

THE GST AND FINANCIAL SERVICES: PAUSING FOR PERSPECTIVE

Michael Firth[†]

(PricewaterhouseCoopers LLP, Canada)

Kenneth McKenzie

(The School of Public Policy and Department of Economics,
University of Calgary)

SUMMARY

The treatment of financial services has long been viewed as one of the more technical, and difficult, areas in value added taxation. Financial intermediaries add value by reducing transaction costs for clients. While in principle this value added should be taxed under a comprehensive VAT, this has proven to be difficult to do in practice because of measurement issues. The predominant approach adopted in most countries – albeit with several variations on the theme – has thus been to exempt most financial services from VAT. This was the approach adopted in Canada at the initiation of the GST just over twenty years ago. While this approach is far from perfect, and introduces several distortions into the economy, it has by and large been concluded that it is the most practical approach to dealing with financial services under a VAT. Two decades of legal wrangling and Ottawa's habit of retroactively legislating changes to the GST as it relates to financial services have served to muddy the waters in Canada. Recent changes have significantly altered the scope for exemption and resulted in an uneven playing field across financial services. This paper argues that the best solution for Canada is to stick with the exemption approach, but to go back to basics with an eye for reducing existing distortions and restoring a semblance of neutrality. Specifically, the paper calls for a reset of the “arranging for” exemption for financial services; the creation of a new GST-recovery system for financial services; a new structure for taxing imported supplies; and a limit to retroactive legislative amendments and minimum requirements for future amendments. The authors also argue that consideration should be given to zero-rating “business to business” financial transactions so as to remove the GST embedded in transactions between financial institutions and businesses.

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I. INTRODUCTION

January 1, 2011 marked the 20th anniversary of the introduction of the GST in Canada. Five provinces are now fully harmonized into the federal taxing statute (New Brunswick, Newfoundland & Labrador, Nova Scotia, Ontario and British Columbia), one of those (British Columbia) having recently resolved through a plebiscite to reverse that move, and one province (Quebec) has been promised \$2.2 billion in subsidy payments by the federal government for harmonizing, notwithstanding it will continue to operate a provincial near-clone of the tax in a provincial statute. While some progress has been made, only when the GST is fully harmonized with a uniform rate and base will Canada reap the full rewards of introducing the tax.

To be so far from achieving that goal after 20 years is a sad story of missed opportunity, and a future of continuing and unnecessary administrative and compliance costs. Moreover, after 20 years, despite numerous tweaks, the GST/HST is beginning to show its age. In particular, while the GST was most certainly not a perfect VAT at its inception, there is reason to believe that it has drifted even farther from some notion of an ideal VAT in the intervening 20-year period.¹ This, we think, is particularly true in the treatment of financial services.

The purpose of this paper is to provide an analysis of the GST as it relates to financial services in Canada. The treatment of financial services is perhaps one of the more complicated and controversial areas in the analysis of VAT. To lay the groundwork for the discussion we begin with a discussion of first principles, primarily from the theoretical economics literature, on the subject of VAT applied to financial services. The underlying question that motivates this discussion is: if we *could* apply the GST to financial services, *should* we? We begin with a general discussion of first principles as they apply to the taxation of all goods and services, and then refine the discussion to the financial sector.

We then turn to a brief discussion of the nature of financial services and the underlying difficulties that are associated with taxing them. We rotate the question posed in the previous paragraph, asking: if we *should* apply the GST to financial services, *could* we?

This is followed by a description and analysis of the current system in Canada as it applies to the financial sector. The treatment of financial services under the GST is characterized by the exemption of many activities from the tax. The numerous legislative changes that have occurred over the last 20 years, in particular over 2009 and 2010, involved significant changes in the scope for exemption.

We then address the broad question of whether or not the financial sector is advantaged by the current exemption-based system. We argue that the answer to this question is not straightforward, and depends upon a number of key factors.

This is followed by a summary of where we stand on a number of the issues, and by our list of recommendations. Our emphasis is on suggesting practical options for improving the working of the exemption-based approach to taxing financial transactions, as it currently exists in Canada. The approach is grounded by a familiarity with the current state of affairs, and concerns about the ability to implement options that deviate significantly from the basic exemption approach. We end with a short concluding section.

¹ For more on this, see Smart, M. (2012), "Departures from Neutrality in Canada's Goods and Services Tax," *SPP Research Papers*, Volume 5, Issue 5, February. The School of Public Policy, University of Calgary.

In terms of what we do not cover, this paper is not intended to be a cookbook of the VAT as it applies to financial services. In particular, it does not include an extensive discussion of the approaches to taxing financial services taken in other countries around the world, or of various (largely theoretical) alternative approaches to taxing financial institutions under a VAT. While we do discuss these matters where appropriate, we do not deal with them in a systematic way. These issues have been well discussed and documented elsewhere.²

II. IF WE *COULD* APPLY THE GST TO FINANCIAL SERVICES, *SHOULD WE?*

General Discussion

We begin with a general discussion of the VAT from a theoretical perspective. While we take a very pragmatic approach in the rest of the paper — understanding that tax policy falls under the heading of the art of the possible — we think that these theoretical considerations are important not only to fix ideas, but to establish a prism through which we can filter the ensuing discussion. Following the general discussion, we refine the dialogue to consider the implications for financial services in particular. For the most part practical issues associated with applying VAT to financial intermediation will be ignored in this section (but will be addressed in more detail below).

To address the question posed in the title to this section we begin with a discussion of first principles underlying the VAT. Virtually by definition, a fundamental first principle underlying a comprehensive VAT is that the final consumption of all goods and services should be taxed at a uniform rate. The key words here are “final,” “all” and “uniform.” This principle is fairly straightforward and is in fact the defining feature of a pure VAT.³

However, the notion that a consumption tax should be levied on all goods and services at a uniform rate is in fact antithetical to much of optimal tax theory in economics. There are two seminal results, or first principles, in optimal tax theory that guide the thinking of economists in this regard. The first concerns which goods should be taxed, and the second concerns the optimal configuration of tax rates on the goods that are taxed.

With regard to the former — which goods should be taxed — one of the most important guiding principles in the theory of tax policy is that, in general, taxes should only be levied on final consumption (purchases by final consumers), and not on intermediate transactions or inputs (purchases by businesses). This insight is formally contained in the seminal production efficiency theorem developed by Diamond and Mirrlees.⁴ The production efficiency theorem states that if there are no restrictions on the tax instruments that can be deployed by the government,

² See European Commission (1997). *Value-Added Tax: A Study of Methods of Taxing Financial and Insurance Services* (Brussels: European Commission).

³ See, for example, Poddar, S. (2003), “Consumption Taxes: The Role of the Value-Added Tax,” in Patrick Honohan (Ed.), *Taxation of Financial Intermediation: Theory and Practice for Emerging Economies*, Washington, DC: The World Bank.

⁴ Diamond, Peter and James Mirrlees (1971), “Optimal Taxation and Public Production I: Production Efficiency,” *The American Economic Review* 61(1), 8-27.

including the use of taxes on pure economic profits, distortionary taxes should not be imposed on intermediate transactions. This theorem follows from the simple fact that any distortionary tax levied on intermediate inputs will lower aggregate output by introducing production inefficiencies (distortions in the use of intermediate inputs); eliminating these inefficiencies, and using other tax instruments to capture a share of the resulting increase in aggregate output, in order to generate the required tax revenue, is desirable. It turns out that this idea is perfectly consistent with the idea behind a comprehensive VAT mentioned above, which in principle does not tax intermediate inputs, but only final consumption goods. We will have reason to refer to the production efficiency theorem several times in the ensuing discussion.

The second issue — the optimal configuration of the rates imposed on final consumption goods that are subject to tax — falls under the purview of the so-called *Ramsey Rules* of optimal commodity taxation. In their simplest form these rules abstract from distributional considerations, focusing on efficiency, and describe the characteristics of a commodity tax system that minimizes the cost of economic distortions associated with raising a given amount of revenue. These distortions arise because of changes in relative prices associated with taxes.

There are two popular interpretations of the *Ramsey Rules*.⁵ One falls under the heading of the *Inverse Elasticity Rule*, which says that under certain conditions higher tax rates should be levied on goods with lower demand elasticities.⁶ Low elasticity means that the demand for a good is not very responsive, or sensitive, to changes in its price. So, the *Inverse Elasticity Rule* says that in order to minimize the costs associated with distortions caused by the commodity tax system, we should levy higher tax rates on goods whose demands are not very responsive to price changes.

The second interpretation, due to Corlett and Hague,⁷ and not surprisingly referred to as the *Corlett-Hague Rule*, is more general and says that to minimize the costs of distortions caused by the tax system, goods that are more complementary with the consumption of leisure (which is generally viewed as being non-taxable) should be taxed at higher rates. The phrase “complementary with the consumption of leisure” perhaps requires some interpretation. First, what do we mean by leisure? Leisure is simply time not devoted to paid work. Economists treat leisure as a good just like any other good, the price of which is the forgone wages that could have been earned by working. So when economists refer to consuming leisure, they mean spending time doing anything other than earning a wage. Leisure is a non-taxable good simply because it cannot be properly measured due to the absence of a market based transaction; we cannot measure it so we cannot tax it. What about complementary? Loosely speaking, a good is complementary with leisure if it tends to be consumed jointly with leisure.⁸

⁵ For a more in-depth discussion of the Ramsey Rules at the undergraduate level see Rosen, H., B. G. Dahlby, R. Smith, J.F. Wen and T. Snodden (2008), *Public Finance in Canada*, 3rd edition. McGraw-Hill. For a more technical treatment see Auerbach, A. and J. Hines Jr (2002), “Taxation and Economic Efficiency,” Chapter 21 in *Handbook of Public Economics*, Volume 3, A. Auerbach and M. Feldstein eds., Elsevier Science.

⁶ The inverse elasticity rule arises under the extreme simplifying assumption that the cross-price elasticity between all taxable goods is zero.

⁷ Corlett, W.J. and D.C. Hague (1953), “Complementarity and the Excess Burden of Taxation,” *Review of Economic Studies* (21), 21-30.

⁸ More formally, a good is complementary with leisure if the compensated demand for leisure declines as the price of the good increases.

Thus, and again speaking loosely, the *Corlett-Hague Rule* says that because leisure cannot be taxed directly, we can tax it indirectly by imposing higher taxes on goods that are consumed jointly with leisure. This will reduce the incentives for individuals to substitute away from taxed goods towards the non-taxed consumption of leisure, and reduce the distortions caused by the commodity tax system.

The important lesson of both the *Inverse Elasticity Rule* and the *Corlett-Hague Rule* is that, in general, since goods differ in their degree of complementarity with leisure and in their demand elasticities, optimal commodity tax considerations emphatically do not proscribe uniform tax rates on all goods and services.

Finally, it should be noted that the introduction of distributional considerations into the mix can argue for even more deviation from uniformity, as goods consumed disproportionately by individuals with high marginal social valuations should be taxed at a lower rate.⁹

These two sets of first principles — the idea of a comprehensive and uniform GST on all final consumption goods, and the non-uniform taxation associated with optimal commodity tax theory — would appear to be in direct contradiction to each other. How can we square the circle? There are several ways to approach this.

First, one can think of a uniform and comprehensive GST as equivalent to a proportional tax on labour income. In this case, one can imagine a uniform GST combined with a set of individualized commodity taxes (or subsidies) to accommodate optimal commodity tax considerations. The GST may then be viewed at the average rate imposed on commodities, and in this sense should be levied on a comprehensive rate at a uniform rate. While this view is widely held,¹⁰ it really just avoids the uniformity question by defining it away. We are, and should be, concerned with the properties of the overall commodity tax regime.

Second, implementing a commodity tax regime according to the principles of the *Ramsey Rules* would be administratively costly and difficult to implement in practice. The informational requirements and the administrative and compliance effort required to implement an optimal commodity tax regime along these lines are extremely high. While this may be viewed as more of a practical than a theoretical consideration, and as such should be relegated to the discussion of practical issues to be addressed below, it bears mentioning here because research that explicitly incorporates administrative costs into a theoretical optimal commodity tax framework shows that these costs tend to push the optimal commodity system towards uniformity, at least across broad classes of goods.¹¹

⁹ Diamond ((1975), “A Many-person Ramsey Tax Rule,” *Journal of Public Economics*, 335-43) first added equity objectives to the Ramsey analysis. Individuals, or groups of individuals, can have a high marginal social valuation for two reasons. The first is because the underlying “social welfare function” governing the choices of government places a higher weight on some individuals. The second is that the assumptions that economists typically make regarding individual preferences suggests that their own individual marginal valuation of income declines as their income increases. Thus, the contribution that an extra dollar of income makes to the well-being of a low-income individual is higher than that of a higher-income individual. These two factors point to a higher marginal valuation placed on income received by lower-income individuals, and in favour of levying lower tax rates on goods consumed by those individuals.

¹⁰ See Poddar (2003) op. cit.

¹¹ See Kopczuk, W. and J. Slemrod (2006), “Putting Firms into Optimal Tax Theory,” *American Economic Review (Papers and Proceedings)* 96(2): 130-34.

Third, it turns out that in the special case where consumer preferences take a particular form, and the government has other instruments to achieve distributional objectives (such as a non-linear income tax), the optimal commodity tax system in the Ramsey sense does in fact call for a comprehensive tax at uniform rates.¹² While this result neatly squares the circle with respect to our two sets of principles — it calls for a comprehensive and uniform GST on final consumption even accounting for optimal tax considerations — it rests on a restrictive set of assumptions regarding individual preferences that we know are not likely to be true in practice.¹³

So where does this leave us? As the above discussion suggests, it is not a straightforward matter to write down a set of robust first principles that may be used to address the question of what should and should not in principle be taxed under a GST, and at what rates. Depending upon how the question is posed and what assumptions are made, in principle the GST should be levied on a comprehensive base at uniform rates, or at differentiated rates according to their demand elasticities and/or the complementarity of the goods with leisure, and possibly differentiated according to the consumption patterns of different groups in society.

What Does this Mean for Financial Services?

Turning the question explicitly to financial services, when addressing the question of whether financial services should (if they could) be taxed, it is important to distinguish between the purchase of financial services by businesses and consumers. For purchases by businesses — so called business-to-business (B2B) transactions — the literature provides an answer that is relatively clear: purchases of financial services by businesses should not be subject to GST. For purchases by consumers — business-to-consumer (B2C) transactions — the answer is somewhat less clear.

¹² A. Akinson and J. Stiglitz ((1976) “The Design of Tax Structure: Direct versus Indirect Taxation,” *Journal of Public Economics* 6, 55-75) show that if the income tax is optimally designed to achieve distributional objectives, and preferences are weakly separable between consumption goods and leisure, the optimal commodity tax rate is uniform across all goods. As discussed above, this can alternatively be viewed as eliminating the VAT altogether, and augmenting the non-linear income tax with a linear proportional tax on (non-capital) income. Louis Kaplow ((2006) “On the Undesirability of Commodity Taxation Even When Income Taxation is Not Optimal,” *Journal of Public Economics* 90, 1235-1250) extends this result to show that it holds even when the non-linear income tax is not optimally designed. In particular, he shows that moving to a uniform consumption tax is optimal under any income tax system, so long as the income tax is adjusted so as to maintain “distributional neutrality.” This result also rests upon the assumption of the weak separability of preferences. Finally, Angus Deaton ((1981) “Optimal Taxes and the Structure of Preferences,” *Econometrica* 49, 1245-1260) abstracting from distributional considerations, employs yet another separability concept. He shows that uniform commodity taxes will be efficient if preferences between goods and leisure are *quasi-separable*.

¹³ Martin Browning and Costas Meghir ((1991) “The Effects of Male and Female Labour Supply on Commodity Demands,” *Econometrica* 59(4), 925-951) test for the separability of commodity demands from labour and reject weak separability.

PURCHASES BY BUSINESSES

The production efficiency theorem is quite explicit in its implications for the treatment of B2B financial services — they should not be taxed. The non-taxation of intermediate financial transactions with businesses can be achieved in two fundamental ways. If GST is levied on the purchase of a financial service, regardless of whether or not the underlying price is explicit or implicit by way of the margin (and ignoring measurement issues with regard to the latter for now; this issue will be discussed below), the business should get a full input credit for the GST paid on the service, and the financial institution providing the service should get full credit for the GST paid on the inputs purchased to produce the service. If no GST is levied on the transaction, then the GST levied on the inputs used by the financial intermediary to provide the service to businesses should still be fully credited on the part of the financial intermediary — this is, of course, zero-rating.

It is important to note that the exemption of financial services from the GST, which, as will be discussed below, is the case for many financial services in Canada, does not generally achieve this result. In this case, while no GST is levied on the transaction, the financial intermediary receives no credit for the GST on inputs used to produce the financial service. The GST paid on these inputs will therefore be embedded in either the fee charged for the financial service or in the margin. The presence of this embedded GST amounts to taxation by exemption on the business use of financial services, and violates the production efficiency theorem.

As discussed by Dasgupta and Stiglitz,^{14, 15} a potential caveat to this result is that the production efficiency theorem is conditional on the unrestricted ability of the government to levy other taxes, and in particular taxes on pure profits.¹⁶ If access to these other tax instruments is limited for some reason, the theorem technically does not hold. In this case, a type of second-best theorem applies, under which the presence of pre-existing distortions (in this case a restriction on tax instruments) *may* justify taxes on intermediate transactions by businesses.

It is important to emphasize the “may.” Whether or not taxing intermediate business inputs is ultimately desirable depends upon the nature of the limits placed on the tax instruments available to government, and on the size of the distortions caused by the suite of instruments that are employed. The size of the distortions depends critically on the responsiveness (the elasticity) of various activities to price changes. It is widely believed that business activities, in particular those in relation to financial matters, are quite responsive to price changes, as businesses are quite adept at restructuring their financial activities to avoid taxes. This suggests that taxes imposed on the business use of financial intermediate inputs are likely to give rise to significant distortions and generate high efficiency costs and should, as a result, be avoided.

¹⁴ Dasgupta, Partha and Joseph Stiglitz, 1971. “Differential Taxation, Public Goods and Economic Efficiency”, *Review of Economic Studies*, Vol. 38(114), pages 151-74, April.

¹⁵ Dasgupta, Partha and Joseph Stiglitz, Joseph E, 1972. “On Optimal Taxation and Public Production”, *Review of Economic Studies*, Vol. 39(1), pages 87-103, January.

¹⁶ The fact that significant pure profits are thought to arise in the financial sector (and also the resource sector), speaks to the importance of imposing some sort of tax on those profits. Depending upon how it is designed, the corporate income tax could play this role.

This means that the non-taxation of business purchases of financial intermediation as suggested by the production efficiency theorem is a relatively robust guide to tax policy. Thus, in our view, the treatment of B2B financial services is straightforward, at least in principle — they should not be taxed. If GST is applied, both businesses and financial institutions should get full credit for GST paid; if it is not, the provider of the financial service should get full credit for the supporting inputs so as to eliminate taxation by exemption.

PURCHASES BY CONSUMERS

Matters are not as straightforward when it comes to the treatment of B2C financial transactions. Indeed, economists studying this issue have, at various times and using different approaches, arrived at four quite different conclusions:

1. No taxation.
2. Full taxation of fee-based services, no taxation of margin-based services.
3. Full taxation of both fee- and margin-based services.
4. Taxation of both fee- and margin-based services but at lower rates.

The no-taxation result is most commonly associated with Grubert and Mackie.¹⁷ Their argument is simple — financial services are not purchased for their consumption value per se, but rather are intermediate transactions undertaken to facilitate consumption. This can be viewed as loosely following the logic of the production efficiency theorem, in the sense that financial services sold to consumers are of the nature of intermediate transactions made to facilitate final consumption and should not be taxed. Following this reasoning, Grubert and Mackie argue that financial services purchased by consumers should not be taxed under a GST.

Chia and Whalley are also sometimes associated with this view. They argue that,

No utility per se flows from the use of intermediation services. Since financial services do not enter preferences directly, it may be inappropriate to include them in a broadly based indirect tax such as a VAT.¹⁸

However, it is important to note that Chia and Whalley do not go as far as Grubert and Mackie, in that they merely show that a GST that does not tax financial services results in lower distortionary costs than a system under which they were fully taxed. They allow for the possibility that it may be optimal to include financial services in the GST but at a lower rate. This issue will be revisited below.

While superficially appealing, it now seems widely understood that the view that financial services should not be taxed simply because they have no direct consumption value is a red herring, and is a misapplication of the insights of the production efficiency theorem —

¹⁷ Grubert, Harry and James Mackie (2000), “Must Financial Services Be Taxed Under a Consumption Tax?,” *National Tax Journal*, 53(1), 23-40.

¹⁸ Chia, Ngee-Choon and John Whalley (1999), “The Tax Treatment of Financial Intermediation,” *Journal of Money, Credit, and Banking* 31(4), 704-719. P. 705.

Boadway and Keen refer to it as a “fallacy.”¹⁹ They argue that many goods that no one would question should be taxed under a GST have a similar characteristic, in that they are a means to an end rather than ends in themselves, and are therefore of the nature of intermediate transactions. Indeed, virtually every good may be thought of in those terms, in the sense that they are inputs into some notion of well-being. More important, Boadway and Keen point out, is how financial services enter into the pattern of net trades as reflected in the budget constraint. This real-world view of the GST is a useful guide to what should and should not be subject to GST.

The view that all financial-based services should in principle be subject to GST like any other good or service (reminder — this ignores practical issues), seems now to be relatively widely accepted, and has given rise to a number of studies that seek to describe ways in which this might be done (one such approach is discussed in section III). However, it has been questioned. Boadway and Keen refer to it as a “half truth,”²⁰ and argue using principles from optimal commodity taxation similar to those discussed above that, while financial services should in principle be subject to taxation, it is not clear that they should be taxed at the same rate as other commodities. Other studies that explicitly model financial and other similar services also argue for a lower rate.²¹

III. IF WE *SHOULD* APPLY THE GST TO FINANCIAL SERVICES, *COULD WE?*

In this section we rotate the question posed in the previous section and ask: if we should apply GST to financial services, *could we?*

The fundamental issue concerns the nature of the value added associated with financial flows and our ability to measure it. In the absence of transaction costs and informational market imperfections, financial securities act as pure claims on future, perhaps risky, cash flows and as such create no value added per se. This suggests that financial flows should not be taxable in and of themselves — they are mere financial transfers. But of course it is the very presence of these transaction costs and imperfections that generate the need for financial intermediaries. In a

¹⁹ Boadway, Robin and Michael Keen (2003). “Theoretical Perspectives on the Taxation of Capital Income and Financial Services,” in Patrick Honohan (Ed.), *Taxation of Financial Intermediation: Theory and Practice for Emerging Economies*, Washington, DC: The World Bank. See also Auerbach, Alan J. and Roger H. Gordon (2002), “Taxation of Financial Services Under a VAT,” *American Economic Review*, 92(2), 411-416; Zee, Howell H (2006), “VAT Treatment of Financial Services: A Primer on Conceptual Issues and Country Practices,” *Intertax* 34(10): 458-74; and Gendron, Pierre-Pascal (2008), “VAT Treatment of Financial Services: Assessment and Policy Proposal for Developing Countries,” *Bulletin for International Taxation*, 62(11): 494-507.

²⁰ Boadway and Keen (2003) op. cit.

²¹ See, for example, Lockwood, Ben. (2010), “How Should Financial Intermediation Services be Taxed?,” *Warwick Economic Research Papers* No. 948.) The analysis of H. J. Klevin, W. Richter and P.B. Sorenson ((2000) “Optimal Taxation with Household Production,” *Oxford Economic Papers* 52, 584-594) and John Piggott and John Whalley ((2001) “VAT Base-Broadening, Self-Supply and the Informal Sector,” *The American Economic Review* 91(4), 1084-1094) suggests that services that can either be purchased on the market or in which the individual can “do it yourself” should be taxed at a lower rate. Many financial services fall in this do-it-yourself category — individuals can do their own market research and use discount brokerage services or pay a full-service financial advisor; they can invest in mutual funds or diversify their own portfolios; they can invest in corporate debt directly, doing their own due diligence, or place their savings in banks, who in turn lend to businesses. To the extent that some financial services have this do-it-yourself characteristic, the logic set forth by Klevin, Richeter and Sorenson and Piggott and Whalley suggests that they should be taxed at lower rates.

fundamental sense, the role of financial intermediaries is to reduce the costs of transacting in both financial and non-financial markets. It is this sense in which financial intermediaries add value.

For example, in the case of a bank, both loans and deposits constitute a pure transfer of funds and should not be subject to tax. Pure (risk-free) interest payments are compensation for deferred consumption and should not be taxed. Similarly, risk premiums charged on loans are compensation for the risk of default and should not be taxed. On the other hand, compensation to a bank for the costs associated with managing loans and deposits, including the return to shareholders (profits), constitute value added and should be taxed.²²

More specifically, financial institutions create value added in several ways. For example, in the first instance, banks pool the savings of savers to make loans to borrowers. This provides cost savings due to indivisibilities in financial markets (many small savers, fewer larger borrowers), by reducing the number of individual contracts required between lenders and borrowers. Banks also lower the costs that may be incurred by lenders in obtaining information about prospective borrowers and in monitoring and enforcing loan contracts, etc. A related service involves the pooling of risks. By pooling savings, banks also pool risks, providing inexpensive diversification for savers. Insurance companies provide a cost-effective way of pooling the risk of losses, and mutual funds provide a cost-effective way of diversifying investment portfolios. Stockbrokers provide expert advice, research and analysis in a cost-effective manner. Moreover, financial intermediaries can facilitate transactions in the real economy with cheque-clearing services and credit card services. There are a myriad of other activities performed by financial intermediaries, but the point is that these activities add value by reducing the costs of transacting on the part of individuals and companies. It is this value added that, conceptually at least, should be subject to taxation.

Measuring this value added is not straightforward. The reason lies primarily in the fact that in many cases financial institutions do not charge explicit fees for their services, but rather earn compensation in the form of a margin or spread. For example, banks do not charge explicit fees for the cost savings realized by pooling savings and risks, and managing loans and deposits, but rather earn a spread by paying a lower rate of interest on savings than they earn on loans. Yet not all of the spread may be due to value-added services. Some of it, for example, will be due to a risk premium reflecting the default risk of loans. Distinguishing the risk premium from the value-added service is not straightforward. While some financial services are fee-based — safety deposit box rentals, broker commissions, trustee services, etc. — many are margin-based. It is the inability to measure the value added embedded in the margin on a transaction-by-transaction basis that is the essence of the problem in applying a credit and invoice VAT to financial services. As a result, much of the value added generated by financial institutions cannot be measured directly, but rather must be inferred indirectly.

While it is possible to charge VAT on fee-based services while exempting margin-based services, and this is indeed done under Canada's GST, this gives rise to incentives to convert fees and commissions to margins. For example, a broker can charge an explicit commission for facilitating a security transaction, or he can buy the security from the seller at a discount and sell it to a buyer at a premium and earn an implicit commission equal to the spread between the two. Applying the GST to fee-based services but not to margin-based services not only creates an incentive to substitute margins for fees, but can result in an uneven playing field between similar financial activities. We return to this below.

²² See Poddar, Satya and Morely English (1997), "Taxation of Financial Services under a Value-Added Tax: Applying the Cash-Flow Approach," (1997) *National Tax Journal* Vol. 50, No.1, 89-111.

To see the nature of the problem, consider the following simple example. A \$100 deposit is made by a consumer; the interest rate on the deposit is seven percent. The \$100 deposit is in turn loaned by the bank (at this point to either another consumer or a business) at an interest rate of 15 percent. The difference between the loan interest rate and the deposit interest rate, eight percent, is the margin or spread. The income from the spread, in this case \$8, is used by the bank to pay its employees, to cover the cost of materials and supplies, equipment and buildings, and to generate a profit to compensate its shareholders for the provision of capital. It is this \$8 that constitutes value added of financial intermediation and *if* that value added should be taxed (and as discussed in the previous question, there is some debate on this issue), it should form the basis of the tax.

While in this simple example it is easy to identify this value added, in practice it is more difficult. As we move away from this simple world, things become considerably more complicated. For example, financial flows within an institution typically co-mingle and there is a good deal of what may be thought of as cross-subsidization across activities — it is virtually impossible to identify the sources and uses of the funds underlying a specific transaction.

An obvious solution would be to abandon any attempt to levy the tax on a transaction-by-transaction basis and move to an aggregate approach.²³ And in this simple example, if *all* of the bank's depositors and *all* of its borrowers were consumers, this would be relatively straightforward, as the entire eight percent spread constitutes value added accruing to consumers, be they lenders or borrowers. However, if, for example, the lender is a consumer and the borrower is a firm (or any number of other combinations, including lenders/borrowers who are non-resident), a portion of the spread is value added accruing to the consumer lender and a portion is value added accruing to the business borrower. As discussed in the previous section, the principle of production efficiency requires that the latter be free of tax, and in the normal operation of a VAT applied to non-financial goods and services it is. Even if (and this is a big *if*) the gross margin and the associated value added could be identified, how can we split it between services provided to consumer lenders and business borrowers?

To see this, consider the artificial concept of a pure interest rate. This is the *hypothetical* interest rate on a direct loan that involves no intermediation services and no default risk. Say this pure interest rate is 12 percent. Continuing the above example, this means that of the eight percent margin that represents the value added of bank intermediation, five percent accrues to consumers (15-7 percent) and three percent to businesses (15-12 percent). Only the former should be taxed. While conceptually straightforward, the problem is identifying precisely what the pure interest rate is, even on an aggregate basis.

The Full Taxation of Financial Services: The Cash Flow Method

As discussed above, the taxation of fee-based services under a standard credit and invoice VAT is straightforward; the problem arises for margin-based services. Particularly vexing is the difficulty of breaking the margin down into the value added accruing to lenders and borrowers. The so-called cash *flow method* has been suggested as a way of dealing with this.

²³ See Gendron (2008) op. cit. for a brief discussion of various aggregation approaches.

The cash flow method has been considered both as an alternative form of a VAT (i.e., applied to all sectors as an alternative to an invoice and credit VAT) and even as a substitute for the corporate income tax.²⁴ More recently, the cash flow method has been suggested as a way to bring financial transactions into the VAT operating in conjunction with an invoice and credit VAT applied to the rest of the economy.²⁵

The idea behind the cash flow method is to treat the cash flows of financial transactions in the same fashion as flows from non-financial purchases and sales. Thus, cash inflows to those providing financial services (including interest and principle payments, premiums, etc.) are treated as taxable sales, and cash outflows (including loans made) are treated as the purchase of taxable inputs carrying creditable VAT. This, coupled with the full recoverability of VAT paid on real inputs purchased by financial institutions (materials, equipment, etc.), ensures that all B2B transactions are subject to VAT that is fully creditable, while B2C transactions are taxed.

The cash flow approach operates in a straightforward manner and achieves the stated intent in the case of many types of financial transactions. Here we illustrate the idea behind it in a very simple environment.²⁶ Consider the example discussed above: a \$100 deposit earning interest at seven percent financing a \$100 loan paying an interest rate of 15 percent. The resulting margin is eight percent. The deposits and loans are for one period. The GST rate is 10 percent. Recall the notion of a pure rate of interest discussed above, and *assume that the pure rate of interest is equal to the interest rate on risk-free government bonds* (12 percent). Table 1 illustrates the application of the cash flow tax to financial flows.

TABLE 1: CASH FLOW METHOD EXAMPLE (10 PERCENT GST)

Panel A: Consumer Depositor – Consumer Borrower

Tax Payments by Bank:

	Bank Inflow	Bank Outflow	Tax/Credit
Period 1			
Deposit	\$100		\$10
Loan		-\$100	-\$10
Period 1 Total	\$100	-\$100	\$0
Period 2			
Loan Principal Repayment	\$100		\$10
Loan Interest	\$15		\$1.50
Deposit Withdrawal		-\$100	-\$10
Deposit Interest		-\$7	-\$7.0
Period 2 Total	\$115	-\$107	\$.80

Value Added of Banking Services to Consumer: **\$8**
 Government Revenue in Period 2: **\$.80**

²⁴ See Meade, James, ed. (1978), *The Structure and Reform of Direct Taxation*. London: Allen & Unwin.

²⁵ See, for example, Poddar and English (1997) op. cit.

²⁶ This is based on Poddar and English *ibid*.

Panel B: Consumer Depositor – Business Borrower

Tax Payments by Bank Identical to Panel A.

Tax Payments by Business Borrower:

	Bank Inflow	Bank Outflow	Tax/Credit
Period 1			
Loan	\$100		\$10
Period 1 Total	\$100		\$10
Period 2			
Loan Principal Repayment		-\$100	-\$10
Loan Interest		-\$15	\$-1.50
Period 2 Total		-\$115	\$-11.50

Value Added of Banking Services to Consumer: **\$5**

Government Revenue in Period 2:

Period 1 Tax: \$0 from Bank +\$10 from Borrower	\$10
Interest on \$10 at 12 percent:	\$1.20
Period 2 Tax: \$0.80 from bank -\$11.50 from Borrower	-\$10.70
Total	\$0.50

Panel A illustrates the case where both the depositor and the borrower are consumers (or non-registered businesses). As is seen, at the bank level all cash inflows are taxed, while all cash outflows are creditable. The result is that the full \$8 in value added, all of which accrues to consumers in this case, is taxed at the 10 percent rate generating \$0.80 in GST revenue, as intended.

Panel B illustrates the case where the depositor is a consumer and the borrower is a business. As discussed above, the key here is to split the value added between the consumer (which is taxable) and the business (which is not). The key assumption here is that the pure rate of interest is equal to the risk from rate on government bonds. As is seen the result is that the \$5 in value added accruing to consumers is taxed at the 10 percent rate generating \$0.50 in GST revenue, as intended.

The cash flow method can be extended to other types of banking transactions, including those involving non-residents;²⁷ it has also been illustrated for term insurance.²⁸ However, and importantly, a key question is the applicability of such an approach to more complicated financial transactions and other financial services. As indicated by Crawford, Keen and Smith: “the literature has struggled, however, to find simple ways of administering such a system for other intermediation services.”²⁹ Other difficulties concern the appropriateness of equating the

²⁷ Ibid.

²⁸ See Ebrill, Liam, Michael Keen, Jean-Paul Bodin, and Victoria Summers (2001), *The Modern VAT* (Washington: International Monetary Fund).

²⁹ Crawford, I., M. Keen and S. Smith (2010), “Value Added Tax and Excises”, Chapter 4 in *Dimensions of Tax Design: The Mirrlees Review*, J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), Oxford University Press.

pure rate of interest to the interest rate on government bonds; cash flow difficulties on the part of businesses (in particular small businesses) who must pay tax on loans up front, waiting until repayment for the credit; problems associated with changes in the VAT rate;³⁰ and implications for the international competitiveness for a country that goes it alone in this regard. Moreover, following such an approach for the financial sector alone would take the financial sector out of the credit-invoice transactional VAT system, generating a huge hole given the inter-relationships of the sector with other economic sectors, and would place revenue at risk due to opportunities for financial statement manipulation, transfer pricing and income-shifting.

With regard to the latter, the problems of putting a working cash flow model into legislation, and having it audited, would be significant. As will be discussed below in more detail, the GST legislation has already ventured into cost accounting in two specific areas: the rules governing recovery of input credits by financial institutions, and the new regime applying GST to the loading portion of imported services between non-arms-length parties. Both of these areas involve legislated calculations related to various costs incurred by the entity to determine the real tax impact. Both topics are fraught with difficulty and uncertainty, and have consumed an inordinate amount of the resources of financial institutions and the Canada Revenue Agency in years of wrangling during audits and in the courts. The taxpayer experience of legislated calculation related to a financial institution's costs in these two limited aspects has been so unsatisfactory, for so long, that it alone is, in our view, a sufficient deterrent to further consideration of the cash flow method for Canada.

IV. THE CURRENT SYSTEM: NOT BROKE UNTIL WE FIXED IT?

After considering other options, taxation by exemption of financial services was the model chosen for the Canadian GST. As indicated above, under the exemption approach no GST is levied on a transaction that is exempt under the GST, nor is the provider able to recover the GST on the inputs used in the provision of the good or service.

The initial definition of exempt financial services was fairly broad, including borrowing and lending, the provision of insurance and the claims activity underlying insurance, and a broad range of services related to financial instruments, including the service of arranging for the supply of a financial service, or intermediation. Specific exclusions render management and advisory services and administrative services taxable. Investment advisory services, including fully discretionary investment management services, were also excluded from exemption. Canada's chosen alternative to corporate VAT grouping rules was a set of specific elections between parties that either relieve the obligation to collect tax (in full recovery situations) or alter the treatment of taxable supplies of services to being exempt (with resulting restrictions on recovery by the supplier).

The first 20 years of the Canadian system have been eventful ones for financial services. A review of the developments in the definition of exempt activities, the problems with the legislative amendment process, and the operational aspects for registrants, is essential to understand the nature of the policy landscape.

³⁰ See Poddar and English (1997) *op. cit.*

As with any legislative definition, there has been a steady stream of disputes and case law to clarify what was within the exemption. While some legislative responses to these disputes have served to preserve the scope of the exemption as originally intended and widely understood, amendments during the last 10 years have significantly modified the economic impact of the tax in two areas — dramatically narrowing the exemption of arranging for services typically supplied by a financial institution, and with regard to self-assessment on imported services between establishments of an entity straddling the border or between non-arms-length parties. We discuss each in turn.

Scope of the exemption — arranging for services

The taxation of fully discretionary investment management services has been challenged under the definition on a number of occasions involving mutual funds, pension funds, charitable trusts, segregated funds of life insurers (deemed to be a person separate from the insurer), and private individuals. In every instance, presumably having had the opportunity to consider the financial intermediation nature of this service and the merits of whether, as the taxpayer was asserting, the service was in fact within the exemption as drafted, the government amended the legislation (often retroactively) to ensure that investment management services remained outside the exemption.

In order to avoid distortion between the direct selling of financial services and a supply made through a broker, agent or other form of intermediary, the original exemption for services included any service of arranging for the supply of a service that itself was an exempt financial service. This vital feature ensured the amount of sticking tax in different distribution models remained roughly equal, based on the assumption that an independent broker and an employee will each consume similar amounts of GST-bearing costs in performing their function. The feature applies to a range of services which the financial institution might perform either in-house or choose to outsource, such as telephone call centres.

On December 14, 2009 the federal Department of Finance issued a press release announcing changes to the definition of a financial service that would be effective from that day, even though the supporting legislation did not emerge until March 22, 2010, and there was a significant difference between the concepts in the press release and the ultimate legislation. On February 11, 2010, the Canada Revenue Agency (CRA) published guidance on the impact of the December 14, 2009 changes in a Notice (Number 250). A chronology of events related to these important changes is presented in the Appendix. A reading of this chronology highlights the presence of many wobbles from both a substantive and procedural perspective. Many intermediation services that had formerly been treated as exempt by the CRA were described as taxable, effective from the date of the Department of Finance press release almost two months earlier, under legislation that had not been published and would not emerge until a month after the CRA Notice.

We will comment on the procedural aspects of the legislative process in a later section, but here will focus on the change to the exemption. Firstly, in relation to the provision of credit, a new exclusion from the definition of an exempt financial service renders taxable:

(r.3) a service (other than a prescribed service) of managing credit that is in respect of credit cards, charge cards, credit accounts, charge accounts, loan accounts or accounts in respect of any advance and is provided to a person granting, or potentially granting, credit in respect of those cards or accounts, including a service provided to the person of

- (i) Checking, evaluating or authorizing credit
- (ii) Making decisions on behalf of the person in relation to a grant, or an application for a grant, of credit
- (iii) Creating or maintaining records for the person in relation to a grant, or an application for a grant, of credit or in relation to the cards or accounts, or
- (iv) Monitoring another person's payment record or dealing with payments made, or to be made, by the other person.

A number of these elements were formerly accepted by the CRA as exempt, specifically as arranging for the supply of a financial service, and in fact described as such in the CRA's own policy paper (No. 239). As such, this is clearly a significant policy change. While consumers generally borrow domestically, industry borrows globally, so by increasing the potentially embedded tax in the cost of lending within Canada, taxes levied on these activities disadvantage Canadian lenders relative to non-Canadian competition. At a harmonized tax rate in Ontario of 13 percent, this effect is not insignificant. Outside of the credit industry, and across the entire spectrum of financial services, also newly excluded from exemption is the following:

(r.4) a service (other than a prescribed service) that is preparatory to the provision or the potential provision of a service referred to in any of paragraphs (a) to (i) and (l), or that is provided in conjunction with a service referred to in any of those paragraphs, and that is

- (i) a service of collection, collating or providing information, or
- (ii) a market research, product design, document preparation, document processing, customer assistance, promotional or advertising service or a similar service.

(r.5) property (other than a financial instrument or prescribed property) that is delivered or made available to a person in conjunction with the rendering by the person of a service referred to in any of paragraphs (a) to (i) and (l).

Scope of the exemption — imported services

When it comes to imported services and self-assessment of tax by entities not entitled to a full input tax credit, Canada went one stage further than most jurisdictions, and created an obligation to self-assess when services flow into Canada between establishments of a single legal entity. The effectiveness of the original legislation was called into question in a 2003 Tax Court of Canada case involving a Canadian branch of a US-based insurer [*State Farm Fire &*

Casualty Company 2001-2226 (GST)G]. Not only did the Court question whether a deemed supply on which to collect tax was successfully created by the law, but it took the view that if in fact a deemed supply existed, the nature of the supply received in Canada by the insurance branch was within the definition of an exempt financial service. The government did not appeal the Tax Court decision, and returned to the drawing board to design its legislative response over the course of two years. That response, contained in the 2010 federal budget, but effective in some respects from January 1, 1991, and in most from November 2005 (the date of a press release with legislation absent, once again), is a significant new policy feature for financial services. Instead of simply fixing the deficiencies in the original design illuminated by the State Farm case, the new rules go much further in their scope, not just replacing the rules applying between establishments of the same entity, but sweeping into the scope of self-assessment any cross-border transactions between non-arms-length parties. Deemed supplies between establishments, and any supplies between non-arms-length parties are now treated as subject to self-assessment tax, with some exceptions for pure financial services. A completely new concept is introduced, however, if a supply contains any elements of loading, defined as:

“**Loading**” means any part of the value of the consideration for a supply of a financial service that is attributable to administrative expenses, an error or profit margin, business handling costs, commissions, communications expenses, claims handling costs, employee compensation or benefits, execution or clearing costs, management fees, marketing or advertising costs, occupancy or equipment expenses, operating expenses, acquisition costs, premium collection costs, processing costs or any other costs or expenses of a person that makes the supply, other than commissions for a specified financial service or the part of the value of the consideration that is equal to

- (a) if the financial service includes the issuance, renewal, variation or transfer of ownership of an insurance policy but not of any other qualifying instrument, the estimate of the net premium of the insurance policy;
- (b) if the financial service includes the issuance, renewal, variation or transfer of ownership of a qualifying instrument (other than an insurance policy), the estimate of the default risk premium that is directly associated with the qualifying instrument; and
- (c) if the financial service includes the issuance, renewal, variation or transfer of ownership of an insurance policy and a qualifying instrument (other than an insurance policy), the amount determined by the formula

$$A + B$$

Where:

A is the estimate of the net premium of the insurance policy; and

B is the estimate of the default risk premium that is directly associated with the qualifying instrument.

If any of these components exist within a financial service, they must be valued and subjected to self-assessment. Having only passed into law in July 2010, it remains to be seen how CRA auditors will apply them from their 1991 or 2005 effective dates. It seems to us that the concepts will be very difficult to apply in many cases, especially to deemed supplies within one entity. This significant new addition to the cross-border aspect of financial services policy will impose a higher tax cost to any cross-border outsourcing or intra-entity assembly of financial products than for the same structure or transaction conducted within Canada; i.e. it significantly extends a tax discrimination beyond the situations that were clearly intended to be discriminated against (even if the initial legislation failed to achieve its aim). Under the pre-existing rules, the nature of a supply could be considered in light of two specific rules developed to deal with situations where taxable and exempt elements exist within one supply, and frequently result in exemption of the supply. One rule disregards any incidental taxable content, and another exempts a bundle of services for one consideration, if more than 50 percent of the bundle would be exempt by nature when considered alone. The new structure for imported services effectively disapplies these rules, with the result that a supply which would be exempt when supplied completely within Canada will be wholly or partly taxable (on the loading content) if it is supplied from outside of Canada. The incremental tax from this measure will be significant on an ongoing basis, but the initial impact will be enormous — auditors are now examining supplies for loading content, and the resulting assessments will cover the period from November 2005.

Distortions Associated with Exemptions

As a general rule, exemptions are anathema to the underlying logic of the VAT. As discussed above, the reason is that because firms are unable to recover the tax paid on its business inputs, the VAT turns into a tax on production inputs used to produce exempt goods and services. This results in taxation by exemption, violates the production efficiency theorem, and introduces several distortions into the economy. A discussion of the nature of these distortions follows.

INPUT DISTORTIONS AND SELF-SUPPLY BIAS IN THE FINANCIAL SECTOR

Financial institutions that make supplies that are exempt from GST are not able to claim input tax credits for the GST levied on the related costs or inputs attributable to those supplies. This irrecoverable GST means that banks are overtaxed on their inputs. This has two effects. First, it increases the cost of providing financial services. To the extent that technological developments over the last several decades have resulted in more complex financial products which require inputs purchased from external service providers, non-recoverable GST has become an even more important part of the cost structure of financial companies.

Second, the non-recovery on GST on their inputs gives financial institutions a clear incentive to substitute away from inputs that are subject to GST towards inputs that are not. Thus, rather than purchasing inputs on the open market, which are subject to irrecoverable GST, a financial institution may opt to provide the input internally, bypassing the market and avoiding the GST.

If purchased inputs bear unrecoverable GST, financial institutions may alter, or distort, their input mix in favour of self-supply, eliminating the benefits of outsourcing. This is an example of a production inefficiency discussed above, and it gives rise to real economic costs in the

form of lower output and production. Recognition of the potentially negative influence of VAT on business outsourcing was a key driver for the review of the VAT as it affects banks and insurers in the European Union.³¹

INPUT DISTORTIONS IN THE BUSINESS SECTOR

When a financial institution is not able to recover the GST on its purchases of inputs, the GST will be embedded in the price charged for those financial services, by way of either the fee or margin. This will be true for both consumer and business purchases of financial services; here we discuss B2B transactions; in the next section we deal with consumers.

As discussed above, a (relatively) inviolate principle of optimal taxation — the production efficiency theorem — is that GST should not be imposed on business inputs. Embedded GST in the price of financial services for business — which we have referred to at times as taxation by exemption — clearly violates this principle. As a result, businesses' purchases of financial services are overtaxed relative to the purchase of inputs for which the GST is fully recoverable.

This not only distorts the use of inputs employed by businesses, but also increases the cost of production, which will in turn be reflected in higher output prices. To the extent that the resulting output is subject to GST, we would observe the prototypical tax cascading associated with exempt treatment. All of these distortions create real economic costs.

CONSUMPTION DISTORTIONS

As discussed, the tax cascading due to the GST embedded in business purchases of financial services will, as mentioned, feed through to affect the prices of many goods and services; the pattern of these distortions will depend on the input mix and source of finance on the part of the businesses' that produce the goods. However, the focus here is on more direct distortions associated with consumer purchases of financial services.

The exemption of many financial services provided to consumers means that, while these services are not subject to GST explicitly visible to consumers in the price, there is still GST embedded in the price, due to the non-recovery of the GST on the inputs purchased by financial institutions. This suggests that relative to other, fully taxable, goods and services, these B2C financial service transactions face a lower effective tax rate than other purchases.

However, one issue seems to have been somewhat ignored in the literature. The term “financial services” covers a broad range of activities — banking (deposits, borrowing, lending), financial securities (purchase, sale, issuance), insurance (life, property, casualty), brokerage services, financial advisory services, etc. As discussed above, not all of these services are treated the same under the GST — some are taxable, others are exempt, and the degree of recovery varies. This means that the GST as it is applied to financial services in Canada not only distorts the price of financial services as some sort of aggregate relative to other goods and services, but also introduces distortions *between* different types of financial services.

³¹ See Firth, Michael (2006), *A Confluence of Uncertainties: The GST and Financial Services*, CICA 2006 Commodity Tax Symposium.

We think that this distinction is important and, as we say, underappreciated. It raises the issue of a level playing field between different types of financial services. The question then becomes: should we be more concerned about the overconsumption of some notion of aggregate financial services relative to other goods and services on the part of consumers due to the lower effective GST rate on financial services, or about distortions introduced between different types of financial services due to their differential treatment? We might think of the former as vertical distortions and the latter as horizontal distortions. Of course the answer to the question is that we should be concerned about both. But we think that this distinction is important, and we return to the policy consequences of it below.

IMPORT BIAS AND INTERNATIONAL COMPETITIVENESS

The destination principle that underlies the GST is compromised in the presence of exemptions and can place Canadian financial institutions at a disadvantage relative to foreign financial institutions. To the extent that non-resident entities provide financial services to Canadian business directly, these services may be free of GST either by virtue of zero-rating by the exporting country (as in the EU) or the lack of tax in the first place (as in the US). Canadian businesses thus have an incentive to import financial services, rather than purchase them domestically from exempt suppliers whose prices may include embedded tax.

These issues have become more important as financial markets have become more globalized over the past decades. Financial deregulation (until perhaps recently) and technological innovations have reduced the costs of supplying financial services both locally and globally. This suggests an increase in the intensity of international competition in financial services. The non-recovery of GST for Canadian financial institutions may pose a significant barrier to the international competitiveness of Canadian institutions.

ADMINISTRATION AND COMPLIANCE COSTS

To the extent that financial institutions are treated in a hybrid manner, with some of their activities taxable under the GST and others exempt, it can create administrative and compliance complexity. There will be compliance costs associated with apportioning GST between taxable and exempt activities. Tracking input use is costly, and to the extent that some sort of ad hoc apportionment formula is used, it will be inexact. At the audit stage, the allocation of inputs between taxable and exempt activities can become a quagmire, which consumes registrant and administrative resources to a degree out of proportion to the actual revenue risk inherent in this area.

Scope of the exemption — discussion

In light of the distortions associated with exemption treatment, as a general matter one might be positively disposed towards a narrowing of exemptions. And indeed, we saw above that the scope for exemption in Canada narrowed significantly in 2010. This was the most dramatic shift in policy affecting financial services that has occurred, notwithstanding the federal Minister of Finance's statement that there was no change in tax policy. Subsequent Tax Court of Canada decisions are now confirming that there was significant shift [Global Cash Access (Canada) Inc 2008-922 (GST)G]. However, it is very important to emphasize that the services

subject to tax due to these changes are the stuff of what many financial institutions subcontract to specialist suppliers to assist them in reaching and serving their customers. The significant narrowing of the exemption of services *supplied to the purveyors* of financial services increased the level of tax on these inputs because many of the subsequent services *provided by* financial institutions are themselves exempt, in which case the tax on the inputs is non-recoverable. The changes are therefore detrimental to further outsourcing, given the high efficiency hurdle that must now exist for the outsourcing project to succeed. Outsourcing arrangements entered into before the policy shift may now be uneconomic, and so be unwound. This highlights the need to carefully consider all of the various factors at play along the supply chain, and not simply adopt a blanket fewer-exemptions-is-better approach. Where the exemption takes place in the supply chain, and what happens after that, is very important.

While the distortions documented here associated with exemption treatment are not trivial, most countries have chosen to live with these distortions in the case of financial services, due to the perceived difficulties in implementing other methods (such as a cash flow approach). The trick is then to take steps to reduce the type of distortions discussed above. We make suggestions on how to do this in the penultimate section of the paper.

Record of Legislative Amendments

For a tax applied to millions of transactions on a daily basis, a high degree of tax certainty is essential. Legislative amendments that are retroactive in their effect create a climate of ongoing uncertainty and damage the credibility and stability of existing tax policy. In terms of the scope of definition of an exempt financial service, it was seen above that the greatest policy shifts for GST and financial services took place in 2010. All were retroactive over several years. Moreover, on the day taxpayers were supposed to apply the changes — the date of announcement — no legislation was available.

Retroactive legislative changes in the area of the GST and financial institutions have a long history in Canada. In April 1996, finance minister Paul Martin introduced modifications to amendments he had proposed 18 months previously, deleting the grandfathering clauses, and making the changes retroactive to the introduction of the tax on January 1, 1991. The changes related to financial services, reaffirming the taxable treatment of discretionary investment management services, and replacing the pre-existing concepts governing recovery of GST by financial institutions. The retroactivity created much debate at the time, and was presented as a regrettable measure of last resort, but necessary to maintain the stability and integrity of the new tax. In op-ed pieces written at the time, then-Globe and Mail financial columnist Terence Corcoran referred to Martin as “The Minister of Retroactivity” and opined that retroactivity “while not unheard of in tax law, is considered a travesty of justice and a profound breach of fundamental rights.”³² Many felt that this was a slippery slope. It seems that they were right.

³² Corcoran, Terrance (1996), “Minister of Retroactivity,” op-ed column in Globe and Mail, Tuesday May 14, 1996.

More recently, in 2010, the Economist Intelligence Unit (EIU), the sister company of the internationally renowned *The Economist* magazine, wrote that current Finance Minister Jim Flaherty “likes to heap lavish praise on his country’s financial system, but behind the scenes Ottawa is in fact regularly kicking the crown jewel of its economy in the teeth with retroactive tax legislation that is arbitrary and harsh.”³³ The EIU went on to state that, “this atmosphere of uncertainty is dangerous as it undermines the credibility of Canadian courts and the country’s legislative process. What is more it poses a serious hurdle to multi-nationals considering an investment in Canada because they can never be sure how services outsourced from head office will be treated by the Canada Revenue Agency (CRA).”³⁴

The *Comprehensive Response of the Government of Canada to the Seventh Report of the Standing Committee on Public Accounts* (hereafter the Report) is often, erroneously in our view, cited as justification for retroactive amendments. A detailed reading of the report fails to support many of the instances of GST retroactivity that have been applied. The introduction to that extensive report states:

“..this report deals exclusively with the management of risk to the tax base resulting from the dispute resolution process. While there may be risks to the tax base associated with other aspects of the tax process, these other risks are not dealt with in this response.”

Section B IV, item 2 of the report provides five factors where it may be appropriate to adopt retroactive clarifying changes. The Report identifies factor B IV 2 (e) as intended to be considered independently from the other four factors;

“e) the amendments are corrections of ambiguous or deficient provisions that were not in accordance with the object of the Act.”

The other four factors are intended to be considered not in isolation but to complement one another. Further detail on the four other factors is provided under the following headings.

- “a) the amendments reflect a long-standing well-known interpretation of the law by the Department of National Revenue;
- b) the amendments reflect a policy that is clear from the relevant provisions that is well-known and understood by taxpayers;
- c) the amendments are intended to prevent a windfall benefit to certain taxpayers;
- d) the amendments are necessary to preserve the stability of the Government’s revenue base;”

Even after providing further detail on each of these factors, however, the Report states;

“As indicated above the presence of one or more of the above factors does not necessarily mean that retroactive legislation will be introduced.”

³³ Economic Intelligence Unit (2010), “Canada financing: A hidden danger tax,” Economic Intelligence Units, Industry Magazine, *The Economist Magazine*. P. 1.

³⁴ Ibid.

Weighed against the five factors in the Report, in our view many of the instances of retroactive amendment of the GST relating to financial services, and of delays and reinterpretation, are not justified.

Aside from the retroactive application of legislated changes, the GST as it relates to financial services has been plagued by the consistent and extensive delay in reacting to Tax Court decisions, and the habit of setting effective date by press release, with detailed application of the rules, and the relevant legislation following much (sometimes years) later. The narrowing of the exemption of arranging for services discussed above was characterized by these delays;³⁵ the chronology presented in the Appendix highlights the problem.

The Administrative Experience

The CRA's role in relation to GST and financial services has been complicated by the record of delays and retroactivity in legislative maintenance by successive governments.

In one area, though, there was experimentation with devolving the rulemaking from the legislation directly to the administrative authority — the Canada Revenue Agency. This was in the area of determining how much GST a financial institution should recover by virtue of the fact that it made some taxable supplies. The experience of each taxpayer is different, and so any comments on the early events surrounding this subject are anecdotal. In the early days of the GST most financial institutions were very focused on the supply side of their activities, ensuring that GST had been correctly applied to all the relevant supplies, and constructing systems to ensure they could cope with the reporting obligations of the tax. Only some years into the life of the tax did larger institutions begin to pay detailed attention to the question of whether the appropriate amount of tax incurred on costs was being tracked and recovered. The original form of the legislation may, in fact, have been too generous when free supplies were included in the capture of a recovery methodology, and so after a couple of attempts to eradicate this defect, new rules were enacted in 1996, retroactive to the inception of the tax. European VAT systems require consideration for there to be a supply, so it is easy to see how this may have been overlooked when the Canadian definition of a supply is extremely broad.

After the 1996 amendments, taxpayers were left with an obligation to develop a method that achieved a level of tax recovery that was fair and reasonable in relation to their mix of taxable and exempt supplies. Better and more versatile data and accounting systems supported a very detailed methodology for recovery, and so towards the end of the 1990s, complex financial institutions discovered that detailed attention to a sophisticated recovery method was rewarded with higher recoveries. These methods all had to be based on as high a degree of attribution of costs to actual supplies as possible, and were subject to the fair and reasonable test. Only about 10 years into the tax, therefore, did practice begin to catch up with policy intent, and recovery levels rose to a level that did, in fact, remove the sticking tax from exported supplies of

³⁵ See Firth, Michael (2010b), "GST Exemption of Financial Intermediation or "Arranging for," (CICA Commodity Tax Symposium).

financial services. When the legislative wording “fair and reasonable” came before the courts, it was interpreted as broad, and not as most fair or most reasonable. In reversing a Tax Court Decision in *Ville de Magog v. The Queen 2002 GTC 1093 (F.C.A)*, the Federal Court of Appeal noted:

“The judge found, in regard to this item, that the percentage used was more reasonable than the one used by the appellant. As I said earlier, it was not the judge’s role to determine whether one method was more reasonable than the other; rather, she was to determine whether the method used by the appellant was fair and reasonable.”³⁶

In response to a significant rise in recovery of tax by financial institutions in the late 1990s new rules were released. The structure of the new rules imposed a low default rate of recovery on banking, insurance and brokerage sectors, with any deviation from those levels being available through a special method agreed with the CRA.

The policy intent that manufacturers of goods and services (in this case financial services) will be able to export from Canada free from the impediment of any hidden taxes seems to have been lost in the process. Rather than retain sight of the original intent, the redesign of the rules, and the frequent (but not universal) experience of their imposition by the CRA can be fairly said to have been tantamount to a tax on financial institutions. As such, it has become a combination of an increase in the level of taxation by exemption for supplies into the domestic market, and the very price lag on exports the GST was intended to eliminate.

This suggests that we need to have a better system to determine GST recovery by suppliers of financial services. This is desirable even if no other aspects of GST as they apply to financial services change, but if Canada adopts either zero-rating or the option to tax B2B supplies (anticipating one of our recommendations below), it is an absolute must.

V. DO FINANCIAL INSTITUTIONS ENJOY A TAX ADVANTAGE UNDER THE GST?

In many ways the answer to this question is fundamental to the debate regarding the GST treatment of financial institutions. However, the answer to the question is not at all straightforward.

The question hinges on the exempt treatment of many financial transactions. As discussed at various points previously, exempt treatment means that while no GST is charged on the transaction of a service, the GST paid on the inputs used in the production of the service is not recovered. Thus, while no GST is paid explicitly on the transaction by the purchaser, there may be embedded tax due to the irrecoverable GST.

³⁶ See also Murray, Brent (2009), “Input Tax Credit Entitlement as Determined by the Courts,” (CICA Commodity Tax Symposium).

The implications of this differ according to whether the transaction is from business-to-business (B2B) or business-to-consumer (B2C). Superficially it would appear obvious that the answer to the question posed in the section heading is yes. This is because the effective tax rate on an exempt transaction due to the hidden embedded GST on a financial service will be lower than the explicit GST rate on a fully taxable service. This means that in B2C transactions, exempt financial services will bear a lower effective tax rate than fully taxed transactions and would therefore appear to receive a tax advantage relative to fully taxed goods and services.

This conclusion ignores a vital point. While exempt B2C financial services bear a lower effective GST rate, B2B services bear a higher effective rate. Of course, this is because under a VAT B2B services are not supposed to bear any tax at all, as GST paid on the purchase of inputs is fully recoverable. Under the exemption approach the financial institution is not able to recover the GST on its inputs, nor is the business able to credit the implicit GST embedded in the price of its purchases. Businesses bear none of the tax on fully taxable transactions but do bear (implicit embedded) tax on exempt transactions. As such, while B2C financial services may be treated favourably relative to taxed supplies (or not, depending upon one's view of the optimal tax considerations), B2B financial services are treated less favourably than taxed supplies. This is really just a restatement of much of what we have said at several points earlier in the paper.

Because of this, it is difficult to say on a conceptual level whether or not the financial services sector as a whole receives more or less favourable treatment. Some analysts have approached the question by undertaking a quantitative analysis of the revenue implications for governments of (somehow) fully taxing all financial services. The idea here is that full taxation would increase government GST revenue from B2C transactions, but will decrease government revenue from B2B transactions.³⁷ In principle, the net impact on government revenues could go either way. Under this approach, if the net impact of full taxation on government revenue is positive, this would suggest that, on the whole, the financial sector is favourably treated under the current system; if it is negative, then it is tax-disadvantaged.

This approach has been used in a couple of studies of the banking sector in the EU. Huzinga (2002) uses national income accounting data from 1998 to estimate the revenue impact of the VAT exemption for core banking services in 13 EU member countries. More recently, a similar study was done by the European Commission (2011).³⁸ Huizinga finds that, on balance, VAT revenues would increase significantly under full taxation, with average yearly additional revenues between €12.0 to €15 billion.³⁹ This would suggest, under the terms discussed above, that the sector is indeed treated favourably. The European Commission reaches a similar conclusion.

A recent study conducted by PriceWaterhouseCoopers,⁴⁰ in conjunction with Ben Lockwood of the Institute for Fiscal Studies in the UK, estimates a substantially lower number, averaging around €6 to €8 billion per year over the period study. However, in half of the years studied full taxation would lead to a reduction in revenue. The PwC study uses more up-to-date and

³⁷ These studies do not address the obviously important issue of how full taxability would be implemented.

³⁸ Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, 28 September, COM (2011) 594 final.

³⁹ Huizinga, Harry (2002), "A European VAT on Financial Services?," *Economic Policy*, October

⁴⁰ PriceWaterhouseCoopers (2011), *How the EU VAT Exemptions Impact the Banking Sector: Study to assess whether banks enjoy a tax advantage as a result of the EU VAT exemption system.*

more refined data than the other studies. In particular, Lockwood and PwC undertake a more detailed measurement of the second-round effects, which take behavioural changes in consumption into account. Moreover, they use a more refined, and updated, estimate of VAT recovery rates on the part of EU banks.

Given the differences in the VAT regimes in Canada and EU countries, it would not be appropriate to project these results into the Canadian context. However, the studies show that in an exemption system similar to Canada's, it is possible that any revenue gains from fully taxing the banking sector could be rather small, and could in fact be negative.

VI. OUR RECOMMENDATIONS

As discussed at the beginning of the paper in the context of first principles, with regard to B2B transactions we think that the production efficiency theorem provides a fairly robust guide to tax policy. It suggests that we should not impose taxes on the intermediate transactions of business. A standard VAT, properly applied, removes these taxes by giving firms tax credits for VAT levied on their inputs, thereby allowing them to recover the VAT paid on those inputs. As we have seen, the exemption treatment of financial institutions gives rise to irrecoverable GST and results in taxation by exemption. We are of the strong view that in the absence of convincing arguments to the contrary, the idea behind the production efficiency theorem should guide any reforms to the GST related to the financial sector. As such, we think that steps should be taken to reduce the taxation by exemption that arises in the case of B2B financial transactions under the current approach.

We think that another key insight from our analysis is that, to the extent possible, all financial services should be treated in a similar manner and taxed at the same effective rate. This relates to the distinction between horizontal and vertical distortions discussed above. We think that it is particularly important that horizontal distortions be eliminated, and that the GST generates a level playing field *between* different types of financial services. Consumers should choose among various financial services — investing in GICs versus mutual funds, term versus whole life insurance, etc. — on the basis of their relevant merits, not because of differences in effective tax rates due to differential treatment under the GST. As such, we think that discrepancies between effective and explicit tax rates for the purchase of financial services should be reduced where possible. In some cases this will involve expanding the exemption system and in other cases narrowing it.

Of course, both of these issues — the elimination of taxes on business inputs and a level playing field in the treatment of all financial services — would be addressed automatically and as a matter of course if the characteristics of financial services were similar to other goods and services, in which case full taxation under the GST could be achieved in the standard way. Indeed, a pure VAT is conceptually designed to achieve just this — the removal of taxes on business inputs and the taxation of all final goods and services at the same uniform rate (thereby eliminating both vertical and horizontal distortions). The problem, as discussed throughout, is that the characteristics of financial services differ in many cases from other goods and services, making it difficult to apply the standard approaches.

While we are supportive of eliminating the taxation of business inputs arising from the existing B2B treatment of financial services and the elimination of differences in effective tax rates across financial services, we are slightly less dogmatic on whether final transactions on the part of consumers — B2C financial transactions — should be subject to full taxation. As discussed at the beginning of the paper, the theoretical economics literature is not at all decisive on this point.

On the whole we find ourselves sympathetic with the idea that that the purchase of financial services on the part of consumers should be taxed, though we admit the possibility of doing so at a lower rate. This last point is informed both by the theoretical insights discussed earlier, but also by practical considerations which suggest that it may be difficult to subject some types of financial services (primarily margin-based services) to full taxation. The taxation-by-exemption approach adopted in most countries with a VAT, including Canada, results in the effective taxation of B2C financial services at rates that are lower than other (fully taxed) goods and services. While we are under no illusion that the result is optimal in any sense, we are slightly comforted by the fact that there may be some justification for taxing these services at lower rates. More to the point, this treatment seems to us to be the lesser of several evils in the taxation of financial services.

In section III a commonly discussed approach to taxing margin-based financial services — the cash flow method — was discussed. While in theory this method would appear to be workable for some simple types of financial services, there is a broad range of services for which it has not been shown to apply. As a result, the cash flow method has not been applied to date in any country.

While we think that Canada should continue to monitor discussions in Europe and other countries on the policy front, we are convinced that Canada should not lead the charge in terms of adopting a radical policy departure from the current exemption-based system. This is based not only on the technical considerations discussed above, but also on our assessment of the legislative record and process that have characterized the GST as it relates to financial services in Canada. Any recommendations for changes to the Canadian system of GST as it applies to financial services has to be informed, and necessarily constrained by, the less than satisfactory record of designing and implementing amendments. Consequently our recommendations are focussed on reforming the existing exemption-based system to make it less distortionary and generally work better, at both the legislative and administrative levels. In doing so we think that the two issues discussed above — the removal of tax on business inputs in B2B transactions, and the creation of a level playing field across financial services — need to be addressed.

In light of all of this, our recommendations may be viewed as seeking to achieve three primary objectives:

- To improve the economic effects of the taxation-by-exemption model by removing some of its more negative aspects;
- To reset the Canadian system such that the amount of non-recoverable GST, or taxation by exemption, contained in the price of any financial service remains relatively constant, regardless of direct assembly and delivery by one entity, or through more diverse assembly and distribution models; and also regardless of which side of the border the value components originate;

- To restore a higher degree of certainty to the legislative framework, and confidence in the design and execution of any amendments to the tax on the part of businesses and practitioners.

These three imperatives underlie, to varying degrees, all of our recommendations.

1. Zero-rating of B2B financial transactions (or the option to tax them)

One of the critical areas of concern is in the area of business-to-business transactions and the presence of embedded GST in the cost of financial services to businesses. Our first recommendation to improve the current system is to zero-rate B2B financial transactions. Under this approach, no GST would be charged on transactions between financial institutions and (registered) businesses, and financial institutions would be able to claim input tax credits on the GST on all of its inputs related to the provision of financial services to businesses. This would eliminate the irrecoverable GST on both the inputs into the production of financial services on the part of financial institutions, and on the financial services purchased by businesses. This would be a major policy change which would go a long way to removing some of the key distortions associated with the exemption approach in the financial sector. It is notable that New Zealand — often touted as having one of the purest VATs in the world — recently introduced zero-rating on B2B financial services. It is also notable that Quebec was comfortable zero-rating financial services in the context of its GST clone, the QST, introduced in 1992, and that there were no substantial administrative concerns (Quebec is slated to switch to exemption in 2013, as part of its harmonization arrangement with the federal government).

The benefit of this approach would clearly be to eliminate the production inefficiencies for both financial institutions and for businesses using financial services, which would remove many of the distortions discussed above, including tax cascading, self-supply bias, and concerns over the international competitiveness of our financial institutions, etc.

A cost of this approach is that financial institutions would need to distinguish between supplies to businesses and supplies to final consumers. This would entail compliance costs. Of course, another cost would be the lost government revenue that arises because of the removal of non-recoverable taxes on the inputs of financial institutions.

Though we would encourage a more thorough analysis of this recommendation, our feeling is that in the case of financial services, these costs may well be outweighed by the benefits of eliminating the production inefficiencies and the associated distortions associated with the current system. As indicated, because embedded GST would be eliminated on B2B financial transactions, this would come with a revenue cost. Unfortunately, we are not in a position to be able to estimate these costs at this time. However, we do note that this cost would be contained in so much as the recommendation applies to B2B transactions only, with (many) B2C transactions remaining exempt.

A slight modification on this would be to give partial credit to financial institutions for GST paid on inputs used in B2B transactions. This exemption-with-partial-credit approach would reduce, but not eliminate, the various distortions associated with the production inefficiencies that arise from taxing financial institution inputs. The exemption-with-partial-credit approach for financial transactions is followed in Australia (though for both B2B and B2C transactions). This is very much an *ad hoc* approach that virtually guarantees the wrong result in all circumstances, and for this reason we do not endorse it.

Failing wholesale B2B zero-rating, an alternative approach would be to give financial institutions the option to tax financial transactions. The VAT Directive for the European Union allows member countries to introduce an option to tax. Currently Austria, Belgium, Estonia, France, Germany and Lithuania allow for an option to tax on financial services. In some of these countries the option to tax is limited to certain types of services, and in most cases is restricted to business-to-business transactions. Current discussions regarding the reform of the VAT in the EU have involved making the option to tax compulsory in all member countries.

The benefit of an option-to-tax approach, especially as it applies to B2B transactions, is that it allows individual financial firms to trade-off the compliance costs of tracking and separating inputs associated with taxable and non-taxable (exempt) activities against the benefits of removing the embedded tax. If the benefits outweigh the costs for an individual institution, it will exercise its option to tax.

In a recent paper, de la Feria and Lockwood⁴¹ analyze the option to tax, from both a legal and economic perspective. They show that if financial firms in a related industry are not able to coordinate their behaviour, there is generally an incentive for firms to opt in on B2B transactions, but not on B2C transactions. In the case where financial firms can coordinate their behaviour (i.e., collectively agree to opt in or not on business-to-business transactions), the incentive to opt in on B2B transactions may disappear. For this reason we consider the option-to-tax approach as a distant second-best choice to zero-rating B2B transactions.

2. A new system for determining recovery of GST by financial institutions

Recommendation number one above serves to remove the unrecoverable tax in the supply chain where banking and insurance services supplies to businesses become component costs of supplies made by those businesses. This not only removes tax cascading where the ultimate supply is to a Canadian consumer, but more importantly removes the tax currently hidden in the export cost of any manufactured goods by virtue of their finance and insurance cost components.

The unlocking of that tax is achieved through a key mechanism of the GST structure — the rules restricting recovery of GST on costs to the financial institution, to the extent that those costs are attributable to the exempt supply. We have already commented on the evolution, structural aspects and administrative frustrations of the current mechanism. Clearly the current system, with its low default recovery percentages as the alternative to a CRA-imposed result, will have to be replaced if B2B zero-rating or the option to tax are introduced, because an institution with mostly business or export customers will need a system that results in very high recoveries.

⁴¹ de la Feria, Rita and Ben Lockwood (2010), “Opting for Opting In? An Evaluation of the European Commission’s Proposals for Reforming VAT on Financial Services,” *Warwick Economic Research Paper* No. 927.

The GST recovery methodology is an area that brings problems and raises anxieties for legislators, administrators, taxpayers, and tax courts (*CIBC World Markets Inc* (2010 TCC 460)). The problem here is that when dealing with a modern financial institution, the cost accounting is vast and complex, and designed for management, not tax accounting purposes. It is not uncommon for cost and revenue data to be viewed through a prism recognizing business lines or groupings, rather than, as the GST recovery calculation requires, distinct legal entities. Whether assembling a detailed GST recovery methodology for a complex financial institution, or auditing it, a particular combination of three different skills (two of them expert), not normally commanded by a single professional, is required. The first, the tax logic, is in fact very simple, and is often stated as the three-bucket approach; the method should attribute costs directly to particular supplies or populations of supplies, be they exempt (bucket one, no recovery of related GST) or taxable (bucket two, full GST recovery) as much as possible. Costs which cannot be attributed in this way (bucket three) need to be subjected to some form of reasonable apportionment that recognizes the mixture of supplies these costs support. Provided the taxpayer is equally diligent in attributing costs to buckets one and two, and comes up with a supportable rationale for the apportionment of the residual tax in bucket three, taxpayer and auditor should be able to agree and move on to more important matters. The second skill required in the case of a complex organization is a cost accounting background familiar with modern accounting conventions and software. The third, often missing on either or both the taxpayer and audit sides, is a skill in building detailed data models that can flow costs to the appropriate supply destination to get the appropriate GST outcome.

In practice, this area can and frequently has become a quagmire on audit, as auditors, understandably influenced by the default minimum recovery rates, treat organizations having higher than average export activity with suspicion. The cost modelling is sufficiently complex that, if either side does not reflect on the methodology as a functional whole to evaluate the reasonableness of the aggregate outcome, but chooses to battle over specific swings or roundabouts within it, years of wrangling can ensue, until the taxpayer gives up, given the my way or the (low default recovery) highway power the CRA now has over any taxpayer without the funds and fortitude to proceed to the Tax Court of Canada. The high cost of litigation relative to the incremental GST recovery at stake will ensure most taxpayers will settle for an amount less than they believe is appropriate.

If we do want to pursue the B2B zero-rating option, then what hope is there that a new system can be designed, and equally importantly, that it can function without either expensive and protracted disputes, or having taxpayers abandoning policy-appropriate recoveries in the face of CRA opposition?

One fundamental concept of the new system is that there will be no normal level of recovery for any bank, insurer, or broker, so the principles, rather than rules-based system will have to be more flexible.

Given the specific skill sets required to develop or audit these methodologies, and that any one taxpayer or auditor will have limited experience, this may be one area where the creation of a suitably qualified body to act as arbitrator of GST recovery methods would be very productive. Recourse to binding technical arbitration could be an alternative to the normal dispute process for the taxpayer. While the arbitrators' decisions should be private (as a detailed methodology necessarily discloses very granular financial details of the entity), it could publish guidelines

on its view on the typical, recurring issues that emerge in the assembly and discussion of recovery models. As the CRA experienced arbitrated decisions, it would build up a body of knowledge on the subject, and hopefully fewer and fewer cases would need to be arbitrated. To accelerate that process, we suggest that the CRA should consider carving off the recovery method from each audit, and putting this aspect in the hands of a few individuals that specialize in recovery methods.

3. A resetting of the exemption for arranging for financial services, based on first principles.

The scope of the exemption for services of arranging for the supply of a financial service needs to be comprehensively reset, to restore the policy objective of this essential provision, i.e., to equalize the level of GST inherent in the final price of any given financial service, regardless of which of a number of different direct or subcontracted assembly and distribution models produce the service. We need to go back to basics on the purpose of this provision. The current state is inequitable between different distribution and assembly models for the same financial product — significant vertical and horizontal distortions that have actually been *installed* into the tax due to the 2010 changes. Surveying the disputes that have driven the legislative amendment process over the 20 years of the GST, it could be said that legislative amendments coming out of the Department of Finance appear in some cases to have ignored these first principles and, as a result, significantly increased the tax base by increasing the non-recoverable tax incurred by suppliers of financial services.

Hopefully the setback in British Columbia will not freeze Canada in a partly harmonized state, and other provinces will see the wisdom of harmonizing. Even with harmonization at its current stage, the resetting of this aspect of the tax is a competitive necessity, in order to rebalance the playing field and commercial imperatives like outsourcing, co-sourcing and the exploitation of more diverse distribution models.

4. A new structure for taxing imported supplies

Should an insurer based in the US and having a branch in Canada pay GST on the salaries of data processors employed in the US, to the extent they process data for the Canadian branch? Should a financial institution in Canada be obliged to extract (or more likely from a practical viewpoint, guess) the loading portion of a financial service or instrument purchased from an affiliate company outside of Canada and remit GST thereon, even though the *very same service or instrument* would be entirely exempt if purchased from a Canadian affiliate, or from a Canadian or non-resident non-affiliate? Most would answer no to these two questions, based on reference to a policy compass. The technical answer today based on the Excise Tax Act is yes. In the case of the latter question the answer is yes, tax is now due on supplies since November 2005, as a result of legislation only receiving Royal Assent in July 2010.

Putting aside the unintelligibility of the current legislation for the moment, we suggest that the twin discriminatory aspects of these provisions need to be reconsidered as a matter of urgency.

Self-assessment of tax by entities unable to fully recover GST/VAT incurred on costs is an essential feature of any VAT, to level the playing field between domestic and non-domestic suppliers competing for domestic custom. Canada went one stage further in the original GST model by requiring self-assessment when goods or services flowed to a Canadian establishment of an entity straddling the border. This discriminates against entities that are not entirely based in Canada, loading them up with non-recoverable GST costs on salaries and finance expenses not incurred by their entirely Canadian-based competitors. In correcting legislative deficiencies in applying that first policy intent, however, we now have another significant new distortion, applying incremental tax to a portion of cross-border-related party transactions, the full extent of which will only become evident as the CRA now applies the new law.

What should be the policy guideline for the new self-assessment rules to take Canada into the future?

The OECD has a working party that considers international VAT supply issues, and sometime in the future we may well see tax treaties on VAT similar to those that now exist on income tax. Indeed some EU VAT refund provisions (such as the 13th directive VAT refunds) have always had reciprocity clauses as a condition for the refund, so when it comes to VAT/GST policy on imported services, discrimination in the form of a covert sticking tax on financial institutions is likely to have broader repercussions for Canadian industry.

GST applied on a self-assessment basis to imported services, at its simplest level, is a function of two questions for the importer;

- Q1. Would I have to pay GST on this if I purchased it in Canada? If yes, proceed to Q2;
- Q2. If I paid GST, would that tax be fully recoverable by me? If yes, you have no obligations. If no, self-assess tax and factor tax into your recovery method as some of it may be recoverable.

We suggest that any tax imposed beyond these questions is discriminatory, distortive, and ultimately unwise for a modern trading nation that places high expectations for growth on the international role of its financial sector. It may be that other jurisdictions will ultimately have to impose a targeted obligation to self-assess on intra-entity events to avoid the routing of domestic third-party costs through export, only to be re-imported intra-entity (so-called round-tripping), but it should be possible to craft rules that deal with that instance in isolation, without recourse to the massive distortion we have just installed in Canada.

5. Harsh retroactive legislative amendments should be restricted to a measure of last resort used only in exceptional circumstances.

Much has been written about the succession of harsh retroactive amendments to the GST, most often directed at the area of financial services. We now see retroactivity resorted to for issues where the revenue dollars are not significant in the grand scheme of things, after matters were already well advanced in the Tax Court of Canada (as in the case of debt recovery services⁴²) and on matters some years after the relevant legislative deficiency has come to light.

⁴² See Firth (2006) op. cit. P. 12-13 re: La Banque Canadienne de Commerce (2004-1427 (GST) G.

The measure was originally justified in 1996 as regrettable but necessary to maintain the integrity of a new tax. 21 years in, that rationale no longer holds water, but retroactive amendments persist.

We strongly recommend that the practice of retroactive amendments to the transaction-based tax be put back in its proper place, as a measure of absolutely last resort. Why? We could not say it better than the *Comprehensive Response of the Government of Canada to the Seventh Report of the Standing Committee on Public Accounts*, discussed above (Section B IV 1, page fifteen):

“Tax policy considerations, however, dictate that retroactive changes remain exceptional. Tax certainty, which requires that taxpayers be able to determine precisely their tax liability, is a fundamental principle of taxation. It is especially important that this principle be respected in the case of a tax, such as the income tax, the collection of which is based on a system of self- assessment. Taxpayers should be able to expect stability and continuity in the tax rules; they should be able to expect certain tax results when they plan their investments on the basis of the rules as they know and understand them.”

6. Setting minimum information and procedural requirements for the amendment process.

We have commented on the wobbles in definition and concept that occurred between the December 14, 2009 Department of Finance press release, the February 2010 CRA Notice No. 250, and the legislation eventually passed in July 2010, *effective from December 14th 2009*.⁴³

It is clear that taxpayers (and in this case, the CRA) are put into a difficult situation by this approach to legislative amendment.

Specifically,

- Changes are announced by press release and effective immediately, with no draft legislation;
- Taxpayers are then expected to make the decision to collect novel incremental tax on transactions, while consultation takes place, and concepts are modified to something unrecognizable from the press release. Often, as with imported services, this takes up to five years;
- Taxpayers are expected to engage with CRA auditors on procedural matters while rules are as yet unpublished, and to either agree audit years, or issue waivers to keep periods open while the rules are refined.

⁴³ See Firth, Michael (2010a), “‘No new taxes?’ No: new taxes. Definitely new taxes,” *CCH GST Monitor*, Sep, no 264.

Going forward, any changes to the GST should be effected in a manner that is respectful of the fact that GST registrants are charged with applying the tax to millions of transactions on a daily basis. Where those transactions are with businesses, the registrant can collect the novel tax subsequently, at administrative expense and some goodwill cost, but where the transaction is with the consumer, often the tax cannot be collected subsequently, and becomes a 100 percent penalty to the registrant.

As an absolute minimum, GST registrants and taxpayers should be able to expect the following.

1. Changes to the tax base should be clearly defined so that it is clear in the announcement exactly what supplies are affected, and from when (ideally, prospective dates allowing for system changes and communication with customers should be chosen);
2. Changes should not be announced until draft legislation can accompany the announcement;
3. Ideally, the CRA should publish its guidance such as Notices or Technical Information Bulletins at the same time as the change is announced;
4. Consultation should take place *before* the change is made, not *after* the effective date has been pegged by a scanty press release, the practical impact of which can be summarized as “Immediate extension to tax base, details to follow in three months....”;
5. Governments should enact the amending legislation at the first possible opportunity.

VII. CONCLUDING STATEMENT

This is a lengthy paper, so our concluding statement will be brief. This paper discusses and analyzes the application of the GST to the financial sector in Canada. The issues are addressed from both an economic and a practitioner point of view. Based on the analysis a number of recommendations are made that we think will improve the manner in which the GST is applied to financial services in Canada. These recommendations are, for the most part, pragmatic in nature, with an emphasis on practical options for improving the working of Canada’s exemption-based GST as it applies to the financial sector.

APPENDIX: CHANGES IN THE SCOPE OF THE EXEMPTION

This appendix contains a chronology of events leading to the legislative changes in 2010 relating to the narrowing of the exemption of arranging for services related to financial services.⁴⁴

December 14, 2009. Finance issues an announcement (2009-115), entitled “*Government of Canada responds to recent Court Decisions on the GST and Financial Services.*” There are three components mentioned in the announcement and backgrounder. The changes to credit and asset management were predicted accurately, but the forerunner of subparagraph (r.4) was only very briefly described as “*facilitatory services.*” The accompanying backgrounder explains...

A facilitatory service comprises the performance or provision of one or more of the following services:

- market research, product design, document preparation or processing, customer assistance, advertising, promotional or similar activities; and
- the collection, collation or provision of information.

Note two aspects of this approach. Performance or provision of any offending activity renders it taxable, so it seemed that the activity did not need to be present or visible in the supply rendered, but merely undertaken by the supplier. Also performance or provision of one or more... comprises a taxable facilitatory service, so at the outset we have a tainting concept being aired, with no thresholds being suggested, or any reference to the blighting activities having to be the dominant, or even a significant, characteristic to trigger exclusion. The Court decisions being reacted to were not all recent. See *Canadian Medical Protective Association* [April 10 2008], *Costco Wholesale Canada Ltd*, [10 March 2009], *Les Promotions D.N.D. Inc* [Jan 27 2006], *President’s Choice Bank* [9 April 2009].

February 11, 2010. The CRA issues Notice No. 250, a listing of a number of examples of services which, in the CRA’s view, are taxable effective December 2009. The financial sector begins to realize how far reaching the changes are, and both financial institutions and their suppliers now face the consequences of having rendered incorrect returns, and having to scramble to collect tax on supplies made over the last two months.

March 22, 2010. A Notice of Ways and Means is tabled in the House of Commons, including a range of amendments to the ETA. Subparagraphs (q.1), (r.3) (r.4) and (r.4) to the definition section 123 (1) of the ETA are included. Gone from (r.4) are the references to “facilitatory services,” and the tainting approach, to be replaced with very different concepts.

⁴⁴ See Firth (2010b) op. cit.

March 26, 2010. The federal Minister of Finance issues a statement (reported in Finance announcement 2010-024) specifically on the GST changes. Specifically, the Minister confirms as follows,

“Businesses need clear GST rules,” said Minister Flaherty. “The proposed changes contained in the Notice of Ways and Means Motion tabled in the House of Commons on March 22, 2010 are designed to confirm our long-standing policy intent and restore the situation that existed prior to the court decisions. We are not imposing new taxes.”

Further, at an event the same day, the Finance Minister also said:

“We will have the tools in the first Budget Implementation Act to make sure we get back to the status quo before the Court cases, so people can rest assured that the treatment of financial services will not change”

The Finance Department release also confirms that the CRA is now reviewing Notice No. 250 in view of the government intent.

May and June 2010. As the federal budget bill [Bill C-9 the Jobs and Economic Growth Act] passes through the legislative process, clause C55, containing the GST changes, attracts attention and comment at both the House of Commons and Senate Finance Committees. Clause 55 is one of four clauses that the Senate Finance Committee recommend be struck from the Bill, but this is not adopted and the GST changes receive Royal Assent along with the rest of the 2010 federal budget on July 12, 2010. A very good summary of the points made by various representatives is the submission to the House of Commons Finance Committee by the Canadian Bar Association (<http://www.cba.org/CBA/submissions/pdf/10-eng.pdf>).

THE EXEMPTION AT THREE POINTS IN TIME

Sector / Type of Supply	Pre December 14, 2009 Announcement ⁴⁵	Initial GST/HST Notice 250	Revised GST/HST Notice 250
Investment Management			
Discretionary management or administration of assets or liabilities	E	T	T (q.1) Example 1 and 2
Non-discretionary management or administration of assets or liabilities	E	T	T
Trade execution (in the course of management or administration of assets)	E	T	T (q.1) Example 1 and 2
Research, analysis, advice, appraisals or reports in respect of assets or liabilities	E?	T	T
Determination of which assets or liabilities are to be acquired or disposed of	E?	T	T
Acting to realise performance targets or other objectives in respect of assets or liabilities	E?	T	T

⁴⁵ Treatment prior to the announcement made on December 14, 2009, is subject to the coming into force provisions for the amendments to the definition of financial service. The supplies made before the announcement date may be exempt under the pre-existing “arranging for” rules if all of the consideration became due or was paid on or before December 14, 2009 and the supplier did not collect GST/HST (i.e., the supplier treated the supply as exempt). If the supplier did collect GST/HST and not all of the consideration became due or was paid on or before December 14, 2009 (i.e., the supplier treated the supply as taxable), then the amendment would be deemed to have come into force on December 17, 1990, effectively being utterly retroactive.

THE EXEMPTION AT THREE POINTS IN TIME (cont'd)

Sector / Type of Supply	Pre December 14, 2009 Announcement	Initial GST/HST Notice 250	Revised GST/HST Notice 250
Finance			
Checking, evaluating or authorizing credit	E	T	T (r.3)
Making decisions on behalf of the person relating to a grant, or an application for a grant, of credit	E	T	T (r.3)
Creating or maintaining records for the person relating to a grant, or an application for a grant, of credit or in relation to the cards or accounts	E	T	T (r.3)
Monitoring another person's payment record or dealing with payments made, or to be made, by the other person	E	T	T (r.3)
Credit management services (including credit card business process outsourcing)	E?	T	T (r.3) and (r.4) Example 5
Merchant credit card promotion and co-branding	E	T	T (r.3) and (r.4) Example 6
Credit card marketing, advertising (excluding application screening, etc.)	T (P-239, Example 5)	T?	T (r.3) and (r.4) Example 7
Credit card promotion (including application screening, etc.)	E (P-239, Example 2)	T?	T (r.3) and (r.4) Example 8
Assisting customers in obtaining property loans from captive financing company (e.g., captive financing by auto dealership)	E (P-239, Example 1)	T?	E Example 13
Assisting customers in obtaining property loans from an independent financing company (e.g., auto dealership referral to third-party financial institution)	E	T?	T (r.3) and (r.4) Example 14
Insurance			
Insurance brokerage (by a licensed insurance broker)	E	T?	E
Insurance agent services (including policy distribution and insurance coverage establishment)	E	T?	E (I) Example 11
Insurance policy promotion and application processing	E (P-239, Example 7)	T?	T Example 12
Brokerage			
Collecting, collating or providing information	E?	T	T
Market research, product design, document preparation, document processing, customer assistance, promotional or advertising service	E?	T	T
Full-service brokerage (including trade execution as the predominant service)	E	T?	E Example 3
Mutual fund servicing (including payment by way of trailer fees)	E (P-119, Examples 1 and 2)	T?	E Example 4
Mortgage brokerage (by a licensed mortgage broker)	E	T?	E Example 9
Mortgage referral services (by a consultant / non-licensed mortgage broker)	T (P-239, Example 5)	T?	T (r.3) and (r.4) Example 10
Business brokerage service (including arranging for the sale of shares)	E (P-239, Examples 3 and 6)	T?	T (r.4) Example 15
Other			
Retailer providing space and services to financial institution for ABM	T	T	T (r.5) Example 16

LEGEND: E - Exempt T - Taxable

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About the Authors:

Michael Firth is an indirect tax Partner at PricewaterhouseCoopers LLP in Toronto, and a member of the Canadian National Tax Services group at PwC Canada. Mike began his career with the United Kingdom Customs and Excise where he spent ten years in a variety of VAT audit, enforcement and training roles before joining PwC in the UK in 1988 to specialize in VAT as it affects the financial sector. Moving to Canada in 1990 to prepare clients for the GST, Mike has also worked in Barbados and Australia during their GST implementations.

Mike is a frequent speaker and writer on GST matters, and is the only two time recipient of the Normand Guerin award for an outstanding contribution to commodity tax studies. Mike was an invited witness to the House of Commons Finance Committee to comment on the package of GST measures included in the 2010 federal budget. He was recently identified in the guide to the world's top indirect tax advisors, published by International Tax Review.

Kenneth J. McKenzie is a Professor in the Department of Economics and The School of Public Policy at the University of Calgary, where he has been since 1992. He received his B.Comm. from the University of Saskatchewan in 1982, his M.A. from the University of Calgary in 1985 and his Ph.D. from Queen's University in 1990. From 1984 to 1986 he was an economist in the Tax Policy Branch of the federal Department of Finance. His first academic appointment was at the University of Toronto in 1990. His principal area of research is public economics, with an emphasis on taxation and political economy. Professor McKenzie has received the Harry Johnson Prize for the best article in the Canadian Journal of Economics (1996, with Herb Emery). He is a two time winner of the Douglas Purvis Memorial Prize for a published work of excellence relating to Canadian public policy (1999, with Ron Kneebone; 2010, with Natalia Sershun). In 2000 he was the recipient of the Faculty of Social Sciences Distinguished Research Award at the University of Calgary. He was the EnCana Scholar at the C.D. Howe Institute, where he delivered the 2001 Benefactors Lecture, and has been a visiting fellow at research institutes in both Germany and Australia. He was the inaugural director in 2004 of the University of Calgary's Institute for Advanced Policy Research. Professor McKenzie has acted as an advisor to governments and institutions at the international, federal and provincial levels. He has been on the Panel of Experts for the International Monetary Fund and the World Bank and has provided analysis and advice on tax policy to several developing countries. He has sat on the Taxation and Finance Committee of the Alberta Economic Development Authority, was a member of the Alberta Business Tax Review Committee in 2000, an expert advisor to the Financial Review Commission in Alberta in 2002, and involved in research for the federal government's Technical Committee on Business Taxation in 1997. In 2007 he was a member of the Alberta Royalty Review Panel. Professor McKenzie has served on the Executive Council of the Canadian Economics Association, and on the editorial boards of the Canadian Journal of Economics and the Canadian Tax Journal and is past editor and associate editor of Canadian Public Policy. He served as Department Head in Economics from 2007-2010, and is currently Director of the Tax and Economic Growth Program in The School of Public Policy.

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