Written Communications and Taxpayers’ Compliance: An Interational Fairness Perspective

Jonathan Farrar and Linda Thorne*

PRÉCIS
Les administrations fiscales communiquent avec les contribuables principalement par écrit. Des études antérieures ont montré que le contenu des communications écrites des administrations fiscales peut avoir une incidence sur l’observation de loi par les contribuables en faisant appel à l’équité interactionnelle. L’équité interactionnelle désigne la qualité du traitement des particuliers par une figure d’autorité et comporte deux dimensions : le ton et l’information. Dans ses communications écrites, une administration fiscale communique, par mégarde ou délibérément, tant un ton que de l’information. À l’aide d’une expérience menée auprès de 287 contribuables, nous avons examiné l’effet des deux dimensions sur l’observation de la loi par les contribuables. Nous avons constaté qu’il y a une relation entre le ton et l’information, et que l’observation est plus élevée lorsque le niveau d’information est élevé et que le ton utilisé est autoritaire. Nous avons aussi remarqué que l’information a un effet positif sur l’observation. Nos résultats peuvent donc être utiles aux administrations fiscales en les aidant à rédiger des communications écrites qui incitent les contribuables à observer la loi.

ABSTRACT
Written communication is the primary means used by tax authorities to communicate with taxpayers. Prior research shows that the content of written communications by tax authorities can influence taxpayers’ compliance by appealing to interactional fairness. Interactional fairness refers to the quality of treatment that individuals receive from an

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authority figure and has two dimensions, tone and information. In written communications from a tax authority, inadvertently or by design, both tone and information are conveyed. In our study, we examine the impact of both dimensions on taxpayers’ compliance through an experiment involving 287 taxpayers. We find an interaction between tone and information, such that compliance is highest in the presence of high information and an authoritative tone. We also find that compliance is positively associated with information. Our findings have practical implications for tax authorities in determining how best to use written communications to encourage taxpayers’ compliance.

**KEYWORDS:** COMMUNICATIONS ■ COMPLIANCE ■ FAIRNESS ■ PSYCHOLOGICAL ASPECTS ■ TAX ADMINISTRATION

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**INTRODUCTION**

In 2013-14, the Canada Revenue Agency (CRA) lost an estimated $16 billion to non-compliance.1 Tax evasion costs governments worldwide an estimated US$3.1 trillion annually, more than 5 percent of world gross domestic product.2 Although deterrence strategies, such as audits and sanctions, are commonly used to thwart tax non-compliance, they are very costly, and tax authorities are continually looking for cost-effective alternatives. Prior research suggests encouraging taxpayers’ perceptions of fairness can be a cost-effective approach to encouraging compliance.3

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The use of written communications with taxpayers is increasing in response to government budget cuts. Written communication is the most widely used form of communication by tax authorities and is on the rise, as tax authorities scale back the size of their office networks and the number of face-to-face interactions declines. For example, in Canada, the CRA closed all of its payment and inquiry service counters in 2013, and discontinued face-to-face outreach sessions, while continuing to issue 129 million pieces of personalized taxpayer correspondence annually. In the United States, in 2011, more than 75 percent of audits of individual taxpayers were conducted via correspondence rather than face-to-face.

A substantial stream of research has investigated how fairness-based approaches can be used to encourage voluntary taxpayer compliance. This research has provided significant insights, showing, in particular, that taxpayers’ perceptions of the fairness of tax procedures and the fairness of assessed taxes generally strengthen taxpayers’ compliance. However, organizational justice research has identified another type of fairness, interactional fairness, which refers to the quality of the treatment provided to individuals by authority figures. Interactional fairness comprises two distinct dimensions, interpersonal fairness and informational fairness. Interpersonal fairness refers to the extent to which decision makers are subject to authoritative versus respectful treatment or tone in their communications with authority figures, whereas informational fairness refers to the extent to which decision makers receive adequate explanations from authority figures. Research indicates that decision


makers’ cooperation is positively associated with interactional fairness. Thus, an interactional fairness perspective may be useful for gaining insight into how written communications can be used to encourage taxpayers’ compliance.

Two studies provide support for the importance of interpersonal fairness in written communications from tax authorities. Doyle et al.\textsuperscript{11} showed that respect or information, and both respect and information together, included in written reminders prompted taxpayers to file their tax returns on time. Similarly, Wenzel\textsuperscript{12} showed that the inclusion of either respectful tone or information in a tax authority’s letters results in higher payment of interim tax bills by taxpayers. However, neither study established which combination of dimensions is most effective, nor did these studies specifically examine taxpayers’ reporting compliance.

In any letter from a tax authority, inadvertently or by design, a particular tone and some amount of information is conveyed. Nevertheless, it remains to be established how both dimensions combine to influence taxpayers’ compliance, and which combination of dimensions results in the highest level of compliance by taxpayers.\textsuperscript{13} Understanding how both dimensions of interactional fairness work together in tax authorities’ letters to influence taxpayers’ compliance is important, since this approach offers tax authorities a cost-effective alternative to sanctions and audits.\textsuperscript{14}

We use an experiment that specifically investigates wording identified in a CRA study\textsuperscript{15} to examine how tone and information jointly influence taxpayers’ compliance. An experiment allows us to manipulate the relevant factors of interest while eliminating or controlling for other factors outside the scope of our study. In our experiment, 287 Canadian taxpayers responded to a tax scenario. The scenario described a taxpayer filing his tax return and subsequently receiving a letter (a notice of assessment) from the CRA. As hypothesized, our findings suggest that information is positively associated with taxpayers’ compliance, and that tone and information


\textsuperscript{13} More broadly, given recent litigation involving CRA officials, interactional fairness is of increasing concern to tax authorities. See John Bevacqua, “Suing Canadian Tax Officials for Negligence: An Assessment of Recent Developments” (2013) 61:4 Canadian Tax Journal 893-914.

\textsuperscript{14} Tax authorities in Ireland and the United Kingdom are considering revisions to wording in written communications with taxpayers. See Irish Government Economic and Evaluation Service, Behavioural Economics (Dublin: IGEES, October 2014); and United Kingdom, Cabinet Office Behavioral Insights Team, Applying Behavioral Insights To Reduce Fraud, Error and Debt (London: Cabinet Office, February 2012).

\textsuperscript{15} Sage Research Corporation, Attitudes Towards Collection and Request To File Letters: Final Report Prepared for Canada Revenue Agency (Burlington, ON: Sage Research, 2011). This study is described in more detail below under the heading “Development of Hypotheses.”
interact to affect taxpayers’ compliance. Surprisingly, we fail to find a positive association between compliance and the dimension of tone on its own; however, our findings suggest that an authoritative tone combined with high information content maximizes taxpayers’ compliance.

Several contributions emerge from our findings. First, we extend the work conducted by Wenzel and Doyle et al. to contribute to the tax literature on the fairness-compliance association by experimentally identifying the joint impact of tone and information on taxpayers’ compliance. Our findings show that an authoritative tone reinforces the positive impact of information on compliance and a respectful tone undermines it. Thus, we refine the understanding of what aspects of tone may be perceived by taxpayers as appropriate in tax authority letters. Second, we contribute to the broader fairness literature by being the first to provide empirical insight into the interplay of the two fairness dimensions (tone and information) underlying the effect of interactional fairness on cooperative behaviour. Third, through our research design we isolate the impact of deterrence from information and highlight the importance of information and explanation for taxpayers’ compliance. Finally, we make a practical contribution of interest to the tax authority by identifying how tone and information can be employed in written communications to encourage taxpayers’ compliance.

The remainder of this article is organized as follows. In the next section, we conduct a literature review and formulate our hypotheses. We then describe our experiment and report our results. We conclude with a discussion of the implications of our findings.

**DEVELOPMENT OF HYPOTHESES**

While there is limited research on how either of the two dimensions of interpersonal fairness, in combination or in isolation, influence taxpayers’ compliance, prior research involving large field studies provides valuable insights into the impact of tax authorities’ written communications on taxpayers’ cooperative behaviour. One large field study conducted by Hasseldine et al.\(^{16}\) compared the rate of compliance for British taxpayers who received one of five different letters from the tax authority with the compliance rate for a control group that did not receive a letter. All groups that received letters had a higher level of reporting of taxable income than the control group. The highest rates of compliance were found in the three groups that received letters with information about detection, including one that described the probability of an audit, a second that described the possible penalties associated with a failed audit, and a third that warned that an audit was likely. Lower rates of compliance were found in the groups that received a letter that included

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This study shows the importance of written communication by the tax authority, and also suggests the importance of the two dimensions of interactional fairness, tone and information, in written communications as factors influencing taxpayers’ cooperation.

In another field experiment, Blumenthal et al. examined whether normative appeals embedded in a letter from the tax authority influenced reporting compliance. These letters contained a neutral tone and normative appeals for payment. One-third of the taxpayers were sent a letter identifying the importance of tax dollars for state programs; one-third were sent a letter suggesting that the majority of taxpayers were compliant; and one-third received no letter. There were no significant differences in the rates of compliance between the three groups of taxpayers. However, a more recent study shows that normative appeals are effective in encouraging taxpayers’ cooperation. Hallsworth et al. conducted a field experiment involving British taxpayers to determine factors that influence timely tax payments. Reminder letters included messages pertaining to social norms and moral duties. Hallsworth et al. found that reminder letters increased taxpayers’ payments, and concluded that the framing of information included in written communications from tax authorities influences taxpayers’ propensity to cooperate.

Only one study, a large field study, has specifically considered how tone influences taxpayers’ responses. Wenzel specifically tested and found that written letters containing respectful language, rather than a control letter with neutral language, increased taxpayers’ propensity to make interim tax payments. Wenzel concluded that a respectful tone reinforced the importance of interactional fairness, and of tone in particular, for taxpayers’ cooperation. Following Wenzel, we argue that when tax authorities are respectful and polite, perceptions of interactional fairness are increased, and consequently, we posit that taxpayers will be more cooperative and more compliant with respectful communications as compared to authoritative communications. This discussion leads to our first hypothesis:

**Hypothesis 1:** A respectful tone in written communications will result in higher compliance than an authoritative tone.

Several studies have specifically examined how the informational dimension included in written communications influences taxpayers’ cooperation. Wenzel’s study provides insight into the impact of information included in written communications on the propensity of taxpayers to make interim tax payments. Wenzel compared the

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19 Supra note 12.
responses of taxpayers who were sent a letter containing explicit information about its contents and purpose with those of taxpayers who received a control letter without this information, and found a significantly greater rate of compliance by taxpayers who received the additional information. Similarly, Alm et al. conducted a laboratory experiment that examined the impact of tax authority-provided information on reported income compliance. In the high information condition, respondents were given the opportunity to receive information pertaining to the computation of their individual tax liabilities, while the remaining respondents were not given the opportunity to receive this information. Respondents in the high information condition reported significantly more income than respondents in the low information condition, a finding that suggests that providing information can directly and positively affect reporting compliance.

In another field study that examined the effect of the inclusion of information in written communications from the tax authority on taxpayers’ cooperation, Perez-Truglia and Troiano sent reminder letters to delinquent taxpayers. Letters included information about financial penalties or shaming, or both. Perez-Truglia and Troiano found that delinquent taxpayers were most likely to pay their tax debts when they received the letter that provided information regarding financial penalties and shaming simultaneously. This finding again provides support for the importance of information for taxpayers’ cooperation.

Empirical tax research indicates that the provision of more information by the tax authority appears to increase taxpayers’ cooperation, a finding that is consistent with an interactional fairness perspective. According to that perspective, the provision of information by authorities increases perceptions of fairness, since it provides a rationale for the process and/or outcome of the authorities’ actions, and to the extent that those actions are seen to be fair, taxpayers’ cooperation increases. Therefore, we anticipate that this behaviour extends to taxpayers’ compliance. This discussion leads to our second hypothesis:

Hypothesis 2: Information included in written communications is positively associated with taxpayers’ compliance.

Our final hypothesis considers the joint impact of the two dimensions of interpersonal fairness: tone and information. In practice, although not necessarily by design, letters from authorities vary in degree of tone and information simultaneously, and consequently interpersonal fairness (tone) and informational fairness

22 Greenberg, supra note 10, at 98, makes this point.
(information) interact to affect behaviour. There is some evidence from the fairness literature that suggests that dimensions of fairness interact with each other. However, we are unaware of any study that provides definitive insight into how they jointly interact in written communications to influence taxpayers’ compliance.

The joint impact of tone and information in written communications by tax authorities was investigated in a recent study conducted for the CRA. The study assessed taxpayer reactions to proposed wording in a collection letter sent to taxpayers who owed a tax debt. Using suggested wording from focus group participants, the study showed that taxpayers were sensitive to the tone of individual words (such as “please” or “still”), preferred a friendlier tone, and preferred to have more information included in the written communication provided by the CRA (such as information about payment options and information about arrears interest). Although the CRA study did not experimentally investigate the impact of these items on compliance, it suggests that taxpayers respond favourably to increased levels of information and are favourably sensitive to a respectful tone in written communications.

One academic study in the tax domain considers both dimensions of interactional fairness in written communications from the tax authority, providing some insight into how these two dimensions may jointly interact to influence compliance. Doyle et al., in cooperation with the Irish tax authority, examined the effect of tax authorities’ written communications when taxpayers were sent letters reminding them to file tax returns that had not been submitted by a tax-filing deadline. In this study, three groups of taxpayers were each sent one of three reminder letters, and a fourth group received no letter. One letter incorporated a more authoritative tone; one letter incorporated respectful language and an explanation describing why the letter was being sent; and one letter was the standard letter then in use, which contained a less authoritative tone with an explanation. Doyle et al. found that all groups of taxpayers who received a written letter from the tax authority were more likely to file a delinquent tax return than taxpayers who received no letter. However, there were no significant differences in submission rates among the three groups who received letters. Thus, this study found that tone and information, alone and in combination, influenced taxpayers’ compliance, but failed to distinguish which combination was likely to result in the highest level of taxpayers’ compliance. Consequently, the


24 Supra note 15.

25 Supra note 11.
combined impact of tone and information on taxpayers’ compliance remains to be empirically examined.26

To hypothesize the joint impact of tone and information on taxpayers’ compliance, we turn to Greenberg, who suggests that individuals are most likely to respond favourably to authorities when tone is respectful and information is high.27 This discussion leads to the following hypothesis:

Hypothesis 3: Tone will moderate the relation between information and tax compliance. Specifically, the effect of information on tax compliance will be stronger where the tone of the communication is respectful than where the tone is authoritative.

METHODOLOGY

Experimental Design

We employ a $2 \times 2$ [(tone: respectful, authoritative) $\times$ (information: high, low)], fully crossed-between-subjects design.

Participants

Participants were Canadian taxpayers recruited from a consumer research firm that has a database of 200,000 Canadians. To ensure that our sample was representative of a typical taxpayer population, we requested that our participants be randomly selected using two parameters, gender and age. We restricted our sample participants to taxpayers between the ages of 18 and 80, evenly distributed across age groups, and with a 50/50 gender split. All respondents were from the same province (Ontario). Once we had received 330 responses,28 the study was terminated. Of the 330 responses received, 43 were incomplete, leaving us with a sample of 287. The demographic profile of the sample is shown in table 1.

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27 Supra note 10, at 93.

28 We received 330 responses to ensure that we had adequate power and that our sample would be representative of the Canadian population. The most recent Canadian data on income levels published by Statistics Canada report the following distribution of the population by income group: less than $25,000, 40.9 percent; $25,000–$50,000, 28.7 percent; $50,000–$75,000, 15.3 percent; $75,000–$100,000, 7.7 percent; and more than $100,000, 7.4 percent. “Individuals by Total Income Level by Province and Territory” (www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/famil105a-eng.htm) (data for 2013). Our sample approximately reflects this distribution. Also, the median age in Canada in 2014 was 41.7: Index Mundi, “Canada Demographics Profile 2014” (www.indexmundi.com/canada/demographics_profile.html). In our sample, it was 38.0 (mean 39.7). Therefore, on the basis of age and income, our sample appears to reasonably represent the Canadian population.
TABLE 1  Demographic Profile Statistics

Sample size. ........................................ $n = 287$

Gender

Male ............................................. $n = 136 (47.4\%)$
Female ........................................... $n = 151 (52.6\%)$

Age .............................................. Mean = 40.3 years
Standard deviation = 14.8 years

Ever had a problem with the tax authority

Yes ............................................... $n = 37 (12.9\%)$
No ............................................... $n = 250 (87.1\%)$

Income

Less than $25,000 .................................. $n = 94 (32.8\%)$
$25,000-$50,000 ................................ $n = 73 (25.4\%)$
$50,001-$75,000 ................................ $n = 53 (18.5\%)$
$75,001-$100,000 ................................ $n = 38 (13.2\%)$
Greater than $100,000............................ $n = 29 (10.1\%)$

Highest level of education completed

High school .................................... $n = 74 (25.7\%)$
Community college ........................... $n = 61 (21.3\%)$
Undergraduate degree ......................... $n = 80 (27.9\%)$
Graduate degree ................................ $n = 59 (20.6\%)$
Other ........................................... $n = 13 (4.5\%)$

Political orientation

Very conservative ............................ $n = 19 (6.6\%)$
Moderately conservative ..................... $n = 44 (15.3\%)$
Slightly conservative ......................... $n = 26 (9.1\%)$
Middle of political spectrum ............... $n = 98 (34.1\%)$
Slightly liberal .............................. $n = 37 (12.9\%)$
Moderately liberal ........................... $n = 42 (14.6\%)$
Very liberal .................................. $n = 21 (7.4\%)$

Experimental Procedures

Potential participants received an e-mail invitation from the consumer research firm
to participate in a questionnaire about income taxes. Individuals willing to participate
in the experiment clicked on a web link and were automatically directed to one of
the experimental conditions. Respondents had a unique user identifier and password
provided by the firm, which ensured that they could not respond to a survey more
than once. Participants were offered an incentive based on a point system specific
to the firm.29 After random assignment to experimental conditions, all participants
across conditions read the same experimental scenario about a generic taxpayer who
filed his tax return on time and expected neither a balance owing nor a refund.

29 Participants received 33 “NetPoints” for completing the survey, which could be redeemed for
cash or prizes once the total number of NetPoints reached a certain threshold (similar to an air
travel points incentive program).
In Canada, as in many other countries, taxpayers are responsible for initiating the preparation and the filing of their tax return, and must submit any payment due to the tax authority. In Canada, after a taxpayer’s tax return has been filed, the CRA initiates a notice of assessment, which is a written letter sent to taxpayers acknowledging receipt of the tax return and either agreeing or disagreeing with the taxpayer’s initial submission. Thus, the primary form of written communication between the tax authority and taxpayers in Canada is the notice of assessment. Included in the notice of assessment is the amount of taxes owing or refundable, if any. A notice of assessment can be sent and received at any time during the calendar year.

Our experiment required participants to determine whether they would report cash income, which is not subject to third-party tax reporting and thus gives taxpayers an opportunity to be non-compliant without detection. The experiment started with participants reading a scenario that involved a fictitious taxpayer (“Jason Burgher”) who purportedly received a notice of assessment from the CRA in which the CRA disagreed with his initial submission. After reading the scenario, participants were instructed to click on a link, which would open the notice of assessment, and then after reading the notice of assessment, complete follow-up questions, which included manipulation checks and demographic questions. (To increase realism, the “notice of assessment” viewed by participants mimicked the typography, format, and general content of an actual notice of assessment issued by the CRA.) For participants assigned to the high information condition, further information as to the reason for the disagreement was provided at the bottom of the letter. This information was omitted for participants in the low information condition. For participants assigned to the respectful tone condition, the notice of assessment began, “Dear Taxpayer, Thank you for filing your tax return,” while for those assigned to the authoritative tone condition, the notice of assessment omitted that wording and included the phrase “If you are still confused.” The wording for all experimental conditions and a sample of one notice of assessment are reproduced in the appendix to this article.

Dependent Variable
Consistent with the findings of the US Internal Revenue Service (IRS) that taxpayers report all or no cash income, and based on the results of our pretests that showed that reporting of income was binary, we used a binary dependent variable. Participants learned that Jason received $5,000 in cash for work that he did on the side and were asked how much of the $5,000 in cash he was more likely to report. Participants could choose either “none of it (0%)” or “all of it (100%).”

30 This approach is consistent with other tax compliance studies. See, for example, Cindy Blanthorne and Steven Kaplan, “An Egocentric Model of the Relations Among the Opportunity To Underreport, Social Norms, Ethical Beliefs, and Underreporting Behavior” (2008) 33:7-8 Accounting, Organizations and Society 684-703.

Independent Variables

We employed two independent variables in this analysis: tone (respectful versus authoritative) and information (high versus low). We specifically chose to manipulate tone using words or phrases that had been identified in the CRA study described above. Participants assigned to the respectful condition saw an introductory phrase, “Dear Taxpayer,” along with the instruction to “please” call the CRA with any questions. (According to the findings in the CRA study, these terms were perceived as respectful.) The letters to participants assigned to the authoritative tone condition contained the term “still” in its follow-up instructions, and did not include “Dear Taxpayer” and “please.” (We used the word “still” because respondents in the CRA study found that it had an authoritative quality.)

For the two information conditions, participants assigned to the high information condition read that the tax return was revised to reflect the total of allowable donation receipts submitted by the taxpayer, whereas participants assigned to the low information condition were given no explanation for the revised outcome.

Control Variables

We controlled for four demographic variables: age, gender, income, and education. We also controlled for political orientation, deterrence, and whether or not the participant had ever had a problem with the tax authority. Also, since prior research suggests that the favourability of an outcome can bias perceptions of interpersonal and informational fairness, we controlled for the outcome on the notice of assessment.

32 Supra note 15.
34 McGowan suggests that tax attitudes are influenced by taxpayers’ political orientation; therefore, we controlled for political orientation using the measure developed by Chin, Hambrick, and Treviño. See John R. McGowan, “The Effect of Political Affiliation on Taxpayers’ Attitudes Toward Alternative Tax Systems” (2000) 22:1 Journal of the American Taxation Association 111-28; and M.K. Chin, Donald C. Hambrick, and Linda K. Treviño, “Political Ideologies of CEOs: The Influence of Executives’ Values on Corporate Social Responsibility” (2013) 58:2 Administrative Science Quarterly 197-232. We controlled for deterrence using the measure developed by Wenzel, which is a composite score of individual responses to four punitive outcomes and the likelihood of their occurrence: see Michael Wenzel, “The Impact of Outcome Orientation and Justice Concerns on Tax Compliance: The Role of Taxpayers’ Identity” (2002) 87:4 Journal of Applied Psychology 629-45. We also asked whether or not the participant ever had a problem with the tax authority, since this circumstance may have biased fairness perceptions.
In the initial scenario, participants were told that when Jason filed his tax return, his calculations showed that he had neither a balance owing nor a refund; however, when participants read the notice of assessment, some learned that the taxpayer was getting a refund (of $800), while others learned that the taxpayer owed money ($800).  

**Manipulation Effectiveness**

We performed manipulation checks for tone and information. Our manipulation check for tone asked participants to rate their agreement with the statement “The CRA treated Jason respectfully.” Our manipulation check for information asked participants to rate their agreement with the statement “In the Notice of Assessment, the CRA justified its actions.” All statements were measured with 7-point Likert scales, with 1 being “strongly agree” and 7 being “strongly disagree.” Tone ($F = 3.63, p = 0.05$) and information ($F = 3.79, p = 0.05$) manipulation checks were supported.

**RESULTS**

To test our hypothesis, we used binary logistic regression analysis, since our dependent variable and independent variables are dichotomous. We used dummy variables of “0” for the “unfair” conditions (authoritative, low information) and “1” for the “fair” conditions (respectful, high information). We also used dummy variables of “0” for 0 percent compliance, and “1” for 100 percent compliance. We entered all independent variables and control variables simultaneously. Regression results are reported in table 2.

We first examine our interaction hypothesis (“H3”). This hypothesis posits that there is an interaction effect between tone and information in influencing taxpayers’

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36 In our study, binary control variables were coded as follows: tax owing (0) and tax refund (1); female gender (0) and male gender (1); and problem with tax authority as “no” (0) and “yes” (1).

37 We tested our manipulation checks through a simple analysis of variance (ANOVA) that tested whether there was a significant difference in the respective manipulations for respondents assigned to the different conditions.


39 We first checked for multicollinearity using the tolerance and VIF (variance inflation factor) statistics, and found no evidence of multicollinearity in the logistic regression model. The model fit statistics indicate an acceptable fit to the data, given that the Hosmer-Lemeshow statistic ($\chi^2 = 4.42, p = 0.82$) is not significant. We also inspected the standardized residuals and deviance statistics (Cook’s distance). No standardized residuals exceeded 3, and no Cook’s distance exceeded 1—results that also indicate an acceptable model fit. See Andy Field, *Discovering Statistics Using SPSS*, 3d ed. (Thousand Oaks, CA: Sage Publications, 2009), at 264-312.

40 The protocol of testing interactions before total effects is discussed in Scott E. Maxwell and Harold D. Delaney, *Designing Experiments and Analyzing Data: A Model Comparison Perspective*, 2d ed. (New York: Taylor and Francis, 2004), at 370-76.
compliance, and that the effect of information on tax compliance will be stronger for a respectful tone than for an authoritative tone. Support for the first part of this hypothesis is indicated by a significant interaction term between tone and information in relation to compliance. As shown in table 2, panel A, the interaction term is significant (Wald $\chi^2 = 4.30, p = 0.04$), confirming the presence of a significant interaction between tone and information, at the 5 percent level of statistical significance.

The second part of H3 is that the effect of information on tax compliance will be stronger for a respectful tone than for an authoritative tone. As shown in table 2, panel A, the interaction term (tone by information) is negative ($\beta = -1.25$), which suggests the relationship between tone and information is contrary to our prediction. Thus, we have only partial support for H3. We present a graph of the interaction in figure 1. Figure 1 shows an ordinal interaction.41

Since we have an ordinal interaction, we can also interpret hypotheses 1 (H1) and 2 (H2). H1 predicts a total effect of respectful tone in written communications on taxpayers’ compliance, and H2 predicts a total effect of information in written

41 In ordinal interactions, lines in a graph will not be parallel, nor will they cross.
communications on taxpayers’ compliance. Support for both hypotheses would be indicated by a significant Wald test value. As shown in table 2, panel A, the Wald test value for tone is 0.02 ($p = 0.89$), and the Wald test value for information is 4.85 ($p = 0.03$). Therefore, only $H_2$ is supported. Consequently, there is a significant total effect of information in written communications on taxpayers’ compliance, which suggests the importance to tax authorities of providing adequate explanations in their written correspondence with taxpayers.

To further assist in the interpretation of the results, we conduct additional statistical analysis of the proportion of individuals being compliant in each experimental condition, as shown in table 3, panel A. The experimental condition with the greatest proportion of compliant individuals was the high information, authoritative tone condition, which is also depicted by the graph of the interaction in figure 1. Thus, our results suggest that compliance is optimized when taxpayers receive an explanation with high information content combined with an authoritative tone.

To provide additional insight into our findings, we examine the odds ratio for each condition, as shown in table 3, panel B. The odds of the occurrence of an event is the probability that the event will occur divided by the probability that the event will not occur. When the tone is authoritative and information is low, the odds of compliance are $0.093$.\footnote{Calculated as $e^{-2.38}$.} However, when the tone is authoritative and information is
high, the odds of compliance are 0.239, an increase of 159 percent, as a result of the presence of additional information.\textsuperscript{43} Furthermore, when the tone is respectful and information is low, the odds of compliance are 0.087, and when the tone is respectful and information is high, the odds of compliance are 0.065, a decrease of 35 percent.\textsuperscript{44} The latter result shows that respectful tone undermines the impact of high information on compliance.

The only significant control variable was deterrence, suggesting that taxpayers’ perceptions of deterrence are relevant to their compliance decision. The outcome control variable was not significant, suggesting that the interactive effect of tone and information did not vary according to outcome.\textsuperscript{45}

**IMPLICATIONS AND CONCLUSIONS**

Tax authorities have the ability to shape and influence the content of written communications at very little cost. Furthermore, tax authority letters are likely to play a role in taxpayers’ perceptions of interactional fairness through the kind of language employed as well as the content of the communication. A better understanding of tax authority-to-taxpayer written communications is important because tax authorities, either unwittingly or by design, appeal to taxpayers’ perceptions of interactional fairness through their choice of tone and information, and those perceptions have an impact on taxpayers’ compliance.

Our research adopts an interactional fairness perspective to experimentally test 287 taxpayers on how two dimensions of a tax authority’s communications—tone

\begin{table}[h]
\centering
\caption{Compliance Across Experimental Conditions}
\begin{tabular}{|l|c|c|}
\hline
 & Low information & High information \\
\hline
Authoritative tone & 42.9\% (30/70) & 57.6\% (38/66) \\
Respectful tone & 38.5\% (30/78) & 37.0\% (27/73) \\
\hline
\end{tabular}
\end{table}

**Panel B: Odds of reporting 100\% of cash income**

<table>
<thead>
<tr>
<th></th>
<th>Low information</th>
<th>High information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authoritative tone</td>
<td>0.093</td>
<td>0.239</td>
</tr>
<tr>
<td>Respectful tone</td>
<td>0.087</td>
<td>0.065</td>
</tr>
</tbody>
</table>

\textsuperscript{43} Calculated as $e^{−2.38 + 0.95}$. The odds of compliance are $e^{0.95}$—that is, 2.59 times as much, or an increase of 159 percent.

\textsuperscript{44} Calculated as $e^{−2.38 − 0.06}$ and $e^{−2.38 − 0.06 + 0.95 − 1.25}$, respectively. The odds of compliance are $e^{0.95 − 1.25} = e^{−0.3}$—that is, 0.74 times as much, or a decrease of 35 percent.

\textsuperscript{45} As a sensitivity analysis, we ran the regression without the outcome control variable and obtained the same main effect of information (Wald $\chi^2 = 4.82$, $p = 0.03$) and significant interaction effect of tone and information (Wald $\chi^2 = 4.32$, $p = 0.04$). Thus, our results do not vary significantly according to whether taxpayers have a refund outcome or a balance owing outcome.
and information—affect taxpayers’ income reporting after receiving a tax notice in which the tax authority disagreed with the tax return submitted by the taxpayer. Our results show that information is positively associated with compliance, and that there is a significant interaction between tone and information, such that providing an authoritative tone reinforces the positive impact of information on compliance. For optimal compliance, tax authorities should provide taxpayers with thorough explanations, using a tone that is authoritative. Our results suggest that information is of paramount importance to taxpayers, and the manner in which this information is conveyed is also influential.

Our research extends existing studies that have indirectly examined the effect of tone or information in a tax authority letter on taxpayers’ cooperative responses by specifically considering and comparing the combined impact of tone and information on taxpayers’ reporting compliance. Surprisingly, our results failed to show that a respectful tone in written communications will result in higher compliance than an authoritative tone. Upon careful review, prior research appears to compare written communications that use a respectful tone with those that use a neutral tone. Thus, our research is the first to experimentally evaluate taxpayer’s compliance under an authoritative condition compared with a respectful condition, and our findings suggest that an authoritative tone originating from the tax authority will result in higher compliance than a respectful tone. Consistent with prior research, our experiment reinforces the importance of information in taxpayer correspondence, and by adopting a fairness perspective, our results suggest that tax authorities may be viewed as fair if they provide explanations, and by so doing, enhance taxpayers’ compliance. From a theoretical perspective, our research is the first to jointly consider and provide empirical evidence of the interplay between tone and information on taxpayers’ compliance. Our study extends prior empirical research by providing insight into the joint interplay of these factors on compliance, and contributes to the broader justice research on interactional fairness by identifying the interactive impact of these factors. Furthermore, because we specifically control for deterrence and outcome in our research design, we tease apart the impact of deterrence, outcome, and information on compliance to show that explanation results in greater taxpayers’ compliance.

There are several limitations to our study. First, the results from this research are specifically tested on Canadian taxpayers using procedures and manipulations reflective of the Canadian tax system, and therefore their application to other taxation environments should be undertaken with care. Second, as with all self-reported research, it is possible that subjects were not completely honest about their income reporting decision. Even though our informed consent assured participants that our study was anonymous and in no way affiliated with the CRA, participants may have altered their responses if they were concerned that the CRA would review their responses. However, to mitigate a possible social desirability bias, we asked subjects

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46 Hasseldine et al., supra note 16, and Perez-Truglia and Troiano, supra note 21.
in the scenario what they thought another taxpayer would do, rather than what they themselves would do. Finally, we assumed that the reporting decision was made at the time the letter was received, consistent with other experimental studies that measure the dependent variable at the time of the manipulation, but in practice, there may be a longer delay between the time of the receipt of the letter and the reporting decision. Future research could investigate this possibility further. Future research could also consider how different measures of the dependent and independent variables may influence findings, and researchers could investigate whether our findings hold across other modes of tax authorities’ communication, such as telephone calls and face-to-face communication. Future research is also needed to consider the effectiveness of other operationalizations of tone and, for example, to compare neutral, authoritative, and respectful tones.

Tax compliance is a complicated phenomenon. It requires a multifaceted policy approach that considers deterrence as well as other aspects of human behaviour. Tax researchers have adopted several theoretical perspectives to study ways of encouraging tax compliance and preventing tax evasion. The deterrence approach to tax compliance suggests that taxpayers’ income reporting decisions are a function of tax rates, audit probability, and penalty rates, and that taxpayers will maximize their expected utility of the evasion gamble. Prior research has established that tax authority letters can be used to promote taxpayers’ compliance when they include normative appeals or threats of sanctions. Nevertheless, appeals to taxpayers’ ethical beliefs, social norms, tax morale, and perceptions of fairness may be more palatable and cost-effective means to influence taxpayers’ behaviour, and specifically taxpayers’ voluntary compliance.

47 See, for example, Alm et al., supra note 20.
52 See Bobek et al., supra note 33.
53 Tax morale is the intrinsic willingness to pay taxes. See Molero and Pujol, supra note 7.
APPENDIX  EXPERIMENTAL INSTRUMENT

Background
Jason Burgher is an employee. He is married with one child. Each year he donates money to some charities.

Jason prepared and filed his 2013 income tax return on time. His calculations showed he had neither balance owing nor refund.

Several weeks later, Jason received a “Notice of Assessment” from the Canada Revenue Agency (CRA). The Notice of Assessment is a letter that the CRA sends to all taxpayers after processing their returns.

To read Jason’s Notice of Assessment, you will have to click on a link that will open a new browser window. Please read the Notice of Assessment carefully, as you will be asked about 15 follow-up questions. When you are done reading the Notice of Assessment, please minimize or exit from the browser window. You will be returned to this screen.

When you are ready to see the Notice of Assessment, please click here and read it carefully.

If you have read the Notice of Assessment, please press ‘Next’ to continue.

Respectful Tone/High Information

Dear Taxpayer,

Thank you for filing your income tax return. Our review of your income tax return for the year 2013 shows that you (get a refund of $800/owe $800). Your tax return has been revised to reflect the total of allowable charitable donation receipts you submitted.

If you have any questions about your assessment, please call our Enquiries service at 1-800-959-8281.

Respectful Tone/Low Information

Dear Taxpayer,

Thank you for filing your income tax return. Our review of your income tax return for the year 2013 shows that you (get a refund of $800/owe $800).

If you have any questions about your assessment, please call our Enquiries service at 1-800-959-8281.

Authoritative Tone/High Information

(You get a refund of $800/You owe $800). Your tax return has been revised to reflect the total of allowable charitable donation receipts you submitted.

If you are still confused, call 1-800-959-8281.
Authoritative Tone/Low Information
(You get a refund of $800/You owe $800).
If you are still confused, call 1-800-959-8281.

Sample of a Hypothetical Notice of Assessment, Illustrating Respectful Tone and High Information Conditions

Note: This illustration is a wholly fictitious form created for the purposes of the study. The taxpayer is a fictitious person. No part of the information shown below was provided or reviewed by, or used with the approval of, the CRA.

Canada Revenue Agency
Agency du revenu du Canada

NOTICE OF ASSESSMENT
T451 E (09)

Date
April 2, 2014

Name
Jason Burgher

Social insurance no.
010 178 010

Tax year
2013

Tax center
Surrey BC V3T 5E1

Summary
0187056

<table>
<thead>
<tr>
<th>Line</th>
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<th>$ Amount on previous assessment</th>
<th>$ Revised amount</th>
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<tr>
<td>435</td>
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<td></td>
<td>Change to tax payable</td>
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</tr>
<tr>
<td></td>
<td>(Revised subtotal – Previous subtotal)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Balance from this reassessment</td>
<td>CR 800</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Refund</td>
<td>CR 800</td>
<td></td>
</tr>
</tbody>
</table>

Explanation of changes and other important information

Dear Taxpayer,

Thank you for filing your income tax return. Our review of your income tax return for the year 2013 shows that you get a refund of $800. Your tax return has been revised to reflect the total of allowable charitable donation receipts you submitted.

If you have any questions about your assessment, please call our Enquiries service at 1-800-959-8281.
Policy Forum: Editor’s Introduction—
Taxation of the Financial Sector

Tax policy for the financial sector receives special attention from many analysts. There are several possible motivations for this attention. Some policy analysts want to ensure neutrality for the financial sector, as compared with the taxation of other industries, arguing that undertaxation of the financial sector leads to an inefficient industrial mix.1 Many others, though, want to go beyond neutrality to tax the financial sector more than other sectors. The motivations range from a corrective, Pigouvian strategy of discouraging putatively “wasteful” speculation, to concern for the fairness of tax burdens, to the desire to gain access to a new revenue source for governments. There are also some analysts who advocate the imposition of a special “benefit tax” to fund the cost of potential future bailouts. Every one of these motivations became much more salient in the wake of the 2008-9 financial crisis, renewing concern about the taxation of the financial sector.

Putting these motivations into action requires a tax policy instrument. The idea of a financial transaction tax (FTT) was crystallized by the economist James Tobin.2 He advocated a tax levied on financial transactions in order to combat what he saw as excess speculation. In recent years, the idea of a financial activities tax (FAT) has supplanted the FTT among many tax policy experts.3 This tax takes the form of an addition-method, accounts-based value-added tax (VAT), through a base formed as the sum of profits and wages in the financial sector.

No matter which of these two taxation methods looks more attractive, both suffer from an important weakness. It is difficult for one country to enact such a tax without displacing financial activity out of the country to other untaxed jurisdictions. For this reason, discussion of these taxes for the European Union as a whole make more sense than the unilateral adoption of such a tax for a country like Canada—unless the United States were to adopt a similar measure.

In this policy forum, we present three articles on the taxation of the financial sector to guide the discussion in Canada. In the first article, Rita de la Feria and Richard Ness describe the progress on implementing an FTT in the European Union. They

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find it hard to defend the proposed FTT as compared with an expansion of the existing VAT for EU countries. In the second article, Michael Keen, Russell Krelove, and John Norregaard discuss the alternative of a FAT, conceived as an addition-based VAT applied to finance alone. After laying out the basic structure, they describe the key implementation challenges that such a FAT would face, including the definition of profits, resolution of the problem of border adjustments, and agreement on the definition of financial activities to which the tax would apply. Finally, in the third article, Pierre-Pascal Gendron tackles the taxation of the financial sector in Canada. He describes the current exemption under the goods and services tax (GST) and points out its shortcomings. He evaluates several alternatives, settling on a model derived from South African experience that would bring some (but not all) types of financial services into the GST system.

This policy forum was organized by my co-editor, Tim Edgar, who conceived it and coordinated the planning and preparation of these interesting pieces with their respective authors. I thank him and acknowledge those efforts.

Kevin Milligan
Editor
Policy Forum: The EU Financial Transaction Tax as an Unsuitable and Unnecessary Proxy Tax

Rita de la Feria and Richard Ness*

PRÉCIS
En 2011, la Commission européenne a proposé d'instituer une taxe sur les transactions financières (TTF) pour les membres de l’UE. Cet article traite des récents développements relatifs à l’approbation de cette TTF de l’UE et des principales préoccupations que soulèvent la taxe proposée, en particulier ses caractéristiques en tant que taxe indirecte. Il y est conclu que dans la mesure où la TTF de l’UE est une taxe indirecte, elle est à la fois inappropriée et inutile, et que l’on atteindrait mieux et plus réallement les objectifs visés de la TTF si l’on imposait la taxe à la valeur ajoutée de l’UE aux services financiers.

ABSTRACT
In 2011, the European Commission presented its proposal for an EU financial transaction tax (FTT). This article analyzes the recent developments as regards the approval of that EU FTT, and the main concerns that the proposed tax gives rise to, considering in particular its characteristics as a proxy tax. The authors conclude that insofar as the EU FTT is a proxy tax, it is both unsuitable and unnecessary, and that extension of the EU value-added tax to financial services would serve as a better and more realistic instrument to attain most of the stated aims of the FTT.

KEYWORDS: FINANCIAL SERVICES • VALUE-ADDED TAX • EUROPEAN UNION

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INTRODUCTION

The impact of the 2008-9 financial crisis on tax policy can hardly be overestimated. The magnitude of the crisis and its consequences have influenced the debate in almost all areas of tax law and have resulted in concrete change in many of them,1 including corporate and personal income tax2 and value-added tax (VAT).3 Among the most significant effects are a reopening of the debate as to how best to tax the financial sector, the introduction by many European countries of bank levies, and discussion on the possible approval in Europe of a tax of wider scope, applicable to financial transactions. This article focuses in particular on the European Union’s proposed financial transaction tax (FTT).

Three years have now passed since the FTT was proposed in its current form.4 The latest reports suggest that, despite the political difficulties, the 10 countries still pursuing adoption of the tax through what is designated the enhanced cooperation procedure may be close to agreement on some of the fundamental details.5 Yet, beyond political dynamics, the FTT as it is proposed raises many concerns. In particular, it is unclear whether the tax would attain the aims that it has set out to achieve, what would be its economic effects, or indeed whether its approval under the enhanced cooperation procedure complies with EU constitutional requirements. This article analyzes the recent developments as regards the approval of an EU FTT, and the main concerns that the proposed tax gives rise to, considering in particular its characteristics as a proxy tax. We conclude that insofar as it is a proxy tax, the EU FTT is both unsuitable and unnecessary, and that extension of the European VAT to financial services would serve as a better and more realistic instrument to attain most of the stated aims of the FTT.

THE EU FTT

An FTT is not the only option for taxing the financial sector: in the aftermath of the financial crisis, various options for taxing the financial sector were presented,6 and indeed several new taxes were implemented in Europe. Bank levies, which typically

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1 For a summary of the changes to UK tax policy, for example, see Giorgia Maffini, ed., Business Taxation Under the Coalition Government (Oxford: Oxford University Centre for Business Taxation, February 2015).
fall directly on bank borrowing and have a clear rationale of discouraging debt and favouring equity, proved particularly popular; 11 countries in Europe have reportedly introduced bank levies, which, although varying greatly in terms of their scope and rate, are said to have a net positive effect of reducing total risk taking among financial institutions. There has also been strong support for a so-called financial activities tax (FAT)—a tax that would work similarly to a VAT—including support from the European Commission: after examining the options for how to tax the financial sector, the commission concluded in 2010 that there was “greater potential for a Financial Activities Tax at EU-level.” Why the European Commission ultimately opted for an FTT, when its own evidence does not seem to support the tax as the best instrument to obtain its stated objectives, is unclear.

Be it as it may, the first legislative proposal for an EU FTT came in 2011. To some extent the proposed FTT was a classic transaction tax in that it sought to discourage a particular transaction, or series of transactions, through the levying of a tax. It was, however, unique in its scope, as well as in its rationale, insofar as it targeted not only currency conversions, or general securities, but a very broad range of financial transactions, and the arguments presented for its introduction went far beyond mere regulatory objectives. The proposal was initially rejected by a majority of member states in 2011 but resuscitated in 2013, with some minor amendments, through the enhanced cooperation procedure. In between the two proposals, France, Italy, and Hungary followed the lead of Greece and Belgium in implementing an FTT.

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9 International Monetary Fund, supra note 6.
bringing the total number of EU member states with an FTT to five, and offering a sneak preview of what the effects of an EU FTT might be.

**The Proposal**

The stated aims of the proposal are as follows:

1. to disincentivize risky behaviour or, as the proposal puts it, transactions that do not enhance the efficiency of the financial markets;
2. to raise revenue to ensure that the financial sector makes a fair and substantial contribution to cover the costs of government-backed bailouts;
3. to ensure a level playing field with other sectors, and compensate for the undertaxation of the financial sector resulting from the exemption applicable under the EU VAT system to financial services; and
4. to avoid a fragmentation of the internal market that might be caused by the introduction of uncoordinated national tax measures.

The proposal for an EU FTT follows what has been designated the “triple A” approach: it would apply to all markets, all instruments, and all financial sectors. And, indeed, the main elements of the proposal are its broad definitions of financial transaction, financial institution, and place of establishment.

With respect to financial transactions, the tax will apply to the purchase, sale, and exchange of financial instruments, intragroup transfers of financial instruments, derivatives contracts, repurchase agreements (repos), reverse repurchase agreements (reverse repos), and securities, lending, and borrowing agreements. Transactions will be subject to tax whether they are carried out in an organized market or over the counter; however, a number of exemptions apply, including the exemption of transactions in primary markets for securities and currencies.

The tax will apply where one of the parties to the transaction is a financial institution established in a participating member state, a term that is broadly defined

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17 On the legal difficulties caused by the Italian FTT, for example, see Luca Rossi and Valentina Buzzi, “IPOS and the Italian Financial Transaction Tax” (2015) 43:5 Intertax 424-27.
18 European Commission, supra note 12.
19 See Rossi and Buzzi, supra note 17.
and encompasses a range of entities; the concept of establishment is equally far reaching, although recent negotiations indicate that this reach might be limited. The tax is payable by the financial institution involved in the transaction to the participating member state in which the financial institution is deemed to be established, at the rates set by that member state. Similar to the approach adopted for the EU VAT, there is no set rate at which the tax will be charged, but merely minimum rates, namely, 0.01 percent of nominal value for derivatives and 0.1 percent for all other financial transactions.

In early negotiations, the easiest aspect to agree upon was reportedly that almost everything that could be construed as a financial transaction should be subject to the tax. As talks have progressed, however, what should be subject to the tax has become a more problematic topic. It has been pointed out that some specific financial structures were not covered by the proposal, leading to concerns over the lack of neutrality to which discrepant treatment of similar products could give rise. Similarly, a number of participating member states have requested carve-outs from the proposal. Italy is eager to extend the FTT to sovereign debt derivatives; and, before its departure from the negotiation process, Estonia (as well as Slovenia) had also wanted to broaden the base. More recent discussions also demonstrate an increased focus on the territorial application of the tax. Whether these requests are genuine attempts to refine and improve the FTT or are motivated by a desire to insulate transactions especially valuable to the member state’s economy is, however, unclear.

The Legislative Procedure

The legal basis used for the initial EU FTT proposal was article 113 of the Treaty on the Functioning of the European Union (TFEU), which allows the approval of EU harmonizing legislation concerning indirect taxation insofar as this is needed in order to ensure the proper functioning of the internal market and avoid distortion of competition. Whether this is the appropriate legal basis for this proposal, and in

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22 Supra note 4, at article 3.
23 See below under the heading “The State of Play.”
24 Englisch et al., supra note 21.
25 Supra note 4, at article 9.
26 See the “Explanatory Memorandum” accompanying the proposal, supra note 4.
30 See below under the heading “The State of Play.”
particular whether the FTT can be regarded as an indirect tax, has been contested.\(^\text{32}\)

In any event, the legislative procedure set out in the proposal does not differ substantially from that set out in the alternative legal basis for tax measures, namely, article 114 of the TFEU. Indeed, the procedure set out in both provisions is a rarity within the EU treaties, giving the Council of the European Union full power to approve new legislation, but only by unanimity.\(^\text{33}\)

While the procedure followed by the council is strict, enlargement of the European Union’s membership has resulted in it being extremely difficult—indeed, nearly impossible—to approve new tax legislation. It is unsurprising, therefore, that negotiations on the first FTT proposal failed; more surprising, perhaps, was the subsequent move toward the presentation in 2013 of an alternative proposal under the enhanced cooperation procedure.

The EU enhanced cooperation procedure was originally established by the Treaty of Amsterdam in 1997\(^\text{34}\) but remained unused until 2010, owing to its “forbiddingly difficult” and restrictive conditions.\(^\text{35}\) In 2001, the Nice treaty\(^\text{36}\) replaced the requirement for unanimity in the Council of the European Union with qualified majority voting, substantively facilitating the potential use of the procedure. The procedure could henceforth be seen as a method of circumventing the requirement for unanimity still applied in a few areas, including for tax measures.

Yet, despite this loosening of the requirements, the FTT proposal is only the third occasion on which the procedure has been used, and the first as regards tax issues.\(^\text{37}\) This means in practice that some uncertainty persists on the application of the procedural and substantive conditions for its use. The fact that these conditions, summarized in table 1, are split between articles 20 and 326 through 334 of the TFEU increases this uncertainty.\(^\text{38}\)


\(^\text{33}\) For a detailed analysis of this provision, see Rita de la Feria, The EU VAT System and the Internal Market (Amsterdam: IBFD, 2009), at 40 et seq.

\(^\text{34}\) OJ C340, 10.11.1997.


\(^\text{36}\) [2001] OJ C80, 10.3.2001, 70.


Whether the FTT respects these conditions for the use of the enhanced cooperation procedure, particularly the substantive ones, has been a heavily debated issue in the last few years. It has been suggested in particular that the FTT could have significant consequences for non-participating member states, including increased costs for government borrowing, new costs of setting up systems to collect the tax and of actually collecting the tax, and reduction of financial activity—leading to lower profits and hence lower income tax receipts, and overall increasing the costs of capital in those countries.39

The arguments presented seem to have influenced the legal challenge to the FTT brought by the United Kingdom.40 Ostensibly, the case focused on the validity of

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>EU Enhanced Cooperation Procedure—Legal Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Procedural conditions</strong></td>
<td><strong>Substantive conditions</strong></td>
</tr>
<tr>
<td>Enhanced cooperation is a last resort procedure that can be used only when it becomes clear that agreement will not be reached between member states within a reasonable period.(^a)</td>
<td>Enhanced cooperation cannot undermine the internal market, or social and territorial cohesion, and cannot constitute a barrier to or discrimination in trade between member states, nor can it distort competition.(^c)</td>
</tr>
<tr>
<td>The procedure cannot be used in areas of exclusive competence of the European Union.(^b)</td>
<td>Enhanced cooperation must respect the competences, rights, and obligations of non-participating member states.</td>
</tr>
<tr>
<td>Use of the procedure must be supported by at least nine member states.</td>
<td></td>
</tr>
</tbody>
</table>

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39 Englisch et al., supra note 21. Similar findings were reached by the Swedish National Debt Office: see Soone, supra note 32, at 46 et seq.

the council’s decision authorizing the use of the procedure, although in practice it became a vehicle for challenging specific features of the proposal. It was argued in particular that some of those features violated one of the substantive conditions for the use of the enhanced cooperation procedure, namely, that it did not respect the rights of non-participating member states by creating significant new costs for those countries. Unsurprisingly, the challenge was rejected, but not without reference to a possible “subsequent action for annulment,” which, some have argued, was all that the United Kingdom had hoped to gain from the challenge. The case is therefore significant, inasmuch as the result guaranteed that future legal challenges to the FTT can be brought before the court.

The State of Play

It has been suggested that the December statement from the EU Council of Finance Ministers on the FTT negotiations contains less information on what the details of the tax will include and more on how to resolve present concerns, such as the allocation of resulting revenues. This gives an insight into where current priorities lie. Indeed, from a legal design perspective, there is still a lot to decide: questions on what to tax, at what rate, and how to do it remain unanswered.

Notwithstanding, the statement does offer some more detail regarding areas where concerns had been raised. It seems to suggest, for example, that shares and derivatives might be dealt with separately, with exemptions being considered for market-making activities in shares but not derivatives. The proposed approach appears to be a direct response to those who had raised concerns that by taxing market makers the FTT may reduce overall market liquidity, as traders adapt their behaviour to avoid the tax. Also of great interest is the potential concession concerning a departure from the residence and issuance principles, which have caused such controversy to date. Although admittedly this applies only with regard to

41 Ness, supra note 38, at 299.


43 See Council of the European Union, supra note 5.


shares, the statement declares that it might be “more sensible to start taxation with only shares issued in the member states.”

Alongside the negotiations concerning the contents of the proposal, the most significant development has been the recent decision by Estonia to leave the enhanced cooperation procedure. The TFEU does not contemplate the possibility of a member state’s leaving the procedure, and while no explicit prohibition against leaving is included, the absence of provisions on this matter stands in contrast to the copious requirements and information set out as regards joining the process. There is precedent for a member state’s departure from negotiations, but this was before the process was fully under way, not after. Given the unprecedented nature of the move, Estonia’s departure raises a number of constitutional concerns, since consent and authorization were given to 11, not 10, member states by both the European Parliament and the council. Most significant of these concerns is that Estonia may not actually be permitted to leave the process, or that its departure renders void the approval given to the use of the procedure for approval of the FTT. To avoid a future legal challenge on these grounds, the remaining 10 member states could seek new consent from the union to progress without Estonia. This would, however, represent an additional hurdle for the FTT, and it could result in some remaining member states deciding that to continue is more effort than it is worth, and also dropping out of the process. The only other alternative appears to be forcing Estonia to remain in the process, in which case it will surely block any further progress by exercising its veto.

In light of the above, the proposed target for approval of the FTT by June 2016—three years and four months after the initial proposal—seems somehow unambitious and unrealistic at the same time.

47 Council of the European Union, supra note 5, at 4.
48 Greece left during discussions concerning the approval of new legislation regarding divorce, approved under the enhanced cooperation procedure; see European Commission, “The European Union’s First Use of Enhanced Cooperation To Help International Couples Approved by EU Governments,” Press Release IP/10/917, July 12, 2010.
51 TFEU article 330.
THE EU FTT AS A PROXY TAX

The perception of the FTT as a proxy, while never truly spelled out, is subjacent to much of the discussion surrounding the introduction of the tax. As mentioned above, one of the key arguments presented by the European Commission for the introduction of an FTT has been the perceived undertaxation of the financial sector under the European VAT system; indeed, the VAT exemption applied to financial services features in every discussion held on the taxation of the financial sector, as a key justification for the introduction of a new tax. In this regard, the rationale presented for the FTT is not distant from that used to justify the existence of insurance premium taxes in many EU member states. The characterization of insurance premium taxes as a proxy tax, compensating for the VAT exemption applicable to insurance services, is reaffirmed by the fact that the tax tends to apply only in countries where a VAT (or goods and services tax) exemption is also present.

The undertaxation of the financial sector under the VAT is, of course, only one of the four reasons presented by the European Commission to justify the introduction of the EU FTT. Indeed, the regulatory dimension of the proposed EU FTT means that the tax cannot be perceived as a mere proxy tax, but rather is a hybrid—partly a proxy tax and partly a regulatory, or Pigouvian, tax. However, it is argued that two other reasons for the FTT presented by the commission, namely, revenue collection and harmonization of the taxation of the financial sector, also could be addressed by the removal of the VAT exemption applicable to financial services, and more effectively so.

The ability of the proposed EU FTT to collect revenue that will significantly contribute to the costs of the financial crisis is one of the central aims of the tax. Yet, as the European Commission itself acknowledged in 2011, it is difficult to predict revenue size without knowing the scope of the tax—that is, to what it will apply. Indeed, it is worth noting that general vagueness over what will be subject to the tax has in the past resulted in haphazard revenue predictions. Moreover, even if this were not the case and the scope of the tax were known, concerns remained over the

53 See IMF, supra note 6, as well as most of the literature on taxation of the financial sector.
54 Case C-308/01, GIL Insurance and Others, ECLI:EU:C:2004:252, at paragraph 14.
model used by the commission’s impact assessment.\textsuperscript{59} Indeed, while the most recent discussion offers a more conservative projection of the revenue-gathering capacity of an EU FTT,\textsuperscript{60} reported experiences with the FTT in both France and Italy provide sober reading: in 2012, the French FTT collected only 44 percent of estimated revenue; and the revenue impact of the Italian FTT was even lower, having collected in 2013 less than 20 percent of the initial estimated revenue.\textsuperscript{61} Of course, both the French and the Italian FTTs are different from the EU FTT proposed by the commission, but nevertheless the results seem to indicate a tendency to systematically overestimate the revenue potential of an FTT.\textsuperscript{62}

The revenue impact of removing the VAT exemption applicable to financial services is also unclear, and cannot be dissociated from the question of undertaxation of the sector resulting from that exemption: if the financial sector is indeed undertaxed, removing the exemption will have a significant revenue impact; if the financial sector is not undertaxed, then removing the exemption will have minimal revenue impact. As the European Commission has stated, this is still “an unsettled empirical question.”\textsuperscript{63} Some have sought to argue that a significant part of the services supplied by the financial sector should not be subject to VAT,\textsuperscript{64} and on this basis conclude that the financial sector is not undertaxed.\textsuperscript{65} This is, however, a controversial assumption. Most take the view that financial services should indeed be subject to VAT\textsuperscript{66}—in which case, applying an exemption does result in undertaxation of the financial sector, and consequently removing it would yield significant revenue gains.\textsuperscript{67} The fact that the Italian regional production tax (IRAP)—a proxy tax on financial services (among other productive business activities) that in economic terms operates similarly to a

\textsuperscript{59} Vella et al., supra note 46, at 618.

\textsuperscript{60} The 2013 proposal estimated an annual revenue intake of €34 billion: see European Commission, supra note 4.

\textsuperscript{61} Maffini and Vella, supra note 11.

\textsuperscript{62} Ibid.

\textsuperscript{63} European Commission, supra note 57, at 14.


VAT—an collects, not significant revenue, but considerably more than the Italian FTT is also indicative.

The final stated aim of the proposed EU FTT is to avoid a fragmentation of the internal market that might be caused by the introduction of uncoordinated national tax measures. If the existence of FTTs in a few European countries before 2011 was already an important element, the introduction of FTTs since then in three more member states further legitimizes this aim. Yet it is questionable whether any of these member states would have felt the need to introduce an FTT if the financial sector were not perceived as undertaxed under the VAT. Indeed, the fact that three of these member states—France, Hungary, and Belgium—have also introduced bank levies, which appear to be more effective as a regulatory tool, indicates that the FTT was introduced in those countries more as a proxy tax than a Pigouvian one. Arguably, therefore, the removal of the VAT exemption applicable to financial services not only would limit the fragmentation of the internal market by removing the need for introduction or maintenance of existing FTTs, but also would further limit the fragmentation of the market by harmonizing the VAT treatment of financial services, which at present is far from uniform.

Given the (partial) proxy nature of the EU FTT, the question then is whether the tax is a suitable and necessary proxy, representing “the best tax instrument that was realistically available,” or whether eliminating the VAT exemption for financial services is not only a better, but also a realistic, option.

A Defective and Unnecessary Proxy

Financial services have been exempt from VAT in Europe, for technical rather than concessional reasons, since the inception of the tax in the 1960s. The rationale for exempting these services has traditionally been not a matter of principle, but the difficulty in determining their value added, and their consequent characterization as services that are “too difficult to tax.” Assessing the FTT as the appropriate instrument to fill this hole in the VAT base is essentially dependent on the answer to two questions: whether the proposed FTT is a suitable proxy, and whether the FTT is a necessary proxy.

Seen against the aims that it sets out to achieve, the proposed EU FTT is a defective proxy. The extension of VAT to financial services would not only better address the existing gap in the VAT base, but it would also provide a more promising source

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68 Despite relevant legal differences; see case C-475/03, Banca Popolare di Cremona, ECLI:EU:C:2006:629.
69 As reported in Maffini and Vella, supra note 11.
70 See the analysis of these discrepancies in de la Feria and Lockwood, supra note 67.
of revenue, and it would mitigate the current fragmentation of the internal market for taxation of the financial sector. In addition, removing the VAT exemption for financial services would address another set of difficulties, namely, those created by that exemption. As summarized in table 2, VAT exemptions generally create economic distortions and legal difficulties. However, regarding the financial services exemption in particular, these distortions are arguably aggravated by the significance of the financial sector in the European economy; indeed, there is some evidence that apportionment of tax calculations is particularly problematic for the financial sector, and that engagement in VAT planning and avoidance is also common in that sector. Therefore, removing the VAT exemption for the financial sector would not only better attain the aims set out for the EU FTT, but also address the many difficulties currently caused by that exemption.

In light of the above, it is somewhat unsurprising that the superiority of a VAT extension over the FTT is implicitly accepted by those who have advocated the adoption of a FAT, invoking its similarity to a VAT as the key argument. Indeed, a few have been explicit in advocating the extension of VAT to financial services as the ideal instrument, but dismiss it on the assumption that such an extension would be impossible, either per se, or within Europe. Seen from this perspective, the FTT would present itself as a necessary proxy tax, but is this a correct assumption?

It is true that for many years it was unclear how financial services could be taxed under a VAT. Yet it is now clear that subjecting the financial sector to a VAT is not only possible in theory under a cash flow mechanism, but after the experiment in Europe in the late 1990s, a real and workable possibility. A separate question is

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76 In addition to the IMF (supra note 9) and the European Commission (supra note 10), supporters of a FAT include Michael P. Devereux, “New Bank Taxes: Why and What Will Be the Effect?” in Taxation and Regulation of the Financial Sector, supra note 65, 25-54; and Kaiding, supra note 11.

77 Mirrlees et al., supra note 65; and Hernández González-Barreda, supra note 20.


whether an extension of VAT to financial services is possible in the European Union, given that such a change would in principle have to be approved by the unanimity of all 28 member states. History supports the skepticism shown by some: there have been various attempts to amend the European VAT treatment of financial services, the last of which was as recent as 2007, and they have all failed to gather the necessary support. Four factors, however, militate in favour of a more optimistic approach:

1. **Not since the late 1990s has full taxation of financial services under a VAT been considered in Europe.** Indeed, the most recent review did not consider full taxation, but rather changes to the scope of the existing exemption. Why this is the case is unclear, but there is a strong argument that should full taxation be proposed, it could gather support, particularly when put as an alternative to another tax on the financial sector.

2. **Technological developments are likely to facilitate the implementation of the VAT in the financial sector.** The main reason presented by the European Commission for the dismissal of full taxation of financial services under the cash flow mechanism was the high compliance costs reported by the financial sector in the context of the late 1990s experiment with the system. While these reports are not publicly available, the technological developments that have taken place in the last 15 years could be a game changer in this regard; indeed, the commission’s proposal in 2007 for an option to tax financial services seems to support this view by assuming the interest of the financial sector in opting for full taxation.

3. **Current public finance pressures and the renewed public interest in taxation of the financial sector are likely to provide an auspicious environment for change.** Concerns over public finances, and the consequent desire to increase tax revenues, have

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81 For a comprehensive analysis, see de la Feria and Lockwood, supra note 67.


already delivered various tax reforms. Given the ability of the extension of VAT to financial services to address most (if not all) of the aims of the proposed EU FTT, there is every reason to believe that a similar, if not stronger, momentum for this reform could be achieved.

4. If unanimity cannot be achieved, the door is now open for the enhanced cooperation procedure to be used within the taxation area. While enhanced cooperation has been a possibility within the EU legislative framework for many years, the proposed FTT has the merit of opening the possibility for its use within taxation. It is unlikely that the genie can be put back in the bottle, and there is certainly a strong argument that if the FTT can be seen to fulfill the conditions for the use of the procedure, so would the extension of VAT to financial services, and probably more so.

**THE EU FTT AS A DISPROPORTIONATE PROXY TAX?**

To the extent that the EU FTT is a proxy tax, it is both unsuitable and unnecessary: unsuitable because it does not fulfill the aims that it sets out to achieve; and unnecessary because taxation of financial services under a VAT is possible, both in theory and in practice. Suitability and necessity are the two key elements for assessing the proportionality of EU legislative measures, a general principle of EU law enshrined in the European treaties with which all legislation must comply. While proportionality has been mentioned briefly in the context of the use of the enhanced cooperation procedure, application of the proportionality test to the EU FTT has never been pursued. The unsuitable and unnecessary nature of the FTT as a proxy tax, however, raises questions over its proportionality. This conclusion in turn further challenges the wisdom, from a policy perspective, of introducing a new proxy tax when fixing an existing one would most likely yield more benefits, at lower costs. Abolition of the VAT exemption for financial services will not have a regulatory effect, but from every other perspective, it presents itself as the best instrument for taxing the financial sector in Europe.

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86 Joint cases C-274/11 and C-295/11, *Spain and Italy v. Council*, ECLI:EU:C:2013:240. See also Englisch et al., supra note 21.
Policy Forum: The Financial Activities Tax
Michael Keen, Russell Krelove, and John Norregaard*

PRÉCIS
Cet article traite des principaux aspects entrant dans l’élaboration d’une taxe sur les activités financières, laquelle est une taxe à la valeur ajoutée (TVA) appliquée aux activités financières. La forme de TVA abordée dans l’article ne résout aucunement les difficultés associées à l’exemption lorsque la TVA figure sur une note de crédit tenant lieu de facture. Toutefois, le principe et l’expérience limitée existante laissent penser qu’elle pourrait constituer un moyen utile dans l’avenir en l’absence de meilleures solutions.

ABSTRACT
This article considers key issues in the design of a financial activities tax, which is an addition-based value-added tax (VAT) applied to financial activities. The form of FAT discussed in the article by no means resolves all the difficulties associated with exemption within an invoice-credit form of VAT, but principle and such limited experience as exists suggest that it may offer a useful way ahead when more perfect solutions are not available.

KEYWORDS: VALUE-ADDED TAX ■ GOODS AND SERVICES TAX ■ FINANCIAL SERVICES ■ FINANCIAL INSTITUTIONS ■ TAX NEUTRALITY ■ WINDFALL PROFITS

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INTRODUCTION

A “financial activities tax” (FAT)—a term coined in 2010 by the International Monetary Fund (IMF)\(^1\)—is a tax on the sum of profits of and remuneration paid by financial institutions. That simple description leaves great flexibility as to how all these terms are defined, how the rate structure is applied, and much else, so that the FAT is in reality a family of possible taxes. Here we focus on one of three considered by the IMF, labelled “FAT1,” which in essence is an addition-based value-added tax (VAT) applied to finance alone.\(^2\)

The purpose of this short article is not to promote FAT1—which from this point we will refer to as simply “the FAT”—as in any sense a way to solve all the problems associated with the common practice of exempting financial services (at least those that are paid for in the form of a margin) within an invoice-credit VAT.\(^3\) These problems are well known. Prominent among them are the “undertaxation” of final consumption (because of the exclusion of value added at the final stage) and the “over-taxation”\(^4\) of financial services used by registered businesses (because of the cascading from unrecovered input tax on purchases by financial institutions)—or, more precisely, the potential violation of production efficiency implied by unrecovered tax on inputs. Administrative complexity (in apportioning input credits between exempt and taxed products) is also a concern. It is known too that these difficulties are in principle soluble, notably along the lines of the cash flow approach set out by Poddar


2 Ibid., at appendix 6, 66-67. The two others are more in the nature of an income tax, focusing on taxing all rents in the financial sector (by excluding remuneration below some level—FAT2) or on discouraging risk taking (by taxing the profit component at an increasing marginal rate—FAT3). See ibid., at 67-68.

3 The central difficulty in bringing margin-based services into the VAT is the allocation of the margin between the two sides of the transaction. (For multiple references on this, see footnote 1 in the third article in this policy forum by Pierre-Pascal Gendron, discussing Canada's goods and services tax [GST].) While exemptions of financial services are widespread in the European Union, more recently introduced VATs have brought more financial services, especially fee-based services and insurance, into the VAT; see, for example, Satya Poddar, “VAT on Financial Services—Searching for a Workable Compromise,” in Richard Krever and David White, eds., *GST in Retrospect and Prospect* (Wellington, NZ: Thomson Brookers, 2007), 179-204. Even in many advanced countries, however, margin-based services—which the European Commission estimates are around two-thirds of all financial services—remain effectively exempt.

4 We have used quotation marks here to caution against the fallacy that final incidence of an input tax somehow matters for the existence of a distortion. It does not. The distortion derives from—indeed is—the wedge that it creates between the tax-exclusive price received by the seller and the tax-inclusive price paid by the buyer. A firm may be able to pass on a tax-induced increase in its input costs to its own customers, for instance, but there is still a distortion because that firm is at the margin willing to pay more for the input than the seller requires to be paid for it but the tax wedge prevents that mutually beneficial transaction from occurring. And the same is true if the tax is passed back to the supplier of the input.
and English and Poddar, and can be mitigated by less perfect methods. But progress along such lines has been slow and limited to relatively few countries—with almost none in the European Union.

The spirit in which the FAT was proposed by the IMF was mainly to draw attention to the need to address these festering problems in the VAT treatment of financial services—and to suggest that progress could be made in relatively straightforward ways. The proposal was made as part of a response to a request to review the tax treatment of the financial sector in the aftermath of the financial crisis, with the thought that before looking to adopt fancy new taxes—though one was proposed—or a generalized financial transaction tax (FTT), it was important to address problems in the existing tax system. Prominent among these were not only the corporate tax incentive to use debt rather than equity finance but also the distortions associated with the VAT (or, in the case of the United States, similar problems associated with sales taxes). As it turned out, the fancy new tax—a charge on, in effect, banks’ wholesale liabilities—gained far more practical attraction than did the FAT (with some variant adopted in over a dozen EU member states). The FAT did win support from the European Commission and others, though it lacked (and still lacks) the popular appeal of the FTT. But nothing has happened since 2010 to weaken these reasons to think carefully about the FAT.

In doing so, we do not delve into the question whether or not it is optimal to tax financial services, but simply presume that it is, nor do we consider the likely wider economic impact of a FAT. And we consider only design issues, touching on revenue implications, for instance, only briefly.

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6 Poddar, supra note 3.
7 For example, by providing some credit in relation to margin-based services for some portion of the input VAT paid. Australia allows a 75 percent credit for VAT payable on listed services used for financial supplies. Singapore also allows financial institutions to claim a credit for a fixed percentage of total input taxes, varying across types of financial institutions.
8 Variants of the cash flow method were piloted in Europe during 1994-1997 but have not been adopted—perhaps, as Kerrigan argues, because the benefits of reform have not been made as clear to policy makers as the perception that compliance costs would be high: Arthur Kerrigan, “The Elusiveness of Neutrality—Why Is It So Difficult To Apply VAT to Financial Services?” (2010) 21:2 International VAT Monitor 103-12.
9 See IMF, supra note 1.
INTERACTION WITH AN INVOICE-CREDIT VAT

The idea of an addition-based VAT comes from the observation that, for a closed economy (border issues are taken up later), value added can be expressed as either revenue minus purchases (the normal base for the VAT) or, equivalently, as wages plus a cash flow notion of profit. A VAT can in principle be implemented straightforwardly by the application to all firms and sectors of either the invoice-credit or the addition method. The essence of the FAT, however, is that it would combine an addition-based VAT on one set of firms or activities with an invoice-credit VAT applying to the generality of other firms or activities. Several jurisdictions, it is important to note, already do something of this sort, whether only in the financial sector or in relation to VAT exemptions more generally; some examples are provided in the accompanying box. We do not here evaluate these experiences—beyond noting that they show a FAT-type approach to be practicable—but focus on the design problems associated with the FAT, beginning with those arising from its interaction with an invoice-credit VAT.

Examples of Addition-Type VATs in the Financial Sector

Israel applies an addition-basis tax to financial institutions, the base being taxable income for company income tax purposes plus wages paid, and the rate being the same as the standard VAT rate (currently 17 percent). Relevant to issues addressed in the text, there are no border adjustments, financial institutions are unable to credit “normal” input VAT against the tax, and the customers of the institutions do not receive any credit for tax paid on their purchases. The tax is administered by the income tax department rather than the VAT department.

Iceland introduced a FAT in early 2012. All financial institutions, including insurance companies, security brokers, management companies of collective investments in transferable securities, and the Housing Financing Fund are liable for the tax. The base is the gross wage bill (taxed at 5.5 percent) plus profit (taxed at 6 percent).


12 Or the subtraction method. On these alternatives, see Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers, The Modern VAT (Washington, DC: International Monetary Fund, 2001), chapter 2, and the references therein.
For business-to-consumer (B2C) transactions, the FAT fits neatly with the exemption of financial services under an invoice-credit VAT: the combination of unrecovered VAT on the financial institution’s inputs and a FAT (with profit evaluated at tax-inclusive prices that reflect this unrecovered input VAT) replicates the outcome under a perfectly functioning VAT, with tax collected on the full value of final consumption. The invoice-credit VAT captures value added at stages prior to financial intermediation, and the FAT then captures the value added at that stage.

Business-to-business (B2B) transactions, however, are problematic. There would, of course, be no difficulty if non-financial VAT-registered businesses were also subject to an addition-based form of VAT, since they would then in effect receive full credit for FAT passed through to their purchases of financial services. This is not the case, however, when—the relevant case in practice—non-financial firms are subject to a standard invoice-credit VAT: then they could take credit only on the basis of invoices reporting FAT that they had been charged. And that does not come naturally to the FAT, since levying of the tax does not require that payment be allocated to particular transactions. In this case, the FAT risks intensifying the production inefficiencies that arise from exemption under the current VAT. This would be a significant drawback, at least if the FAT were levied at a level comparable with current standard VAT rates.13

Quebec taxes financial institutions in the province on an addition basis. These institutions pay a tax (la taxe compensatoire des institutions financiers) on local wages and paid-up capital (for banks, loan and trust companies, and companies trading in securities), or on local wages (for savings and credit unions) and on premiums (for insurance). In all cases, the rate of tax is below the standard provincial VAT rate. For example, for banks, the tax rate on wages is 4.48 percent; for savings and credit unions, it is 3.52 percent (up to March 31, 2017, at which time, it has been announced, the rates will be reduced).

France and Denmark both levy a compensatory tax on the financial sector to broadly offset the undertaxation implied by exemption. In France, la taxe sur les salaires applies to all firms whose turnover exceeds the VAT threshold but are subject to VAT on less than 90 percent of that turnover. The base is total remuneration, regardless of the residence of the employee, adjusted for the proportion of turnover subject to VAT. The rates are progressive on individual salaries, ranging from 4.25 percent to 13.6 percent. This payroll tax has raised significant revenue, the vast bulk of which is believed to come from financial institutions. In Denmark, as in France, the payroll tax applies to various sectors that are largely exempt from VAT. For companies in the financial sector, the tax is currently levied at 13.6 percent of payroll; the rate has been rising in recent years and is planned to increase further.

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13 There may in any case be conceptual merit in taxing financial services at a reduced rate: see, for example, Boadway and Keen, supra note 11.
One way to deal with this problem is by apportioning wages and profits between B2B and B2C transactions and applying the FAT only to the latter component (which would be easier, of course, if financial institutions were able to distinguish between their transactions with registered businesses and their transactions with others), while also apportioning input VAT so as to effectively zero-rate B2B transactions. Issues would arise, of course, as to how to do the apportioning. But those issues already arise for allocating input VAT between taxable and non-taxable outputs. In practice, it seems that pressure to make any such adjustments has not been great: no jurisdiction that has an addition-method VAT for financial services makes any.

**OTHER (BIG) DESIGN ISSUES**

Many other detailed design issues arise in considering a FAT. This section considers some of the most important.

**Defining Profits**

The notion of “profit” implicit in the standard form of VAT is not that used in most countries’ corporate income taxes. Instead, it is a cash flow concept, with full expensing of investment (and no subsequent allowances for depreciation)—this is the essence of a consumption-type VAT—and no deductions for the cost of finance. Such a tax bears only on rents, in the (somewhat loose) sense that the present value of tax paid is positive if and only if the return on investment exceeds the firm’s cost of capital. The tax is therefore, in principle, neutral in the sense of having no impact on marginal financing or investment decisions. While one could simply apply a FAT to profit defined in much the same way as for the corporate income tax, it is natural to use some definition of “profit” that mimics this neutrality feature. There are a number of ways in which this can be done.

The Meade committee, for example, identified three forms of cash flow tax with this neutrality property. These differ in their suitability for the financial sector, as described below:

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14 Kerrigan, supra note 8, suggests that it is possible to calculate the total taxable base for VAT purposes from statutory income statements, and then allocate the margin on financial services provided in supplies to taxable businesses for VAT purposes. See also Peter R. Merrill and Chris R. Edwards, “Cash-Flow Taxation of Financial Services” (1996) 49:3 National Tax Journal 487-500.

15 An alternative would be to allow business users some deemed credit for FAT payments while providing credit for associated input VAT. There are precedents for such arrangements—for example, in the usual treatment of purchases of second-hand goods. Indeed the basic cash flow form of VAT also has a feature of this sort, since financial institutions would receive a credit for outflows (such as withdrawal of deposits) even to unregistered traders that cannot issue invoices.

1. The \( R \) base includes only non-financial transactions in the base and so is closely analogous to the definition implicit in the standard VAT for non-financial companies. This form of tax is clearly inappropriate for businesses engaged in providing margin-based services, because in ignoring financial transactions it would effectively leave the associated profits untaxed.

2. The \( R + F \) base is arrived at by adding to net real flows the total of net financial inflows, including principal amounts. These flows correspond to those taxed in the cash flow VAT mentioned above, the difference being that for such a VAT flows need to be recorded transaction by transaction, whereas under the \( R + F \) base only aggregate flows need be recorded.

3. The \( S \) base is simply net distributions to shareholders: the sum of dividends paid plus repurchases of shares minus new shares issued plus dividends received. From the balance sheet identity, the \( S \) base is exactly equivalent to the \( R + F \) base.

There are many other forms of rent tax. One that has attracted particular interest is the allowance for corporate equity (ACE), which subtracts from profits as usually calculated for business taxation a further deduction for a notional return on equity. There is now quite extensive experience with such schemes: Belgium, Italy, Latvia, and Turkey, for example, have all adopted ACEs, and Brazil has had a corporate income tax with ACE-like features for many years.\(^{17}\)

It is well known that the \( R + F \) base, the \( S \) base, the ACE, and many others are equivalent in principle—not in the sense that they would yield the same tax revenue in each period (in this the ACE will differ from the others) but in that all would leave investment and financing decisions undistorted. They also imply the same tax revenue in present-value terms, up to some constant that is irrelevant in the sense of being fixed by past behaviour.\(^{18}\)

A coherent base for a FAT, intended to address the undertaxation of financial services in many current sales tax systems, might thus comprise a uniform tax on profits defined by one of the methods above (other than the \( R \) base) plus payments to workers measured, for example, by using the definitions and rules currently provided for the income taxation of businesses and individuals.

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\(^{18}\) An ACE, for example, is equivalent to an \( S \)-base cash flow tax plus an allowance for initial capital (the intuition being that an ACE, but not an \( S \)-base cash flow tax, gives a deduction in respect of investments made prior to the adoption of the tax).
Among the possible profit concepts, the ACE is perhaps closest to the treatment under current business taxation; the only adjustments to the business tax base needed to implement a FAT of this type would be to add labour costs back in and deduct an allowance for equity. Familiarity with most of the concepts involved, to both taxpayers and tax officers, is an advantage; it could pave the way, not least, for speedy implementation.\textsuperscript{19} The cash flow $R + F$ approach, on the other hand, is closest to treatment under the standard invoice-credit VAT or, even more so, to that under a cash flow VAT for financial services. But it involves an unfamiliar and more complicated set of adjustments, particularly the need to make adjustments for financial flows of principal amounts of new deposits and lending.

When profits defined in any of these ways are negative in any period, the base would be less than total wages; this causes no particular problem. It is unlikely that loss on capital account would exceed the wage bill, but it is possible. In principle, the excess should (again in order to mimic the standard VAT) be refunded or carried forward with interest.

**Border Adjustment\textsuperscript{20}**

Consistent with the destination principle that is the international norm in indirect taxation—taxing consumption where it occurs, rather than production—most countries that exempt financial services under their VAT allow direct exports of exempt services to be zero-rated. (In the European Union, only exports outside the common zone are zero-rated in this way.) The question arises whether, and if so how, to take exported financial services out of (and bring imported services into) a FAT.\textsuperscript{21}

To match the destination basis of the standard VAT, “zero-rating” might seem appropriate under a FAT (along with zero-rating under the VAT itself). Under the $R + F$ approach, for instance, this would mean including only inflows from domestic transactions in taxable receipts and not allowing deductions for other than domestic outflows; for example, deposits or borrowing from a non-resident would not generate taxable income and neither would their repayment be relieved from tax. Conversely, lending to non-residents would not generate tax relief, and repayments of such

\textsuperscript{19} Of course, an ACE basis for the profit component of a FAT would be less burdensome to administer and comply with were the corporate income tax also to be converted to an ACE—for which many believe there is a strong case.


\textsuperscript{21} Michael Keen and Walter Hellerstein, “Interjurisdictional Issues in the Design of a VAT” (2010) 63:2 Tax Law Review 359-408, present the case for preferring the destination principle on grounds of economic principle, while stressing that zero-rating of exports is not the only way in which it can be implemented.
loans would not be taxable. This treatment is analogous to the treatment of exports under the VAT, in that sales to non-residents do not bear tax. It requires that transactions with non-residents be identified and aggregated. Under alternative definitions of the profit component of the FAT, such as an ACE, destination treatment could be approximated in the same way or by another element of apportionment intended to exclude from the base of the FAT profits attributed to services supplied to non-residents.

With regard to the wage component of the FAT, placing this on a destination basis requires the exclusion of wages associated with export supplies and the inclusion of any wage costs incurred abroad in relation to domestic supplies. In practice, this would likely mean adopting some relatively simple method of allocation, such as including in the base of the FAT only the share of wages corresponding to the share of domestic receipts in total receipts.

There are, though, two difficulties with putting the FAT on a destination basis. The first is an erosion of revenue: countries with a large financial sector may forgo significant revenue by applying a FAT on a destination basis to the extent that the sector’s output is exported. The second is that there will be an incentive—for both financial and non-financial companies—to acquire (or provide) financial services from abroad, rather than domestically. While a similar pro-import bias is commonplace under existing VATs—because exemption means that financial services purchased domestically will likely reflect unrecovered input VAT, whereas imports will be zero-rated in the country of export—the effect would be amplified under a FAT of this form.

These concerns suggest that there is merit in instead levying the FAT on the origin basis—that is, without excluding exports from or including imports in the base—to which the addition method is inherently better suited. But this approach raises some quite deep structural concerns.

Perhaps the most troubling relate to the scope that this would create for tax avoidance and intense international tax competition. Any mechanical rule for apportioning profits and/or wages across jurisdictions invites tax planning and the creation of real distortions to firms’ behaviour. The precise form will, of course, depend on the rule(s) adopted, but the general point has been made clear in the literature on formula apportionment. Related to this, an origin-basis FAT would be more vulnerable than a destination-based one to erosion through international tax competition, since countries would seek to protect their own tax bases and favour

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23 See, for example, International Monetary Fund, Spillovers in International Corporate Taxation, IMF Policy Paper (Washington, DC: IMF, May 9, 2014).
their own financial institutions in international markets (and gain revenue) by charging the tax at a lower rate than their competitors. To guard against this, collective agreement on a minimum FAT rate would be useful—and analogous to agreements within the European Union on minimum rates of VAT and excises. For the European Union, indeed, one could envisage operation of the FAT on a restricted origin basis: origin within the union, destination-based for transactions with the rest of the world, with profits and remuneration allocated between the two.24

Fee-Based Services
A number of countries bring these charges fully into the invoice-credit VAT, albeit with a degree of arbitrariness in the allocation on input tax credits to their provision. There are several options for their treatment in the presence of a FAT. One is to instead exempt them under the VAT and incorporate them fully into the FAT, the difficulty being that this would introduce overtaxation of B2B transactions where previously (apart from the apportionment issue) there was none (though, as noted above, that might be addressed by allowing credit for tax implicitly paid). Another is to retain the invoice element of current VAT treatment but apportion wages (and perhaps profits too) to taxable and exempt activities, and apply the FAT only to the latter. This treatment of wages corresponds to that used in the French payroll tax; the tax base is calculated by adjusting the wage bill by the share of total output that is represented by exempt supplies.

Insurance Premium Taxes
A number of countries, such as the United Kingdom, exempt general insurance from VAT (most exempt life insurance) but levy a special compensatory tax, often in the form of a tax on the premium. In some cases, the revenue raised by premium taxes is significant. Here the most natural approach would be to maintain the premium taxes and in addition bring the supplies under the FAT, either maintaining the current premium rate, so that the tax burden and revenue would increase, or accompanying inclusion in the FAT with a compensating reduction in premium tax rates.

Perimeter
Applying the general principle of the VAT that all firms above some threshold size are liable to the tax, the implication is that all those above some threshold level of financial activity would be required to register for the FAT. In practice, this threshold would likely, and appropriately, be such that any entity with substantial financial

24 The question also arises whether multinational financial institutions operating from countries applying some form of worldwide taxation (which, these days, means primarily the United States) would seek and be able to claim at least part of the FAT paid by their related entities abroad as a credit against corporate tax due in the country of their residence. In some cases, similar issues might arise in relation to the wage component of the FAT. But these are questions for specialist lawyers.
activities would be subject to the tax, even if that entity was part of a wider group with primarily non-financial activities. If necessary, firms might be required to segregate accounts between financial and non-financial activities, similar to the separation between foreign and domestic transactions discussed above in respect of border adjustments. Shackelford et al.\textsuperscript{25} argue that the need to bring into the FAT financial entities within primarily non-financial groups poses significant difficulties; it is hard to see why this should be so, however, since all that is needed is a definition of financial services and some form of threshold below which registration for the tax is not required—both of which are already in place under existing VATs.

**CONCLUSION**

The FAT is not intended as an elegant solution to the evident difficulty of incorporating financial services within an invoice-credit VAT. Its appeal is largely pragmatic, given the equally evident difficulty that many countries have experienced in moving in these more satisfying directions, and not least in lower-income countries that lack the administrative capacity to implement some of the more sophisticated approaches that can now be found in some advanced countries. There are, evidently, many awkward design issues to be faced, notably in the treatment of B2B transactions and in relation to cross-border trade in financial services. These are difficult technical issues, but they do not seem inherently less manageable than those that arise in many other areas of taxation. Administratively, the close relation between the FAT and routine taxes on profits and wages already levied would seem to ease the way to implementation, and there is already some practical experience with FAT-type taxes that merit far more attention than they have yet received.

Of major concern to policy makers, but not discussed here, are the likely revenue implications of adopting a FAT. Calculations by the IMF for a subset of OECD economies suggest that the base of an origin-basis FAT would be very sizable, averaging around 5 percent of gross domestic product (GDP).\textsuperscript{26} For a destination-basis FAT structured so as to replicate an idealized VAT, the revenue impact, relative to exemption, is in principle ambiguous, the question being whether the tax gained on B2C transactions outweighs that lost from B2B. Most of the empirical evidence, however, suggests a revenue gain.\textsuperscript{27}


\textsuperscript{26} IMF, supra note 1, at appendix 6, 70, table A6.1.

\textsuperscript{27} For example, Harry Huizinga, “A European VAT on Financial Services?” (2002) 17:35 Economic Policy 497-534, estimates a revenue increase in 1998 in the EU 15 of around 0.15 percent of their GDP, and the European Commission, Impact Assessment, supra note 20, vol. 1, at annex 11, table 12, estimates much the same for 2008. One cannot, of course, assume that the impact elsewhere would be of similar magnitude or even of the same sign. See also Bernd Genser and Peter Winker, “Measuring the Fiscal Revenue Loss of VAT Exemption in Commercial Banking” (1997) 54:4 Finanzarchiv 563-85; and Buettner and Erbe, supra note 11.
Closely related to this is the question of how a FAT would affect the size of the financial sector. This is of concern not only in much popular discussion; Sahay et al. 28 also suggest that the financial sector may in some cases have become excessive. The differing impacts on business and final users make the impact of the current exemption of financial services on the size of the sector theoretically ambiguous, depending on relative price sensitivities of business and final use: for example, if the elasticity of demand for margin-based services of business users is high and that of final consumer demand is low, the exemption could in principle cause the financial sector to contract. However, the evidence just cited creates some presumption that the exemption of many financial services under the current VATs results in the financial sector being larger than it would be under a perfectly functioning, single-rate VAT levied at a reasonable level. While this does not mean that any tax measure that reduces the size of the sector is efficiency-improving—such a reduction could result, for example, from a costly worsening of the distortion to business use—it does suggest that a well-designed FAT might lead to a somewhat smaller financial sector. That, however, would be a consequence of, and not an objective in, its adoption. The purpose of the FAT is not to promote the stability of the financial sector or to address externalities that may arise from its operation; the tax issues that those concerns raise are rather in terms of eliminating debt bias and, if need be, going further to use tax instruments to discourage borrowing. 29

Over the last few years, the FAT idea has generated significant interest and some further analysis—much of which has broadly agreed with the assessment here. Most notably, the European Commission quickly endorsed the FAT as meriting serious attention by EU members, 30 and provided extensive further analysis. 31 Too much of the recent discussion, however, has been cast in terms of a horse race between the FAT and an FTT. While this is a race that, among tax specialists at least, the FAT has generally won—it has been noted, for instance, that while the European Commission ultimately recommends an FTT, much of its analysis actually tends to favour the FAT 32 —this has distracted from the key issue of whether a FAT is worth adoption in its own right. The case for closer consideration of this issue, taking account of countries’ differing initial positions and priorities, seems to us quite compelling.


29 Michael Keen, “Rethinking the Taxation of the Financial Sector” (2011) 57:1 CESifo Economic Studies 1-24, places the FAT in the wider context of the taxation of the financial sector.

30 European Commission, supra note 10.

31 Ibid. Daniel N. Shaviro, “The Financial Transactions Tax vs. the Financial Activities Tax” (2012) 135:4 Tax Notes 453-74, for example, concludes that a FAT (possibly both FAT1 and FAT3) is generally preferable to an FTT, while Thorsten Beck and Harry Huizinga, “Taxing Banks—Here We Go Again!” Vox, October 25, 2011 (www.voxeu.org/index.php?q=node/7129), remark that “the Commission makes the wrong choice in favoring an FTT over a FAT.”
Policy Forum: Canada’s GST and Financial Services—Where Are We Now and Where Could We Be?

Pierre-Pascal Gendron*

PRÉCIS
L’assujettissement des services financiers à la taxe sur la valeur ajoutée (TVA)/taxe sur les produits et services (TPS) demeure la question de politique de fiscalité indirecte la plus épineuse de toutes. Comme la plupart des pays qui administrent une TVA/TPS, le Canada exonère la plupart des services financiers. L’auteur revoit les contextes économique et légal de ce traitement ainsi que les problèmes qu’ils soulèvent. Il conclut que le traitement actuel est hautement insatisfaisant. Après avoir revu l’expérience internationale à la lumière de celle du Canada, il conclut que le modèle sud-africain serait le meilleur système de remplacement pour le Canada.

ABSTRACT
The treatment of financial services remains the last unconquered frontier in the design of a value-added tax (VAT)/goods and services tax (GST). Like the vast majority of its VAT/GST peers, Canada exempts most financial services under the GST. The author reviews the legal landscape surrounding this treatment as well as the economic issues it raises. He finds that the current treatment is deeply unsatisfactory from many angles. He then reviews the international experience with the Canadian experience in mind and concludes that the South African model would be the best alternative for Canada.

KEYWORDS: GST ■ EXEMPTIONS ■ FINANCIAL SERVICES

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INTRODUCTION

The incorporation of financial services into the base of a value-added tax (VAT) operated on a transaction-by-transaction basis using the invoice-credit method remains the last unconquered frontier for this type of tax. The inability to do all of these things at once in a technically correct and practical way has frustrated policy makers, academics, and practitioners in many countries for a long time. Many fine surveys have covered the field over the years. While the abundant survey work has narrowed down the outstanding issues and uncovered additional technical issues, it has come to a frustrating conclusion: either more work is needed, or more action is needed. The frustration does not appear to have been as palpable in the case of Canada’s goods and services tax (GST)/harmonized sales tax (HST) as it has in other contexts, such as the European Union, Australia, New Zealand, Singapore, and South Africa. There has been relatively little policy work on this issue in the public domain in Canada.

This article will not throw another survey into the mix or take an in-depth look at the experience accumulated outside Canada in attempting to improve the situation. Instead, it focuses on the current situation with the GST in respect of financial services in Canada. It begins with an account of where we are now from both legal and economic perspectives, and then continues with a discussion of what could be done to improve the situation in Canada in light of the Canadian institutional context and existing constraints. The article is not concerned about a policy response to the recent financial crisis: the focus rests entirely on GST design and practice. I recommend that policy options be considered following the principles of the Department of Finance’s recent examination of the GST/HST treatment of financial

services. I close by expressing my preference for the adoption of the South African model in Canada.

WHERE ARE WE NOW?
The vast majority of financial services are exempt from GST/HST when supplied in Canada. This has been the case since the inception of the GST in 1991. The exempt treatment was maintained when the system was expanded to three provinces with the first round of HST harmonization agreements in 1996 and in subsequent HST adoptions in British Columbia, Ontario, and Prince Edward Island. The second round of harmonization (after the first in 1992) between the Quebec sales tax (QST) and the GST expanded the exempt treatment further: the government of Quebec agreed to mirror under its QST legislation the rules for the treatment of financial services and institutions under the GST/HST legislation. In effect, this meant that Quebec has abandoned its unique—and in some circles admired—policy of zero-rating financial services in favour of the exemption policy in effect under the GST/HST. In what follows, I examine the existing system from its legal and economic angles.

The Legal Landscape
Statutory authority resides in the ETA. The sections that are most directly relevant to this article include the following:

- Subsection 123(1) provides definitions of financial services, financial instrument, and other related terms such as insurance policy, money, and so on.
- Section 139 provides for financial services in a mixed supply.
- Section 141.02 provides for input tax credit apportionment rules for financial institutions.
- Section 149 defines financial institutions.
- Section 150 provides for the election for financial institutions to deem supplies within a closely related group to be exempt.
- Schedule V, part VIII contains the exemption provision for the financial services that are not zero-rated.
- Schedule VI, part IX contains the zero-rating provisions for supplies of financial services made to non-residents.

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2 Subsection 123(1) and schedule V of the Excise Tax Act, RSC 1985, c. E-15, as amended (herein referred to as “the ETA”). Unless otherwise stated, statutory references in this article are to the ETA.

3 Canada and Quebec, Comprehensive Integrated Tax Collection Agreement Between the Government of Canada and the Government of Quebec (Ottawa: Department of Finance, 2012).

4 ETA, supra note 2.

The aforementioned portions of the ETA amount to about 45 pages of annotated law, half of which belongs to section 141.02. Those sections are supported by GST/HST regulations. The financial services and financial institutions regulations and the input tax credit allocation methods regulations (which refer to banks, insurers, and securities dealers) are the most directly relevant. Together, they amount to about four annotated pages.

The ETA and GST/HST regulations are supported by a large body of written guidance whose purpose is to help GST registrants and taxpayers comply with their obligations, without having the force of law. This written guidance comprises GST/HST memorandums, technical information bulletins, policy statements, info sheets, and GST/HST notices. Memorandums provide detailed guidance on the interpretation of the law and administrative policy. The chapter on “Special Sectors: Financial Institutions” is 77 pages long. Technical information bulletins are issued to announce changes to administrative policy. The older ones have sometimes been incorporated into memorandums, but the new ones stand until the memorandums undergo revision. A handful of important technical information bulletins concerning financial services and institutions has been issued since 2011. Policy statements consist of technical summaries of administrative policies and simple rulings for use by the Canada Revenue Agency (CRA). Those often deal with narrow issues but are of very limited interest for the treatment of financial services. Info sheets offer guidance in less technical ways than the other publications. Again, with limited exceptions, they are of limited interest for the treatment of financial services.

Court cases, interpretations, and rulings complete the legal picture. There have been a number of important court cases involving GST and financial services, especially in the last decade. Since space restrictions preclude a discussion of those cases and their substantive issues, I will only offer a few remarks. Many cases involve boundary (scope) and definitional issues. One particular problem seems to concern the notion of “arranging for” a financial service in relation to the exemption of financial services. Firth and McKenzie illustrate the idea and its convolutions.

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6 Financial Services and Financial Institutions (GST/HST) Regulations, SOR/91-26, as amended.
7 Input Tax Credit Allocation Methods (GST/HST) Regulations, SC 2010, c. 12, section 91.
10 Interested readers may begin by identifying cases using good secondary sources such as Danny Cisterna and Maria Scullion, “Wolf of Bay Street or Wolf of Main Street? ‘Arranging for’ 4 Years Later,” in 2014 CPA Canada Commodity Tax Symposium (Toronto: Chartered Professional Accountants of Canada, 2014), paper 3; and Firth and McKenzie, supra note 1, at 133.
beautifully when they refer to “legislative changes in 2010 relating to the narrowing of the exemption of arranging for services related to financial services.” Typically, services recently excluded from the scope of the exemption include services of managing credit and services that are preparatory to the provision or potential provision of a service. Examples include credit checks, the creation and maintenance of credit records, the collection and provision of information, promotion, and market research. Interpretations and rulings on the “arranging for” issue are not publicly available on the CRA website, but some are available from secondary sources. Two other major issues that have been identified with financial services include the treatment of imported services (especially the issue of “loading” or adding expenses to arrive at the value of consideration for a supply) and retroactive amendments. The cumulative result of those issues appears simple: more GST revenue from inputs purchased by financial institutions and intermediaries (FIIs). A perception exists that a resolution under the current system is not anywhere in sight.

Taken in one block, the legal and regulatory architecture supporting the GST treatment of financial services is extremely complex and has wide ramifications. The system is supported by numerous rules with numerous exclusions and exceptions. In light of the numerous business transactions between FIIs and other sectors that make taxable supplies for the benefit of those FIIs, the volume of rules and exceptions reflects a contamination effect that stems from two opposing forces: on the one hand, the wish to enforce a broad-based exemption of financial services, and on the other, the wish to maintain the integrity of the GST system by taxing as many goods and services as possible outside the financial sector. The evolution of the system suggests some policy concern for the impact of the system on prices, the way certain transactions are conducted, and their result. Could this be evidence of central planning thinking? I cannot escape the impression of the profound absurdity of the notion that such a complex system is meant to support an actual exemption of financial services as opposed to their taxation.

I would surmise that the system also gives rise to large collection costs (the sum of taxpayer compliance costs and tax administration costs). Yet it could be construed as a very sophisticated mechanism to raise GST revenue from the financial sector by taxing its business inputs. This begs the question “Why not tax inputs (such as payroll and/or assets) directly?” That would be very distorting economically, but far simpler and cheaper in terms of collection costs.

12 Firth and McKenzie, supra note 1, at 158.
13 Cisterna and Scullion, supra note 10, at 47.
14 Firth and McKenzie, supra note 1.
16 For a good general discussion, see Cisterna and Scullion, supra note 10. For a discussion focused on a specific set of services, see Simon Thang, “Financial Loans Intermediation Services: Canada,” in Robert F. van Brederode and Richard Krever, eds., VAT and Financial Services: Comparative Law and Economic Perspectives (Singapore: Springer Science + Business Media, 2016).
To conclude, the system remains inconsistent with the ultimate objective of a broad-based VAT/GST, namely, to tax all final consumption. Intermediate input consumption by FIIs is a poor proxy for final consumption of their services. Economists would insist that a VAT/GST should tax final consumption in a way that does not distort input decisions. The broad exemption of financial services fails to achieve either objective.

**An Economic Perspective**

Surveys of VAT and financial services usually repeat the well-known mantra about the distortions caused by a broad exemption: that it creates incentives to (1) self-supply inputs in order to avoid irrecoverable VAT/GST on purchased inputs, and (2) import financial services since they should be exported by an outside jurisdiction free of VAT/GST (zero-rated). Another general statement about the effects of a broad exemption goes as follows: it results in the overtaxation of financial services used by businesses and FIIs, and in the undertaxation of financial services used by consumers and unregistered businesses. The former point results from the fact that FIIs bear VAT/GST on inputs. The latter point stems from the fact that the last piece of value added, from the seller of services to the final consumer—which largely stems from the labour, creativity, and ingenuity of the financial service provider—remains untaxed.

The economic damage from those distortions is always presumed but never measured or quantified. The incentive to self-supply and the tax burden on inputs are presumed to be serious, although the 5 percent GST would be much less of a concern than any EU member state’s VAT. Of course, I am not mentioning the provincial component of HST, which makes the GST/HST more burdensome than first appears. One should also note that firms that operate in oligopolistic market structures such as Canada’s banking and insurance industries may be well positioned to shift the input VAT/GST that they bear forward to final consumers in some product and customer segments. In any event, after over 20 years of GST, the inefficiencies in input use are priced into the system, so to speak. In other words, they are already capitalized in margins and fees.

The extent of undertaxation of final consumption is also tricky to assess since it depends on market structure, as well as on price elasticities of demand and supply, and cross-price and income elasticities of demand. Those variables are difficult to measure accurately and comprehensively in any case. Moreover, obtaining estimates would require access to confidential information that no financial institution or intermediary would be willing to share for competitive reasons. It is important to remember that we are talking about big numbers in terms of potential additional GST base and even bigger ones if we include the provincial component of the HST. To give an idea, GST revenues amounted to $31.349 billion during fiscal year 2014-2015. In 2014, gross domestic product (GDP) at basic prices in finance and insurance

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amounted to $110.228 billion, or 6.75 percent of GDP (all figures are expressed in constant dollars for 2007). Credit intermediation and monetary authorities accounted for 58.1 percent of the finance and insurance total, while insurance carriers and related activities accounted for 24.5 percent.

Another important unknown number that should command more attention is collection costs. It is inconceivable that such an extraordinarily complex system would not impose large collection costs. For taxpayers, compliance costs have a significant fixed component, so complexity penalizes smaller institutions and intermediaries more. The CRA might worry too, in particular about the resources it devotes to the financial sector. To be complete, all costs related to litigation should be added to collection costs to arrive at collection and litigation costs. Although they are almost never mentioned, those costs are much easier to measure than the economic distortions noted earlier. The CRA and larger FIIs should have internal estimates of administrative and compliance costs, respectively.

Next, there is a potential political cost to the exemption to consider. For the sake of the debate, let’s label the exemption “taxation by exemption,” as is done by some commentators. It is a wonderfully clear phrase. While it is obvious that taxation by exemption is contrary to the logic and purpose of VAT/GST, it is perhaps less obvious that taxation by exemption is a clever but fundamentally anti-democratic revenue tool. It is anti-democratic because most consumers lack sufficient understanding of VAT/GST and especially the distinction between zero-rating (relatively clear) and exemption (apparently clear). This discussion relies on issues and contrasts in arguments similar to those expressed in a debate in this journal on GST-inclusive versus GST-exclusive pricing. In contrast to the health, education, and cultural sectors, in the case of financial services arguments that the exemption is justified on the basis that it applies to merit goods are of no help. As will be shown below, some countries have found ways around the “hard to tax” argument that has been nailed on financial services for a long time.

A separate but related political cost concerns perceptions of inequity. The demand for financial services by households (business-to-consumer, or B2C, services) is almost certainly income-elastic in the sense that the quantity demanded rises with household income. Given that the exemption takes final consumption out of the GST base, it confers a larger absolute benefit as household income increases, with

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20 Cisterna and Scullion, supra note 10, at 14.
the highest benefit going to high-income households. This effect is amplified by the larger shares of expenditures on financial services for high-income households. In this sense, the exemption of financial services is regressive and inequitable. A better understanding of the effect of the exemption would further intensify the existing public perception that the GST is regressive. Strictly speaking, the role of the GST should be to raise revenue efficiently without explicit consideration for vertical equity (ability to pay). At the same time, policy decisions should be made so that the GST should do no more harm than necessary from a vertical equity point of view. The broad exemption of financial services crosses that line.

It may well be that FIIs shift the GST on inputs forward in higher prices or wider margins (such as the difference between the interest rates that banks charge on loans and the rates they pay on deposits). The effects are unpredictable and hard to measure, however, since they depend on market conditions and the relevant elasticities, which may vary by product. Again, institutions such as banks and insurance companies operate in oligopolistic market structures. While they are also subject to some internationally set prices, interest rates, and rates of return, they are able to shift GST on inputs forward depending on market conditions. According to standard economic theory, firms with market power are better able to do this than competitive firms.22 Backward shifting is also possible. The size of the financial sector exceeds the socially optimal size owing to the undertaxation of financial services used by consumers and unregistered businesses. This undertaxation increases the quantity demanded of financial services, ceteris paribus, which also increases input use in the sector over the socially optimal level, a situation that perversely produces GST revenue even though financial services are exempt. Because of their purchasing power, banks and insurance companies could, in principle, drive down the prices that they pay third-party suppliers for purchased taxable inputs. In the end, the fact that institutions may shift the tax forward or backward cannot be part of the policy design calculus because no policy or set of rules can guarantee a particular result in any situation. The exemption is inequitable ex ante, and that is all that matters here.

It must be noted that the revenue impact of the exemption, as opposed to the alternative of full taxation, is very difficult to assess with precision. I am not aware of any publicly available estimates for Canada. Interestingly, the Department of Finance does not produce an estimate of the GST revenue forgone as a result of the exemption of domestic financial services.23 In one study conducted using general equilibrium models for Germany, the authors found that repealing the exemption of financial services would increase VAT revenues by 1.3 percent of existing revenues and produce an economic welfare gain equal to about half of 1 percent of GDP.24

Why Change?

The unvarnished word from the street suggests that the GST treatment of financial services generates a healthy amount of revenue, flawed as it is, and that is why it continues to exist. This good revenue yield is a curse. It introduces significant policy inertia of a kind similar to that which has been used to support keeping old gross receipts (turnover) taxes such as Canada’s own federal sales tax prior to 1991 and the GST and turnover taxes in many developing countries. A lot of “bad” revenue is better than an insufficient amount of “good” revenue.

Sectoral revenue data do not fall within the public domain. It would be very difficult to reconstruct the revenues based on taxable input use. As suggested earlier, the potential numbers are big. The financial sector is an important sector that produces significant GST revenue. Can it continue to do so but more efficiently and fairly?

WHERE COULD WE BE?

Theoretical conceptual thinking to solve the problem of applying VAT/GST to financial services has reached a point of strongly diminishing returns: the technical issues and opportunities are known. We also know what we do not know. The numerous surveys have identified the many possible practical solutions to the problem. This means that the discussion must focus on the most promising practical solutions, and on what other countries have done. As a starting point, I reject solutions based on non-transactional methods (accounts-based VATs) and methods based on national accounts and macroeconomic data. Such methods suffer from several potentially fatal shortcomings. They

- take the financial sector outside the rest of the GST—not a practical move, given the many commercial relationships between the financial sector and the other sectors in the economy;
- create many opportunities for data manipulation and gaming; and
- may exacerbate an existing public perception that the financial sector receives preferential tax treatment from governments.

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26 See supra note 1.

27 For a description of different accounts-based VAT approaches, see Schenk et al., supra note 1, at chapter 2; and for an example of a method based on national accounts and macroeconomic data, see Julio López-Laborda and Guillermo Peña, “A New Method of Financial VAT” (Department of Public Economics, University of Zaragoza, 2015).
I also reject specific taxes that would fall on financial transactions without credits for input taxes. Those taxes could damage the financial system and have a host of unintended consequences.

The International Experience

The vast majority of countries with a VAT have chosen to stay away from reforming the exemption of financial services. For the many developing countries with a VAT, that is a wise move, given their limited administrative capacity and their need to focus on the fundamentals of VAT operation and major revenue sources, which usually relate to other sectors. Some of the countries in a position to do something have done so and have followed different approaches. Those may be summarized very briefly and somewhat simplistically as follows:

- **Australia**: Reduce cascading and the incentive to self-supply by providing for formula-based input tax recovery, subject to conditions.
- **European Union**: Reduce the scope of the exemption by applying a combination of an option to tax, a redefinition of financial supplies, and VAT grouping.
- **New Zealand**: Reduce cascading by zero-rating some business-to-business (B2B) services, subject to conditions, and impose a reverse charge (self-assessment of tax by a registrant) on imported services; also reduce the scope of the exemption by taxing non-life insurance.
- **Singapore**: Reduce the scope of the exemption with taxable fees for intermediary services; and reduce cascading and the incentive to self-supply by providing formula-based input tax recovery, subject to conditions.
- **South Africa**: Reduce the scope of the exemption by taxing all fees and short-term (property and casualty) insurance.

A few remarks are in order concerning the above list. First, there have been attempts to test methods to tax margin-based services and life insurance. In the mid-1990s, Ernst & Young conducted pilot studies with selected financial institutions in EU member states to test the Poddar-English cash flow VAT method with a

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29 Anything more detailed is beyond the scope of this article owing to space restrictions. For a survey, see Schenk et al., supra note 1, at chapters 11 and 12; the taxonomy of methods follows Schenk, supra note 1, at 437.

I worked on this team for a while, and for a number of different institutions in separate countries, and can say that the method worked and produced the correct result. It was cumbersome to use because of the rudimentary state of information systems in use in the 1990s. Today’s enterprise and information systems should accommodate the requisite tax calculation programs without difficulty. Much of the negative feedback by institutions at the time was due to the fact that no institution likes the perception that the services it offers will be taxed, when the starting point is the public perception that the services are untaxed because they are exempt. I return to the cash flow VAT below.

Second, approaches that skirt around the problem never achieve much because they do not solve any of the fundamental problems created by the exemption. They may address some symptoms. This describes many of the ideas for reform in the European Union. In fact, such approaches require more rules to function and are not effective if some countries can opt in and some can opt out. I will not discuss EU approaches further.

Third, zero-rating of B2B transactions creates its own problems. It does not solve the exemption issue. It merely mitigates the problem of cascading and self-supply, at the cost of some complexity in rules and an increased risk of tax-planning behaviour. It can cause revenue leakage when tax-planning opportunities are exploited so that transactions that should not be zero-rated (because they relate to self-supply for own consumption or exempt supplies) are zero-rated. In that case, the tax on inputs is lost. In the Canadian context, where federal and provincial taxes work together under the GST/HST system, those tax-planning opportunities would be more numerous, and the various allocation and place-of-supply rules would have to be complicated even more to deal with those possibilities. It does not seem to be worth the risk in light of the other methods available (such as a cash flow VAT).

Finally, and most importantly, the position that FIIs that make exempt supplies should receive partial credits for VAT/GST paid on inputs is conceptually wrong. For the sake of simplification of this argument, call this approach “exemption with rebate” and assume that institutions make only exempt supplies and that all their purchased inputs are taxable. Recall that under the standard mechanics of a VAT, tax paid on purchased inputs engaged to render exempt supplies is never deductible or creditable against output VAT because there is none, owing to the exempt status of the supplies. That tax cannot be refundable or refunded either. This effectively represents the social compact of the VAT/GST: the right to deduction of input VAT is earned by the collection of output VAT. Refunding that tax is like granting a subsidy.

Some commentators have raised the Diamond and Mirrlees production efficiency theorem to remove input taxes at all costs and hence justify the compensation of


exempt suppliers for input VAT. This position amounts to a weak practical defence of an exemption with rebate for FIIs for a few reasons:

- In a mature VAT system with a longstanding broad exemption of financial services, the inefficiencies attributable to irrecoverable input VAT are priced in (capitalized) since profit-maximizing institutions and intermediaries will have extracted all the possible efficiencies by shifting the tax forward and/or backward as they see fit.
- Removing the inefficiency ex post by means of a rebate cannot be presumed to achieve the same impact on prices as removing it naturally by taxing services ex ante and providing a normal right to deduct the tax. In a second-best world, the two scenarios will have very different effects on product pricing and efficiency.
- Rebates would create two new non-neutralities, the first offsetting an existing non-neutrality (input choice distortions), and the second providing preferential treatment of the financial sector that is not available to other sectors.
- An exemption with rebate may be interpreted as a subsidy (too much credit) to suppliers. Luckily, that would be of no direct consequence for international trade since exports of financial services should be zero-rated anyway.

To sum up, the case for exemption with rebate for the financial sector is weak on both efficiency and equality-of-treatment grounds.

The Canadian Experience

No dramatic changes to the GST treatment of financial services have taken place in 20 years, aside from continuous regulation-making and the occasional court case and retroactive amendment response. Ironically, it took a recent round of GST harmonization to bring about change. Under the Comprehensive Integrated Tax Collection

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33 For a defence of the spirit of this approach, see Firth and McKenzie, supra note 1; for a general but neutral discussion of efficiency considerations in relation to the GST, see Bass and Gendron, supra note 15, at 8:3.

34 One could argue that the public service bodies (PSB) rebate under the GST/HST achieves this result too since it is effectively an exemption-with-rebate system parallel to the main GST/HST system. That is correct, but with two important distinctions: first, many PSBs make many non-commercial supplies not for profit whereas FIIs make exclusively commercial supplies in the pursuit of profit; second, many supplies by PSBs should be taxable, and straightforwardly so, under the regular GST/HST system. For GST-PSB and exemption regime reform proposals, see Pierre-Pascal Gendron, “Canada’s GST at 21: A Tax Expenditure View of Reform” (2012) 1:2 World Journal of VAT/GST Law 125-48; and Pierre-Pascal Gendron, “VAT Treatment of Public-Sector Bodies: The Canadian Model,” in VAT Exemptions: Consequences and Design Alternatives, supra note 25, 103-33.

35 See Cisterna and Scullion, supra note 10; and Firth and McKenzie, supra note 1.
Agreement Between the Government of Canada and the Government of Quebec, the latter agrees to follow the GST base for the treatment of financial services under the QST. In effect, this means that the QST system has transitioned from zero-rating of financial services to exemption. Over the years, many pundits have wished for zero-rating treatment to be extended to the GST/HST, without perhaps knowing that the government of Quebec imposed, as offsets, compensatory taxes on financial institutions and restrictions on input tax refunds to large corporations. Financial institutions were deemed large corporations under this regime. Now that it is done, there is a silver lining in the Canada-Quebec deal: it presents a more or less uniform GST base for financial services as a starting point for future reform.

Another very important development in 2012 was the Department of Finance’s examination of the GST/HST treatment of financial services. Finance acknowledged that the system is very complex and wanted to determine whether changes could improve the system. The examination was to be comprehensive and was to follow the principle of broad revenue neutrality (my emphasis) as well as the general tax policy principles of efficiency, fairness, and simplicity. Finance chose five design considerations to explore—definition and scope of financial services, treatment of inputs, import rules, grouping rules, and subnational considerations—and used an analytical framework containing the following elements:

- neutrality and economic efficiency,
- certainty and simplicity,
- administrative efficiency,
- flexibility/adaptability,
- revenue impacts, and
- provincial considerations.

The process involved rounds of meetings with numerous industry stakeholders (industry associations, institutions, professional associations, advisers, etc.) and feedback, followed by analytical work and policy option development, development of recommendations, and a commitment to consult stakeholders if changes will be made. While it does not look as though the examination will lead to major changes in the treatment of financial services, in my opinion it was a very important step in the right direction, and the process could serve as a road map for actual reform.

The approach that Finance followed in its examination was eminently reasonable. Some remarks are in order. I prefer to interpret “broad revenue neutrality” in a very broad sense indeed by taking it to mean that revenue neutrality should be achieved

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36 Supra note 3.
37 This section is based on discussions with Department of Finance officials in January and February 2016 as well as a copy of a presentation that Finance officials made to financial industry stakeholders in 2012.
within the overall GST system. This perspective could avoid unnecessary and nonsensical limitations on reform options. Should reforms be contained strictly within the GST as it concerns the financial sector and FIIs? After all, the current treatment of financial services contaminates elements of the GST that lie outside the financial sector and financial services. Broadly interpreted, revenue neutrality could mean that any revenue loss from a reform of the treatment of financial services could be offset by eliminating ineffectual GST tax expenditures, for example. To press the point further, it might even be desirable to rely more on the GST in exchange for income tax reductions. This recommendation was made recently in Quebec.38

The analytical framework described by Finance does not provide much detail on the necessary modelling. It would be highly desirable to conduct economic studies to estimate the price elasticities and income elasticities of various financial services. Obviously this would require data from client files with financial institutions. The latter will be reluctant to share those data for confidentiality and competitive reasons. Presumably Finance has the partial equilibrium and general equilibrium models to produce sectoral estimates.

Policy Options for Canada

I agree that any policy options to improve Canada’s GST/HST treatment of financial services should follow Finance’s principles of good tax policy and its analytical framework. Here are my own operational principles for a preferred approach for Canada, given the history of GST/HST and financial services, and the case law:

1. Changes in rules and regulations will not fix the problems. GST law, regulations, rules, and technical guidance cannot keep up with the complexity of financial services and innovation in products, service delivery, and information technology. The GST is not an economic planning tool.
2. Input tax credits would be allowed only to the extent that some outputs are taxable.
3. FIIs that made a combination of taxable and exempt supplies would be allowed credit for input GST based on suitable input allocation models.
4. Input allocation models to deal with mixed supplies should ideally be agreed upon between FIIs and the CRA, and be based on industrywide consultations.39
5. All business services that are not genuine financial services should be taxable, and so a strict economic substance test should be applied when drafting the definition of what constitutes a financial service and the attendant rules.

38 Québec, Se tourner vers l’avenir du Québec, Rapport final de la Commission d’examen sur la fiscalité québécoise (Québec: Gouvernement du Québec, 2015).
Policy options for Canada are split into short-term to medium-term, and long-term. In the short to medium term, Canada should adopt the South African model:

- Tax all fee-based financial services.
- Tax all property and casualty insurance, including intermediary fees related to such insurance.\(^40\)
- Zero-rate only exports of financial services by registered financial institutions.
- Exempt only margin-based services and *term* insurance, including any policy with a savings element.\(^41\)

While space restrictions prevent a full discussion of all the advantages and disadvantages of the South African model and its operational performance—this has been done elsewhere\(^42\)—it is helpful to make a few remarks. First, the alleged problem of substitution of margin-based remuneration for fee-based remuneration in the presence of the tax does not seem to have materialized in any serious way in South Africa. There are often good business and economic reasons to use a certain mode of remuneration, which may not be overturned by a tax. The relatively low rate of the GST (5 percent) should be reassuring in this regard. Second, many financial services purchased by consumers are fee-based, so taxing fees brings the effective GST base closer to the ideal. This is reinforced by the addition of property and casualty insurance where, again, household consumption is important. Finally, medium- to high-income households would now pay GST on financial services in a transparent way. This would remove a benefit from the exemption to such households, an important selling point for the public. In my opinion, this model comes closest to the principles dear to the Department of Finance, including especially simplicity and equity (and a broader notion of efficiency, if one considers the possibility of very significant reductions in collection costs). For the longer term, Finance should think of ways of completing the reform. It should therefore study, in consultation with the industry, the applicability of the cash flow VAT method with a tax calculation account in taxing margin-based services. It is reassuring to note that the authors of the latest comprehensive state-of-the-art review of tax design are bullish on the cash flow VAT method, especially if it is accompanied by the tax calculation account methodology.\(^43\)  

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\(^40\) This means that separate provincial taxes on property and casualty insurance should be abolished since they would be redundant and economically inferior to the GST.

\(^41\) In South Africa, a long-term policy is defined to include an assistance policy; a disability policy, fund policy, health policy, or sinking fund policy; or a contract comprising a combination of any of those policies.

\(^42\) Morden, supra note 39.

\(^43\) Mirrlees et al., supra note 28, at chapter 8.
CONCLUSION

The taxation of financial services under the GST presents a formidable policy challenge in several dimensions. The current treatment—a broad exemption—is deeply unsatisfactory to all stakeholders. In this article, I have examined the legal and economic landscape and concluded that there is a strong case for making financial services taxable and simplifying the existing system. On the basis of international and Canadian experience, I believe that the best approach is to follow the model that South Africa adopted effective October 1, 1996. Under that model, all fee-based services and property and casualty insurance would be subject to GST (and HST if participating provinces go along).
FINANCES OF THE NATION

Richard Bird and Michael Smart*

TAXING CONSUMPTION IN CANADA: RATES, REVENUES, AND REDISTRIBUTION


PRÉCIS

Le présent article porte sur le rôle des taxes de vente et de la taxe d’accise dans les recettes du gouvernement et dans l’économie canadienne. On y explore plus particulièrement les effets des taxes à la consommation sur les ménages canadiens afin d’établir si le fardeau fiscal repose de façon disproportionnée sur les ménages à faible revenu comparativement aux ménages à revenu élevé, et dans quelle mesure. Les auteurs présentent des données sur les taux des taxes de vente prévus par la loi et cernent quelle part du produit national brut du Canada et des recettes du gouvernement est attribuable aux taxes de vente et d’accise au cours des 34 dernières années (1981-2014). Ils analysent ensuite les données transversales sur les habitudes de consommation et les paiements de taxes des ménages canadiens, et concluent que le caractère régressif présumé des taxes de vente — en particulier les taxes générales sur les ventes comme la taxe sur les produits et services — est loin d’être évident.

ABSTRACT

This article examines the role of sales and excise taxes in government revenues and in the Canadian economy. In particular, it explores the distributional effects of consumption taxes among Canadian households, to determine whether and to what extent the tax burden is borne disproportionately by low-income households rather than high-income households. The authors present data on statutory sales tax rates and track the share of...
sales and excise taxes in Canada's gross domestic product and government revenues over the past 34 years (1981-2014). They then analyze cross-sectional data on consumption patterns and tax payments of Canadian households, and conclude that the presumed regressivity of sales taxes—particularly general sales taxes like the goods and services tax—is far from clear.

**KEYWORDS:** SALES TAXES ■ EXCISE TAXES ■ RATES ■ REVENUE ■ INCIDENCE ■ REDISTRIBUTION
STATE SOVEREIGNTY AND THE MULTILATERAL INSTRUMENT

Ian Bradley and Jonathan Bright**

The base erosion and profit shifting (BEPS) project represents a significant increase in international tax cooperation to address perceived flaws in the global tax system. As part of this project, a multilateral instrument has been proposed to simultaneously amend the bilateral tax treaties of participating states, in order to implement the treaty-based measures arising from the project. The authors of this article believe that to achieve its goals, this multilateral instrument will need to be more than a one-time undertaking; it will need to respond to new developments and resolve disputes on an ongoing basis. This may require centralized management, which, the authors argue, would have a significant impact on the tax sovereignty of participating states. Despite the current desire for tax cooperation, concerns over the potential cession of state sovereignty to an international body may limit the effectiveness of the multilateral instrument in the long run.

KEYWORDS: BEPS ■ INTERNATIONAL ■ MULTILATERAL ■ OECD ■ TRADE ■ TREATY

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** Of PwC Law LLP, Toronto. The authors note that on May 31, 2016, the OECD released a “request for input” on various questions relating to the development of the proposed multilateral instrument. The OECD document raises questions similar or identical to those identified by the authors in this article, but it does not provide any responses to those questions.
NON-RESIDENT TRUSTS: SELECTED INTERPRETIVE AND PLANNING ISSUES—PART 1

Elie S. Roth and Kim Brown**

The amendments to the non-resident trust rules in section 94 of the Income Tax Act enacted in 2013 were introduced to curtail the avoidance or deferral of Canadian income tax through the use of non-resident trusts. Part 1 of this two-part article provides an overview of key provisions of the non-resident trust rules, and explores practical situations and selected interpretive issues relating to the application of the rules in the context of corporate estate freeze transactions. Part 2 will discuss the potential application of the non-resident trust rules in other circumstances, including estate planning, corporate transactions, immigration, and emigration, and will discuss certain planning issues that arise having regard to the potential scope and effect of these provisions.

KEYWORDS: NON-RESIDENT TRUSTS ■ ESTATE FREEZE ■ BENEFICIARIES ■ CONTRIBUTIONS ■ ANTI-AVOIDANCE RULES

** Of Davies Ward Phillips & Vineberg LLP, Toronto. The authors would like to thank their colleagues Tim Youdan and Chris Anderson for their comments and suggestions on a prior version of this article.
Planification fiscale personnelle

Co-rédacteurs: Gabriel Baron et Maureen De Lisser

Fiducies non-résidentes: Planification et interprétation — première partie

Elie S. Roth et Kim Brown

L’adoption, en 2013, des modifications aux règles relatives aux fiducies non-résidentes de l’article 94 de la Loi de l’impôt sur le revenu visait à réduire l’évitement ou le report de l’impôt sur le revenu canadien par l’utilisation d’une fiducie non-résidente. La première partie de cet article en deux parties donne un aperçu des principales dispositions des règles relatives aux fiducies non-résidentes et explore des situations pratiques ainsi que certains problèmes d’interprétation liés à l’application de ces règles dans le contexte d’opérations de gel successorale de société. La deuxième partie sera consacrée à l’application potentielle des règles relatives aux fiducies non-résidentes dans d’autres circonstances, incluant la planification successorale, les opérations de sociétés, l’immigration et l’émigration, et abordera certaines questions de planification qui se posent quant à la portée et à l’effet potentiel des dispositions concernées.

Mots-clés: non-résident • fiducie • gel successoral • bénéficiaire • apport • règle anti-évitement

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WHAT'S NEW IN THE NEW US MODEL TREATY?

Michael J. Miller**

INTRODUCTION

On February 17, 2016, the US Treasury Department (“Treasury”) released its new model income tax convention (“the 2016 US model”).¹ The 2016 US model features an overhauled limitation-on-benefits (LOB) article and several new restrictions on treaty access.

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Current Tax Reading

Co-Editors: Robin Boadway, Tim Edgar, Jinyan Li, and Alan Macnaughton*

Advisory Reports

Over the past year, three reports from advisory groups covering very different aspects of tax policy have appeared. The first, published by the Organisation for Economic Co-operation and Development (OECD), focuses on administrative issues in international corporate taxation. The second looks at reform of the provincial tax system in Quebec. The third makes recommendations for reforming the royalty structure in Alberta’s oil and gas industries. Unlike many tax policy proposals, elements of these reports seem destined to be implemented.


The base erosion and profit shifting (BEPS) project is a collaborative effort of the OECD and G20 member countries. It formulates tax strategies to deal with the ineffectiveness of national tax laws in coping with tax-minimization actions of multinational corporations. In these final reports, the project identified 15 actions that nations could undertake collectively to counter BEPS. The intention is to tax profits where they are generated by economic activities—that is, on a territorial basis; to increase certainty by reducing disputes over tax rules; and to standardize compliance procedures. The final reports constitute 15 separate lengthy components covering each of the actions. The executive summaries outline each of the actions in a concise and readable form.

Five of the actions are concerned with well-known ways of shifting profits from high-tax to low-tax jurisdictions: (1) transfer pricing of intrafirm transactions (actions 8-10); (2) financial arrangements such as borrowing in high-tax countries to finance investments in low-tax countries in order to take advantage of interest deductibility (action 4), and (3) profit-shifting opportunities in the digital and information economy, such as locating intellectual property rights in low-tax jurisdictions (action 1).
Action 7 addresses problems associated with artificially avoiding permanent establishment status so as to escape taxation in a country in which business activity is actually undertaken. Action 6 is concerned with claiming treaty rights when they are not appropriate. Some actions are directed at problems that arise when tax laws of two or more nations are inconsistent so corporations can exploit them to achieve double non-taxation (action 2) or when controlled foreign company rules can be manipulated by a parent corporation to shift income to a foreign subsidiary (action 3).

Other actions are devoted to increasing transparency and thus accountability. Action 11 proposes ways of improving the data available to assess the extent to which BEPS is occurring; for example, governments would be asked to provide more corporate tax statistics in an internationally consistent way. Action 5 deals with the issue of preferential tax regimes as a source of artificial profit shifting, and with the lack of transparency and effective action to counter them. Action 12 makes recommendations for the design of mandatory disclosure rules concerning abusive arrangements as a way of enhancing transparency and of providing early information about tax-planning schemes that exploit vulnerabilities in tax systems. The rules would require disclosure by both the promoters of such schemes and the taxpayers, and would be enforceable by penalties. Information sharing would also be encouraged among tax administrations, subject to reasonable privacy constraints. Action 13 requires that rates be developed for consistent transfer-pricing documentation and country-by-country reporting.

The final two actions deal with process. Action 14 seeks to enhance dispute settlement mechanisms. Action 15 is concerned with modernizing bilateral tax treaties, many of which go back to principles developed by the League of Nations in the 1920s. The OECD and the United Nations have developed an updated model tax treaty convention more suitable to today’s globalized world. Action 15 proposes to develop a multinational instrument that can be used to update existing bilateral tax treaties.

R.B.


The Québec Taxation Review Committee, chaired by Professor Luc Godbout, was established in June 2014. Its remit was to analyze and propose reforms that would make the Quebec tax system fairer and more efficient and would foster work, saving, investment, and growth, while contributing to budget balance. Remarkably, the committee’s final report was published in March 2015, less than a year later. The report consists of six volumes, and this summary provides an overview of its recommendations.

The committee proposes a revenue-neutral reform of the provincial revenue system encompassing all its elements, including personal and corporate taxation, sales
and excise tax, and user pricing. Nine basic principles—some in conflict—inform the report. They include adopting a system-wide approach that takes into account equity, neutrality, simplicity, transparency, predictability, minimization of cost, diversity, and compliance. In turn, this approach leads to eight objectives: economic growth, business investment, labour market participation, savings, sustainable development, full revenue collection, adaptation to a changing society, and an equitable distribution of wealth with support for the disadvantaged.

Broadly speaking, the proposed reform would reduce personal, corporate, and payroll taxes, funding this change through reduced tax expenditures and increases in consumption taxation and user fees. In other words, it would broaden income tax bases, reduce rates, and change the tax mix from direct taxes to consumption taxes and user fees. As well, there would be some increase in progressivity of personal taxes, and some structural enhancements to facilitate labour market participation for both young and old workers and to increase investment by facilitating transfers of businesses. In addition, some forward-looking proposals are made for major adjustments to the tax system.

More specifically, some of the key recommendations include the following. In the personal tax system, progressivity would be enhanced by increasing the basic personal exemption and the number of tax brackets from four to nine while holding the top rate at 50 percent overall. The health-care contribution would be eliminated, and the income-splitting proposal of the federal government would not be followed. For the corporate tax, the general rate would fall from 11.9 to 10 percent, and refundability of tax credits would be eliminated for large corporations. For small and medium-sized enterprises (SMEs), payroll taxes would be reduced and the small business deduction would be replaced with a growth premium available to SMEs with at least five employees. The small business rate would be 4 percent on income between $100,000 and $500,000, compared with the current rate of 8 percent on all income up to $500,000.

The Quebec sales tax rate would increase from 9.975 to 11 percent, and specific excises on tobacco, alcohol, fuel, and insurance premiums would all increase; low-income persons would be compensated by an enhancement of the solidarity tax credit. There would be an increase in electricity prices for both households and corporations, and in the fee for child care. There would be an enhancement of the tax credit for work and a new work premium for experienced workers, as well as a tax shield that reduces the adverse effect of increases in work income on refundable tax credits. Finally, there would be an enhanced effort to combat tax evasion and tax avoidance, to improve the taxation of e-commerce, and to better oversee the provisions respecting trusts.

In the longer term, the committee recommends replacing the partial exemption of capital gains with the taxation of real capital gains on assets held for at least one year, as well as

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1. At 18.
2. At 19.
3. At 12.
year. In addition, the capital gains exemption on principal residences would be transformed into an additional RRSP contribution, and the treatment of stock options as capital gains would be changed. More radically, the committee recommends that the government study changing the income tax system into a dual income tax system of the sort used in the Nordic countries, recognizing that this would entail collaboration with the federal government.

Overall, the report of the committee respects the current structure of major taxes, eschewing the call for major changes in the base of the personal and corporate tax system found, for example, in the Mirrlees review in the United Kingdom. Nonetheless, several of the proposals represent a divergence of the Quebec tax system from that of the federal government and other provinces. Quebec can act on most of these matters unilaterally because it is not bound by tax collection agreements, but obviously what Quebec does may have implications for future federal tax reform.

R.B.


The focus of the panel’s work was on the broader royalty framework rather than on the rates alone. Its mandate combined giving optimal returns to Alberta on its oil and gas resources with encouraging investment, job creation, diversification, and innovation, and supporting responsible development. The new framework that it proposes would apply to new wells operating from 2017. Broadly speaking, the panel suggests that the oil sands royalty framework works well, based as it is on profits. But it calls for more transparency on oil and gas to be achieved by several measures, including publication of a capital cost index and of revenue, expense, and royalty information on each oil sands project. It also recommends the annual publication of the returns to the province, industry costs, investment levels, job creation, and environmental performance. More generally, the panel emphasizes the crucial difference between the value of a resource (price less cost) and its final price or the revenue it generates.

To put royalties in context, the panel compares Alberta’s share of resource value with the shares of jurisdictions elsewhere, and finds it to be comparable. Alberta takes in a share of resource value that is roughly in the middle of the pack among its peers, and it provides a competitive investment environment. Interestingly, its share lags behind that of the US states.

Apart from the oil sands, existing royalty rates apply not to value but to revenues or production levels of resources, albeit in a way that takes into account resource

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prices and project size. The royalty structures for crude oil, liquids, and natural gas do not respond well to changes in costs, technology, and productivity. Moreover, although the distinction between oil and gas wells is not meaningful, the two are treated very differently. This contrasts with the revenue-minus-costs approach taken in the oil sands, which is consistent with best practices. But there is a lack of transparency about costs, and thus there is less trust in the system.

The panel makes a number of recommendations based on the guiding principles mentioned above. Most important, the royalty framework for crude oil, liquids, and natural gas should be modernized. Above all, it should emulate the revenue-minus-costs approach, including recouping certain upfront capital costs, much like the cash flow tax principle often used as a benchmark ideal. The panel proposes harmonizing the royalty structures across crude oil, liquids, and natural gas to remove distortions. It would replace existing drilling programs with a single formula to calculate the drilling and completion cost allowance for each well, and calibrate it to a capital cost index reflecting current average costs. A flat royalty rate of 5 percent would be applied until cumulative revenues from a well equal the well’s drilling and completion cost allowance, followed by higher post-payout royalty rates that increase with price.5

The existing system for oil sands would be maintained. This system involves an initial royalty of up to 9 percent on gross revenues until initial costs are covered, followed by a profit-based royalty of 25 to 40 percent.6 The transparency of allowable costs would be enhanced. At the same time, the panel recommends a strategy of increasing value-added production in both bitumen and natural gas.

Overall, the panel stresses the importance of including costs consistently in the determination of royalties, so that they are based more on value than on production (the revenue-minus-costs approach). This approach would bring the Alberta royalty regime closer to standard systems found in jurisdictions such as Norway and Australia, where the aim is to design resource taxes that apply to resource rents. Oddly, there is limited discussion of the complementary role of auctions as efficient revenue generators. These represent a significant source of Alberta oil and gas revenues.

R.B.

**EXCISE TAXES**

Excise taxes are mainstays of virtually all tax systems. Unlike other taxes, they fulfill more than a revenue-raising role. Excise taxes on tobacco and alcohol products address costs that users impose on third parties (externalities) and discourage behaviour that leads to social problems and addiction. Excise taxes on petroleum products address different sorts of third-party issues, including environmental costs and congestion. The three papers reviewed below provide useful perspectives on some of

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5 At 57.
6 At 12.
the economic issues associated with excise taxes on tobacco, alcohol, and petroleum and use very different methodologies.


Richard Bird explores problems with designing excise taxes to address the adverse health and social consequences of consuming tobacco and alcohol and using the proceeds to finance public health initiatives. The marrying of sin taxes with virtue expenditures has apparently been successful in the Philippines. Should it be emulated elsewhere? Bird’s message is cautionary: it is difficult to know the right level for such taxes in any given country, and there is no good economic or political case for earmarking excise tax revenues to public health programs.

Bird begins by outlining three different approaches to the taxing of alcohol and tobacco. The first is the public health approach, which favours reducing consumption of tobacco and deterring excessive, but not moderate, consumption of alcohol. He argues that it is difficult to design a system that is directed to the most harmful use, as opposed to aggregate consumption, and that differentiates among different product forms. The second is the economic approach, which focuses only on externalities caused by consumption rather than total costs, including those to users. It also addresses equity, efficiency, and administrative cost issues. The neglect of costs to users calls for lower tax rates, but ignoring addiction problems is questionable. Moreover, identifying externalities is difficult. The alternative to taxing externalities often used is the regulation of cigarette and alcohol use. The final approach is the political economy approach, which treats alcohol and tobacco taxes as acceptable ways of raising revenues while deterring bad consumption.

Bird relates these three approaches to three concepts of the appropriate excise tax level: (1) the revenue-maximizing tax rate (RMTR), (2) the socially optimal tax rate (OTR), and (3) the politically acceptable tax rate (PATR), and they are not likely to be the same. In principle, the RMTR is based on elasticities of demand, but these are not known with any certainty. Calculating the OTR is both conceptually and practically very difficult. The PATR can be interpreted as the one actually enacted, which varies notably across countries.

Bird then discusses other factors involved in choosing excise tax design. One is the choice between specific (per unit) and ad valorem tax rates. The former are simpler to administer but must be revised periodically. Another factor is the choice between uniform rates and rates that are differentiated by product characteristics, such as alcohol content, type of drink, and type of tobacco product. Again, no clear principles emerge, other than the truism that simpler taxes are easier to administer.
Other factors are equity and efficiency, which are typically in conflict. Bird points out that differentiated rates can be used to reduce regressivity, but at the expense of simplicity. Regressivity may even be a virtue, since the poor may be more price-sensitive and so will benefit more from the tax. Ease of administration is an issue, and is made more difficult by illegal sales and smuggling from abroad. Simple tax forms and a strong tax administration are important for achieving the objectives of excise taxes. A final factor is the mix of taxation and regulation: the latter can be useful in targeting certain users (for example, the young) that taxes cannot target.

Bird then briefly turns to earmarking. He argues that although it is tempting to argue for linking good taxes with health benefits to good expenditures on the improvement of health, there is really no long-term rationale for doing so. The chances that revenues raised by excise taxes will equal the amount that should be spent are small, and earmarking cannot be perfect given the fungibility of money. Earmarking has little empirical effect on amounts actually spent, and it may reduce accountability.

Bird concludes that it is best to use simple taxes, to use regulation for fine tuning, and to pay close attention to tax administration. He illustrates his arguments by using examples from the United Kingdom and the Philippines and other ASEAN (Association of Southeast Asian Nations) countries.

**R.B.**


Ian Irvine and William Sims consider a situation in which legal and illegal tobacco sales coexist. Like Richard Bird, they suppose that tobacco taxation can have different objectives: to reduce consumption, to raise revenues, and to reduce illegal activity. The existence of illegal activity complicates the effect of excise taxes: higher taxes can increase consumption by stimulating illegal sales. This point is relevant in the Canadian context, where illegal sales are estimated to be up to 20 percent of total consumption.

Irvine and Sims formulate a function that the government optimizes that is based on different types of consumption—premium legal, discount legal, and illegal—and that captures the foregoing three objectives. Illegal consumption can be more toxic than legal consumption, and the tax applies only to the two forms of legal sales. A revenue-maximizing government maximizes the revenue from legal sales. A paternalistic government aims to minimize aggregate consumption, which is the sum of the three types of consumption, weighted by social costs. A tough-on-crime government minimizes illegal sales.

Consumers are assumed to have constant-elasticity-of-substitution preferences over the three types of cigarettes. Parameters are chosen to calibrate the demand for cigarettes to the actual market shares, given the overall elasticity of demand for cigarettes of \(-0.3\), and assuming either high or low elasticities of substitution among cigarette types. There is an assumed cost of illegal cigarettes, which includes toxicity,
policing, loss of social capital, and social norm effects. The exercise is to simulate the effects of tax policy changes.

The main results for each of the three objectives include the following. With respect to the paternalistic objective, higher taxes are not particularly effective in decreasing overall weighted demand. The higher the social costs of illegal cigarettes, the less effective the taxes when people shift to socially costly illegal purchases. In fact, weighted demand could increase with a tax increase. With a revenue-maximizing objective, tax cuts will not raise revenues when the share of illegal products is relatively small. The tough-on-crime results are clearcut: a decline in cigarette taxes reduces illegal purchases. The conclusion is that the impact of tax policy on paternalistic quantity-minimizing policy is ambiguous in light of the extra weight given to illegal consumption. Reduced cigarette taxes may be welfare-improving, except for a revenue-maximizing government.

R.B.


Joel Wood constructs a calibrated empirical model to calculate optimal gasoline taxes in Ontario and the Greater Toronto-Hamilton area (GTHA), using Canadian data and taking account of distortionary income taxes. The task is ambitious, given that gas taxes exist at more than one level of government. Additional gas taxes have been suggested as an option for financing transit in the GTHA. The optimal gas tax has both an externality-correcting (Pigouvian) component and a revenue-raising (Ramsey) component. Wood estimates the size of these for the GTHA and for Ontario, building on an existing model by Parry and Small and assuming that all revenues are earmarked for transit.

Wood uses a representative household model—equity considerations are ignored—with aggregate consumption, variable leisure, travel distance and time, pollution, and accidents as variables. The government taxes income and gasoline and has access to a lump-sum tax intended to approximate the harmonized sales tax. The model is solved by using 2006 Canadian data, with parameter values used to calibrate the model solution to actual data. The author calculates optimal gas taxes containing both Pigou and Ramsey components algebraically using the calibrated model. The Pigou components correct for congestion, pollution, and accident externalities, while the Ramsey component is based on the inelasticity of gas demand.

The optimal GTHA gas tax is calculated to be $0.4057 per litre, which is $0.247 higher than the existing tax but $0.02 lower than that in Vancouver. If no GTHA tax is imposed, Ontario-wide tax should be only $0.2851, reflecting the lower level of average congestion Ontario-wide. The Pigouvian component makes up over two-thirds of the total. These results suggest that a regional gas tax is justified while the Ontario-wide tax remains at its existing level. Moreover, a higher gas tax would be justified regardless of what is done with revenues. These results are similar to those that have been calculated for the United Kingdom and the United States.
Wood discusses briefly the effect of the gas tax on equity. He also notes the impact of increased fuel efficiency, which would reduce both revenues and externalities from driving.

R.B.

**TAXATION AT THE TOP**

In the past few decades, income inequality has increased significantly; the increase has been driven in large part by a growing concentration of income at the top. There has been much interest in the potential role of tax policy in addressing this issue, and particularly in whether tax rates at the top should be increased. The three papers reviewed below deal with different aspects of the problem. Lemieux and Riddell examine the characteristics of the top 1 percent of income earners and, in particular, the factors that might have driven their relative success. Milligan and Smart consider the effects of increasing the tax rate faced by the top 1 percent, both on the revenue raised and on the measure of inequality. Osberg addresses the topical question of how high the top tax rate could be, and what it should be.


There are many possible explanations for the growing income share of the top 1 percent. On the one hand, market factors might predominate—for example, technological changes, globalization, and economies of scale that increase the skill premium for the top earners. Alternatively, institutional factors might be responsible—for example, bargaining power or the ability to extract rents by top earners such as chief executives, financial sector workers, and superstars. These alternative explanations have implications for tax policy. If top incomes are largely driven by rent-seeking behaviour, taxing them might both be warranted and have limited economic consequences. On the other hand, if market factors are important, taxing them at high rates could have significant disincentive and efficiency consequences.

Thomas Lemieux and W. Craig Riddell use Canadian census master-file data to get a detailed picture of the top 1 percent. Their results are quite revealing relative to what one could infer using less detailed data sources, such as tax files. They find that labour earnings have been a much larger share of top income earners than of other income groups, and that the share has been relatively constant over time. Top earners, most of whom are men, also work substantially longer hours than others.

The probability of an individual being in the top 1 percent increases with working age and education level. A medical degree is particularly important, but that credential has recently lost ground along with other health-related degrees. Commerce, management, and business degrees have grown in importance in recent years. Those with engineering and applied science degrees are disproportionately represented in the top 1 percent, but their share has not increased much over time.
The share of top earners from mathematics and computer science increased greatly a few decades ago, but has since declined.

Industry of employment and occupation have been especially important. A growing share of top earners work in finance, insurance, and business services and in oil, gas, and mining, but the share of top earners in manufacturing has declined. The share of senior management among top earners has increased considerably, especially in finance and insurance. There has also been growth in the natural and applied science professions.

Lemieux and Riddell conclude that executives and persons working in finance and business services and in oil and gas are the most important drivers of the top 1 percent. More persons in the natural and applied sciences and in computer science are also represented in the top 1 percent, but their increase has been less than the above categories. There are more computer scientists in the top 1 percent, but still a modest number, while the share of health-sector persons has declined. The authors conclude that their detailed results are more consistent with rent extraction than with market-based explanations, though both play a role. To the extent that this is true, some support could be given for increasing the top income tax rates.


Several provinces have recently increased their tax rates on top incomes, while the federal top tax rate had not changed until the 2016 budget. Kevin Milligan and Michael Smart evaluate the effects of provincial increases in tax rates by 5 percentage points for the top 1 percent. The analysis is based on their estimates of the elasticity of taxable income with respect to the marginal tax rate. Changes in taxable income resulting from changes in marginal tax rates can reflect not only changes in real behaviour, but also the shifting of income into sheltered forms or out of the taxing jurisdiction.

The authors describe the evolution of top marginal tax rates by the provinces since 2000, highlighting increases in recent years in some provinces. They trace the increases in the share of income of the top 1 percent over provinces; these data form the basis for their empirical analysis, which regresses the top income share against the top net-of-tax earnings rate (that is, 1 minus the top marginal tax rate). This calculation leads to an elasticity of taxable income of 0.664, which is comparable to estimates found in other Canadian studies. Thus, a 10 percent increase in the marginal tax rate causes taxable income to fall by 6.64 percent, thereby eroding the expected revenue gain. The authors show that this elasticity increases the higher up the income distribution scale one goes.

They use these estimates to simulate an increase in the tax rate paid by the top 1 percent by 5 percentage points for each of the provinces. They assess the effect of
such a change on the progressivity of the tax system in each province and on the tax revenue generated. Both effects vary considerably across provinces. Moreover, such a change would have only a modest effect on inequality, since it applies to only a small proportion of income earned by the top 1 percent. In addition, provincial top tax rate increases would spill over to federal tax revenues, since the federal income tax base would also be reduced.

R.B.


Lars Osberg begins by reviewing some evidence on top marginal tax rates. He points out that the top rate in Canada is relatively low by OECD standards and is below the estimated revenue-maximizing rate. The current rate of about 50 percent is lower than the historical average of close to 70 percent. Top tax rates by province are generally lower in Canada than in US states: the highest rates are in New York and California and the lowest are in Alberta and Newfoundland and Labrador.

Estimates of revenue-maximizing top rates rely heavily on labour supply effects, and Osberg ingeniously points out a deficiency in the assumption underlying many of these estimates. He argues that because the time available for work is fixed, if work effort increases with the after-tax wage rate, leisure falls and marginal value—and the so-called income effect—rises. Eventually, the income effect must outweigh the substitution effect, leading to a backward-bending labour supply curve (as empirical studies have found).

Existing estimates of the elasticity of taxable income at the top typically assume a fixed elasticity of labour supply, which is not plausible. In fact, given the very wide range of incomes in the top 1 percent, a fixed elasticity of labour supply would have to be extremely low to prevent maximum labour supply from being reached. This outcome is inconsistent with estimates of the elasticity of taxable income, which suggest high elasticities of labour supply. Thus, high estimates of the responsiveness of work effort are inherently implausible. Osberg recognizes that there are other margins of response to tax rate increases, such as changes in the form of income, bargaining for rents, evasion, and migration. But induced lower bargaining from higher marginal tax rates just shifts the income to other taxpayers who pay the tax, and increased avoidance is an argument for tightening administration. Osberg claims that labour supply elasticity is the socially relevant response to tax rate changes.

He addresses a number of other considerations in evaluating the top tax rate. First, income from capital makes up a third of top 1 percent income, and inheritances are increasing components of wealth, so the focus on earnings is undermined. Second, high incomes are partly due to luck, and progressive income tax is a form of insurance. A reasonable amount of risk aversion can increase marginal top rates
substantially, assuming that some of them represent luck rather than effort. Third, higher after-tax income is spent largely on status goods that influence social ranking. The cost of raising top rates is small if ranking is not affected. Fourth, the alleged threat of migration of top earners due to higher Canadian taxes is not supported by evidence. Finally, tax avoidance and evasion are facilitated to the extent that enforcement is weak and penalties are low. Moreover, whistleblowers or informants could be used to reduce evasion as they are in other countries, and as the Canada Revenue Agency (CRA) now does for international tax reporting under the offshore tax informant program. (On this topic, see the review of Bethmann and Kvasnicka, *International Tax Evasion, State Purchases of Confidential Bank Data and Voluntary Disclosures*, below.)

Osberg finishes by arguing that there is scope for both higher top tax rates and tougher tax administration. For example, he calculates that increasing the marginal tax rate to 65 percent for those with taxable incomes above $205,000 would increase revenues by $15.8 billion—enough to abolish post-secondary tuition fees and double the guaranteed income supplement for seniors.


This year’s report contains all the usual material on the cost of special tax measures, plus interesting analyses of the working income tax benefit and the charitable tax credit.

The working income tax benefit is a refundable tax credit that supplements the earnings of 1.5 million low-income workers at a cost of $1.2 billion, with the purpose of increasing the returns to work and encouraging participation in the labour force. The benefit is particularly important for people who would otherwise be on social assistance, since the loss of social assistance on entering the labour force presents a “welfare wall” that reduces the labour supply. The study does not directly measure this labour supply effect, but instead provides interesting statistical data on the nature of recipients.

The most striking statistical relationship is the one between the method of filing the personal income tax return and the take-up rate for the benefit: people who file a paper return have a take-up rate of only 49 percent, as compared with 86 percent for people who file their own returns using tax software and 94 percent for people who file their returns through an agent. The non-claimants represent 13 percent of

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7 At 36.
8 At 285.
9 At 289, table 2. The figures are for the 2012 taxation year.
all of those eligible for the benefit, so the group is not small.\(^{10}\) Further, people who file a paper return still have a low take-up rate (51 percent) even if the amount of the annual benefit is $600 or more.\(^{11}\) A $600 benefit is quite significant for the low-income workers who are eligible for the benefit, given that the maximum net income for recipients of the benefit is less than $28,000.\(^{12}\)

The source of this take-up problem is that claimants have to complete schedule 6. The CRA cannot determine eligibility unless this schedule is filled out because certain amounts, such as income earned on a reserve, are not available elsewhere on the return. The report is silent on the topic of whether the CRA makes any effort to contact benefit-eligible non-claimants. With respect to the possibility that a taxpayer is ineligible because of income earned on a reserve, one would think that the CRA could use the taxpayer's address (which would show whether he or she was living on a reserve) to identify and contact eligible non-claimants.

The structure of the working income tax benefit is that of a flat-topped pyramid—a range of incomes over which the benefit is being phased in, a range of incomes in which the maximum benefit is paid, and a range of incomes over which the benefit is being phased out. However, the phase-in is based on working income, while the phase-out is based on net income. This results in the curious situation in which 6 percent of claimants are simultaneously in the phase-in and phase-out portions of the benefit schedule.\(^{13}\) This result can occur because of significant income from sources that are part of net income but not part of working income.

The main focus of the report's analysis of the working income tax benefit is in the persistence of claims: do workers claim the benefit once, because of a year with temporarily low income, or is the benefit generally going to workers who experience low income on a recurring basis? For 2009 claimants, 63 percent also made a claim in the subsequent three years, while 20 percent made a claim in all of those years.\(^{14}\) Thus, there is an element of truth in both stories.

The second study in the report concerns the response of individuals to changes in what economists call the price of charitable donations—the after-tax cost of donating $1.\(^{15}\) This response is a function of both federal and provincial tax credits for donations and the capital gains tax exemption for donating certain assets that have appreciated in value (most notably, publicly traded securities). On average (both mean and median), this after-tax cost is 67 cents—that is, the government is paying

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\(^{10}\) At 289.

\(^{11}\) At 289, table 3.

\(^{12}\) At 287, charts 1 and 2.

\(^{13}\) At 293.

\(^{14}\) At 299, table 14.

\(^{15}\) This publication is a follow-up to a broader government report on charitable donations: see Canada, Department of Finance, *Tax Expenditures and Evaluations 2014* (Ottawa: Department of Finance, 2014). See this feature (2015) 63:3 *Canadian Tax Journal* 885-904, at 890-92.
about one-third of the cost of donations. This cost is highest in British Columbia—about 70 cents (because of the relatively low provincial tax credit rate of 5 percent for donations below the $200 threshold). It is the lowest in Quebec, about 62 cents, where there is a high tax credit rate for both those above and those below the $200 threshold.

Overall, the study found an elasticity with respect to the after-tax price of −1.1. In other words, a 1 percent reduction in the after-tax price of giving is expected to increase charitable donations by 1.1 percent. As the report notes, the argument for providing tax incentives for charitable donations is stronger where taxpayers are highly responsive to tax incentives. The report draws no conclusions about where an elasticity of the estimated magnitude falls on this spectrum, but it seems impossible to avoid the conclusion that the argument in support of incentives has been shown to be weak. After all, the government could just give the money to charities directly instead of using a tax incentive; an elasticity of −1.1 implies that the tax incentive increases donations by just 10 percent above this direct-donation standard.

The above estimate is an average response for various types of donors, and thus the study does not attempt to discover whether there is more responsiveness among higher-income donors or those donors eligible for the capital gains exemption on donation. This omission is unfortunate, particularly in the latter case, because the argument for the special incentive for those donors is based on a hypothesis of greater responsiveness. However, the report mentions some interesting statistical data relevant to this issue: the non-taxation of capital gains accounts for 2 percent of overall tax assistance for donations by individuals and, for those donations, only about 20 percent of the tax assistance arises from the capital gains preference. On the other hand, the figures are for 2012, and they might be higher in a time of higher price appreciation on the stock market.

The study notes in passing that total charitable donations have declined by about 6 percent in real (inflation-adjusted) terms since the 2007 peak. The report minimizes the importance of this decline, noting that most of the decline took place during the last economic recession, and that a similar decline in donations occurred in the economic slowdown of the early 2000s. The implication appears to be that

16 At 308, table 4. Individuals who earned less than $40,000 of adjusted income over the sample period (1997-2012) were excluded from the analysis in order to have a fair test of responsiveness to tax incentives. The problem is that charitable donations of non-taxable individuals are generally not included in the data because the tax credit is non-refundable.

17 At 309, chart 2.

18 At 311, table 5.

19 At 303.

20 Ibid. The 20 percent is my inference, derived by dividing the 2 percent mentioned above from the report’s figure that 9 percent of overall tax assistance is for donations eligible for the capital gains tax exemption.

21 At 304.
no change in policy is needed; donations will increase again when the economy recovers.

One other noteworthy aspect of the report is that footnotes disclose the names of the authors of the two studies. This information has never before been given by the Tax Policy Branch of the Department of Finance. Does this disclosure reflect a desire on the part of the government to distance itself from the opinions expressed (they could be said to be just the opinions of the authors and not those of the government), or does it reflect a general desire by the new government to allow civil service scientists to present their findings to the public without applying a political filter?

A.M.


Paying whistleblowers for information, as the CRA has recently begun to do under its offshore tax informant program, is controversial wherever it is practised in the world. Perhaps such payment is un-Canadian, as some say. Nevertheless, the evidence seems to suggest that it is an effective strategy.

Germany’s most populous federal state, North-Rhine Westphalia (NRW), has been particularly active in this regard, buying confidential bank data offered for sale by whistleblowers. On ten occasions since 2010, it has bought data on unreported income in Swiss bank accounts. Although the amount paid appears to be unknown, it is no doubt small relative to the rewards—the NRW government estimates that the purchases have led to additional tax revenue of €2 billion from the named tax evaders.22

The discussion paper shows that the data purchases are also profitable on a second dimension—their effect on voluntary disclosures by other taxpayers, who are presumably taking advantage of the immunity from prosecution for tax fraud provided to those who so disclose in advance of an investigation being started. The NRW government discloses the timing and content of data acquisitions, and it provides data on monthly disclosures by NRW residents involving Swiss banks. The statistical analysis in the discussion paper shows that the number of voluntary disclosures increases by 254 percent in the first month after a new data acquisition emerges, compared with the number that would have occurred had no such purchase taken place. The effect declines only slightly in the second month to 212 percent, and does not disappear until the fifth month.23

A.M.

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22 At 2.
23 At 9.