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Current Tax Reading

Co-Editors: Bev Dahlby, Tim Edgar, Jinyan Li, and Alan Macnaughton*

Alex Himelfarb and Jordan Himelfarb, eds., *Tax Is Not a Four Letter Word: A Different Take on Taxes in Canada* (Waterloo, ON: Wilfrid Laurier Press, 2013), 293 pages, ISBN 978-1-55458-832-9

Richard Swift, ed., *The Great Revenue Robbery: How To Stop the Tax Cut Scam and Save Canada* (Toronto: Between the Lines, 2013), 159 pages, ISBN 978-1-77113-103-2

The political history of Anglo-American democracies over the past three decades is defined by the rising influence of neoconservative ideology in framing national policy, beginning with the Thatcher-led Conservative Party in the United Kingdom and the Reagan-led Republican Party in the United States. Neoconservatism has come to dominate political discourse in both of those countries, as well as—though perhaps more subtly—in Canada. A key message of this version of neoconservative politics is the need to reduce the size and involvement of government in the lives of citizens, in favour of an increased role for private markets, and a critical element of that message is the need to reduce taxes. To realize this result, taxes are relentlessly characterized as dampening economic growth that would otherwise be generated by the private sector, without providing a sufficient offsetting benefit. The political imperative thus becomes the need to deliver tax cuts.

The two collections of papers that are the subject of this review provide an important counterweight to the dominance of the neoconservative message in Canada. The principal point of emphasis is the importance of public goods and services desired by Canadians and the need to increase revenue through increased levels of taxation for reinvestment in these goods and services.

Tax Is Not a Four Letter Word consists of 13 papers, along with an editors' introduction and a brief conclusion. The editors are refreshingly candid in acknowledging up front that they have made no attempt to be even-handed and provide a forum for the anti-tax/anti-government policy agenda. They have instead brought together this set of papers advocating a more balanced public policy debate on taxes through a renewed emphasis on the need for taxation and, in particular, on what taxes purchase.

* Bev Dahlby is a Distinguished Fellow in Tax and Economic Growth, University of Calgary. Tim Edgar is of Osgoode Hall Law School, York University, Toronto, and the Faculty of Law, the University of Sydney. Jinyan Li is of Osgoode Hall Law School, York University, Toronto. Alan Macnaughton is of the School of Accounting and Finance, University of Waterloo. The initials below each review identify the author of the review.

The editors concede that the contributors disagree on many important issues, such as the desirable mix of taxes, whether tax levels should increase, or whether tax reforms should be revenue-neutral. Irrespective of these kinds of disagreements, the editors are certainly correct in emphasizing that the contributors (and the editors themselves) agree that Canadians need to have a more balanced public conversation about taxes focused on the consequences and costs of tax cuts.

The papers are organized thematically in four parts. The first and third parts are devoted, respectively, to an examination of issues of public finance generally and tax reform more specifically. The second and fourth parts focus on the politics of the public policy debate about taxes in Canada.

The five papers in part one are grouped under the heading "The Conversation Today." The first paper is written by Jim Stanford, a well-known economist with the former Canadian Auto Workers union (now part of a merged labour organization under the name Unifor). Stanford presents an overview of the economic consequences of taxation and spending policies, emphasizing the positive effects for growth that well-designed policies can provide. He argues that the empirical evidence supports the intuitively obvious link between wise public spending and economic growth, and therefore the need for sound taxation policies to support this link. The second paper, by the public finance academic Robin Boadway, describes the increasing decentralization of tax and spending in Canada, and the consequences of this trend for the ability of the federal government to promote national objectives. Among his set of policy recommendations, one of the more intriguing is that the provinces should vacate the corporate income tax and that a cash flow tax should be adopted at the federal level as a means to tax economic rents. As Boadway points out, the impact of a cash flow tax would be most pronounced for, though not limited to, the resource sector. Following the papers by Stanford and Boadway are two separate but related papers by another well-known economist, Hugh Mackenzie. The first of Mackenzie's papers describes how political discussion of taxes in Canada occurs in a vacuum, with the taxation decision being separated from the spending decision and, in particular, from the goods and services for which tax revenues can be used. The second paper follows logically from the first; it surveys the benefits that taxes purchase in Canada and what is lost when taxes are reduced. The last paper in part one, by polling expert Frank Graves, provides a fascinating tour through data regarding the attitudes of Canadians to taxes.

Part two, titled "How We Got Here," consists of three papers. The first two focus on the takeover of Canadian politics by the neoconservative counterrevolution and explain how this ideological shift has shaped Canadian tax and public policy making. First, Matt Fodor, a doctoral student in political science at York University, Toronto, describes the adoption and modification of the Thatcher and Reagan versions of neoconservatism in Canada. Then two public policy analysts, Eugene Lang and Philip DeMont, examine how neoconservative ideas have shaped Canadian economic policy, resulting in a significant reduction in taxation levels and in the delivery of public goods and services. The third paper in part two, by a former journalist, Trish Hennessy, describes how the political rhetoric of the neoconservative movement evolved and how it has shaped attitudes to taxation among the Canadian electorate.

The four papers in part three are grouped under the heading "A Different Take on Taxes." These papers differ from the papers in the other parts of the book in their focus on specific ideas for tax reform. The first paper in part three is written by two economists at the Canadian Centre for Policy Alternatives, Marc Lee and Iglika Ivanova. They describe an agenda for tax reform intended to make the Canadian tax system more progressive. While that description is light on detail, it includes a proposal to broaden the personal income tax base by taxing both capital gains and most returns to saving at full rates. A number of tax expenditures would be rationalized, including tax assistance for retirement savings, a wide range of broad-based refundable tax credits, the preferential treatment of employee stock options, and tax recognition for donations to registered charities. Lee and Ivanova also advocate increasing the top income tax rate for individuals in the top 1.0 to 0.1 percent of the income distribution, and adopting a wealth transfer tax. Corporate tax rates would be increased, although Lee and Ivanova support movement to a cash flow base focused on economic rents, particularly in the resource sector. Additional revenue generated from these reforms would be devoted to delivery of a basic or guaranteed income. The second paper in part three reviews the standard case for a carbon tax and is notable primarily because it is written by the former leader of the federal Liberal Party, Stéphane Dion. Readers may recall that under his leadership, the Liberals were defeated in the 2008 federal election in no small part because of the inclusion of a carbon tax in the party's campaign platform. The third paper in part three is by the economist Toby Sanger, who outlines the case for a financial transactions tax (FTT). Sanger's views will likely be familiar to readers who are versed in the literature on such a tax; however, this paper may be of particular interest for his critique of many of the standard arguments against the adoption of an FTT. The last paper in part three, by the economist C. Scott Clark, echoes the earlier paper by Lee and Ivanova, although Clark's broad agenda for tax reform is organized around a tax simplification theme. Like Lee and Ivanova, Clark advocates alteration of the tax mix to rely less on consumption taxes and more on income taxes.

Part four of the book, titled "How To Get There," consists of a single paper by two political scientists, Paul Saurette of the University of Ottawa and Shane Gunster of Simon Fraser University. Saurette and Gunster detail and analyze how the neoconservative policy agenda was brought from the margins of popular policy debate into the mainstream of political discourse. Consistent with the title of this part, they lay out the lessons to be learned by progressives favouring higher levels of taxation and increased government involvement in the economy and in Canadian society more generally. The lessons are set out at the end of the paper as a series of recommendations that is notable for its failure to include any use of the New Democratic Party (NDP) to deliver the content of much of the policy message. This omission may reflect the abandonment of the NDP's historical role as a voice for alternative policy ideas. For many on the left of the political spectrum, the NDP has become just another political party trapped in mainstream policy thought in order to advance its political ambitions.

The second book, *The Great Revenue Robbery*, consists of eight papers wrapped within an introduction and a conclusion that are independent papers themselves. As is summarized in the conclusion, written by Murray Dobbin, the president of Canadians for Tax Fairness, the papers in this book collectively argue that governments of the past 20 years have (1) slashed taxes to deliberately reduce government's social and economic capacity, (2) systematically misled Canadians about the reasons for the real impact of tax cuts, and (3) created a level of inequality not seen since the 1920s. Although these themes are broadly similar to those examined in *Tax Is Not a Four Letter Word*, most of the papers in *The Great Revenue Robbery* are quite different in tone and style (as might be expected from the respective titles of the two books). While the papers in the former volume are more formal and academic, with references and citations to the relevant literature, the papers in the latter volume tend to be more impassioned, with much less documentation of related source material. The difference in content and style may reflect the fact that the majority of the contributors to *The Great Revenue Robbery* are social activists, while the contributors to *Tax Is Not a Four Letter Word* are predominantly academics and policy analysts. That said, there is some overlap in contributions and contributors: the papers by Hennessy and Sanger described above appear in both books, while Jim Stanford contributed an original paper to each.

The introduction to *The Great Revenue Robbery*, by Dennis Howlett, the executive director of Canadians for Tax Fairness, lays out a broad agenda for tax reform that is not dissimilar to that described by Lee and Ivanova in *Tax Is Not a Four Letter Word*. In addition to the paper by Sanger on the adoption of an FTT, four other papers focus on the subject of tax reform at a more detailed level. In "The Failure of Corporate Tax Cuts To Stimulate Business Investment," Stanford presents data supporting the argument captured in the title to his paper. He argues that, in the face of the evidence, tax preferences for business investment should be eliminated, and the additional revenue realized as a result should be used to make public investments, especially in much-needed infrastructure. Stanford's paper stands out from the others as evidence-based and academically rigorous. Another paper, by Joe Gunn, "Taxes and Ecological Justice," reviews the case for environmental taxation. There is also a paper on tax havens, titled "The Trouble with Tax Havens: Whose Shelter?" by Peter Gillespie. The focus of this paper is, however, extremely general. At best it can be taken as yet another call for the need for more robust information-reporting requirements and enforcement efforts regarding personal wealth held offshore. The use of tax havens by multinational corporations as a means to achieve international tax-planning objectives is not considered. Finally, there is a unique paper, "Tax Justice and the Civil Economy," by Joe Restakis, on the tax treatment of cooperatives. Unfortunately, it is not entirely clear what the thesis of this paper is.

"Pushing the Envelope: The Overton Window and the Left," by Diane Gibson, analyzes the political ascent of the neoconservative counterrevolution. The term "Overton window" refers to an idea developed by the conservative thinker Joseph Overton. He argued that policy options on a particular issue can be placed on a political spectrum ranging from left to right. The "Overton window" represents those options that are currently politically feasible and are the subject of current public debate. The way to pull the window toward either the left or the right is to start talking outside the window. Overton's principal claim is that new ideas on public policy are developed outside government. After describing how leaders of the neo-conservative movement implemented Overton's idea, Gibson maps a similar tactical strategy for progressives in Canada. The conclusion to *The Great Revenue Robbery*, noted above, is more in the nature of an impassioned call to arms to those on the left. This same political perspective is found in a paper by Richard Swift, the editor of the book, titled "The Power of Conventional Thinking." But the focus of Swift's paper is the co-opting of the Canadian media by the anti-tax movement. It is a much-needed contribution that is surprisingly lacking in *Tax Is Not a Four Letter Word*.

T.E.

Brian M. Studniberg, "The Concept of De Facto Control in Canadian Tax Law: Taber Solids and Beyond" (2013) 54:1 *Canadian Business Law Journal* 17-37

This article critically reviews the relevant case law interpreting the concept of de facto control (or "control in fact") of a corporation as provided for in subsection 256(5.1) of the Income Tax Act.[1] Enacted in 1988, this provision is intended to extend the concept of control of a corporation beyond the concept of de jure (or legal) control, which, as developed by Canadian courts, broadly means voting control of a corporation's board of directors. The concept of control in fact is relevant where a provision of the Act uses the phrase "controlled directly or indirectly in any manner whatever" as opposed to a reference to the word "control" unmodified. In defining the concept of control in fact, subsection 256(5.1) provides only that the term includes any fact pattern in which a particular taxpayer or group of taxpayers has "direct or indirect influence that, if exercised, would result in control in fact." In terms of the content of this wording, the subsection provides only a set of specifically excepted, and narrowly defined, fact patterns. Canadian courts have thus been given the task of providing content in a general way to the concept of control in fact.

The article begins by examining the "board control test" articulated by the Federal Court of Appeal in *Silicon Graphics Ltd. v. Canada*[2] as one possible approach to the concept of control in fact. Under this approach, control in fact is considered to exist where a taxpayer or a group of taxpayers has a clear right and ability to effect a significant change in a corporation's board of directors or its powers, or to influence the way that shareholders, who would otherwise have the ability to elect the board, behave.[3] This concept of control in fact is firmly grounded in the concept of legal control in the sense that the former is based on the same focus as the latter, but extends to those circumstances in which there is an ability to control the board of directors other than through the ownership of voting shares. Studniberg follows the discussion of *Silicon Graphics* and the board control test with a review of subsequent

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this feature are to the Act.

2 2002 FCA 260.

3 Ibid., at paragraph 67.

case law articulating an "operational control test" as an alternative approach to the concept of control in fact. Under this alternative, control in fact is considered to exist where a taxpayer or a group of taxpayers has sufficient influence to exert control over the business or other affairs of a corporation. This concept of control is not grounded in any way in the concept of legal control since the focus moves away from a focus on the board of directors. The operational control test thereby potentially extends to a much wider range of fact patterns than that contemplated by the board control test.

Studniberg then goes on to consider the Tax Court of Canada's decision in *Taber Solids (1998) Ltd. v. The Queen*.[4] He argues that the attempt of Miller J in this case to reconcile the board control and operational control tests fails to sufficiently clear up confusion resulting from the case law after *Silicon Graphics*. Miller J in *Taber Solids* concluded that operational control can coexist with board control if operational control is limited to those circumstances in which what would otherwise be board decisions reside elsewhere. Operational control cannot, however, be sufficient on its own to constitute control in fact. Studniberg suggests that this reconciliation of the two tests is based on a misreading of the case law subsequent to *Silicon Graphics*, and that the narrower test of board control should be preferred exclusively in defining the concept of control in fact. He supports this suggestion with a reading of the legislative history of subsection 256(5.1), including the proposition that the enumerated exceptions in the provision for certain relationships concerning operation of a corporation's business suggest only that the "provision proper is not intended to connote such considerations."[5] But given the current state of the case law, Studniberg recommends enactment of a clarifying amendment to subsection 256(5.1) that would ensure that the provision extends only to circumstances that constitute control of a corporation's board of directors consistent with *Silicon Graphics*.

T.E.

Robin Boadway and Michael Keen, *Rent Taxes and Royalties in Designing Fiscal Regimes for Non-Renewable Resources*, CESifo Working Paper no. 4568 (Munich: Center for Economic Studies and Ifo Institute, January 2014) (www.cesifo-group.de/ifoHome/publications/working-papers/CESifoWP/CESifoWPdetails?wp_num=4568&CESifoWP.search=+)

Taxes and royalties from natural resource industries are a major source of revenue for many developing countries and some member countries of the Organisation for Economic Co-operation and Development (OECD), such as Canada, Australia, Norway, and the United Kingdom. Collecting a substantial share of the economic rents generated by natural resource industries, without imposing punitive taxes that distort investment decisions, is crucial for the long-run development prospects of many developing countries, and also Canadian provinces and territories. Without a

4 2009 TCC 527.

5 Studniberg, at 32.

properly functioning tax system, which allows development of the resource base by private-sector investment, governments will instead rely on national oil and mining companies to develop resources. In too many cases this results in inefficient production, inadequate investment, and corruption. It is also important to understand the implications of taxes for mineral and oil and gas exploration and production if sound environmental policies are to be adopted.

Given the importance of this topic, it is not surprising that the International Monetary Fund (IMF), the World Bank, and other international institutions have devoted considerable resources to developing models of the best practices for tax systems for non-renewable resource industries. However, there are still large gaps in our knowledge of how fiscal systems affect resource industries, and more analysis is needed in order to design optimal taxation and royalty systems. This paper by Boadway and Keen, which builds on their previous work,[6] describes the design of cash flow based tax systems and then explains why resource royalties, which are the equivalent of excise taxes on the production of a resource, might be part of an efficient system.

Boadway and Keen provide an elegant model of a firm's investment and production decisions with regard to a resource deposit. This framework is then used to show how cash flow taxation in its various forms—such as an ACE (allowance for corporate equity), a "Brown tax," or an RTT (resource rent tax)—can be implemented. Such taxes can collect the economic rents generated by a resource project without affecting the investment and production decisions that would have occurred in the absence of the tax. To the extent that there are no other market failures, these cash flow based taxes will be economically efficient means of collecting economic rents, and they have been used as models for taxation in the oil sands industry in Canada and the mining sector in Australia.

However, there are many unresolved issues in the design of resource rent taxes, and royalties based on production or revenues are still widely used for collecting revenues from the resource sector. Boadway and Keen use the framework described above to show that royalties will generally reduce extraction rates, lead to premature termination of production, and discourage exploration and development activity. They then consider a number of "complicating factors" that affect the design of cash flow taxes and royalty systems. For example, the public sector may use a different discount rate to value future revenue streams than the private sector, leading to a divergence in the optimal rate of development from the perspective of the firm and that of the government. (However, for small projects this should affect the government's savings and investment profile and not the design of the optimal tax system.) A more important divergence between the public and private sectors may be their ability to handle risk. Boadway and Keen develop a model in which (1) there is uncertainty about the price of the resource and (2) resource revenue streams are risky.

6 Robin Boadway and Michael Keen, "Theoretical Perspectives on Resource Tax Design," in Philip Daniel, Michael Keen, and Charles McPherson, eds., *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (London: Routledge, 2010), 13-74.

In this model, the public and private sectors can have different valuations of risk as reflected in different coefficients of relative risk aversion. Boadway and Keen show that the cash flow tax rate should be progressive—that is, increase with the price of the resource—if the government is less risk-averse than the private sector. In countries where resource revenues are the major source of funds for the government, it is possible that the public sector may be more risk-averse than the international oil companies that develop the resource, which typically have a broad base of shareholders with well-diversified portfolios of financial assets. In such circumstances, the Boadway and Keen model implies that the cash flow tax rate should decline when resource prices increase and increase when prices decline, a result that seems to be at variance with most tax-rate structures. The implementation of cash flow tax regimes is also constrained by the ability of governments to monitor revenues and costs in the calculation of cash flows. Under a cash flow tax regime, firms will have an incentive to exaggerate costs, perhaps through transfer pricing or "gold plating," and underreport revenues. Using a relatively simple model of this type of distortion, Boadway and Keen show that the optimal system may be a combination of a cash flow tax and a royalty, because a royalty discourages investment and thus offsets the tendency for overinvestment induced by the cash flow tax. Boadway and Keen also develop a model in which firms have unobservable differences in the cost of developing a resource. In this model, which is analogous to the two-person optimal income tax problem, the government may use a combination of cash flow taxes and royalties to efficiently extract rents from the two types of firms.

The final topic concerns the inability of governments to commit to a particular fiscal regime. Given that resource projects usually involve large upfront investments that are irreversible and immobile, governments may be tempted to change the fiscal regime after the firm has sunk its investments into the project. Anticipating such behaviour, firms underinvest in their projects. Boadway and Keen show that in the absence of other distortions, such as asymmetric information, the optimal cash flow tax is time-consistent. That is, the government would not change the cash flow tax rate after investments have been made and production has started to take place. With royalties, a time-consistent royalty regime would require an upfront subsidy for the initial investment.

By extending the basic framework in which cash flow taxes have been analyzed, Boadway and Keen consider a wider array of policy combinations that are reflected in the fiscal regimes that the governments of resource-rich countries have adopted. Much more work needs to be done, especially with regard to incorporating the full array of fiscal instruments that affect non-renewable resource industries, including bonus bid or auction systems, property taxes, and corporate income taxes. The general equilibrium effects of the resource tax system in resource-dependent economies also need to be considered. In addition, more attention needs to be paid to the optimal rate for a cash flow tax and not just the design of the cash flow optimal tax system. Still, this paper provides an excellent starting point for the analysis of these issues.

B.D.

Michael Devereux, Nils Johannesen, and John Vella, *Can Taxes Tame the Banks? Capital Structure Responses to the Post-Crisis Bank Levies*, CESifo Area Conference on Public Economics, April 11-13, 2013 (Munich: Center for Economic Studies and Ifo Institute, 2013), 19 pages (www.cesifo-group.de/portal/page/portal/CFP_CONF/CFP_CONF_2013/Conf-pse13-Van%20der%20Ploeg/Papers/pse13_Johannesen.pdf)

The financial crisis of 2008-9 reinvigorated academic and policy-making interest in the design of prudential regulatory regimes governing the financial sector as a policy instrument intended to moderate financial instability. The crisis also motivated interest in the role of taxation as a complement to these regimes. Yet in practice, the use of tax instruments has been modest, with bank leverage taxes being the instrument of choice of national policymakers. The motivating purpose of these taxes is the raising of sufficient revenue from the financial sector to reimburse taxpayers for the direct fiscal costs of government bailouts. An attractive feature of bank leverage taxes in performing this revenue-raising function is a presumed empirical effect: that is, such taxes should suppress bank leverage ratios and thereby support the goal of prudential regulatory regimes. In effect, policy makers have operated on the empirical assumption that by raising the price of debt, bank leverage taxes would cause affected financial institutions to respond by substituting equity for debt at the margin. This decidedly secondary property of bank leverage taxes may explain, in part at least, why they have been preferred, since the financial crisis, over other possible taxes on the financial sector, such as FTTs (financial transactions taxes).

In this important paper, Devereux et al. test empirically how banks may have responded to the introduction of leverage taxes following the crisis; it is the first study of which we are aware that tests the hypothesis that bank leverage taxes can cause an increase in equity financing. Devereux et al. also test a critical related hypothesis, that bank leverage taxes can cause an increase in the riskiness of bank asset portfolios. The authors use a panel data set of 5,000 European banks in the sample period 2008-2011, which saw the introduction of bank leverage taxes in 13 EU countries. Information regarding these taxes, including their rates, bases, and implementation dates, was collected manually by the authors from various sources. Devereux et al. find that banks in countries introducing bank leverage taxes systematically increased their levels of equity capital, but they also increased the riskiness of their asset portfolios. Moreover, banks subject to larger taxes systematically increased their equity ratios and asset riskiness relative to banks subject to smaller taxes or those not subject to bank leverage taxes. On average, these taxes were found to increase equity-asset ratios by 1.0-1.5 percentage points, but this altered ratio was associated with increased riskiness of bank assets.

Devereux et al. observe that the important policy lesson from their empirical findings is that bank leverage taxes may have interacted with prudential regulatory regimes in unintended ways. In short, these taxes appear to have induced banks to raise more equity capital, but the imposition by prudential regulatory regimes of minimum capital adequacy ratios based on risk-weighted assets appears to have allowed banks to increase the riskiness of their asset portfolios and adjust their risk-return payoff profiles while still complying with these regimes. In this respect, it is notable that Devereux et al. find that the bank leverage taxes in the relevant EU countries had only a modest effect on the riskiness of assets for average banks, whereas the effects were found to be larger for banks that were more likely to be constrained by regulatory capital requirements.

T.E.

John Grahl and Photis Lysandrou, "The European Commission's Proposal for a Financial Transactions Tax: A Critical Assessment"
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A financial transactions tax, or FTT, has received some attention in the post-financial crisis literature, as well as in policy-making circles, as a tax instrument intended to recover the direct costs of government-funded bailouts of affected financial institutions. This tax instrument has a relatively lengthy history in the tax literature, dating from the seminal proposal for its application to currency transactions in the spot market articulated by the Nobel economist James Tobin;[7] it has since been the focus of contentious debate in both the academic literature and the arena of public policy. It is therefore perhaps not surprising that the FTT resurfaced as a possible post-crisis tax instrument. Most prominently, the European Commission (EC) recommended adoption by EU member states of an FTT[8] over a tax on some measure of the value added or excess profits of financial institutions proposed by the IMF under the label "financial activities tax" (FAT).[9] The EC also initially supported the adoption of a FAT, but subsequently altered its position in favour of an FTT. The authors of this article provide a novel critique of the particular version of an FTT proposed by the EC, and argue that a FAT is the superior policy instrument.

As Grahl and Lysandrou observe, the EC's rationale for the choice of an FTT was the ability of this type of tax to generate revenue and stabilize financial markets by dampening trading volume. This rationale is the standard one articulated in the tax literature and, in fact, is the focus of much of the contentiousness in the literature, since the impact of an FTT as a revenue-generating policy instrument with desirable efficiency-enhancing properties remains ambiguous. Grahl and Lysandrou correctly emphasize that the standard rationale for an FTT put forward by the EC is based on the premise that all short-term trading of securities, currencies, and other commodities is speculative in nature and therefore a defensible target of the tax because

7 James Tobin, "A Proposal for International Monetary Reform" (1978) 4:3-4 *Eastern Economic Journal* 153-59.

8 European Commission, *Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC*, COM(2011) 594 final, September 28, 2011.

9 See Stijn Claessens, Michael Keen, and Ceyla Pazarbasioglu, eds., *Financial Sector Taxation: The IMF's Report to the G-20 and Background Material* (Washington, DC: IMF, September 2010), reviewed in this feature (2010) 58:4 *Canadian Tax Journal* 1053-68, at 1063-64.

of the associated market instability in performing a valuable price-revelation function. Grahl and Lysandrou note that, even in the presence of a desirable behavioural effect, the choice of an FTT as a response to the 2008-9 financial crisis is odd, since speculative trading was not the cause of the crisis—though this motivating feature of the EC recommendation is emphasized in the post-crisis literature considering the choice of tax instrument to generate revenue to recover the direct fiscal costs of bailouts, while providing a behavioural response that addresses the causes of the crisis. But Grahl and Lysandrou go beyond this observation to critique the FTT proposed by the EC as overinclusive because of its premise that all short-term trading is speculative and is thus implemented either by financial institutions that are peripheral to the financial system, or as a peripheral function of financial institutions that are central to the financial system.

The standard critique of an FTT in the literature assumes that all targeted short-term trading is speculative but that at some point the tax imposes efficiency losses because of a loss of desirable price-revelation function and the provision of market liquidity. In this respect, Grahl and Lysandrou suggest that the FTT proposed by the EC justifiably attempts to distinguish "good" from "bad" trading on the basis of the presence of a link to underlying economic fundamentals. For example, the proposed FTT provides an exception for primary market transactions so as not to undermine the raising of capital by governments and corporations. The relatively low proposed rates for trades in derivatives and securities are also said to have been chosen so as not to affect, in any significant way, long-term buy-and-hold strategies connected to activities in the real non-financial sector. However, Grahl and Lysandrou argue that, even with these refinements, the proposed FTT remains overinclusive because of a failure to go further in distinguishing between "good" and "bad" trades in the secondary market. Their critique focuses on the identity of the market actors involved in high-frequency trading and, in particular, singles out large institutional investors, such as pension funds and mutual funds, as well as regulated banks transacting in the interbank market.

With respect to institutional investors, Grahl and Lysandrou describe how the asset management function performed by these investors has changed dramatically. They emphasize that the conventional distinction between "passive" and "active" portfolio management is no longer valid. Instead, portfolio balancing, which requires continuous algorithmic trading, is required to maintain the representative nature of portfolios defined in terms of benchmarking to specified indexes. They observe that this trend has been driven by structural changes in the asset management industry intended to realize more accountable and efficient intermediation. Grahl and Lysandrou argue that the proposed FTT would undermine this desirable development by taxing algorithmic trading without distinguishing it from the high-frequency trading associated with speculative technical trading of hedge funds that would be a justifiable target of the tax.

With respect to the interbank market, Grahl and Lysandrou argue that the application of the proposed FTT to the repo market, on the grounds that these short-term financing transactions take the legal form of a sale and purchase of securities, would impair operation of the short-term money market. This would result in reduced availability of short-term financing and increased transacting costs, with damaging consequences. Moreover, the negative consequences of the EC's position on the application of the proposed FTT to the interbank repo market are compounded by an illogical intention not to apply the tax to foreign exchange swaps. The illogicality follows from the fact that the economics of a collateralized repo financing in euros in the European interbank market using government securities can be replicated by entering into a foreign exchange swap selling US dollars for euros and then repurchasing US dollars with euros. The transactions can be almost identical, with the only difference being the nature of the collateral—US dollars in the case of a foreign exchange swap and government securities in the case of a repo. Grahl and Lysandrou suggest that inconsistency of treatment under the proposed FTT would cause substitution of foreign exchange swaps using US dollars for repos using European government securities, which could impair the liquidity of the European interbank repo market in euro denominated bonds, while making the liquidity of the European banking system dependent on credit conditions in the United States. This thinning of the repo market would also make it less effective as a transmission mechanism for monetary policy set by the European Central Bank. A subsequent extension of the proposed FTT to spot transactions in currency markets, but not to forward foreign exchange transactions, obviously does not address the inconsistency of treatment of substitutable transactions that would have these effects.

Given the identified weaknesses of the FTT proposed by the EC, Grahl and Lysandrou offer a political economy explanation for its emergence over a FAT. They suggest that it was chosen because of its prominence in the media and in popular opinion as a desirable tax instrument, while in reality it poses much less of a threat to the interests of banks than a FAT, which can be targeted to specific financial institutions. The proposed FTT conveniently allows the EC to respond to popular opinion by maintaining the appearance of getting tough on European banks. Grahl and Lysandrou speculate that European banks were willing to accept the proposed FTT, even though they would be affected the most by its application to the interbank money market, because they know that the refusal of the United Kingdom and certain other national authorities within the European Union to implement the tax would make it unworkable and eventually lead to its repeal. This probable fate is only strengthened by the strong objections of the European fund industry to the proposed FTT.

T.E.

Jonas Frank and Jorge Martinez-Vazquez, *Decentralization and Infrastructure: From Gaps to Solutions*, International Center for Public Policy Working Paper 14-05 (Atlanta: Georgia State University, Andrew Young School of Policy Studies, January 2014) (http://ideas.repec.org/p/ays/ispwps/paper1405.html)

Subnational governments play an important role in the provision of public infrastructure because the benefits are often concentrated in a particular region. Effective provision of infrastructure by subnational governments imposes formidable challenges to governments throughout the world. This paper by Frank and Martinez-Vazquez summarizes the issues and analysis in 14 papers that are to be published in a forthcoming volume. (The individual papers can be downloaded from http://ideas.repec.org/s/ays/ispwps.html.) The range of topics includes the measurement of infrastructure gaps, the quality of infrastructure, assignment of responsibilities, financing issues, grant design, macroeconomic investment cycles, political economy analysis, and corruption concerns that are associated with local infrastructure projects. Frank and Martinez-Vazquez emphasize three main challenges in developing effective local infrastructure spending policies: (1) "coordination matters" across and between levels of government, especially for "network infrastructure" such as roads, bridges, electricity, and water systems; (2) "equity or fairness matters" for improving access to public services and reducing poverty in developing countries; and (3) "efficiency matters" to ensure that the public receives value for money.[10]

The papers summarized by Frank and Martinez-Vazquez deal with the provision of infrastructure in developing and developed countries around the world. Many of the issues discussed are, of course, familiar problems in Canada, where there has been a renewed focus on infrastructure spending and intergovernmental grant programs to address alleged infrastructure deficits. It is interesting to note that while Canadian public infrastructure spending has been increasing in recent years, and has been rated as high quality by surveys from the World Economic Forum, the level of spending in Canada, at less than 4 percent of gross domestic product (GDP), is much lower than that in many developing countries, such as India, but also less than that in Australia.[11] This paper and the 14 other papers that it summarizes should provide a useful resource for policy makers, given the challenges that infrastructure poses in a highly decentralized country such as Canada.

B.D.

Henrik Jacobsen Kleven, Camille Landais, Emmanuel Saez, and Esben Schultz, "Migration and Wage Effects of Taxing Top Earners: Evidence from the Foreigners' Tax Scheme in Denmark"
(2014) 129:1 *Quarterly Journal of Economics* 333-78

The mobility of high income earners has recently been highlighted by the French government's introduction of a 75 percent tax on incomes above €1 million. While the responses of some high-profile taxpayers, such as Gérard Dépardieu, attract media attention, there are few empirical studies of the responsiveness of international migration of high income earners to differences in national tax rates. Kleven et al. address this gap in the literature with an econometric study of the migration responses to a Danish tax provision that lowers, for three years, the average income tax rate of highly paid foreign workers from their "normal" average tax rate of 55 percent (and a marginal rate of 62 percent) to 30 percent. The program

10 Frank and Martinez-Vazquez, at 2-3.

11 Ibid., at 7, figure 1.

became effective in 1991, and the threshold for eligibility for the lower tax rate was restricted to those with annual earnings of more than €100,000 in 2009, which corresponds to the 99th percentile in the earnings distribution in Denmark.

The study found a large migration response to the program. The number of foreign workers earning above the threshold doubled compared to the number earning slightly below the threshold, and the elasticity of migration with respect to the net-of-tax rate (1 minus the average tax rate) was found to be between 1.5 and 2.0. This implies that the number of highly paid foreign workers increased by 80 to 110 percent in response to the reduction in the average tax rate from 55 percent to 30 percent. The study also found evidence that earnings of a high-income foreign worker declined during the scheme but increased after the individual's tax rate rose when the scheme terminated. The authors interpret this as evidence that the earnings of high-income workers are determined in a bargaining framework as a weighted average of the worker's marginal productivity and the worker's reservation wage, with the weight on the marginal product being determined by the bargaining power of the employer and the weight on the reservation wage being determined by the bargaining power of the employee. In this Nash bargaining model, a reduction in the average tax rate reduces the employee's reservation wage and therefore leads to a lower agreed wage as long as employers have some bargaining power. In other words, part of the reduction in average tax rates was shifted to employers through lower wage rates, an effect that is at variance with the standard competitive model, where workers receive all of the benefits of a wage rate reduction either because the supply of labour is very inelastic or because the demand for labour is highly elastic. Econometric estimates of the effect of lower average tax rates on earnings implied that the elasticity of gross earnings with respect to the net-of-tax rate was −0.36. This implies that the gross wage rate declined by about 20 percent in response to a reduction in the average tax rate from 55 percent to 30 percent. The authors point out that a number of European countries—notably Belgium, Finland, the Netherlands, Portugal, Spain, Sweden, and Switzerland—have introduced programs to lower tax rates for high-income foreign workers and that this tax competition may require international coordination and regulation.

B.D.

Alberto Alesina and Francesco Passarelli, "Regulation Versus Taxation"
(2014) 110:1 *Journal of Public Economics* 147-56

Rafael Aigner, *Environmental Taxation and Redistribution Concerns*
(Open Access Publication Server of the ZBW-Leibniz Information Centre for Economics, 2013) (http://hdl.handle.net/10419/79859)

In the first of the two studies reviewed here, Alesina and Passarelli consider an important aspect of environmental policy—the choice between taxes and regulations to reduce the use of products that generate harmful externalities. While the normative question has been addressed in the economics literature, especially in the context where there is uncertainty regarding the costs of abatement and damages, the political economy aspects of the issues have received less attention. Alesina and Passarelli use a simple yet elegant model in which individuals differ in their cost of adjustment to a lower level of an activity that generates a negative externality, to determine the policy instrument that would be adopted under majority voting. Three policy instruments are considered: (1) a rule that puts an upper bound or limit on the amount of the externality-generating activity that an individual can undertake; (2) a quota that imposes the same proportional reduction in the activity on all individuals; and (3) a per-unit tax on the activity with the tax revenues being remitted to all individuals on an equal per capita basis. An individual's preferred rule, quota, or tax rate is the one that equates his or her marginal benefit from reducing the harmful effects of the activity with the marginal adjustment cost that the individual will face in adopting that value for the preferred instrument.

Individuals differ in the amount of the activity that they would undertake in the absence of a policy to limit the activity, and therefore the distribution of the activity among the population is a key determinant of the policy instrument that will be preferred by the majority of the population. Voting is assumed to take place in two stages. At the first stage, the instrument is chosen, and at the second stage, the level of that instrument is chosen. Therefore, the second-stage decision influences the voter's first-stage decision. Alesina and Passarelli show that the quota is generally, though not always, dominated by a either a rule or a tax. Roughly speaking, the majority of individuals will prefer a rule if the median individual's activity level is lower than the average activity level and will prefer a tax when the median individual's activity level is greater than the average. An example of the former would be emissions of greenhouse gases (GHGs) that are concentrated in a few large emitters, and an example of the latter would be emissions from automobiles. In other words, the Alesina and Passarelli model predicts that GHG emissions from electricity generation based on fossil fuel and oil sands production will be subject to regulations that limit emissions rather than a carbon tax that would be paid by everyone, and that automobile emissions will be subject to a tax on gasoline rather than a limit on the volume of emissions.

Alesina and Passarelli also derive the policy instrument that would maximize a utilitarian social welfare function and compare it with the instrument that would be chosen under majority voting. Two interesting propositions emerge from this comparison. First, if the utilitarian solution would be a tax and the majority prefers a rule, then the chosen rule is more restrictive than the rule that would maximize the utilitarian social welfare function. In other words, the majority prefers a rule that is overly restrictive relative to the utilitarian criterion. Conversely, if the utilitarian solution would be a rule and the majority prefers a tax, then the chosen tax rate is lower than the tax rate that would maximize the utilitarian social welfare function. In other words, the majority-chosen tax rate is too lenient relative to the utilitarian criterion. If one applies these propositions to the examples given above, the Alesina and Passarelli model predicts that democratic governments might choose overly restrictive regulations for large emitters of GHGs but levy taxes on motive fuels at rates that are too low.

Two interesting extensions of the model are suggested, although not pursued in the article. First, the overly restrictive policies that would be adopted in the case where there are a few large emitters may be countered by the lobbying activity of those emitters, in which case lobbying may shift the policies closer to the utilitarian maximizing policies. Second, Alesina and Passarelli suggest that assigning the powers of taxation or regulation to regions where large emitters are concentrated might "counter balance the power of the least concerned"[12] and yield more efficient policies. The analysis of concurrent federal and provincial powers over environmental policies might be usefully examined in this framework, although Alesina and Passarelli warn that "implementation problems of such schemes are, however, extremely severe."[13]

The Alesina and Passarelli paper reviewed above did not incorporate two important issues that affect the optimal Pigouvian tax rate: concerns about distributional equity, and the use of distortionary taxes to finance public services and redistribute income. Aigner's study attempts to clarify how these two factors should affect the tax rates that are adopted to reduce the use of commodities that generate harmful externalities. Aigner adopts a standard optimal income tax model with two groups of individuals who earn different wage rates, allocate their consumption spending between a "clean" and a "dirty" commodity, and decide how much labour to supply. The optimal income tax rate, income transfers, and the excise tax rate imposed on the dirty commodity are chosen to maximize a social welfare function that places different weights on the well-being of the high- and low-productivity individuals subject to an exogenous revenue-raising constraint. As is well known, in such models if the self-selection constraint is binding, the labour market decision of the low-productivity workers is distorted, and those workers face a positive marginal tax rate on their earnings. The marginal cost of public funds (MCF) is the reduction in social welfare if the government has to raise an additional dollar of tax revenue. In the model adopted by Aigner, the MCF has a relatively simple form. Aigner shows that the MCF increases in the weight in the social welfare function that is placed on the well-being of low-productivity workers. In other words, the greater society's redistributional concerns, the higher is the marginal tax rate on the earnings of low-productivity workers, the greater the distortion in the labour supply decisions of those workers, and the higher the marginal cost of public funds.

The optimal Pigouvian tax on the dirty commodity is equal to the marginal external damage caused by consumption of the commodity divided by the MCF. This means that a greater concern about distributional equity is reflected in a higher MCF and results in a lower optimal Pigouvian tax rate. Intuitively, if the Pigouvian tax rate were set at the optimal level, equal to the marginal external damage of consumption of the commodity, a reduction in that tax rate would generate consumer

12 Alesina and Passarelli, at 153.

13 Ibid.

benefits that would outweigh the additional damage from increased consumption of the commodity. Or to put it another way, the Pigouvian tax generates revenue and reduces the harmful externality from consumption of the commodity. The more weight that the society places on revenues because of the concern for redistribution, the less importance it will place on reducing the harmful externality. Although the model is highly specialized, the general principle that Pigouvian taxes on a harmful commodity should be lower in societies where the MCF is higher should be an important consideration in developing tax policies to reduce emissions from harmful products.

B.D.

Kim Brooks, ed., *The Quest for Tax Reform Continues: The Royal Commission on Taxation Fifty Years Later* (Toronto: Carswell, 2013), 360 pages, ISBN 978-0-7798-5491-2

It is almost 50 years since the release of the report of the Royal Commission on Taxation[14] ("the Carter report"), yet this publication arguably remains the gold standard when it comes to a comprehensive examination of a national tax system. Indeed, for some tax-policy wonks, the report has attained iconic status. As a partial testament to such status, this collection of 15 papers is the result of a conference held at Dalhousie law school in September 2013 to commemorate the 50th anniversary of the appointment, by order in council, of the commission. For the most part, the papers pick up selected threads of the subjects addressed in the Carter report and revisit those subjects as they are currently understood and framed in both the literature and tax policy debates. The authors and titles are as follows:

- Elsbeth Heaman, "The Politics of Fairness: Income Tax in Canada Before 1917"
- Shirley Tillotson, "The Politics of Carter-Era Tax Reform: A Revisionist Account"
- Allison Christians, "Drawing the Boundaries of Tax Justice"
- Thaddeus Hwong, "Tax Levels, Tax Mixes and Income Redistribution in Canada and Selected OECD Countries Since Carter"
- Kirk A. Collins and Tim Edgar, "The Carter Report's Corporate Income Tax Proposals: Why They Were Rejected and an Assessment of the Current Canadian System as an Imperfect Alternative"
- Kathryn James, "The Carter Commission and the Value-Added Tax (VAT): A Prescient Review of the VAT Before Its Time Had Come"
- Arthur J. Cockfield and Catherine Brown, "Revisiting the Carter Commission's International Tax Work"

14 Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) (chair: Kenneth LeM. Carter).

- Michael A. Livingston, "Convergence, Divergence, and the Limits of Tax Globalization: The Canadian Experience"
- Claire Young, "'Beyond Conjugality': Time for the Tax System To Take That Concept Seriously"
- Tamara Larre, "Views of Dependency in the Tax System: The Minimal Changes over the Past 50 Years"
- Faye L. Woodman, "As the Baby-Boomers Age, How Should They Be Taxed?: The 'Old' Age Tax Credit and 'New' Age-Dependent Taxation"
- Chris Sprysak, "Taxing Me or We: Yet Another Look at the Carter Commission's Recommendation for Joint Returns"
- Colin Jackson, "Settlement and Compromise in Canadian Income Tax Law Since Carter"
- Lori McMillan, "Noncharitable Nonprofit Organizations in Canada"
- Carl MacArthur, "Assessing the Fairness of Tax Avoidance: The Need To Consider Economic Substance"

T.E.

Emily Satterthwaite, "Taxing by Default"
(2013) 59:2 *McGill Law Journal* 337-73

This article is notable for its attempt to provide a theoretical framework for the use of tax elections, a subject on which there is very little policy-oriented literature.[15] Satterthwaite argues that the default rule applicable in the absence of an election should be set according to the preferences of the majority of eligible taxpayers. The exception to this policy prescription is the choice of a penalty default structure that conveys valuable information to the government. Satterthwaite illustrates her theoretical argument by applying it to two familiar provisions in the Act providing rollover treatment on a transfer of property: subsection 73(1) (transfer of capital property to a spouse or former spouse), and subsection 85(1) (transfer of eligible property to a taxable Canadian corporation). She concludes that the design of subsection 73(1) is sound, with the default rule of rollover treatment avoiding unnecessary transaction costs for the majority of taxpayers, and no loss of valuable information for the government in setting the default rule in this way. On the other hand, she argues that the design of subsection 85(1) is unsound, with its default rule of fair market value recognition. Satterthwaite characterizes this default rule as "counter-majoritarian" and unnecessary, since the government could obtain the information revealed by an election to apply rollover treatment at lower costs with routine information reporting. She recommends that subsection 85(1) be amended to provide mandatory rollover treatment as the default rule, with an election available for a minority of taxpayers who prefer fair market value recognition.

T.E.

15 See, for example, Heather M. Field, "Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System" (2010) 47:1 *Harvard Journal on Legislation* 21-73.

Arthur J. Cockfield and Jonah Mayles, "The Influence of Historical Tax Law Developments on Anglo-American Laws and Politics"
(2013) 5:1 *Columbia Journal of Tax Law* 40-68

Tax policy implementation tends to involve more than just a bit of politics. This article discusses three important periods in Anglo-American history when the link between tax and politics had profound consequences for the development of political and legal institutions that laid the foundations for modern liberal democracies. Although the events in these periods of history are well known, Cockfield and Mayles provide accounts at a level of detail that is worth reading in its own right, as well as being necessary to advance the thesis of the article.

The article begins with a discussion of the events surrounding Magna Carta and the Charter of Liberties in early medieval England. This period is reviewed because it saw the first restriction on the ability of the monarchy to tax English subjects as the king saw fit. The article then recounts a series of important tax disputes in 17th-century England that ultimately led to the Glorious Revolution and the English Bill of Rights. This period is important for the emergence of the concept of a constitutional monarchy. Finally, the article turns to the role of tax laws in the American Revolution and the subsequent development of the American Republic.

The common theme drawn out from the account of events in these three periods is the political struggle against "bad taxes," which the authors define as unrepresentative taxes without due process protections. The political institutions that followed from this struggle are seen to have resulted in the development of "good tax laws," which the authors define as laws that promoted representative taxes along with procedural protections against arbitrary imprisonment for non-payment. Cockfield and Mayles, however, go beyond this claim and suggest that the relevant developments influenced broader social change, including the development of liberalism as a guiding political philosophy. They emphasize the important role of taxes in the development of liberalism in shaping norms that underlie modern liberal democracies.

T.E.

Arthur J. Cockfield, "The Limits of the International Tax Regime as a Commitment Projector" (2013) 33:1 *Virginia Tax Review* 59-113

This article draws on the literature on transaction costs as a means to conceptualize what the author refers to as the "international tax regime" as a political and legal system addressing transaction costs for cross-border investment. Cockfield claims that the international tax regime has "an uneven record with respect to reducing transaction costs for taxpayers and others."[16] He identifies the international tax regime with the network of bilateral tax treaties based largely on the OECD model treaty. Transaction costs are defined as the costs associated with discerning a price for a given exchange and, when this concept is applied to the international tax regime, are tantamount to the costs of discerning the price of inbound or outbound

16 Cockfield, at 61.

investment. An important component of this price is the tax cost, which is effectively set through the international tax regime as a governmental commitment. Conceptualized in transaction cost terms, the international tax regime is seen to signal credible political commitments that permit taxpayers to reduce transaction costs that would otherwise be necessary to protect against tax risk associated with cross-border investment.

Cockfield argues that, as a "commitment projector," the international tax regime has performed well in eliminating double taxation by residence and source countries. By committing to such elimination, governments reduce the risk that income taxation will reduce cross-border investment. The international tax regime is characterized as a "commitment projector" that enables governments to offer reasonably reliable promises to affected taxpayers, the public, and other governments. Another recently developed component of the international tax regime that also performs well when assessed in terms of a transaction cost analysis, but is only highlighted in the article, is the development of an efficacious and extrajudicial dispute resolution process.

Despite the success of the commitment to eliminate double taxation that was the original motivation for creation of the international tax regime, Cockfield cautions that the regime should not always be seen as an effective means to lower transaction costs through the implementation of credible government promises. Indeed, he claims that in other respects, the international tax regime can be seen to increase transaction costs. He emphasizes, in particular, the uneven acceptance by governments of cross-border tax planning implemented by multinational firms, and the adoption by the United States of the Foreign Account Tax Compliance Act (FATCA).

With respect to cross-border tax planning, Cockfield suggests that the increased transaction costs resulting from the tax-planning effort that is required in the face of uneven and complex anti-avoidance responses of governments remain acceptable to multinational firms because the associated tax savings are greater than those costs. With respect to FATCA, Cockfield suggests that its unilateral adoption by the United States outside the system of information exchange developed as part of the international tax regime may result in longer-term reputational costs for the United States, which could raise transaction costs. But it may also be a factor that causes countries to move more quickly to a system of automatic information exchange as part of the international tax regime. If this turns out to be the case, the US initiative may ultimately prove to be a positive development. These two examples underscore Cockfield's principal assertion that the international tax regime may lower or raise transaction costs, depending on the effect of the context on the credibility of government promises.

T.E.

Michael Devereux and Simon Loretz, "What Do We Know About Corporate Tax Competition?" (2013) 66:3 *National Tax Journal* 745-74

Public concern over corporate tax competition arises from the view that it will lead to a race to the bottom, which will reduce total public tax revenues and shift more of the tax burden to personal income and sales taxes. In response to that concern, over the last 30 years economists have developed theoretical models to study the implications of tax competition, and more recently there has been an upsurge of empirical studies of corporate tax-rate competition. In this article, Devereux and Loretz review the empirical literature and evaluate the implications of its findings. To derive the testable predictions of the theoretical literature, they compare the implications of capital tax competition with three basic models of competition in commodity markets: the Bertrand price competition model, in which there are a large number of firms and prices are driven down to marginal costs of production; the Stackelberg price leadership model, in which a dominant firm sets a price based on the likely responses of a competitive fringe of smaller firms; and the monopoly model, in which a firm has market power because of economies of scale. The Bertrand model of tax competition implies that corporate tax rates are driven to zero. The Stackelberg model applies to large capital-exporting countries, such as the United States, which can influence the corporate tax rates in other countries by providing domestic corporations with a tax credit for foreign corporate taxes up to the domestic corporate tax rate. The monopoly model applies to governments in countries where agglomeration economies create locational rents that can be captured through higher corporate taxes.

Three main predictions emerge from the theoretical literature on corporate tax competition. First, tax competition will lead to the lowering of tax rates, especially by small countries. Second, countries will lower or raise their corporate tax rates in response to lower or higher rates in neighbouring countries. More formally, this means that corporate tax-rate reaction functions will have positive slopes. Third, increases in economic integration will have a non-linear impact on the strength of tax competition; that is, more integration might initially increase agglomeration advantages, leading to greater monopoly power for some countries and higher corporate tax rates, but beyond some point increased integration, because of reduced travel and communications costs, might eliminate the agglomeration advantages, leading to corporate tax-rate reductions.

As Devereux and Loretz point out, testing these propositions is difficult because we lack clear counterfactuals to what would occur in the absence of corporate tax competition, and measuring changes in economic integration is difficult. Furthermore, countries can compete over a variety of parameters that affect after-tax corporate profits. Marginal effective tax rates affect the volume of investment in a particular country, average effective tax rates affect the location of investments, and statutory tax rates affect opportunities for profit shifting through transfer pricing and debt placement.

The authors note that many empirical studies document declines in statutory tax rates, accompanied by base-broadening measures that offset the decline in average effective tax rates on corporate profits, although there is some tendency for countries to reduce average effective tax rates for more internationally mobile firms. Another broad conclusion from the empirical literature is that there appears to be a negative relationship between measures of economic openness and statutory tax rates, as well as ex ante average and marginal effective tax rates, while ratios of corporate tax revenues to GDP remain relatively constant because openness increases corporate profits. Several studies also find that countries' reaction functions with respect to corporate income tax rates have positive slopes. Finally, although the United States may have been the Stackelberg leader in the past, the smaller countries in the European Union are increasingly viewed as the driving force in corporate tax competition.

By summarizing the predictions of a range of theoretical models and discussing the inherent problems in formulating and testing predictions of tax competition, Devereux and Loretz provide a useful review of the state of the art, which will be a valuable addition to reading lists for graduate courses in the economics of taxation.

B.D.

William Gale and Samuel Brown, "Small Business, Innovation, and Tax Policy: A Review" (2013) 66:4 *National Tax Journal* 871-92

Concerns about productivity growth and competitiveness have led OECD countries to adopt a wide range of policies to promote innovation. Often the intended targets of these policies are small startup firms with high growth potential. This article surveys the evidence concerning the links between tax policies that favour small business and the prevalence of entrepreneurship and innovation. Although the authors focus on US studies, much of the discussion is relevant for Canadian public policy. One important issue that is examined is the claim that small business is responsible for the majority of net job creation in the United States. Gale and Brown report on a number of studies that indicate that the link between size of the firm and employment growth is mainly attributable to the fact that new firms start small. It is "newness," not "smallness," that is the characteristic that is linked with net job creation—although the authors note that 40 percent of the jobs created by startups are lost after five years, and "most firms do not grow even as they age; rather most firms start and stay small."[17]

Although the link between small business, startups, and growth is tenuous, governments around the world have adopted tax policies that favour small business. Gale and Brown review the main features of the US tax system that favour small business, including the immediate expensing of equipment, the research and experimentation credit, the qualified production activities income deduction, and other measures such as the small business innovation research program. Gale and Brown also review several studies that document the relatively high compliance costs that the tax system in the United States imposes on small business, but they note that small business is a major avenue for tax evasion. Internal Revenue Service (IRS) data indicated that in 2001 "43 percent of all business income that should have been reported on the income tax form was not reported."[18] Gale and Brown discuss a number of

17 Gale and Brown, at 877.

18 Ibid., at 881.

empirical studies that examine the link between tax rates and individuals reporting self-employment income, which is taken as a proxy for entrepreneurship. An increase in the average tax-rate differential between self-employment income and wage and salary income has been found to increase self-employment income, although a higher differential in the marginal income tax rate reduces self-employment income. The latter effect is interpreted as indicating that "people move to self-employment in part because business ownership may provide opportunities to avoid or evade taxes."[19]

Gale and Brown conclude their review of the literature by emphasizing that it is important for public policies to distinguish between policies to promote innovation and entrepreneurship on the one hand and policies to support small business on the other, and that very little is known about the effectiveness of tax and other policies in promoting startups, financing, investment, and growth of entrepreneurial firms.

B.D.

Lawrence Zelenak, *Learning To Love Form 1040: Two Cheers for the Return-Based Mass Income Tax* (Chicago: University of Chicago Press, 2013), 161 pages, ISBN 978-0-226-01892-8

Elimination of the filing of returns for personal income tax purposes is a reform that has received considerable attention in the literature and has been implemented by several countries. Realization of this reform requires substantive simplification of the personal income tax base so that withholding at source can be sufficiently precise to be final. In particular, various substantive provisions that account for the different personal circumstances of individuals must be eliminated. Realization of this substantive reform is arguably a desirable goal that allows the realization of compliance and administrative savings through the use of withholding at source as final rather than provisional. But in this book, Lawrence Zelenak of Duke University law school defends a return-based personal income tax as an important policy instrument to promote what he calls "fiscal citizenship."

Zelenak's use of the term "fiscal citizenship" has two related but different components. One consists of a substantive element that emphasizes the fiscal dimension of citizenship captured in US Supreme Court Justice Oliver Wendell Holmes's famous remark, "Taxes are what we pay for civilized society."[20] This substantive component ideally means that a citizen is well informed concerning both the revenue-raising and the spending functions of government and is thereby able to participate more effectively in all manner of civic activities. The other meaning, which is in fact the basis for Zelenak's support of a return-based mass income tax, consists of the formalization and recognition of the substantive financial responsibilities of citizenship. Zelenak sees the preparation and filing of a personal income tax return as the principal means by which citizens connect with the US federal government in the fiscal context.

19 Ibid., at 882.

20 *Compania de Tabacos v. Collector*, 275 US 87, at 100 (1927).

Filing of the personal income tax return—form 1040 in the United States—serves what Zelenak characterizes as a highly visible civic ceremony that focuses the attention of an individual taxpayer on his or her status as a purchaser of civilization.

Zelenak acknowledges that this civic ceremony can be rejected in the case of tax protesters or undermined in the case of tax cheaters. In both cases, a return-based personal income tax serves as a vehicle for not paying taxes (in whole or in part), and this ability to choose not to comply tends to be seen as a weakness as compared with sales taxes or return-free income taxes. He suggests, however, that even in these cases there is an important societal dimension that can be framed as a positive feature. In the case of tax protesters, the return-based personal income tax may serve an important safety-valve function. In the case of small-scale cheating, it may perform the same safety-valve function by allowing a taxpayer to feel empowered to resist an overreaching government without resorting to the extreme position of refusing to file and pay any tax. Zelenak also suggests that a vulnerability to small-scale cheating can be framed as a positive feature in that it signals that the taxpayer is trusted by government, and this may foster a reciprocal sense of trust in government.

A separate chapter (chapter five) recounts the extension of the personal income tax in the United States from a tax on high-income individuals to its current mass tax status as a means to finance US expenditures during the Second World War, and subsequently the growth of the welfare state. Zelenak details how the Roosevelt administration strenuously opposed adoption of a retail sales tax as a mass tax to finance the war. It was this opposition that led to a political compromise and conversion of the personal income tax to a mass tax. But even then, a preferred alternative was a personal income tax without return filing and the use of final withholding at source. Zelenak argues that the return-based income tax is, in fact, an accident of history. More particularly, Congress failed to understand the difference between a return-free tax with final withholding and a system whereby the IRS calculates tax liabilities on the basis of information provided by taxpayers. Mistakenly thinking that it was enacting the former, Congress enacted the latter. And although there remains a taxpayer option to have the IRS calculate tax liability, it has been allowed to erode away with its eligibility limitation of gross income of $10,000 or less.

Despite dissatisfaction with the current return-based system with inexact withholding, Zelenak suggests that the system is maintained as an enduring political compromise between proponents of large government, who prefer low-visibility taxes, and proponents of small government, who prefer highly visible taxes. He advances this suggested political compromise as an entirely descriptive claim regarding the maintenance of a return-based personal income tax. As a normative or prescriptive matter, he prefers such a system for its ability to foster fiscal citizenship. He does not, however, favour maintenance of the status quo unaltered. Indeed, in the title to the book, Zelenak awards the return-based personal income tax only two cheers, rather than the traditional three, because he believes that its significance as a ceremony in the exercise of fiscal citizenship could be realized much more effectively. He thus supports the policy goal of substantive rule simplification advocated by proponents of a return-free personal income tax with final withholding at source.

Yet simplification for Zelenak is desirable to address frustration with the complexity now associated with the filing of personal income tax returns. This complexity has driven an explosive growth in the use of tax-return preparers, which Zelenak sees as undermining the return-filing process as a ritual of fiscal citizenship.

In chapter four, Zelenak describes the addiction of the US Congress to personal tax expenditures, which is primarily responsible for the increased complexity of the personal income tax. Not surprisingly, he joins the chorus of those who advocate elimination of many of these spending programs, albeit with different goals in mind. Interestingly, however, Zelenak would retain two relatively large tax expenditure programs—the deduction for charitable contributions and the earned income tax credit (EITC)—as important expressions of fiscal citizenship. He would maintain the deduction for charitable contributions because it enables taxpayers to choose to satisfy their financial obligations to society either by paying a specified amount of tax or by contributing a larger amount to charity. He would maintain the EITC as an anti-poverty program that promotes a sense of economic citizenship by ensuring that all citizens engaged in full-time employment are able to support their families at a minimal level of decency.

The last chapter (chapter seven) makes the case for substantive rule simplification to allow the return-based mass income tax to realize its full potential as a rite of fiscal citizenship. Zelenak therefore rejects simplification as a means to allow a return-free personal income tax with final withholding at source. Nonetheless, he accepts a system of "prefilling" of personal income tax returns that would be based on information on file with the IRS. Such a system was introduced in California in an attempt to realize compliance cost savings.[21] Because taxpayers would be given the opportunity to review and amend their prefilled returns, Zelenak suggests that many of the fiscal citizenship benefits of the current system could be maintained while reducing compliance costs.

Readers may find the separate chapter (chapter six) on the income tax in popular US culture intriguing and amusing. In this chapter, Zelenak examines the treatment of the personal income tax in nearly 100 radio and television sitcoms from the 1940s to the present, as well as in more than 200 cartoons appearing in the *New Yorker* magazine from the 1920s to the present. As expressions of popular culture, these sources are examined in an attempt to get some sense of popular attitudes to the personal income tax. Zelenak finds that, in older sitcoms from the 1940s to the 1960s, the theme of the return-filing process featured prominently and positively as an important instrument of fiscal citizenship. Perhaps not surprisingly, given increased dissatisfaction with the US income tax system, attitudes toward return-based taxation are considerably less positive in more recent sitcoms. This same general trend

21 Prefilled returns have been adopted or used in trials in several jurisdictions, including Quebec. See François Vaillancourt, ed., *Prefilled Personal Income Tax Returns: A Comparative Analysis of Australia, Belgium, California, Québec, and Spain* (Vancouver: Fraser Institute, June 2011), reviewed in this feature (2011) 59:1 *Canadian Tax Journal* 167-82, at 172.

does not appear in the *New Yorker* cartoons. In fact, Zelenak cannot detect any clear deterioration in attitudes to the return-based personal income tax, which he attributes to the different demographic of the audience for the magazine. In contrast with sitcoms, which tend to have a very broad audience, the readership of the *New Yorker* has always been predominantly upper-middle class. For interested readers, Zelenak has previously published some of the results of this creative vein of research in an article in *Tax Notes*.[22]

T.E.

Richard Brooks, *The Great Tax Robbery: How Britain Became a Tax Haven for Fat Cats and Big Business* (London: Oneworld, 2013), 297 pages, ISBN 978-1-85168-935-4

This provocatively titled book provides an entertaining account of the current state and history of tax avoidance in the United Kingdom. It is a story that has many parallels in other countries, including Canada. Corporate tax avoidance, in particular, has been the focus of public anger in the wake of the 2008-9 financial crisis. In the United Kingdom, however, this anger was amplified at the political level with a set of hearings before the House of Commons Committee of Public Accounts in the wake of revelations concerning the settlement of tax disputes by Her Majesty's Revenue & Customs (HMRC) with Vodafone and Goldman Sachs.[23] The author, who is a former UK tax inspector turned journalist, uses these hearings as an entrée into his account of the rich history of tax avoidance in the United Kingdom, providing much-needed context for an understanding of what has become a somewhat notorious current state of affairs. Because of his background, Brooks is able to tell his story in a way that is technically knowledgeable while remaining entertaining and accessible for readers who are not tax practitioners, policy makers, administrators, or academics. There is also a tone of moral indignation and outrage at the excesses of what the author refers to as "the tax avoidance industry." Suffice it to say that tax practitioners, as well as the UK political leadership and the tax administration leadership of HMRC, do not appear in a favourable light.

After an introductory chapter that broadly sketches the present state of the UK tax system, Brooks provides a brief early history of tax avoidance in the United Kingdom up to the 1970s and early 1980s, which were marked by growth in tax-avoidance structures marketed to individuals and which culminated in the so-called Rossminster affair. The next chapter describes the growth through the 1990s and

22 Lawrence Zelenak, "Six Decades of the Federal Income Tax in Sitcoms" (2007) 117:13 *Tax Notes* 1265-88.

23 See United Kingdom, House of Commons, Committee of Public Accounts, *HM Revenue & Customs 2010-11 Accounts: Tax Disputes*, Sixty-First Report of Session 2010-11. See also United Kingdom, House of Commons, Committee of Public Accounts, *Tax Avoidance: The Role of Large Accountancy Firms*, Forty-Fourth Report of Session 2012-13, reviewed in this feature (2013) 61:3 *Canadian Tax Journal* 857-74, at 873-74.

early 2000s of the UK corporate tax shelter industry. As in the corporate tax shelter industry in the United States, these avoidance transactions share the common characteristic of a lack of economic substance in the sense that they were implemented entirely to create or trade a tax attribute. Two chapters are then devoted to offshore planning by UK-based multinationals focused on UK tax benefits. A principal focus is the structure used by Vodafone for its acquisition of the former German conglomerate, Mannesmann AG. The structure is a familiar one to tax practitioners, whereby operating income is stripped out of a source-country subsidiary and channelled through a tax-advantaged holding company. In the Vodafone case, the structure arguably ran afoul of the UK controlled foreign corporation rules, but was settled on very generous terms by the leadership of HMRC. A later chapter details tax-planning structures of UK-based multinationals focused on source-country tax benefits, with an emphasis on the deleterious effects for developing countries in particular. Tax planning for high-wealth individuals is similarly reviewed in a separate chapter, along with another chapter on offshore tax evasion. An especially interesting chapter discusses the close relationship that developed between the leadership of the UK tax administration and large corporate taxpayers and their advisers in the name of the maintenance of "client relationships." One hopes that this situation is unique to the United Kingdom—in which case it will serve as a compelling cautionary tale for other tax administrations that have embraced a culture of taxpayer-friendly service.

The final chapter describes a set of initiatives that, in Brooks's view, could together tame the tax-avoidance industry. The initiatives are in fact familiar fare, and not especially radical. Along with a call for a return to a much more adversarial relationship between large corporate taxpayers and the tax administration, Brooks suggests the adoption of (1) more effective exchange of information between national tax administrations, (2) a personal and corporate minimum tax, and (3) harsh penalties for unsuccessful tax avoidance. He also advocates publication of taxes paid and accounting income of multinationals, broken down geographically. A unique recommendation is a requirement that the European Union act to exclude tax-avoidance corporate structures from the application of the "fundamental freedoms" guaranteed by EU law. This recommendation would be supported by the application of sanctions to member states that facilitate tax avoidance. Brooks fails, however, to recommend the retroactive application of anti-avoidance legislation to targeted structures. In combination with the robust information-reporting requirements that the United Kingdom has adopted for aggressive tax avoidance, this practice could go a long way toward addressing the policy problems presented by such avoidance.[24] The omission is strange, given that Brooks favourably notes the few occasions on

24 For a discussion of the policy case supporting the retroactive application of specific anti-avoidance rules, see Benjamin Alarie, "Retroactivity and the General Anti-Avoidance Rule," in David G. Duff and Harry Erlichman, eds., *Tax Avoidance in Canada After Canada Trustco and Mathew* (Toronto: Irwin Law, 2007), 197-219.

which this approach has been used in the past by policy makers in the United Kingdom. Brooks only briefly mentions, albeit critically, the recent adoption of a general anti-avoidance rule in the United Kingdom, and this cursory treatment is similarly odd, given that he is critical in earlier chapters of past failures to enact such a provision. But these omissions are certainly not fatal to what is in no way an attempt to provide a rigorous policy analysis of tax avoidance and the range of policy options that could be adopted in an effort to constrain it.

T.E.