TAX TRANSPARENCY

By
W. Bartley Hildreth
(Encyclopedia of Taxation and Tax Policy, 2nd Edition, 2005)

Tax transparency refers to the symmetry of information between tax authorities and taxpayers. The economics of information affects markets and accountability (Hayek, 1945; Stiglitz, 1999). In the context of taxation, transparency is important from the first day that a tax structure is introduced in the policy arena to the last day of its economic impact. Information relevance depends on the needs of taxpayers, not just what the tax authority provides.

Adam Smith's (1776) second maxim of tax policy calls for a tax to be "certain, and not arbitrary….clear and plain to the contributor, and to every other person." Smith adds: "The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt." By this logic, taxes that are clear and plain, instead of uncertain and complex, helps avoid corruption. Tax transparency, therefore, promotes good governance.

Tax transparency is a responsibility shared by the tax authority and the taxpayer and includes an open and participatory policy process and clear and tractable tax rules. As the traditional target of transparency initiatives, the tax authority is used here as the aggregate institution represented by a diverse group of policy makers, officials and administrators of the tax system. Tax authorities typically enjoy discretion in the extent of their openness during tax policymaking and in their provision of information later during tax administration. Taxpayers, usually, are on the receiving end of this information flow, but understanding a tax begins with a degree of participation.

Tax transparency entails an open policymaking process. The goal is to minimize the secrecy of decision-making. On occasion, there may be a need to prevent premature disclosure in order to avoid tax-induced transactions. Frequently, however, surprise is a political strategy. Regardless, tax transparency calls for the initiator of tax proposals to make timely disclosure of all tax details to allow inquiry and debate during the remainder of the tax policy process. Disclosure includes the release of the data and tax incidence models upon which the proposed policies are premised. Only by having access to the equal information can the assumptions, methods, and results be contested by others (Burton, 2002). Transparency further requires accurate and rational justifications for tax proposals including how the tax fits into an integrated, comprehensive revenue and expenditure policy package, so that the merits of the proposal can be evaluated in full context. In contrast, transparency is reduced when the tax change occurs without public debate or legislative action (Vetter & Gallaway, 1998). Two notable non-transparent actions with respect to the treatment of exemptions and deductions to the personal income tax include the phase-out of these provisions at specific income levels and any failure to index for inflation (AICPA, 2003). Tax expenditure budgets expose the cost of tax preferences (Stiglitz, 1998).

Expanding the "circle" of involved participants in policy making strengthens transparency and improves decision-making quality by providing tax authorities with different perspectives (Stiglitz, 1999; Everson, 2004). Passive taxpayer behavior during the policy process is contrary to the contest of ideas expected by a transparent policy process. Taxpayers have an incentive to take advantage of an open policy process that could impose a tax burden. Public choice theory suggests that if only elites exercise the option to participate, then the self-interest of those participants can accentuate the propensity of policymakers to follow incentives other than welfare maximization. The cost of participation, however, may outweigh individual benefits. Taxpayers may respond to opacity by using the ballot to impose tax limits and transparency institutions.

Tax transparency demands the tax authority to provide clear tax rules. Imprecision and vagueness are not only contrary to transparency, but can make it difficult to assess and collect taxes (Burgess & Stern, 1993). While taxpayer ignorance of the law is no excuse, the tax authority has the burden to make clear tax rules. Obscurity in tax rates and base violate transparency (Mikesell, 1998; AICPA, 2003). Hiding a tax in prices is an example of non-transparency, as with the taxing of business inputs in a retail sales tax. Moreover, transparency is violated when the application of tax rules are subject to negotiation for particular taxpayers (International Monetary Fund, 2004). Clarity also requires precise rules on taxpayer rights and responsibilities.

Transparency fundamentally rests on the taxpayer being able to understand and meet tax responsibilities by predicting the consequences of taxable characteristics. Tractable tax policy leaves few borderline cases in the application of tax rules (Paul, 1997). In all but objectively observable, direct tax structures (e.g., the poll tax), individuals differ with respect to the taxable characteristic (Atkinson & Stiglitz, 1976). Tax systems, therefore, emphasize voluntary compliance to elicit the needed tax-relevant information. Taxpayers must know how to meet tax rules and to calculate their respective tax burden. Retroactive taxes violate the principle of predictability. There are problems with “unduly complex rules” as there are with “uncertain but less complex standards” (Weisbach, 1999). The use of anti-abuse rules as a bridge between complexity and uncertainty introduces its own transparency problem. By definition, an anti-abuse rule prevents literal compliance with a tax rule from overruling the purpose of the tax law. In another example, partnerships offer tax transparency in that the tax burden resides with the partners instead of the pass-through partnership entity (Seevers, 2001). Additional transparency initiatives include the call for public release of corporate tax returns for comparison to corporate financial statements, and, in a more successful effort, the pressure on "tax haven" countries to increase the flow of information to other members of the international community (Makhlouf, 2000).

In summary, uncertainty and complexity promote tax illusion and tax evasion. Transparency reduces principle-agent problems and minimizes transaction costs in the economy. However, tax transparency is not costless and the benefits may be hard to prove.

Cross-references: Partnerships, Tax administration, Tax evasion, Tax expenditures, Tax illusion, Tax incidence

American Institute of Certified Public Accountants [AICPA]. *Guiding Principles for Tax Law Transparency*. New York: Tax Division, American Institute for Certified Public Accountants, Inc., 2003.

Atkinson, Anthony B. and Joseph E. Stiglitz, "The Design of Tax Structures: Direct versus Indirect Taxation." *Journal of Public Economics* 6 (1976): 55-75.

Burton, David R. "Reforming the Federal Tax Policy Process," *Cato Institute Policy Analysis*, No. 463, December 17, 2002.

Burgess, Robin & Nicholas Stern, "Taxation and Development." 31 *Journal of Economic Literature* (June 1993): 762-830.

Everson, Mark W. "Remarks of Mark W. Everson Commissioner of Internal Revenue before the National Press Club Washington D.C." Accessible: http://www.irs.gov/newsroom/article/0,,id=121226,00.html

Hayek, F. A. “The Use of Knowledge in Society” *The American Economic Review* 35 (September 1945): 519-530.

International Monetary Fund. “Manual on Fiscal Transparency.” Accessible: http://www.imf.org/external/np/fad/trans/manual/sec01b.htm

Makhlouf, Gabriel. “Transparency in Tax Systems: Keeping Pace with the Information Age.” *INTERTAX: European Tax Review* 28 (February 2000): 64-66.

Mikesell, John. “Changing the Federal Tax Philosophy: A National Value-Added Tax or Retail Sales Tax?” *Public Budgeting & Finance* 18 (Summer 1998): 53-68.

Paul, Deborah L. “The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?” *North Carolina Law Review* 76 (November 1997): 151-221.

Seevers, Martin H. “Taxation of Partnerships and Partners Engaged in International Transactions: Issues in Cross-Border Transactions in Germany and the U.S.” *Houston Business & Tax Law Journal* 2 (2001/2002): 143-173.

Smith, Adam. *An Inquiry into the Nature and Causes of the Wealth of Nations.* London: Methuen and Co., 1776.

Stiglitz, Joseph E. “Distinguished Lecture on Economics in Government: The Private Uses of Public Interests: Incentives and Institutions.” *Journal of Economic Perspectives* 12 (Spring 1998): 3-22.

Stiglitz, Joseph E. “On Liberty, the Right to Know, and Public Discourse: The Role of Transparency in Public Life.” Oxford Amnesty Lecture, Oxford, UK, January 27, 1999.

Vetter, Richard K. and Lowell E. Gallaway. *Underlying Principles of Tax Policy*. Washington, D.C.: Joint Economic Committee, August 1998.

Weisbach, David A. “Costs of Departures from Formalism: Formalism in the Tax Law.” *University of Chicago Law Review* (Summer 1999): 860-886.