consulting relevant tax law to achieve a particular result would probably fall into the same category as it would appear on its face to apply to virtually all transactions involving sophisticated taxpayers. This would amount to granting tax authorities and courts discretion to characterise transactions at will without any requirement of consistency, adherence to principle or coherence with stable norms.

[26] ibid 188.

Although anti-abuse rules potentially conflict with the narrow-scope rule of law, it should not be difficult to design general anti-abuse rules that do not do so. The key is to establish some background norm against which transactions can be found to be abusive that provides sufficient guidance for taxpayers and revenue officials. This animates the anti-abuse rule by providing a justiciable standard for identifying abusive transactions. Such a norm can be established by inferring the underlying purposes of a statutory scheme or by reference to some general set of background norms, such as anti-abuse doctrines, recognised in case law. Without such background norms, anti-abuse rules risk degenerating into a free-flowing permission for tax authorities and judges to recharacterise transactions for any reason it wishes or to impose tax against disfavoured taxpayers at will. However, if the tax statute in question has intelligible purposes that can be used to identify abusive transactions, then the application of a general anti-abuse rule ('GAAR') to transactions that fall within its scope is not a breach of the rule of law. Of course, some statutes may not have sufficiently clear charging provisions to allow interpreters to determine which transactions are abusive. In such cases, there may be no way to find that a transaction should not receive the treatment that the best reading of each section of the statute would suggest. Finding such a transaction to be abusive would be a breach of the rule of law not because anti-abuse rules violate the rule of law but because the *application* of the anti-abuse rule to these facts violates the rule of law. This kind of legal mistake is possible in applying any kind of legal rule: there is no substitute for sound legal judgment. Opponents of GAAR might contend that it strikes the balance between reliance on plain meaning and purposive interpretation unwisely or that it gives too much power to the Revenue rather than taxpayers. But these are best understood either as disagreements about legal method or about the relative importance of values internal to the narrow-scope rule of law rather than an argument that GAARs are categorically antithetical to the rule of law.

Overlaying a statutory scheme with a set of principles used to determine how it is applied to facts makes the law more complicated. But this does not in itself create a conflict with the rule of law. The law should put citizens on notice of the rules that they must follow and provide enough guidance that citizens and officials can usually tell whether these norms have been violated. This does not require that the legal norms take the form of bright line rules rather than abstract principles.[27] Properly enacted prospective legal norms may comply with the rule of law even if they require judgment to apply the abstract norms to a specific fact pattern. Not infrequently, the law sets down a standard that requires the adjudicator to determine how highly abstract principles apply given the concrete facts of the situation at hand. This might involve deciding whether a defendant's conduct has been 'reasonable', 'dishonest', 'unconscionable', 'reckless' or any one of the many other thickly descriptive terms that appear in the law.[28] Or it might involve applying terms such as 'distortion of competition' that require a particular form of policy analysis.[29] Although bright line rules typically yield greater certainty, this is not always so and in complex areas of law such as tax it is not possible to eliminate all uncertainties. Moreover, preference for rules over standards may lead to more complex statutes with more scope for internal contradictions or unclarities as drafters try to provide a rule for every possible contingency.[30] A strongly principle-based approach to tax statutes might find the resources to disallow transactions to seem to flout the purposes of a

[27] F Schauer, 'Rules and the Rule of Law' (1991) 14 *Harvard Journal of Law & Public Policy* 645, 648–57.
[28] B Williams, *Ethics and the Limits of Philosophy* (Cambridge MA, Harvard University Press, 1985) 140–45.
[29] Competition Act 1998, s 2.
[30] David Weisbach attributes an argument to Stanley Surrey that the replacement of rules by standards allows for statutes that are simpler. D Weisbach, 'Formalism in the Tax Law' (1999) 66 *University of Chicago Law Review* 860, 861, citing S Surrey, 'Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail' (1969) 34 *Law & Contemporary Problems* 673, 707 n 31.

statute even without a statutory anti-abuse rule.[31] There are reasonable disputes to be had about the relative merits of rules and principles as legal norms.[32] But almost any perspective would allow that adjudication in light of principles is sometimes superior to use of bright-line rules even if reasonable minds might differ on how often such situations arise.

One might object that even if use of thickly descriptive terms is apt in areas of law such as criminal law or tort law that partially track ordinary moral judgments about human conduct, it is out of place in law that determine citizen's property entitlements where certainty and stability have special priority. But the law uses principles or standards in these cases as well. Consider the prohibition on agreements that 'have as their object or effect the prevention, restriction or distortion of competition'[33] or the role of unconscionability in proprietary estoppel.[34] The former threatens businesses with enormous fines for what would otherwise be ordinary, perfectly legal, commercial activity while the latter transfers property rights based on morally infused judgments about a party's conduct. Unfettered discretion to determine what behaviour is anti-competitive or conscionable might leave judges with excessive discretion in ways that would make it difficult to comply with the law. However, in practice, the meanings of these terms are filled in by legal precedents (and in the case of competition law regulatory guidance) that provides exemplars of the prohibited types of actions, giving substances to what otherwise might be objectionably vague standards. The use of standards or principles to construe statutory provisions may slightly shift the balance of power away from legislatures and toward judges or toward administrative agencies. This may be desirable as a means to fine-tune statutory rules in light of new circumstances and of background normative commitments or undesirable as a matter of democratic legitimacy. In any case, the rule of law does not require that legal norms are created only by legislatures, unless the legal system in question has a constitutional rule of legislative supremacy that makes the legislature the only source of law.

To apply the distinction between constrained and unconstrained anti-abuse rules to specific legislation, consider the UK's recently enacted GAAR, which contains passages that arguably fall on either side of this distinction.[35] This is a particularly fraught example given the UK's historically formalistic approach to tax statues and that one motive for the enactment of the GAAR was the purported inadequacy of UK court's more recent turn to purposive interpretation of tax statutes in combatting tax avoidance schemes.[36] The GAAR's states that weather a taxpayer's position is abusive should be considered in light of 'the principles and policy underlying the tax provisions' and whether the transaction involves 'contrived and abnormal steps'.[37] The former provides a normative baseline against which a transaction might be considered abusive[38] while the latter implicates a body of pre-existing case law that provides guidance regarding what types of actions might constitute 'contrived and abnormal steps'.[39] In these respects, the GAAR provides a workable standard for identifying abusive transactions,

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[31] E Simpson, 'The *Ramsay* Principle: A Curious Incident of Judicial Reticence?' (2004) 4 *British Tax Review* 358.

[32] R Dworkin, *Law's Empire* (Cambridge MA, Harvard University Press, 1986); M Berman, 'How Practices Make Principles, and How Principles Make Rules' (University of Pennsylvania Carey Law School, 2022) All Faculty Scholarship 2765. Available at: https://scholarship.law.upenn.edu/faculty_scholarship/2765; A Scalia, 'The Rule of Law as a Law of Rules' (1989) 56 *University of Chicago Law Review* 1175.

[33] Competition Act 1998, s 2(1)(b).

[34] *Taylors Fashions v Liverpool Victoria Trustees Ltd* [1982] 1 QB 133.

[35] Finance Act 2013, ss 206–215.

[36] See A Brassey, 'Tax, GAAR and the Rule of Law' (PhD thesis, University of Cambridge, 2017) 32–38.

[37] Finance Act 2013, s 207(2).

[38] It is also in accord with the dominant trend in recent case law. See, e.g., *Collector of Stamp Revenue v Arrowtown* [2003] 6 ITLR 454, cited approvingly in *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51.

[39] *WT Ramsey Ltd v IRC* [1982] AC 300; *IRC v Burmah Oil Co Ltd* [1982] STC 30; *Furniss v Dawson* [1984] AC 474.

albeit one that requires thoughtful interpretation of statutory schemes and a precise understanding of the true nature of the transaction and a strong grasp of how the economics of a particular transaction interacts with the policy aims of a statute. Similar considerations apply to doctrines used to police tax avoidance schemes such as the step transaction doctrine and the economic substance doctrine, which both provide rules, albeit highly abstract ones, that can separate permissible from impermissible claims.[40] Less reassuring is the GAAR's admonition to consider 'whether the arrangements are intended to exploit any shortcoming in the tax provisions'.[41] If this is construed as meaning something like 'whether the arrangement is intended to subvert the purpose of the statute by exploitation of technical mistakes in drafting', then this is probably harmless. However, since this would arguably be duplicative of the first criterion, one fears that something more is intended here. If the reference to 'shortcomings' is meant to invite revenue officials and judges to make judgments about shortcomings in tax statutes unmoored from any limiting principles provided by statute or case law, this undermines the rule of law by creating unfettered discretion to impose taxes. The problem is not so much that normative language such as 'shortcomings' is inappropriate as that it is difficult to see how case law could provide sufficient guidance to narrow the meaning of 'shortcomings' given that tax avoidance cases will often require analysis of new combinations of statutory provisions that do not closely match any 'shortcoming' identified in previous cases. Outside of generic technical mistakes such as scrivener's errors, the reasons that a particular provision is a shortcoming may be particular to the facts of a specific transaction or to the statutory provisions involved.

WIDE-SCOPE RULE OF LAW: A LAW GOVERNED ORDER

Whereas the narrow-scope rule of law is concerned with whether laws have the right form and are applied properly by the legal system, the wide-scope rule of law is concerned with whether a political system is ordered through law or by some other means. The former considers whether the legal system is bound by rules, the latter considers the role of law and the legal system in the polity. In a polity characterised by the wide-scope rule of law, law constrains the actions of the state, regulates the relations between citizens and determines the allocation of benefits and burdens of cooperation between citizens. Ruling through law can be contrasted with personal commands of a king or dictator, with the decisions of some collective body as in a one-party system, and with customary social norms operating outside the context of a full legal system with secondary rules.[42] The wide-scope rule of law is thus a matter not only of following the rules, but also of the role of legal rule following in government and society. Law, in the sense of a set of norms that are general, impersonal, prospective, and stable, is only one way to govern. It happens to be extremely convenient for societies with complex economies and, for this reason, it is tempting for those brought up in such societies to regard legal governance as natural or inevitable. But this perspective should not be allowed to obscure the nature of law as a cultural artifact that performs functions that might be carried out – albeit not always very well – by other means.

Although some authors use to term 'rule by law' to describe authoritarian law-bound governments,[43] it is helpful here to use the term in a morally neutral way to describe states that govern through law whether they are relatively free, relatively unfree, or somewhere in between. Under the wide-scope rule of law, governmental decisions are made according to a

[40] *Knetsch v United States*, 364 US 361 (1960); *McDonalds Restaurants of Illinois v Commissioner*, 688 F2d 520 (7th Cir 1982); *Hitch v Stone* [2001] EWCA Civ 63.
[41] Finance Act 2013, s 207(2)(c).
[42] On the nature of secondary rules, see HLA Hart, T*he Concept of Law* (Oxford, OUP, 1961) 78–79.
[43] B Tamanaha, *On the Rule of Law: History, Politics, Theory* (Cambridge, CUP, 2004).

pre-existing body of rules that have been enacted by following the correct procedures for creating law in the given legal system. Even in a domain as seemingly law bound as taxation, there is scope for determining tax payments by direct negotiation between the taxpayer and the revenue authorities. Such negotiations take place against the background of legal norms but the negotiations themselves may be more constrained or less constrained by law depending on the nature of the legal rules and the political culture within which they operate.

The distinction between the narrow-scope rule of law and the wide-scope rule of law is orthogonal to the distinction discussed previously between thin and thick conceptions of the rule of law. In keeping with the thin conception of the rule of law defended previously, the analysis here will treat the wide-scope rule of law as consistent with democracy, substantive equality and a market economy, but as neither requiring nor entailing any of these.[44] In this, usage will depart from Hayek whose conception of the rule of law is close to what I call the wide-scope rule of law, but who posits a close connection between the rule of law and the protection of freedom, both political and economic.[45] It is, of course, possible, perhaps even likely, that as an empirical matter the wide-scope rule of law is more likely in polities that are democratic, have a free market economic system or embrace some conception of substantive equality, but analytical clarity is not well served by building controversial empirical claims into normative concepts.

The relationship between the narrow-scope rule of law and the wide-scope rule of law is complex. A legal system that meets a certain minimum standard in terms of the narrow-scope rule of law is required for the wide-scope rule of law. A society cannot be ordered by law unless it has a legal system that meets certain minimal conditions for the narrow-scope rule of law. Although having laws and legal institutions that conform to the rule of law is a necessary condition for having a law-governed society, it is not sufficient. There are several ways in which a polity with a functional legal system might fail to exemplify the wide-scope rule of law. It is possible to have a system of government with a good deal of law and some legal institutions in which government, or at least the type of high-stakes decisions that determine the character of a polity, are not made according to law. Such a system might have a more or less important place for law, but the key decisions are made on political grounds. This disconnect can arise in a variety of ways. One way is that the rule of law might exist only for a small elite with the masses being ruled by some combination of customary social norms and brute force. This state of affairs is often found in societies, such as many of those in medieval and early modern Europe, which feature multiple legal systems with partially overlapping jurisdictions that govern relations between particular estates or social groups.[46] Such a society might evolve into a law-governed social order as the rule of law is progressively extended from the elite to the rest of society[47] but, of course, many legal systems of this kind fail to evolve in this way. A second way in which the narrow scope rule of law may come apart from the wide scope rule of law is where a reasonably well-functioning legal system exists alongside a political system the operates outside the legal system with few legal constraints. Various one-party dictatorships, for example some of the Warsaw Pact countries during the Cold War, might fit this description. These might be contrasted with one-party dictatorships, such as the People's Republic of China during the cultural revolution, which lack rule of law in either the narrow or

[44] With respect to the relationship between free markets and the rule of law, the terms of debate have perhaps not entirely caught up to political realities. In much of the developed world, defenders of the social welfare state are, in some senses, conservatives seeking to preserve the status quo whereas libertarian critics are reformers. This means that concern for the wide-scope rule of law does not necessarily have a right-wing valence: the established order includes not only entitlements to private property but also to public benefits.

[45] Hayek, above n 18, 309–10.

[46] See H Berman, *Law and Revolution: The Formation of the Western Legal Tradition* (Cambridge, MA, Harvard University Press, 1983).

[47] D North, J Wallis and B Weingast, *Violence and Social Orders* (Cambridge, CUP, 2009) 154–58.

the wide sense. Finally, the narrow-scope rule of law can come apart from the wide-scope rule of law if laws are systematically ignored or if judicial rulings are systematically disregarded. It is possible for a legal system to be internally in good working order in the sense that courts issue rulings in accordance with the law but for these to have limited influence on social, economic or political matters.

Although the two senses of the rule of law are distinct, they are mutually reinforcing. A legal system that complies with the narrow-scope rule of law is necessary for a polity that is ordered by the wide-scope rule of law. And a polity with a strong rule-of-law culture creates demand for legal institutions that apply the law fairly and impartially. This kind of virtuous cycle is mirrored by a various cycle in which deficits in each sense of the rule of law reinforce each other. A legal system that does not comply with the narrow scope rule of law will tend to undermine the wide scope rule of law since well-functioning legal institutions are necessary for a polity to be organised through law. Likewise, a society which is lawless will tend to undermine the narrow-scope rule of law by corrupting legal institutions. It will also cause distrust, even when this is only partially justified, because citizens who have little positive experience with impartial application of the laws by the government will not expect this of judges, prosecutors, and other legal officials.

The wide-scope rule of law has a different relationship to specific legal provisions than the narrow-scope rule of law. As discussed above in the context of Raz's theory, the narrow-scope rule of law protects the interests of individuals subject to the legal system from arbitrary government action and allows law to perform its function of guiding action. By contrast, the wide-scope rule of law is largely concerned with the systemic effects of law rather than with individual acts of rule following and the virtues of rule-based governance and social order structured by law. Because it is concerned with the role of law in the polity as a whole, the wide-scope rule of law does not typically imply limits on the formal properties of laws beyond those already implied by the narrow-scope rule of law. However, it introduces a range of additional normative considerations that go beyond the narrow-scope rule of law including whether particular laws are conducive to a law-governed social order and which laws are suitable given the extent to which rule of law principles pervade government and society. A law may be consistent with the narrow-scope rule of law, yet tends to undermine government by law. Alternatively, a legal rule might be well-adapted for contexts with impartial judiciaries, law-abiding citizens and rule-following government officials but deeply inappropriate for polities with none of these.

TAXATION AND TRUST: THE POLITICAL CONTEXT OF THE LEGAL SYSTEM

The suitability of general anti-abuse rules depends on political context including the degree to which the wide-scope rule of law is observed. Because collecting taxes requires application of the law by a wide range of officials and quasi-voluntary compliance with the law by large numbers of citizens, the wide-scope rule of law is of great importance for taxation.[48] Trust by taxpayers in the state is important for the efficient collection of taxes. [49] Brute force always remains a fall-back option, but this is expensive and only partially effective since jailed or exiled taxpayers may not yield much revenue. The amount of coercion required to collect revenue is inversely related to tax morale, which is the willingness of taxpayers to comply with the law for reasons other than threat of punishment.[50] Taxpayers who perceive the tax system as fair and legitimate, the tax authorities to be following the law and the courts to be impartial

[48] M Levi, *Of Rule and Revenue* (Berkeley, University of California Press, 1988) 52–57.
[49] B Torgler, 'Tax Morale, Rule-Governed Behaviour and Trust' (2003) 14 *Constitutional Political Economy* 119, 119.
[50] E Luttmer and M Singhal, 'Tax Morale' (2014) 28 *Journal of Economic Perspectives* 149, 151–54.

when hearing disputes between taxpayers and the state are more likely to pay their taxes with less resistance.[51] This is not only because taxpayers are more likely to believe that their own tax assessment is in accordance with the law, but also because taxpayers are more likely to believe that others will pay their fair share. Distrust from taxpayers has the inverse result: less willingness to comply with tax law, more coercion necessary for collecting taxes and scepticism that others will pay their fair share.

Although hardly the only factor in trust in government, whether political authorities follow the law and resolve conflicts according to the law plays a significant role in whether citizens trust political authorities and comply with the law.[52] In societies with a weak rule of law culture, taxpayers are unlikely to trust revenue authorities or courts and are likely to expect that their fellow citizens will not comply with tax laws except under threat of punishment.[53] This undermines tax morale.[54] To some extent, this distrust is justified since polities with wide-scope rule of law deficits have less effective political and legal institutions. However, even when courts and revenue officials apply the law impartially and fairly, they are apt to be regarded with suspicion since taxpayers will approach new encounters with the legal system in light of their previous experiences with officials who often do not follow the law.

When trust in tax officials and courts is low, it is better to adopt rules that reduce official discretion and are easier for taxpayers to monitor, partially because this prevents abuse of discretion, and partially because making it easier for taxpayers to tell that officials are following the law builds trust in government[55] As a general matter, formalistic methods of statutory interpretation make it easier to monitor the compliance of officials with the law than do purposive interpretation, anti-abuse doctrines and anti-abuse rules. They also serve the limit the discretion of those who apply the rules.[56] Purposive interpretation and the application of anti-abuse rules require considering how particular statutory provisions interact with the policy aims of statutes and the background principles of statutory interpretation. In a tax context, this requires a considerable degree of sophistication about the economics of taxation as well as legal skill. Applying anti-abuse rules and doctrines is considerably more demanding than decoding particular statutory provisions (itself often a difficult task in long and technical tax statutes) since the former requires the latter but the latter does not require the former. Anti-abuse rules additionally run the risk of being used as cover for tax authorities making demands that go beyond any reasonable interpretation of the statute and involve unequal treatment of similarly situated taxpayers. The failure mode of anti-abuse rule as free-floating permission to recharacterize transactions is more likely in polities with a weak culture of wide-scope rule of law.

Matters are different where adherence to the wide-scope rule of law creates greater trust between taxpayers and the state. In this context taxpayers are more likely to trust courts and (to a lesser extent) revenue officials to use complex tools such as anti-abuse rules and purposive interpretation fairly and in a way that reflects a good-faith attempt to get the law right even when they do not agree with their judgments about how to apply the law. In a high-trust context,

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[51] Torgler, above n 49, 134; B Torgler, 'Tax Morale in Asian Countries' (2004) 15 *Journal of Asian Economics* 237; B Torgler, 'Tax Morale in Latin America' (2005) 122 *Public Choice* 133; B Torgler, 'Tax Morale and Direct Democracy' (2005) 21 *European Journal of Political Economy* 525.

[52] T Tyler, 'Does the American Public Accept the Rule of Law? The Findings of Psychological Research on Deference to Authority' (2007) 56 *DePaul Law Review* 661, 661.

[53] MFM Martinangeli, M Povitkina, S Jagers and B Rothstein, 'Institutional Quality Causes Generalised Trust: Experimental Evidence on Trusting under the Shadow of Doubt' (Forthcoming 2024) *68 American Journal of Political Science*, https://doi.org/10.1111/ajps.12780; F Herreros, 'The State and Trust' (2023) 26 *Annual Review of Political Science* 117, 124.

[54] Luttmer and Singhal, above n 50, 157.

[55] Tyler, above n 52, 693–94.

[56] F Schauer, 'Formalism' (1988) 97 *Yale Law Journal* 509, 540–44.

anti-abuse rules can potentially boost tax morale by increasing taxpayers' confidence that other taxpayers will make reasonable contributions and that the tax system as a whole reflects a coherent policy aimed at apportioning contributions fairly among taxpayers. A polity with a well-developed rule of law culture may therefore be able to realise any benefits that anti-abuse rules yield in reducing tax avoidance without diminishing tax morale. Anti-abuse rules, at least when well drafted, are apt for polities characterised by the rule of law in both the narrow scope and wide scope sense.[57]

CONCLUSION

The case of tax avoidance illustrates how the complex internal structure of the rule of law requires trade-offs between different aspects of the rule of law and how the proper approach to tax avoidance law may depend on the political context of a particular legal system. Legal norms that leave taxpayers chronically uncertain of their legal obligations are a threat to the narrow-scope rule of law. Nevertheless, this insight does not yield a straightforward argument in favour of more formal methodologies of statutory interpretation or against anti-abuse doctrines. As long as the applicable legal norms are known in advance, it is not a violation of the rule of law to decide cases based on principles rather than rules or on economic substance rather than legal form. Less formal, more purposive, forms of adjudication tend to rely more on complex reasoning and sound judgment by judges. However, in a legal system with a skilled and impartial judiciary, they are not inherently threatening to the rule of law.

Purposivist methods of statutory interpretation and anti-abuse doctrines are less desirable in polities with deficits in the wide-scope rule of law. When the judiciary is highly politicised and tax disputes are connected to broader political conflict it is better to adopt more formal methods of adjudication that rely less on abstract reasoning about tax policy by judges and that are easier to monitor for signs of bias. Tax law methodology, therefore, should be calibrated to political and cultural context.[58] Approaches that might best for politically stable polities with highly skilled impartial judiciaries might be ill-suited for other contexts.

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[57] If this analysis is correct, the history of UK tax avoidance jurisprudence is peculiar. The UK is widely considered to have an admirable tradition of judicial independence, political stability and adherence to the rule of law. It exploits this reputation by serving as a forum of choice for resolving commercial disputes. Yet despite this, its twentieth law of tax avoidance embraces a formalism that implies distrust of the judiciary and the elevation of certainty for individual taxpayers over fair allocation of tax burdens. An admittedly speculative explanation for this phenomenon is that UK tax avoidance jurisprudence developed in the early to mid-twentieth century against the background of political conflict over progressive taxation (see, e.g. *IRC v Duke of Westminster* [1936] AC 1). This might have made judges more sympathetic to taxpayers engaged in efforts to minimise their tax obligations and pushed UK tax avoidance jurisprudence in a formalist direction in a key formative period. In any case, the pendulum has now swung far enough in the other direction that the UK might no longer be an outlier in the law of tax avoidance relative to similar jurisdictions (see, e.g. *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UKHL 51). Alternatively, this phenomenon may reflect a more general preference in the UK legal system for formalistic modes of interpretation and rule-bound decision making. See generally P Atiyah and R Summers, *Form and Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory, and Legal Institutions* (Oxford, OUP, 1987).

[58] Elsewhere, I have made a similar argument regarding the choice between methods of statutory interpretation. See I Lindsay, 'Convention, Social Trust, and Legal Interpretation' in K Vallier and M Weber eds, *Social Trust* (New York, Routledge, 2021).