

## SALES TAXES IN CANADA: THE GST-HST-QST-RST “SYSTEM”

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**Final Draft: May 29, 2009**

Canadians developed and implemented a sales tax system that no one in their right mind would have designed from scratch. Nonetheless, more by accident than design, Canada ended up being a bold innovator in sales tax policy and administration in several important respects. For decades, academics had argued almost unanimously that one could not impose a standard invoice-credit destination-based value added tax (VAT) at the subnational level of government.<sup>2</sup> Canada's almost two decades of experience demonstrates conclusively that this view is incorrect: not only can it be done, but it has been done, and done well. Moreover, Canadian experience also demonstrates that a federal VAT can work perfectly well in a country in which some subnational units have their own VATs, some have their own retail sales taxes (RSTs), and some have no sales tax at all.

The facts are thus on the ground and visible: the Canadian system not only works but works fairly well -- at least in Canada. A similar system could in principle work equally well in the United States. Indeed, the US could not only learn from Canadian experience but it could also do better in a number of ways if it wished to do so. Basketball and telephones were also invented by Canadians, but both were adopted, adapted and in many ways improved by Americans.<sup>3</sup> We see no reason why two-level sales taxation should be any different. Canadian experience shows that the existence or non-existence of subnational retail sales taxes is, in both technical and economic terms, a matter of indifference when considering a federal VAT. On the other hand, the existence of a federal VAT may be extremely important from the perspective of subnational governments that wish to improve their sales taxes.

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<sup>2</sup> One of us was also guilty as charged: see Richard M. Bird “Federal-Provincial Taxation in Turbulent Times,” *Canadian Public Administration*, 36 (4, 1993), 479-96; for a different and more recent view, see Richard M. Bird and Pierre-Pascal Gendron, *The VAT in Developing and Transitional Countries* (New York: Cambridge University Press, 2007).

<sup>3</sup> Although it seems that that every country has its own version of who invented what, the Canadian content of both the items mentioned is at least as well documented as most things in Wikipedia. (Incidentally, Canada also lays claim to both the zipper and the electric light bulb, not to mention insulin, instant mashed potatoes, and the instant replay feature so familiar from sports telecasts!)

As Table 1 shows, the Canadian sales tax 'system' is not simple.<sup>4</sup>

**Table 1**  
**Sales Taxes in Canada**

<i>Jurisdiction</i>	<i>Name of Tax</i>	<i>Type of Tax</i>	<i>Rate (%)</i>	<i>Yield as a share of total taxes (%)</i>	<i>Administration</i>	<i>Comments</i>
<b>Canada</b>	GST/HST	VAT	5 / 13	17.3	Federal except in Québec, where it is provincial	GST rate (federal) is 5% and applied throughout the country; the federal government also administers a provincial sales tax rate of 8% in the three HST provinces (sum is 13%)
<b>Newfoundland and Labrador</b>	HST	VAT	8	25.1	Federal	HST revenues collected in the three HST provinces are distributed to provinces based on estimated taxable consumption
<b>Nova Scotia</b>	HST	VAT	8	44.2	Federal	Same as for Newfoundland
<b>New Brunswick</b>	HST	VAT	8	15.3	Federal	Same as for Newfoundland
<b>Prince Edward Island</b>	PST	RST	10	27.4	Provincial	Applied to retail sales price including GST
<b>Québec</b>	QST (TVQ)	VAT	7.5	16.2	Provincial	Applied to GST base plus GST
<b>Ontario</b>	PST	RST	8	22.3	Provincial	Applied to retail sales price, (excluding GST)
<b>Manitoba</b>	PST	RST	7	23.1	Provincial	Same as Ontario
<b>Saskatchewan</b>	PST	RST	5	18.4	Provincial	Same as Ontario
<b>British Columbia</b>	PST	RST	7	16.8	Provincial	Same as Ontario

*Sources:* Rates shown are for 2008; revenue shares were calculated on the basis of data from Karin Treff and David B. Perry, *2007 Finances of the Nation* (Toronto: Canadian Tax Foundation, 2008).

*Note:* As discussed later in the text, the base of the Québec Sales Tax (QST or TVQ, *Taxe de vente du Québec*) differs slightly from that of the GST. Moreover, although the base of the provincial HSTs is the same as that of the GST, as we discuss later, each province can alter the effective base by rebating its tax. As is also discussed further below, each Retail Sales Tax (RST) province has its own tax base, generally with considerable taxation of business inputs and with limited coverage of services. These taxes are not coordinated in any way with each other or with the federal GST.

<sup>4</sup> Table 1 is an updated and expanded version of a table in Richard M. Bird, Jack M. Mintz and Thomas A. Wilson, "Coordinating Federal and Provincial Sales Taxes: Lessons from the Canadian Experience," *National Tax Journal*, 59 (4, December 2006), 899-903. In fact, the system is considerably more complex than shown in Table 1. Although treaty Indians on reserves are allowed to purchase goods and services for use on reserves on a zero-rated basis under the federal goods and services tax (GST), as of January 2, 2009, 22 First Nations (out of over 600 in the country) imposed their own First Nations GST (FNGST) -- in lieu of the federal GST -- on all taxable supplies purchased on First Nations lands. The FNGST is administered free of charge by the federal government at the same rate, and in the same way, as the GST, with all proceeds (C\$9.4 million in 2006/07) going to the First Nation concerned. These interesting arrangements are not further discussed in the present paper: for an initial appraisal, see the audit report available at [http://www.fin.gc.ca/activity/pubs/afnsta\\_1e.html](http://www.fin.gc.ca/activity/pubs/afnsta_1e.html) (accessed on May 22, 2009).

In the next four sections of the paper we discuss, in order, the four principal components of that system:

- The federal VAT introduced in 1991 -- the Goods and Services Tax (GST);
- The extension of the GST in 1997 to three small eastern provinces -- the Harmonized Sales Tax (HST);<sup>5</sup>
- The unique provincial VAT introduced in 1991 in the province of Québec -- the Québec Sales Tax (QST); and, finally,
- The provincial sales tax that continues to exist in most other provinces -- the retail sales tax (RST).<sup>6</sup>

The scope of VAT in Canada will expand shortly and in a significant way as the Province of Ontario announced in its March 2009 that it will essentially, with some minor variations, join the GST/HST system with a provincial component of 8% -- the same rate as its present RST -- on July 1, 2010.<sup>7</sup> We discuss this prospective change briefly later in this paper.

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<sup>5</sup> Strictly speaking, the terminology sometimes used in Canada, especially at the federal level, is not GST (for federal) and HST (for provincial) as we use those terms here but rather CVAT (for Canada-VAT, not the Compensating VAT as discussed in McLure (this volume) for the federal portion of the tax that applies in all provinces) and PVAT (Provincial-VAT) for the portion of the tax that applies on property or services supplied in or brought into a participating province. The official name of the (combined) federal-provincial tax is the GST/HST, as discussed further in the text below.

It is also common in Canada to refer to all three varieties of subnational sales taxes simply as Provincial Sales Taxes (PSTs): for example, see the discussion in Karin Treff and David B. Perry, *2007 Finances of the Nation* (Toronto: Canadian Tax Foundation, 2008), chap. 5. (As we argue later in this paper, this treatment is basically correct: it makes almost no difference to the country as a whole whether any particular province chooses to impose its sales tax in the form of VAT or an RST. It may, however, make a considerable difference to the province in question.) Along the same lines, provincial governments usually refer to their sales tax (regardless of how it is characterized in this paper) simply as a PST (provincial sales tax) rather than an RST (retail sales tax) or a VAT (HST or QST, as the case may be): we have adopted the RST terminology here for clarification.

<sup>6</sup> The province of Alberta and the three northern territories (Yukon, Northwest Territories, Nunavut) have no sales tax, although the GST applies in those jurisdictions.

<sup>7</sup> Ontario Ministry of Finance, *2009 Ontario Budget* (Toronto: Government of Ontario, 2009), available at [http://www.fin.gov.on.ca/english/budget/ontariobudgets/2009/chpt3.html#c3\\_salestax](http://www.fin.gov.on.ca/english/budget/ontariobudgets/2009/chpt3.html#c3_salestax) (accessed on May 22, 2009).

## THE FEDERAL GOODS AND SERVICES TAX (GST)

VAT did not come to Canada quickly or quietly. Its gestation period was long and its birth in 1991 was politically painful. Indeed, in its early years the GST was the most heartily disliked tax in Canada.<sup>8</sup> One result of all the fuss was that from the beginning the GST has had certain structural defects. Another result was the rather peculiar arrangement made with the province of Québec to have the provincial tax administration administer the federal GST in that province together with its own independent VAT, the QST. Equally peculiar in some ways were the arrangements made a few years later to have the federal government administer in several provinces a uniform provincial VAT, the HST, on essentially the same base as the GST. After the initial turbulence died down, for a decade or so it appeared that the GST had become a stable and accepted part of the Canadian tax system. In 2006, however, the then newly-elected Conservative government took the somewhat surprising step of living up to one of its campaign promises by reducing the GST tax rate from the 7% rate initially imposed in 1991 first to 6% on July 1, 2006, and then, on January 1, 2008, to the current rate of 5%.

### The Birth of the GST

Canada first introduced a federal sales tax in 1920 in the form of a 1% turnover tax, applied to all sales except those at retail. The aim of the new tax was essentially to pay off the debts incurred as a result of the First World War.<sup>9</sup> Although one fiscal historian has called the introduction of the tax "a quick, easy delivery,"<sup>10</sup> from the beginning the new tax was exceedingly unpopular with business, largely owing to its effects on non-integrated firms such as wholesalers. As a result, after a number of modifications, the turnover tax was replaced in 1924 by a 6% tax on sales by manufacturers -- the manufacturers' sales tax (MST). This tax too was far from popular, and its rate was gradually lowered to a level of only 1% in 1930 with the apparent intention of abolishing it the next year. However, the depression intervened. Increasing fiscal deficits led instead to an increase of the sales tax rate to 8% in 1936, when it yielded 31% of all federal revenue.<sup>11</sup>

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<sup>8</sup> See the survey evidence reported in Richard M. Bird, *Where Do We Go From Here? Alternatives to the GST* (Toronto: KPMG Centre for Government, 1994).

<sup>9</sup> In doing so, Canada followed a precedent set by Germany, France, and other European countries. On the introduction and early years of the federal sales tax, see J. Harvey Perry, *Taxes, Tariffs and Subsidies: A History of Canadian Fiscal Development* (Toronto: University of Toronto Press, 1955), vol. 1, chap. 13; see also John F. Due, *Sales Taxation* (Urbana: University of Illinois Press, 1957), chap. 8.

<sup>10</sup> W. Irwin Gillespie, *Tax, Borrow and Spend: Financing Federal Spending in Canada, 1867-1990* (Ottawa: Carleton University Press, 1991), p. 118.

<sup>11</sup> The depression also led to the introduction of the first subnational sales taxes in Canada, with provincial retail sales taxes being imposed in Saskatchewan in 1937 and in Québec in 1940. Interestingly, the first such tax in Canada was actually a local retail sales tax imposed in Montréal in 1935. When Québec moved into the sales tax field itself in 1940, it not only left the Montréal tax in place but also introduced a similar tax in Québec City. Subsequently, the municipal sales tax (at rates of 1% or 2%) spread to a number of other municipalities in the province until 1964, when it was taken over by the province (see James A. Johnson, "New Tax Sources and Tax-Sharing for Canadian Municipalities," in Canadian Tax Foundation,

An important Royal Commission report at the end of the 1930s recommended the elimination of the federal sales tax both because of its regressivity and the "cascading" that resulted from taxing inputs.<sup>12</sup> Subsequently, in part to hold down prices during wartime, the rate of the MST was not raised during the Second World War. Soon after the war, however, the rate began to creep up. So did the volume of complaints about the structure and operation of the tax, particularly from manufacturers. In response, an expert committee was appointed in 1955 to study the sales tax and to make recommendations for its reform. The committee's primary recommendation was to move the MST forward to the wholesale level essentially to reduce the valuation problems that had arisen as the federal government attempted through an extensive series of administrative regulations to treat different types of sales by taxpayers (to other manufacturers, to wholesalers to retailers, and to final consumers) more evenly.<sup>13</sup> This report turned out to be only the first in a series of subsequent official reports recommending various reforms in the sales tax.<sup>14</sup>

Ten years later, the Royal Commission on Taxation (the Carter Commission), although it discussed briefly the possibility of a value-added tax, concluded that the best road to pursue would be an integrated "national" retail sales tax under which the provinces would administer a combined federal and provincial tax.<sup>15</sup> In response, the government of the day stated that it intended to restructure the federal sales tax but would first deal with the income tax. In 1975, the first official discussion paper on the sales tax reform finally emerged. Essentially, this study supported the recommendation of the report of the 1956 sales tax committee to move to a wholesale level tax.<sup>16</sup> A later report reached the same conclusion.<sup>17</sup> Although both these reports recognized that a federal retail level tax would be economically preferable, both thought such a tax would be too complicated to implement owing to the existence of retail sales taxes in most provinces.

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1973 Conference Report (Toronto, 1974), pp. 591-612). At present, there are no general local sales taxes in any province. However, the City of Toronto and municipalities in Nova Scotia may impose taxes on land transfers, and municipalities in Manitoba and Saskatchewan may impose amusement taxes. In British Columbia, the province will collect an additional (to the provincial sales tax) 2% tax on hotel rooms if municipalities wish to impose it.

<sup>12</sup> See Canada, *Report of the Royal Commission on Dominion-Provincial Relations* (Ottawa: King's Printer, 1940).

<sup>13</sup> Canada, Sales Tax Committee, *Report of the Sales Tax Committee to the Minister of Finance* (Ottawa: Queen's Printer, 1956). Another issue that caused considerable concern under the MST was the treatment of imports: domestic manufacturers claimed, often with some justice, that their sales prices incorporated distribution costs like advertising that were not included in the tax base for competing imported goods. See Malcolm Gillis, "Federal Sales Taxation: a Survey of Six Decades of Experience, Critiques, and Reform Proposals," *Canadian Tax Journal*, 33 (1, January-February 1985), 68-98, for further discussion.

<sup>14</sup> For a brief review of these reports, see Richard Domingue and Jean Soucy, *The Goods and Services Tax: 10 Years Later* (Ottawa: Library of Parliament, 2000), as well as Gillis, *supra* note 13.

<sup>15</sup> *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966).

<sup>16</sup> Canada Department of Finance, *Federal Sales and Excise Taxation*, Discussion Paper (Ottawa: Government of Canada, June 1975).

<sup>17</sup> Canada Department of Finance, *Report of the Commodity Tax Review Group* (Ottawa: Government of Canada, June 1977)

As time went on, however, the government changed its tune. A 1983 report concluded that there were three alternatives to replace the MST: an integrated national retail sales tax (as had been recommended by the 1966 Royal Commission), a separate federal retail sales tax, or a federal VAT.<sup>18</sup> In addition, that report suggested that even if a purely federal VAT were to be introduced provinces should be "...encouraged to join in the administration of such a tax" (p.58). The following year, in November 1984, the government officially announced for the first time that it was considering replacing the MST by a VAT.<sup>19</sup>

By the 1980s, perceptions of sales taxation had changed for a number of reasons. In addition to the generally more favorable view of consumption taxation that was becoming visible in many democracies around the world in this period, the increasingly difficult deficit position of the federal government was a critical factor in Canada. When a new Conservative government took office in 1984, the federal deficit was almost 9% of GDP. It was not surprising that the succeeding decade saw numerous tax increases, not least in the sales tax.<sup>20</sup> By 1989, when the MST yielded 15% of all federal tax revenue<sup>21</sup> the base of the tax had been moved forward on an industry-by-industry basis to encompass more and more of the distribution sector. Nonetheless, the sales tax base was beginning to erode. The continuous re-definition of 'manufacturing' to encompass more distribution services had largely been done administratively rather than by changing the law, and these administrative rulings were being increasingly challenged by taxpayers, often successfully. To sustain sales tax revenues and cope with increasing deficits, the tax rate thus had to be raised from 9% to 10% in 1984, 11% in January 1986, 12% in April 1986, and finally, in 1989, to 13.5%.<sup>22</sup> It became more and more difficult to maintain revenue from this source simply by raising the rate on a shrinking base. Moreover, the MST continued to have many serious administrative deficiencies as well as undesirable economic effects, and it was definitely not popular with manufacturers.

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<sup>18</sup> Canada Department of Finance, *Report of the Federal Sales Tax Review Committee* (Ottawa: Government of Canada, May 1983). This paper had been preceded by yet another proposal to move the MST to the wholesale level: see *Proposal to Shift the Federal Sales Tax to the Wholesale Trade Level* (Ottawa: Government of Canada, April 1982).

<sup>19</sup> See Domingue and Soucy, *supra* note 14.

<sup>20</sup> For a detailed account of this period, see Thomas A. Wilson and D. Peter Dungan, *Fiscal Policy in Canada: an Appraisal* (Toronto: Canadian Tax Foundation, 1993).

<sup>21</sup> J. Harvey Perry, *Taxation in Canada* (Fifth edition; Toronto: Canadian Tax Foundation, 1990), pp. 104-5. Interestingly, as Table 1 indicates, the GST continues to provide much the same share of federal taxes as did the MST.

<sup>22</sup> A similar pattern of rate increases offsetting base shrinkage has recently been observed with respect to state sales taxes in the US: see John L. Mikesell, "Dynamic Patterns in State Sales Tax Structures: Tax Policy Change and Convergence, 1979-2007," *State Tax Notes*, 51 (3, January 19, 2009) pp. 175-88. In the case of the Canadian federal MST, the special rate for building materials was increased from 5% to 9% and the rate for alcohol and tobacco rose from 12% to 19%. The MST base was also expanded to include most telecommunication services in 1983 (initially at a rate of 6%, later raised to 8%). Although MST revenues actually grew faster (10.7% per annum) than nominal GDP (8.0% per annum) from 1980 to 1990, this was attributable largely to the substantial increases in MST rates. Without these rate increases, MST revenue growth would have been at most 6.3% per annum (Bird, Mintz and Wilson, *supra* note 4).

Still, since no one else in the country appeared to know the tax existed and 15% of revenue from an invisible tax was no small gift to a hard-pressed government, the federal government made a bold and controversial decision when it finally decided at the end of the 1980s to scrap the MST and replace it by a VAT. In addition to the need to maintain revenues, another important factor shaping this decision was increasing concern about the undesirable economic effects of the MST. Close to half the revenue collected from this tax came not from consumption but rather from taxes on business inputs such as investment goods. These input taxes were then cascaded through the system and incorporated in the price of even such exempt items as food as well as in export prices.<sup>23</sup> Moreover, the significant taxes imposed on capital goods by the MST raised the cost of capital and discouraged investment in physical capital. A government that had just signed a free-trade agreement with the United States and was increasingly worried about Canada's international competitive position did not want to tax investment and exports or favor imports. A VAT was thus favored as the best way both to eliminate the taxation of business inputs and to treat exports and imports more neutrally.

For these reasons, in 1987 the federal government proposed substantial reforms in both sales and income taxes.<sup>24</sup> Earlier indications of government intentions had suggested that the MST might be replaced by a VAT, either in the form of a Business Transfer Tax (an accounts-based subtraction method VAT) or the more familiar credit-invoice VAT.<sup>25</sup> In its 1987 White Paper, however, the Government stated that it would prefer to replace both federal and provincial sales taxes by a single "national" VAT. Income tax reform went ahead, but the federal government postponed sales tax reform until after the 1988 election. By then, however, it had become clear that there was no support for an integrated national tax. The federal government therefore decided to introduce its own invoice-credit VAT to replace the MST.<sup>26</sup>

Provincial reaction was immediate and negative. Three large provinces -- Alberta, Ontario, and British Columbia -- launched legal action against the federal government for exceeding its constitutional powers by introducing such a tax. Although it did not join in this suit, Québec also declared that it considered the decision to be unconstitutional. This initial furor died down quickly, however, and negotiations on a

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<sup>23</sup> Chun-Yan Kuo, Thomas C. McGirr, and Satya N. Poddar, "Measuring the Non-Neutrality of Sales and Excise Taxes in Canada," *Canadian Tax Journal*, 36 (May/June 1988), 655-70. For a thorough discussion of the economics of the federal sales tax, see John Whalley and Deborah Fretz, *The Economics of the Goods and Services Tax* (Toronto: Canadian Tax Foundation, 1990).

<sup>24</sup> The Government's proposals were set out in a series of documents released under the name of the then Minister of Finance (Michael Wilson), as follows: *Tax Reform in 1987: Sales Tax Reform* [the White Paper] (Ottawa: Department of Finance, June 18, 1987); *The Goods and Services Tax* (Ottawa: Department of Finance, April 27, 1989); *Goods and Services Tax: An Overview* (Ottawa: Department of Finance, August 1989); *Goods and Services Tax: Technical Paper* (Ottawa: Department of Finance, August 1989); and *Goods and Services Tax* (Ottawa: Department of Finance, December 19, 1989).

<sup>25</sup> The business transfer tax is an accounts-based subtraction method VAT in which companies would remit tax on the difference between sales and purchase of goods and services, including capital goods. For a more complete discussion, see Jack M. Mintz, "The Business Transfer Tax as a Consumption Tax," *Tax Notes International*, 10 (1, January 2, 1995), 75-86.

<sup>26</sup> This option had already been floated in the 1987 White Paper, *supra* note 24.

possible 'joint' approach to the VAT began with several provinces, including Québec.<sup>27</sup> Finally, on January 1, 1991, Canada laid its antique manufacturers' sales tax to rest and followed most countries around the world by introducing a new federal VAT in the standard credit-invoice form, called the Goods and Services Tax (GST).<sup>28</sup>

Although the federal-provincial fuss had largely faded away by the time the GST was introduced in 1991, many experts remained concerned about the administrative and compliance complexities of the VAT and many citizens were bothered by the potential distributional consequences of the tax.<sup>29</sup> The latter issue in particular led to considerable political heat when the new tax was thrown on the fire already set alight by the concurrent and prolonged controversy over the free-trade agreement with the United States. In the end, the government was able to push the GST through Parliament only by -- for the first time in Canadian history -- reviving a long-forgotten constitutional power to appoint a sufficient number of new Senators to force through final legislative approval.<sup>30</sup> The ruling Conservative party paid the price in the 1993 election, the first after the tax was introduced. In what was probably the most dramatic collapse ever of a political party in a stable democratic country, the Conservatives were virtually eliminated from Parliament, falling from a majority of 169 seats to a pitiful remnant of only two elected members.<sup>31</sup>

The new Liberal government elected in 1993 promised to replace the VAT with some other form of consumption tax, which they originally thought might be the Business Transfer Tax mentioned above. However, the House of Commons Finance Committee charged with reviewing the issue in the end recommended that the federal GST should instead be replaced by a harmonized federal-provincial sales tax. The Committee concluded that the Business Transfer Tax would not function well because under section 125 of the Constitution provincial bodies could not be taxed and because it would require

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<sup>27</sup> Prince Edward Island, Manitoba and Saskatchewan also entered into negotiations with the federal government, although to this day none of these provinces have entered into any arrangements with respect to sales taxation (except on certain imports of foreign goods; see below). The constitutional case launched by Alberta, Ontario and British Columbia was subsequently decided in favor of the federal government in 1992 (*Reference GST [1992] 2 S.C.R. 445*).

<sup>28</sup> As mentioned, the replacement of the MST by the GST was originally proposed as part of a comprehensive reform of the federal income and sales taxes. Unfortunately, in the end income tax reform was introduced three years before the sales tax reform, which was likely one reason why the latter reform proved so unpopular. Other arguments made against the sales tax reform were that: (1) it would be regressive, (2) it would produce excessive revenues for the federal government, (3) it would be too costly in terms of compliance and administrative costs, and even that (4) it was inferior to other possible reforms (e.g. in the existing sales tax or in payroll taxes). For a summary and survey of these arguments, see Bird *supra* note 8.

<sup>29</sup> For extensive discussion of such worries and concerns, see Whalley and Fretz *supra* note 23.

<sup>30</sup> A specified number of Senators from each province (more in larger provinces) are appointed by the federal government in Canada. However, once appointed, they may remain in office until age 75. The Senate cannot initiate revenue legislation, but it can block it. Because most Senators had been appointed by the Liberal opposition during its many years in power, most were Liberals and hence opposed to the GST.

<sup>31</sup> There were, of course, other issues than the GST -- notably opposition to NAFTA -- that produced this dire result. For a useful brief appraisal of the politics of GST adoption in Canada and elsewhere, see Richard Eccleston, *Taxing Reforms: The Politics of the Consumption Tax in Japan, the United States, Canada and Australia* (Cheltenham, UK: Edward Elgar, 2007).

making purchases from non-registered businesses ineligible deductions from the tax base, thereby making the tax much like a credit-invoice VAT in any case.<sup>32</sup> The ultimate solution reached by the new government was in any case quite different. After three small Atlantic provinces (New Brunswick, Nova Scotia and Newfoundland and Labrador) finally agreed in 1996 to replace their RSTs with VATs under the name of the Harmonized Sales Tax (HST), in return for a substantial initial payment from the federal government. That government simply declared victory: as initially promised in its election campaign, it had indeed replaced the GST --by the (renamed but identical) GST/HST.<sup>33</sup>

The case for reforming the federal sales tax was undoubtedly strong and the government had been committed to do so for some years before it introduced the GST in 1991. Nonetheless, it remains far from clear exactly just why this particular Conservative government, unlike so many other governments before and after, actually decided to live up to this particular commitment. Why it agreed to the unusual arrangements with Québec in 1991 (other perhaps than to ensure that at least one province would simultaneously adopt a VAT) is equally unclear. Still, the deeds were done. After vigorously attacking the GST during its ultimately successful 1993 election campaign the succeeding Liberal government in the end not only kept the tax but also persuaded three other provinces to sign on to a different form of provincial VAT that was, unlike the tax in force since 1991 in Québec, applied directly to the same base as the federal GST. And there the situation still stands. For over a decade, Canada has thus had not only a federal VAT but two distinct varieties of provincial VATs -- the QST and the HST.

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<sup>32</sup> Standing Committee on Finance, *Replacing the GST: Options for Canada* (Ottawa: House of Commons, June 1994). Domingue and Soucy, *supra* note 14 provide a convenient summary of the other alternatives considered in this report.

<sup>33</sup> See *supra* note 5 on the terminology of sales taxation in Canada. The initial compensatory payment to the HST provinces was intended to offset approximately half of the initial estimated revenue loss, since the provincial sales tax rates were being substantially reduced in all three provinces. The payment was calculated by applying the following percentages to the estimated revenue loss in excess of 5% of existing revenues: for the first two years, 50% in the third year, and 25% in the fourth year. For example, if RST revenues were 100 and HST revenues were 90, then the transitional assistance would be  $5+5+2.5+1.25 = 13.75$ .

## How Good a Tax Is the GST?

Was the GST worth the effort? On balance, the evidence seems clear: from the perspective of Canada (if not that of the political party that introduced the tax), it was. Essentially, the GST satisfied the two principal objectives set out when it was first proposed: to stabilize the revenues from this source<sup>34</sup> and to reduce the hidden taxation of exports and investment.<sup>35</sup> Even the new government that came to power after the 1993 election, although it had explicitly campaigned on a platform of eliminating the GST,<sup>36</sup> in the end did no more change the name of the tax to the present cumbersome Goods and Services Tax/Harmonized Sales Tax (GST/HST). The GST -- under its new name -- was here to stay.

One result of its difficult birth, however, was that Canada's GST, while substantially better in some respects -- for example, with respect to the treatment of both the public sector<sup>37</sup> and housing<sup>38</sup> -- than the standard European Union (EU) VAT, fell far short of the "new model" comprehensive GST that had been implemented in New Zealand only a few years earlier.<sup>39</sup> Three examples may be mentioned of ways in which Canada unnecessarily -- in economic if not in political terms -- reduced the scope and increased the costs and complexity of the GST.

One example is Canada's unique "double dip" approach to dealing with the perceived regressivity issue. Since on the whole there was no net increase in sales taxes when the GST was introduced and the new tax, unlike the tax it replaced, resulted in little cascading, there probably was not much impact on the net redistributive outcome of the fiscal system as a result of the GST.<sup>40</sup> Nonetheless, the high political visibility of the

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<sup>34</sup> For discussion of the revenue performance of the GST, see Bird, Mintz and Wilson, *supra* note 4. In an attempt to offset the widespread public impression that the GST was a new tax that would substantially increase government revenues, all GST revenue (net of credits and rebates) was transferred to a newly created "Debt Servicing and Reduction Account" with all the proceeds being formally earmarked to debt service and reduction. Of course, this was simply window dressing since the cost of debt service was much larger than the revenue from the GST at the time. It also had no visible effect upon the extremely adverse public perception of what many Canadians at the time called the "Gouge and Screw Tax."

<sup>35</sup> The extent of these hidden taxes was set out in Kuo, McGirr and Poddar, *supra* note 23. The extent to which moving to a VAT base reduced taxes on investment in the HST provinces and Quebec is discussed in Michael Smart and Richard Bird, "The Impact on Investment of Replacing a Retail Sales Tax by a Value-Added Tax: Evidence from Canadian Experience," June 2008, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1273773](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1273773) (accessed May 22, 2009).

<sup>36</sup> See *Creating Opportunity: the Liberal Plan for Canada* (Ottawa: Liberal Party of Canada, 1993).

<sup>37</sup> See Gendron (this volume).

<sup>38</sup> See Satya Poddar (this volume).

<sup>39</sup> House of Commons Standing Committee on Finance and Economic Affairs (*Eleventh Report. Minutes of Proceedings and Testimony*, Issue Number 147 (Ottawa: House of Commons, March 15, 1988) had urged the government to apply the New Zealand model and impose the VAT on as broad a base as possible, in particular including food. Canada chose to take a different route. For a recent detailed discussion of the GST in New Zealand, which like all taxes has its problems, see Richard Krever and David White, eds., *GST in Retrospect and Prospect* (Wellington: Thomson Brookers Ltd., 2007).

<sup>40</sup> The complexity of the incidence issue and some of the conflicting views on its importance and nature is evident from such early exchanges as that between Patrick Grady, "An Analysis of the Distributional

GST meant that most Canadians thought of it as a "new" tax. The previous federal sales tax had not been visible. The GST law allowed registered firms to quote either tax exclusive or tax inclusive prices. In fact, however, in virtually every case retailers treated the new GST exactly like the existing RST by adding it onto the price at the cash register.<sup>41</sup> Now, however, Canadians got the bad news every time they had to dig into their pockets to pay the highly visible GST.<sup>42</sup> Moreover, they had to pay the GST not only on goods but also on many services that were exempt from provincial RSTs. Politically, it was clear that something had to be done to avoid the appearance of increasing taxes on the poor.

The logical approach, given Canada's long tradition of providing refundable income tax credits for those whose income is low enough to qualify, was simply to create yet another refundable income tax credit -- the "GST credit" -- set at such a level as to provide a more than sufficient offset to any conceivable additional regressivity that might arise from the introduction of the GST. This was done, to the satisfaction of the experts for the most part.<sup>43</sup> However, few other Canadians seem to have connected the proposed new income tax offset with what they saw as a new tax on food, and in the run-up to the introduction of the GST criticism of its alleged regressivity continued to mount. The outcome was an almost comical situation in which at just about the moment when the entire implementation package was ready to be launched for a GST that did tax food, the

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Impact of the Goods and Services Tax," *Canadian Tax Journal*, 38 (May/June 1990), 632-43, and W. Irwin Gillespie, "How to Create a Tax Burden Where No Tax Burden Exists: A Critical Examination of Grady's 'An Analysis of the Distributional Impact of the Goods and Services Tax'," *Canadian Tax Journal*, 39 (No. 4, 1991), 925-36. The issue has subsequently been revisited a number of times in the literature without throwing all that much more light on it. For a recent contribution that argues replacing the RST by the HST had little distributional impact, see Michael Smart and Richard M. Bird, "The Economic Incidence of Replacing a Retail Sales Tax by a Value-Added Tax: Evidence from Canadian Experience," *Canadian Public Policy*, 35 (1, 2009), 85-97.

<sup>41</sup> The RST must, for constitutional reasons, be expressed as a tax on purchasers (since provinces are restricted to levying only "direct" taxes). Separate quotation of the RST reflects this legal requirement. The GST is under no such constraint, however. Reportedly, the option for separate quotation of the GST was required in order to comply with the law in the province of Manitoba, although obviously its application could not be restricted to that province.

<sup>42</sup> The law provides for either tax-inclusive or tax-exclusive pricing. It is clear, however, that the original intention was to have tax-inclusive pricing (as with the VAT in the EU), with GST shown separately on the receipt or invoice but included in the posted price) rather than tax-exclusive pricing (as in the RST), and that this was still the aim at the time of the introduction of the HST. Indeed, the stated intention at the time of the adoption of the HST (see, for example, Department of Finance Canada, News Releases 1996-075 and 1997-003) was to "enforce the requirement" to implement tax-inclusive pricing. However, as a result of extensive public criticism in the end vendors were again given the option of tax-exclusive pricing (David Murrell and Weiqiu Yu, "The Effect of the Harmonized Sales Tax on Consumer Prices in Atlantic Canada," *Canadian Public Policy*, 26 (4, 2000), 451-60). Tax-exclusive pricing continues to prevail in Canada.

<sup>43</sup> In 2008, the GST credit was C\$237 for each spouse and C\$125 for each dependent child. Although Canada does not have joint filing, one spouse nonetheless must claim credit for both spouses and for dependent children. The credit was reduced by 5% of the excess family income over C\$30,936. (The amounts are adjusted annually in accordance with CPI changes.) Some provinces provide additional sales tax credits for their own sales taxes. All these credits are refundable. In Ontario for example, when a child becomes 19, if they file their own return and have no income, they received a credit in 2008 of C\$337 (C\$237 for GST from the federal government and C\$100 for the RST from the provincial government).

Prime Minister of the day publicly stated that the GST would not tax "basic groceries." Although the GST credit remained in place, the result of this fiasco was that everyone involved in preparing for the introduction of the tax had to go back to the drawing board, decide -- rather arbitrarily<sup>44</sup> -- exactly what was meant by "basic groceries", redraft the law, regulations, and returns accordingly, and adjust the rate and revenue estimates as required. Of course, untaxing food, unlike the targeted GST credit, benefits everyone who eats, regardless of their income level.<sup>45</sup> More importantly, the creation of this extensive zero-rating of particular products introduced still more complexity into what one of the present authors once labeled "probably the most complex VAT law in the world."<sup>46</sup>

In addition to food, special treatments are provided for many other activities including small businesses,<sup>47</sup> nonprofit organizations, charities, the so-called MASH (municipality-academic-school-hospital) sector,<sup>48</sup> tourist expenditures by non-residents,<sup>49</sup>

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<sup>44</sup> To mention a favorite example, five donuts are taxable but six or more are exempt.

<sup>45</sup> The estimated revenue cost of zero rating basic groceries (C\$3.8 billion in 2006) exceeds the total GST credit (C\$3.5 billion), according to Department of Finance, *Tax Expenditures and Evaluations 2008*, Table 3, available at [http://www.fin.gc.ca/taxexp-depfisc/2008/Taxexp-depfisc08\\_eng.pdf](http://www.fin.gc.ca/taxexp-depfisc/2008/Taxexp-depfisc08_eng.pdf) (accessed on May 22, 2009).

<sup>46</sup> Bird, *supra* note 8, at 5. Interestingly, a recent research paper from the Agricultural Institute of Canada proposed that the GST should be imposed on food -- and the revenues used to finance "sustainable agriculture": see Hugh Maynard and Jacques Nault, *Big Farms, Small Farms: Strategies and Sustainable Agriculture to Fit All Sizes* (Ottawa: Agricultural Institute of Canada, September 2005). Earmarking always appears attractive to those whose interests are served.

<sup>47</sup> The so-called "quick method" permits certain businesses to calculate their GST liability by multiplying the taxable sales by a stated rate rather than reporting separately the output tax due and the input tax credits claimed. In effect, this approach turns the GST into a lower rate gross receipts tax for many taxpayers -- for example, 1.8% for small resale businesses compared to the basic GST rate of 5%. Presumably, the rates provided are intended to represent some sort of presumptive sectoral average although we are not aware of any empirical study of the dispersion of the input/output ratio within the sectors affected. Fortunately for baffled taxpayers -- or at least for their advisers -- this "simple" system is explained in a 27 page pamphlet (RC 4058) available from the Canada Revenue Agency. Different rates are established for retailers and wholesalers and (at less favorable rates) for service businesses. Variant systems exist for qualifying nonprofit public or nonprofit organizations and for businesses that use yet another special procedure called the "simplified method" of accounting for input tax credits. In total, however, it appears that well under 5% of GST taxpayers use any of these simplified accounting systems. (About half of all returns are received from corporations, which account for about three-quarters of collections.)

<sup>48</sup> MASH was originally MUSH (U for university) but subsequently altered to encompass post-secondary institutions other than universities.

<sup>49</sup> In 2006, the then newly elected Conservative government, back from the political wilderness after thorough reconstruction following the 1993 election fiasco discussed earlier, announced the impending end of the rebate for tourist expenditures. Legislation was introduced to take effect in 2008. This policy change was likely motivated by an internal audit study which found that in the 2004/05 fiscal year, over 622,000 visitor rebate claims for a total of C\$59 million were processed. These claims represented over two-thirds of the total number of rebates processed, but less than 2% of the amount of rebates. The administrative costs of this program were high: 67 FTEs (full-time employees) and C\$2.8 million. (Canada Revenue Agency, *Audit of GST/HST Visitor and Domestic Rebate Programs* (Ottawa: Government of Canada), available at <http://www.cra-arc.gc.ca/gncy/ntrnl/2006/rbts-eng.html> (accessed on May 22, 2009). As might be expected, the affected industries reacted very strongly. Unsurprisingly, (as explained in another Canada Revenue Agency publication (GST/HST Notice No. 2001, August 2007) substantial GST incentives are still offered to both foreign conventions and tourist packages. With the GST, as with most taxes, once you give something away, it is very hard to take it (completely) back.

real estate, and financial institutions. A further concession was made to the inevitable complaints of the millions of small businesses that for the first time had to deal with the federal sales tax administration by providing a special one-time subsidy (C\$1,000) to assist in the upgrading of cash registers and similar systems. As with food, Canada appears to have gone the extra mile in this respect compared to other countries.<sup>50</sup> Apart from the case of food discussed above and the financial sector which is basically exempt (as in the EU), the treatment of both the public and nonprofit sectors and real estate under Canada's GST is perhaps more logical than in the VATs of many European countries. But it is nonetheless complex.

To a considerable extent, Canada takes what may be called the "rebate approach" to VAT relief. The GST tax expenditure accounts identify 14 different exemptions (including both such standard exemptions as domestic financial services and the cost of the threshold and quick relief methods for small suppliers as well as such more peculiar items as exemptions for ferry tolls, childcare and personal services and some legal aid services), five zero-rated categories (including medical devices and prescription drugs as well as basic groceries), and 14 different rebates. Thirteen different reasons for rebates are identified on the general GST rebate form ranging from such obvious ones as errors and certain purchases for non-residents to less obvious activities like certain expenses of legal aid plans and "eligible travel expenses" for Indian bands and tribal councils. Other specific rebates apply to the MASH and housing sectors: in fact, the single most expensive rebate item recorded in the tax expenditure accounts is for new housing (C\$1 billion in 2005).<sup>51</sup> Registered charities and non-profit activities also have specified partial rebates.<sup>52</sup>

Many activities benefit from a variety of reliefs. With respect to education, for example, in addition to an exemption for tuition, rebates are granted for book purchases made by public institutions and more generally rebates of input tax at prescribed percentages are paid to colleges, schools, and universities. This system is not simple: every university, for example, carries out both exempt activities and taxable activities and therefore is required to prorate its input credits. Although universities are eligible for a 67% rebate of GST paid on all eligible inputs, careful accounting is required to ensure that inputs used to provide a lengthy list of prescribed property or services are excluded. Moreover, other rules also come into play: for example, if a computer purchased by a university will be used more than 50% by an associated hospital, the rebate of input tax may be based on the higher (83%) rebate rate provided hospitals.

Similar complexities arise elsewhere. For example, while health care services are exempt there are also rebates to hospitals and zero rating of prescription drugs and medical devices. Municipalities benefit from both a 100% rebate (since 2004) and

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<sup>50</sup> Compare, for example, the treatment of small business in other countries described in OECD, *Taxing Consumption* (Paris: OECD, 1988). Canadian sensitivity to small business remains high. A prominent feature in the impending Ontario move from an RST to (essentially) an HST, for example, is a 'transitional' credit of up to C\$1,000 for businesses with less than C\$2 million in taxable sales.

<sup>51</sup> For further discussion of the GST treatment of housing, see Poddar (this volume).

<sup>52</sup> For further discussion of GST rebates in the public, non-profit and charity sectors, see Gendron (this volume).

specific exemptions for municipal transit, water and garbage collection services. Charities and nonprofit organizations get rebates and in addition certain supplies made by nonprofit organizations are exempt. Long-term residential rent is exempt at the same time as new residential rental properties are eligible for rebates. Canada's GST may have only one positive rate; but between exemptions, zero-rating and rebates in practice it has many different effective rates varying by sector and activity.

In short, the GST in Canada is definitely not a simple tax. The original law was long and complicated owing to the many special treatments of different sectors and activities already mentioned. It was also complex because many aspects of the income tax law were carried over into the GST. An example is the GST treatment of automobile benefits provided to an employee, which an earlier study noted required as many as nine flowcharts to depict the possible outcomes of the rules in different circumstances.<sup>53</sup> Although subsequent amendments and clarifications reduced some of this complexity, over time additional complications and obscurities have crept in to replace them to the point where the body of tax law and regulation that would-be GST tax specialists are expected to master in Canada is becoming almost as formidable as in the case of the income tax.<sup>54</sup>

Some of this complexity reflects the apparent fact that Canadians, unlike most Europeans but much like Americans, seem as a rule to be unwilling to leave the details to regulations or to deal with many problems by broad definitions subject to administrative interpretation. Moreover, the scope of the Canadian GST was deliberately designed to be more comprehensive than that of most European VATs, as indicated by the extent to which it attempts to encompass the (inherently not revenue productive) activities of nonprofit and public sector organizations. Another instance of perhaps egregious over-reach is the attempt to extend the tax base beyond the border by registering all nonresidents who sell by mail in Canada if their *worldwide* sales exceed \$30,000.<sup>55</sup> This rule may be compared, for example, to the usual EU rule for distance selling which has a much higher threshold (€100,000) for sales by a firm in a member state to nontaxable persons in another member state before requiring registration in that state (and payment of tax to it).<sup>56</sup>

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<sup>53</sup> This and numerous other instances of the complexity of the GST are detailed in Richard M. Bird, "The Cost and Complexity of Canada's VAT: the GST in International Perspective," *Tax Notes International*, 8 (1, January 3, 1994), 37-47.

<sup>54</sup> However, there is far less case law. In addition to the Supreme Court reference on the constitutionality of the GST mentioned earlier, over the years there have been a considerable number of court cases related to the GST with 1,486 cases reported in the Tax Court and 177 cases in the Federal Court of Appeal, as well as two additional Supreme Court cases that touched, albeit tangentially, on the GST. Since 1996, 911 Tax Court decisions related to GST have been reported compared to 4,891 on income tax (see [www.tcc-cci.gc.ca](http://www.tcc-cci.gc.ca), accessed on March 2, 2009). As yet, however, it appears that no one has examined these cases to determine either if any patterns are discernible or if, and to what extent, GST legislation and administration has been modified as a result. We are grateful to Ben Alarie for discussion of this point.

<sup>55</sup> In 2004, however, only about 18,000 nonresidents were registered and only C\$8.3 million was collected from this source.

<sup>56</sup> For more detailed discussions of EU rules, see Keen and Hellerstein (this volume), Cnossen (this volume), and Duncan (this volume).

Like all real-world taxes the GST is an uneasy compromise between political expediency (basic groceries, special small business rules) and conceptual perfectionism (fringe benefits, sales by nonresidents, etc.). It could also perhaps have been also better implemented from the beginning.<sup>57</sup> As it was, the lengthy delay in passing the legislation and the major last-minute changes made in some key elements of the tax made it impossible to implement the well-planned educational campaign that had been intended.<sup>58</sup> Moreover, the political fallout also made it extremely difficult to live up to the common prescription by VAT experts that the most important year for VAT administration is the first year. During this period ideally every VAT registrant should receive a visit from a VAT official to make sure that the enterprise knows both what its obligations are and how to comply with them -- and also to make them aware that somebody is watching them. Of course, it would have been difficult in any case to meet this requirement because of the extremely wide net cast by the GST, sweeping up thousands of entities that previously had little or nothing to do with the revenue agency, and the relatively few well-trained officials available for the task. While some of the initial difficulties encountered were overcome with time, almost a decade after the introduction of the GST the Auditor-General of Canada was still pointing out serious flaws in GST administration, particularly with respect to audit.<sup>59</sup>

Nonetheless, the GST works and on the whole works well. In fiscal year 2003 (April 1, 2003 – March 31, 2004), for example, 2.8 million entities were registered for GST, 8.5 million GST returns were received, and a grand total of C\$143.8 billion was reported as GST on taxable sales.<sup>60</sup> Since, however, C\$129.8 billion of this amount was

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<sup>57</sup> An official account may be found in Michael Smith, *The Clean Launch: How Revenue Canada, Customs and Excise Implemented the GST* (Ottawa: Canadian Centre for Management Development, 1992). Three critical aspects of the introduction of the GST that made the launch far less "clean" than it should have been are not highlighted in this account, which is focused on the extensive and largely successful administrative reorganization within the revenue agency. One aspect was the need to revise the law and all accompanying materials at a very late date owing to the unanticipated political decision to zero-rate "basic groceries." Another hitch in the process arose when a planned wide-ranging advertising educational campaign to introduce the new tax and to explain it both to the many new taxpayers (GST registrants) and to the public at large had to be canceled owing to the delays in passing the legislation -- delays that in the end were overcome only by unprecedented new senatorial appointments. Finally, although it is (unsurprisingly) more difficult to document, it appears that presumably as a result of the very strong visible public dislike of the tax a decision was made not to enforce the GST very rigorously in its first few years. One result was a marked increase in cross-border shopping encouraged by a favorable exchange rate (Michelle Boisvert and Wayne R. Thirsk, "Border Taxes, Cross-Border Shopping, and the Differential Incidence of the GST," *Canadian Tax Journal*, 42 (1994), 1276-93). For this and other reasons, some analysts have argued that the result of introducing the GST in Canada may have been to increase tax evasion rather than to reduce it as experience in other countries had suggested might occur: see, for example, Peter S. Spiro, "Evidence of a Post-GST Increase in the Underground Economy," *Canadian Tax Journal*, 41 (1993), 247-58.

<sup>58</sup> A recent GAO report (United States Government Accountability Office, *Value-Added Taxes: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition*, Report GAO-08-0566 (Washington, D.C.: GAO, April 2008) at 6, comments that Canada had difficulty in getting many firms registered prior to VAT implementation. No wonder: given the political uproar, until the very last minute most Canadians did not believe that the tax would actually be introduced.

<sup>59</sup> Office of the Auditor General of Canada, *Report of the Auditor General of Canada* (Ottawa: Government of Canada, 1999).

<sup>60</sup> Those unfamiliar with how VATs work may be a bit startled if they realize that the implicit taxable GST base was thus, at \$2,046 billion, about 166% of GDP in the same period; of course, as the subsequent text

claimed by taxpayers as input tax credits, net GST revenue collected by the Canada Revenue Agency (CRA) for the year came to only C\$14.0 billion.<sup>61</sup> Interestingly, less than one-fifth of net collections (after ITC offsets) came from the retail trade sector -- and none from the manufacturing and wholesale trade sectors, where ITC claims more than offset GST due on sales.<sup>62</sup> To put this another way, most of the net GST revenue that

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shows, such figures tell us nothing about the real tax base. Most of the information in this paragraph comes from Canada Revenue Agency (CRA), *Compendium of GST/HST Statistics 2004 Edition*, available at [http://www.cra-arc.gc.ca/gncy/stts/gb02/pst/gst\\_hst/menu-eng.html](http://www.cra-arc.gc.ca/gncy/stts/gb02/pst/gst_hst/menu-eng.html) (accessed May 22, 2009). Although this compendium is supposed to be issued annually, this is the most recent edition available. Some additional (and updated) information comes from the *2007-08 CRA Annual Report to Parliament*, available at <http://www.cra-arc.gc.ca/gncy/nnnl/menu-eng.html> (accessed May 22, 2009). Note that the figures just mentioned are quite different than the numbers reported in the public (and fiscal) accounts as GST revenues, for a number of reasons. First, the HST revenues (provincial sales taxes) collected by CRA appear to be included. Second, revenues reported by CRA are gross of the GST credit. Third, the substantial fraction of GST revenues collected at the border on imports is clearly not included in more recent data: GST/HST on imports is now collected by the Canada Border Services Agency (CBSA). This agency, created in December 2003, took over the customs function from what was then called the Canada Customs and Revenue Agency. Most of these 'border taxes' are subsequently offset by input tax credits (ITCs), but all credits are dealt with (and reported) by CRA, not CBSA. Third, GST amounts conventionally reported in official fiscal data is reduced by two items: (1) GST paid by federal departments is returned (remitted) to them and hence not included in budgetary receipts; (2) the GST credit paid through the income tax is deducted from GST revenues.

To illustrate how all this works, for the fiscal year (ending March 31) 2007-08 (all amounts in C\$), Department of Finance, *Fiscal Reference Tables 2008*, available at [http://www.fin.gc.ca/toc/2008/frm08\\_eng.asp](http://www.fin.gc.ca/toc/2008/frm08_eng.asp), accessed May 22, 2009, shows net GST revenue as \$29.9 billion. According to the *Public Accounts of Canada 2008*, available at <http://www.tpsgc-pwgsc.gc.ca/recgen/txt/72-eng.html>, accessed May 22, 2009, however, this figure reflects actual net collections of \$34.6 billion less remissions of GST paid by federal ministries of \$1.1 billion and also GST credits (refundable credits against the income tax; see *supra* note 43) of \$3.5 billion. However, the *2007-08 CRA Annual Report* states that net GST collections for the year by CRA were only \$11.6 billion, with an additional \$1 billion going to the three HST provinces as provincial VAT. Finally, the Public Accounts show that \$19.5 billion was collected by the CBSA; \$19.5 billion (CBSA) plus \$11.6 billion (CRA) plus \$3.5 billion (remissions plus GST credit) add up to \$34.6 billion. As a further complication, it should be noted that in addition to the GST credit and the remissions mentioned above, CRA rebated an additional \$4 billion for the various reasons (housing, etc.) mentioned earlier in the text.

To sum up, even though fiscal statistics show net GST revenue as only \$29.9 billion, in total in 2007-08, \$39.6 billion in net GST was actually collected from the public (\$19.6 by CBSA on imports and about \$20 billion by CRA), after offsetting input tax credits. The \$10 billion difference is accounted for essentially by 'tax expenditures' in the form of rebates (\$4.5 billion -- including \$2.6 billion to the MASH sector, \$1.0 billion to new housing, \$0.4 billion to the non-profits and charities, and a bit less than \$0.1 billion to foreign visitors (see *supra* note 49) -- in calendar 2006, the last period for which estimates are available (Department of Finance, *supra* note 45, Table 3), including the GST credit.

<sup>61</sup>As Sjibren Cnossen, "VAT and RST: A Comparison," *Canadian Tax Journal*, 35 (3, 1987), 559-615, emphasizes, if -- as seems broadly reasonable in Canada -- the average length of time required for remitting tax and processing refunds is about the same as the average period required for settling accounts receivable and payable, net GST is actually collected from registered firms only when they sell to someone outside this group. Since the "output tax" recorded by GST registered entities does not in fact accrue to the government until after the "input tax credit" has been applied, the cash flows associated with the GST are essentially no different than those associated with a retail sales tax.

<sup>62</sup>In fact, according to the data in the CRA *Compendium* (*supra* note 60) total GST refunds paid out by CRA in 2003-04 to taxpayers whose input credits exceeded their output tax liabilities appear to be almost twice as large -- C\$27.3 billion -- as net revenue reported by CRA. However, as shown in *supra* note 60, one must be very careful in interpreting such figures. Similarly, although Graham Harrison and Russell

flows to the federal government comes, in the end, from such “non-traditional” sales tax sectors as transportation, communications, utilities, and other services. For example, the housing sector is surprisingly important. In 2006, C\$3.5 billion was collected as GST on new residential properties. Even after offsetting rebates for new owners (and some rental property) of a bit less than \$1 billion, net collections from housing were still C\$2.6 billion, or almost 20% of total net GST.

The administrative burden of the tax does not seem excessive, although it is difficult to be very precise since little information is available on a “tax” basis. In fiscal 2006, however, the Canada Revenue Agency noted that about 600,000 “non-compliance occurrences” resulted in additional GST assessments of C\$1.1 billion and 63,000 GST audits yielded an additional C\$600 million.<sup>63</sup> A major ‘risk analysis’ program with respect to GST launched in 2000 (though not fully implemented nationally until 2004) was focused, in part, on the possibility of fraudulent refund claims. For the three fiscal years ending in 2003, about 1,300 GST returns with fraudulent refund claims (totaling C\$9 million) were detected.<sup>64</sup> The estimated “non-compliance” rate fell from over 9% in 1998-99 to less than 4% in 2003-04.<sup>65</sup> The relatively settled state of the GST is suggested also by the fact that there were only 4,400 written inquiries for rulings and interpretations in that year, compared, for example, to more than 70,000 inquiries with respect to social security contributions.

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Krelove, “VAT Refunds: A Review of Country Experience,” Working Paper WP 05/218 (Washington, D.C.: International Monetary Fund, November 2005), show that on the average Canada “refunds” a rather high proportion of about 50% of its GST, it is not clear from their paper which of the various possible denominators measuring “GST” is used to compute this fraction. This ratio is certainly plausible if one includes all the rebates to public sector and related activities as “refunds” but then it is not very comparable to the similar fractions that are reported for EU countries, since the latter generally make similar “tax expenditures” simply by exempting such activities.

<sup>63</sup> In Quebec, 45 GST cases were referred to the Department of Justice for criminal prosecution; unfortunately, the number of GST cases for the rest of the country is not available.

<sup>64</sup> Canada Revenue Agency, *The Canada Revenue Agency: The First Five Years* (Ottawa: Government of Canada, 2005), p. 61.

<sup>65</sup> An internal audit found that increased effort was needed to pursue nonregistrants as was a reform of the penalty structure. Reportedly, 33 FTEs (out of 674 staff devoted to non-registration/non-filing (NR/NF) activities) focused on expanding GST registrations in 2005/06, with the effort adding some 7,400 new registrants (and an estimated C\$80 million in past and current revenue): see Canada Revenue Agency, *GST/HST Regulatory Compliance Evaluation Study Non-Registration* (Ottawa: Government of Canada, July 2008), available at <http://www.cra-arc.gc.ca/gncy/ntrnl/2008/rgst-cmp-vl-eng.html> (accessed on January 5, 2009). Since, as GAO, *supra* note 58 at 29, observes, over a third of GST registrants in 2004 had sales less than the (low) threshold of C\$30,000, it is not surprising that the revenue yield per new registrant was so low. (CRA reportedly devotes 1,000 to 1,250 FTE to the “underground economy” -- see UK National Audit Office, *Comparing How Some Tax Authorities Tackle the Hidden Economy*, April 2008 -- but it is not clear if this figure overlaps with the NR/NF figure cited above.)<sup>65</sup> Interestingly, the internal audit cited also notes that the penalty structure is not well designed in the sense that it did not adequately penalize taxpayers for failing to provide required information that was needed to enforce taxes on others – a common design mistake noted emphasized long ago by Oliver Oldman, “Controlling Income Tax Evasion,” in Joint Tax Program, *Problems of Tax Administration in Latin America* (Johns Hopkins Press for Organization of American States and Inter-American Development Bank, 1965), 296.

## A Federal VAT Meets Provincial RSTs

On the whole, though it could certainly use improvement in a number of respects, Canada's GST is now a well functioning and well administered VAT. It demonstrates conclusively that a federal VAT is perfectly feasible in a North American federal country with a competent administration, regardless of the extent and nature of sales taxes that may or may not exist at subnational levels. Indeed, that is almost certainly the key lesson for the United States from Canadian experience: it can be done.

Obviously, it was easier in some ways to introduce a federal VAT in a country with long experience with federal sales taxes than would be the case in the United States. However, it cannot be emphasized enough that from the perspective of the Canadian public the federal GST in Canada was seen to be a new federal tax: that was the political reality facing the federal government at the time of the introduction of the GST. The combination of the extended and very public political battle over introducing the tax and the "in your face" visibility of the GST made it a highly salient issue.<sup>66</sup> Since tax policy in the real world is more a matter of politics than economics or administration, even though a general sales tax would be completely new at the federal level in the United States, the US may thus have something to learn from Canada's experience with the GST. In particular, and the major focus of the balance of this paper, the Canadian story with respect to the way in which federal and provincial sales taxes interact -- or do not interact -- appears to be highly relevant to the parallel situation in the United States where most states now have retail sales taxes that are, despite the best efforts of the ongoing Streamlined Sales Tax Project, still largely uncoordinated.<sup>67</sup>

As mentioned earlier the federal government had recognized from the beginning that a major political problem in introducing a federal VAT in Canada was the simple fact that all provinces except Alberta already levied retail sales taxes, at rates ranging at the time from 7% to 12%. The GST is of course a very different tax to the RST in the way it operates, so it looks quite different (and more complex) to the firms that actually pay the taxes over to the government. To consumers, however, a sales tax that they have to pay when they buy anything is a sales tax, no matter what it may be called or to which government the money flows. The main economic benefit of the GST is that it frees most business inputs from tax. The political side of this coin, however, is a hidden political benefit to governments from the RST in that between a third and a half of all RST

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<sup>66</sup> Somewhat curiously, although tax visibility has often been discussed in general terms in the literature (for an early example see Vito Tanzi, "International Burdens: A Study of Tax Ratios in the OECD Countries," in *Taxation: A Radical Approach* (London: Institute of Economic Affairs, 1970)), only very recently under the name of "saliency" has theoretical and empirical literature begun to take this important characteristic explicitly into account: see Raj Chetty, Adam Looney, and Kory Kroft, "Saliency and Taxation: Theory and Evidence," Working Paper 13330 (Cambridge, MA: National Bureau of Economic Research, Inc., August 2007), and Brian D. Galle, "Do Hidden Taxes Increase Welfare?", November 22, 2008, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1113585&CFID=4503457&CFTOKEN=51121740](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1113585&CFID=4503457&CFTOKEN=51121740) (accessed May 22, 2009).

<sup>67</sup> See, for example, Walter Hellerstein, "State Sales Tax Reform in the United States: The Streamlined Sales Tax Project," *Bulletin for International Fiscal Documentation*, 59 (5, 2005), 170-94.

revenue comes from taxes on business inputs and is thus hidden from the consumer. Even though the downside of such input taxes is that they cascade unevenly into the prices of goods and services whether they are explicitly subject to the RST or not, most people do not understand the cascading issue. Many seem to think that if "business" pays the tax that means they -- the public -- do not. Such hidden taxes are economically distorting, but nonetheless they often appear to be more palatable politically than visible taxes imposed on final consumers.

In the Canadian case, on the whole it seems fair to say that no one aside from a few fiscal experts and the federal government liked the GST. As far as the Canadian public was concerned, the federal government was not only imposing a new tax on transactions but it was also expanding the tax base to encompass a much broader range of consumer services. In principle, businesses might be expected to prefer the GST because it relieves them of tax on inputs, and a few large firms (especially those in exporting or import-competing industries) did so. In fact, however, for many small businesses and especially service firms the GST constituted a new and unwanted additional compliance burden.<sup>68</sup> In addition, a wide variety of public, charitable, and nonprofit organizations that had previously escaped both the income tax and the RST were now faced with coping with the intricacies of the GST. Finally, provincial governments understandably saw the federal government as crowding them out of "tax room" at the retail tax level and complicating their already sufficiently difficult fiscal life.

As described earlier, some of the early official reports envisaged several different ways in which both federal and provincial sales taxes might work together. In the end, however, none of these paths was followed. Desperate to get some province on board, the federal government finally managed to strike a rather curious deal with Québec, a province in which they faced serious political difficulties owing to the rise of the separatist movement. At the same time as the GST was introduced at the federal level, Québec followed the federal lead and simultaneously replaced its RST by a new provincial VAT, the Québec Sales Tax (QST, or TVQ, *Taxe de vente du Québec*).<sup>69</sup> Under the federal-Québec agreement, Québec was to collect not only the QST but also the federal GST and to be compensated by the federal government for the costs it incurred in doing so.<sup>70</sup>

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<sup>68</sup> See Plamondon and Associates Inc. *GST Compliance Costs for Small Business in Canada* (Ottawa: Department of Finance, 1993).

<sup>69</sup> Québec's constitutional authority to impose such a tax was ratified by the Supreme Court in *Reference Quebec Sales Tax [1994] 2 S.C.R. 715*.

<sup>70</sup> Québec receives a negotiated annual fee for administering the GST in the province. Canada Revenue Agency, *Annual Report 2007-08* reports this fee as C\$140.7 million in 2007/08, compared to C\$157.4 million in 2006/07, and C\$131.4 million the previous year. Interestingly, *Revenu Québec Rapport annuel de gestion 2007-2008* (Québec: Gouvernement du Québec, 2008), available at [http://revenu.gouv.qc.ca/documents/eng/publications/adm/ADM-500\(2008-10\).pdf](http://revenu.gouv.qc.ca/documents/eng/publications/adm/ADM-500(2008-10).pdf) (accessed on March 17, 2009) reports it received only \$129.2 million from the CRA in fiscal 2007-08 to administer the GST in Québec. We have not attempted to unravel this little puzzle.

As discussed above, the final result of the prior campaign promise by the new government elected in 1993 to abolish the GST was actually the current federal tax, officially known as the GST/HST. Essentially, the GST remained exactly as it was: a federal credit-invoice VAT. In addition, however, following characteristically prolonged and convoluted federal-provincial negotiations three small Atlantic provinces (New Brunswick, Nova Scotia and Newfoundland and Labrador) followed Québec and replaced their RSTs by provincial VATs levied at uniform rate of 8%.<sup>71</sup> Unlike the Québec case, however, the new provincial VAT was levied on the same base as the federal GST. Moreover, the federal government collected both federal and provincial VATs under the name of the Harmonized Sales Tax (HST).<sup>72</sup>

As just mentioned, the federal government had earlier accepted a rather peculiar agreement with Québec (discussed in more detail below) under which that province not only administered its own version of a VAT but also the federal GST within the province. It probably did so owing not only to its rather strained (especially at that time) relations with the province but also in an effort to induce other recalcitrant provinces to hop on the VAT bandwagon. As subsequent developments suggested, the HST path of a combined federal and provincial tax, administered federally, was undoubtedly its preferred approach. Until 2009, however, no other province proved willing to accept the restrictions of the HST agreement.<sup>73</sup> Nor had any province chosen to take sales tax reform in its own hands in the more independent Québec-style, that is, by adopting a provincial VAT that is less closely tied to the federal GST system.

It was thus somewhat of a surprise when, in March 2009, Canada's largest province, Ontario, announced that it intended to replace its existing 8% RST by an 8% VAT imposed on essentially the same base as the federal GST.<sup>74</sup> Since this new tax -- rather curiously called the "Single Sales Tax" in the budget -- will be administered by the federal government along with the GST and the revenues will, at least initially, be allocated in the same way as the HST revenues received by the three HST provinces, as discussed below, in effect Ontario has joined the HST system. Although it had been

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<sup>71</sup> Why the federal government insisted that all HST provinces apply the same rate is unclear: as Michael Smart and Richard M. Bird, "The GST Cut and Fiscal Imbalance," in Charles Beach, Michael Smart, and Thomas A. Wilson, eds., *The 2006 Federal Budget: Rethinking Fiscal Priorities* (Montreal: McGill-Queen's University Press, 2007), 73-100, argue, and we discuss further below, there is no technical necessity for such uniformity.

<sup>72</sup> As discussed *supra* in note 5, we often use this label to mean only the provincial component of this tax.

<sup>73</sup> However, an official report in one province (Saskatchewan: see *Final Report of the Saskatchewan Business Tax Review Committee*, Regina, 2005) recommended that, provided it received adequate compensation, the province should essentially sign up for the HST -- although at a lower rate (5%). Interestingly, Saskatchewan had actually announced in 1991 that the province would harmonize its sales tax with the GST in 1992. However, when 1992 arrived a new NDP (socialist) government was in power in the province, and it did not happen. Saskatchewan has nevertheless been reducing its RST rate over the years, and it now -- unsurprisingly -- stands at 5%.

<sup>74</sup> See *supra* note 7. Of course, numerous outside reports (e.g. Peter Dungan et al., *Growth-Oriented Sales Tax Reform for Ontario: Replacing the Retail Sales Tax with a 7.5 Percent Value-Added Tax*, Commentary 273 (Toronto: C. D. Howe Institute, September 2008), available at [http://www.cdhowe.org/pdf/Commentary\\_273.pdf](http://www.cdhowe.org/pdf/Commentary_273.pdf) (accessed on May 29, 2009) had earlier suggested that Ontario should convert its existing RST to a VAT with the same base as the federal GST.

apparent -- if not very publicly visible -- that the province was considering sales tax reform, its decision (in effect) to join the HST came as a complete surprise. Although in common Canadian fashion, nothing is yet completely clear or finally decided -- tentatively, it is hoped to have it all worked out by September 2009, for implementation on July 1, 2010 -- there appear to have been at least three reasons for the provincial decision to follow this path:

- First, the province appears to have been persuaded by earlier empirical studies of the HST experience that the shift in sales taxation would benefit it economically, perhaps quite substantially.<sup>75</sup>
- Second, for (unclear) reasons of its own, the federal government gave Ontario what looks to be a very good deal. Not only will Ontario receive a special additional federal payment of C\$4.3 billion (C\$3 billion on introduction of the tax, and C\$1.3 billion if it is still in force one year later) but the federal government will cover all the costs of administering the tax. Moreover, the federal government has accepted more base deviations from Ontario (e.g. zero-rating for children's clothing and other items) than in any HST province but also (for five years, followed by a three-year phase-out) Ontario can also impose ITC restrictions provided they are similar to and no greater than those already in place in the QST (as discussed below).
- Third, by imposing the 8% rate already in force in the HST provinces -- a rate that was (as discussed later) substantially below their previous RST rates<sup>76</sup> -- Ontario will apparently increase its sales tax take significantly.<sup>77</sup>

More money, lower administrative outlay, better economic outcomes: what's not to like? Of course, the politics of the tax substitution are by no means as simple as this may suggest. However, there is probably enough money attached to this reform to allow the province to buy its way out of any tough spots, although of course this remains to be seen. Apart from the general question of tax harmonization, federal-provincial issues also affected some important areas with respect to the design of the GST. Under Canada's constitution, federal and provincial governments cannot tax each other, so the federal GST could not be applied to sales to provincial governments. However, the governments of the HST provinces, like the federal government, have agreed to pay GST/HST on their

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<sup>75</sup> In particular, Michael Smart, *Lessons in Harmony: What Experience in the Atlantic Provinces Shows about the Benefits of the Harmonized Sales Tax*, Commentary 253 (Toronto: C.D. Howe Institute, 2007), available at [http://www.cdhowe.org/pdf/commentary\\_253.pdf](http://www.cdhowe.org/pdf/commentary_253.pdf) (accessed on May 29, 2009).

<sup>76</sup> Indeed, this rate reduction and the consequent revenue loss was the stated rationale for the original HST compensatory payment: see *supra* note 33. No one has officially stated any rationale for the payment to Ontario, which has, we argue, actually increased its sales tax take by the reform. However, two possible rationales might be suggested: first, although no one is likely to say so out loud given regional sensitivities, what is good for Ontario (40% of Canada's economy) is likely good for Canada; second, in the current economic crisis, giving a major boost to private investment through this sales tax reform may be more useful than most of the other federal outlays (e.g. subsidies to this and that currently fashionable activity and general public infrastructure funding) being called "stimulus" payments these days.

<sup>77</sup> Note the title of the report cited in *supra* note 74: the data in this report suggest that a 7.5% VAT would yield the same revenue as an 8% RST for Ontario. Similarly, in an unpublished study, Michael Smart ("A Look at Sales Tax Reform in Ontario," University of Toronto, May 2009) estimates that the sales tax reform may increase revenue by almost 13%.

taxable purchases.<sup>78</sup> Sales to other provinces are not taxable if properly certified; since suppliers are entitled to claim input tax credits (ITCs) on all supplies made to provincial or territorial governments, whether or not GST/HST is collected, in effect such sales are zero-rated.<sup>79</sup> These rules do not apply to provincial public sector enterprises (Crown corporations) such as the large electricity suppliers, so these companies are both responsible for collecting the tax on their sales and can claim refunds of taxes imposed on their inputs. In principle, the important public sector institutions included in the so-called MASH sector were, as agents of the provinces, exempt from charging federal GST on sales (unless they sold taxable goods). On the other hand, unlike the provincial governments these institutions were subject to tax on business inputs. However, the federal government decided to provide a partial refund of taxes on inputs purchased by the MASH sector in order to keep them in the more or less same relative position as they had previously been under the manufacturers' sales tax (which was embodied in the prices of their inputs). Although the refunds varied by type of provincial body, on average they amounted to roughly two-thirds of input taxes paid by the sector.<sup>80</sup>

Canada is the only federal OECD country -- other than the U.S. -- in which subnational governments have the choice of whether or not to impose their own VATs: five of them (assuming the newly proposed Ontario tax comes into effect) have chosen to do so, in three slightly different ways, as Table 2 summarizes.<sup>81</sup> The details are filled in later in this paper.

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<sup>78</sup> Interestingly, both the province of Prince Edward Island (which levies its own RST) and the territory of Nunavut (which has no sales tax) have also agreed to pay tax on taxable purchases. Such agreements are reciprocal, that is, the federal government at least in the case of PEI, would also agree to pay RST on its purchases. From the perspective of vendors, it is obviously simpler to be able to apply tax than to deal with exemptions, so it is not surprising that the federal government attempts to negotiate such arrangements through the reciprocal tax agreements related to GST that it has with all provinces. These agreements are in any case needed to deal with a variety of issues -- for example, those related to the characterization of financial services in Québec (which, as discussed later, treats them differently under the its own VAT than under the GST, which it also administers) and, more generally, whether hospitals in particular provinces are considered part of the provincial public sector or not. For further discussion of some aspects of the GST treatment of provinces, see Gendron (this volume).

<sup>79</sup> Although all governments are subject to GST/HST on taxable supplies, all departments and agencies are registered as one entity and hence supplies within any government (broadly defined) are not taxable. In addition, certain supplies are specifically exempted e.g. most registration, information provision, and licensing activity as well as homemaker services provided in residences, garbage collection, and law enforcement and fire protection.

<sup>80</sup> Given the huge and varied collection of VAT registrants in Canada lumped together as 'non-profits' their 50% rebate seems more likely to be a compromise between 0% and 100% than an estimate based on any careful study. Interestingly, as Tables 3 and 5 below show, the same (arbitrary) rate is currently applied in all other Canadian VATs, although most apply other rebates in other sectors: the appeal of a good compromise unblemished by any factual basis should not, it seems, be underestimated! The appropriate treatment of public sector agencies has recently been the subject of several studies in the European Union: see e.g. M. C. Wassenaar and R. H. J. M. Gradus, "Contracting Out: The Importance of a Solution for the VAT Distortion," *CEifo Economic Studies* 50 (2, 2004), 377-96. For a fuller discussion, see Pierre-Pascal Gendron, "Value Added Tax Treatment of Public Bodies and Non-Profit Organizations: A Developing Country Perspective," *Bulletin for International Fiscal Documentation*, 59 (11, December 2005), 514-26, and Gendron (this volume).

<sup>81</sup> For a brief discussion of the other two federal countries with subnational VATs (Brazil and India), see Richard M. Bird, "Central and Subnational VATs in Federal Countries," Paper Prepared for a Conference

**Table 2**  
**Comparison of Some Key Features of Canada's Subnational VAT Regimes**

	<b>QST</b>	<b>HST</b>	<b>HST (Ontario)</b>
<b>On destination basis</b>	Yes	Yes	Yes
<b>Autonomy in rate-setting</b>	Yes	Yes (in principle)	Yes (in principle)
<b>GST base</b>	Yes (with minor exceptions)	Yes	Yes
<b>More zero-rating than GST</b>	Yes	Yes	Yes
<b>Input credit restrictions</b>	Yes	No	Yes
<b>Good administration</b>	Yes; provincial	Yes; federal	Yes; federal
<b>Good cooperation between central and sub-national governments</b>	Yes	Yes	Yes

When it comes to ways to relate a federal VAT to subnational sales taxes, Canada thus provides a particularly interesting experiment from a US perspective. Not only is it the only VAT country in which the federal VAT was introduced in circumstances in which most subnational governments already had RSTs in place, but that VAT -- the GST -- has subsequently thrived in an environment in which:

- Four subnational jurisdictions have no sales tax (Alberta and the three northern territories -- Northwest Territories, Nunavut, and Yukon).
- Three provinces (New Brunswick, Nova Scotia, and Newfoundland and Labrador) impose a uniform tax, the HST, on the same base as the federal tax which is administered along with the GST by the federal tax administration. A fourth province, Ontario, is apparently about to join this group.
- One province (Québec) levies an independent VAT, the QST, which includes the federal GST in its base and is administered, together with the federal GST, by the provincial tax administration.
- Four provinces (British Columbia, Saskatchewan, Manitoba, and Prince Edward Island) will continue to impose separate RSTs administered provincially, with one of these provinces (Prince Edward Island) including the GST in its tax base.

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sponsored by the Dubai Economic Council, October 26-27, 2008 (revised January 29, 2009); see also Perry (this volume). The present paper is concerned only with "conventional" VATs levied on consumption, which almost invariably take the form of a destination type multistage transaction tax imposed by an invoice credit system. An alternative form of local business tax is sometimes (Italy, Japan and to some extent Michigan and New Hampshire) imposed on a base that is analytically equivalent to an income-type origin base VAT, but such taxes are not further discussed here: see Richard M. Bird, "A New Look at Local Business Taxes," *Tax Notes International*, 30 (7, May 19, 2003), 695-711. Michigan has just introduced a curious tax formally called a 'modified gross receipts tax' but probably better called an "apportioned" VAT: see Michael J. McIntyre and Richard D. Pomp, "Michigan's New Apportioned Value Added Tax," *State Tax Notes*, 51 (9, March 2, 2009), 673-87.

## THE HARMONIZED SALES TAX (HST)

Following the election of the Liberal government in 1993, the House of Commons Standing Committee on Finance was, as the winners had promised in their election campaign, directed to consider alternatives to the GST. The resulting report proposed full integration of the federal and provincial sales taxes through a 10% VAT with distinct federal (4%) and provincial (6%) components. In addition, the committee suggested that the business transfer tax (subtraction VAT) be considered for small businesses.<sup>82</sup> In response, in August 1994 the government proposed an integrated VAT with 5% federal and 7% provincial components. Anticipated revenue losses were to be made up by increasing other taxes, particular the personal income tax. This proposal was rejected by the provinces essentially for two reasons -- the expected revenue loss and the increased visible provincial tax burden that would be imposed on consumers.

Discussions continued between various governments but nothing happened until 1996 when the harmonized sales tax (HST) was introduced to take effect in 1997. Three of the four small Atlantic provinces agreed in exchange for an explicit one-time revenue payment of slightly less than C\$1 billion to replace their previous RSTs by a new provincial VAT, with the federal government collecting both federal and provincial components of the tax. An additional financial benefit, of course, was that they no longer had to collect their own sales taxes: in contrast to the Québec case, in which the Canada Revenue Agency (CRA) compensates the Québec tax agency, Revenu Québec (RQ), for collecting the GST, so long as the HST provinces apply their tax to the GST base the federal government will collect the tax for them free of charge.<sup>83</sup>

Interestingly, this adjustment payment was based on a formula calculated to apply to all provinces and not simply those which ended up signing on for the HST: as we point out later, revenue allocation under the HST is still in fact set up on the same basis: that is, the mechanism for incorporating additional provinces is already in place.<sup>84</sup> Even

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<sup>82</sup> Standing Committee, *supra* note 32.

<sup>83</sup> The CRA also administers some, but not all, of the provincial rebate schemes (set out later in Table 3). Others -- e.g. New Brunswick's refund for the provincial tax on property and services used directly in research and development by a university or Nova Scotia's rebate for the provincial tax on emergency vehicles (up to C\$185,000) purchased by volunteer fire departments -- are administered directly by the provinces. Interestingly, it appears in the prospective (not yet finalized) agreement with Ontario, the federal government has agreed to administer all the 'deviant' provincial provisions in terms of zero rating and ITC restrictions. Incidentally, it should be mentioned that the CRA, although a federal agency, is legally controlled by a Board of Management that is dominated by provincially-appointed members: it was structured in this way in part to recognize the long-standing role of the federal revenue agency in collecting, under agreement, most provincial and corporate income taxes, and also, evidently, in order to facilitate extending this role to collecting provincial sales taxes.

<sup>84</sup> Under the formula used to establish the HST, the three largest provinces -- Québec, Ontario, and British Columbia -- would not have seen their revenues decreased by more than 5% (the minimum loss needed to trigger a compensation payment) and hence would not have been eligible for compensation. However, Saskatchewan, Manitoba and Prince Edward Island would have been entitled to such compensation and, had they signed on in 1996, would have received another C\$540 million in adjustment assistance from the

more interesting in some ways, the original federal proposal was based on the assumption that the HST rate would be 15% in the four Atlantic provinces, but only 14% elsewhere in the country. While this differentiation was clearly intended to recognize the fact that the Atlantic region had higher sales tax rates than the rest of the country, it was thus clear from the beginning that, despite the uniform 8% rate initially agreed by the participating provinces (that is, the present three HST provinces) -- and also despite the fact that Ontario has, for its own reasons, adopted a similar rate -- the integrated GST/HST does not require uniform provincial sales tax rates either technically or legally.<sup>85</sup>

Nonetheless, the fact is that the HST is currently applied at a uniform rate of 8% in the three participating provinces. Moreover, the HST agreement binds the three provinces to maintain a uniform rate, although it also makes it clear that the rate is determined by them and not by the federal government.<sup>86</sup> Specifically, all three provinces must agree before the rate can be lowered, presumably in order to reduce the possibility of tax competition between these three small neighboring jurisdictions in the form of cross-border shopping. On the other hand, and perhaps somewhat surprisingly, only two out of three provinces need to agree in order to raise the rate. The important point, however, is that since the determination of the HST rate is controlled by the provincial and not the federal government, the HST rate in the Canadian system is very different from the superficially similar "regional" rates established by central governments in a number of other countries -- for example, the reduced rate of the Mexican VAT applied in the northern border states.<sup>87</sup>

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federal government. As mentioned earlier, no similar considerations appear to have been taken into account in the new agreement with Ontario.

<sup>85</sup> The RST rate in Newfoundland was 12% and it was 11% in Nova Scotia and New Brunswick at the time these provinces introduced the 8% HST. Apart from neighboring Prince Edward Island, which had -- and still has -- an RST of 10%, at the time the other RST provinces had rates of 7%, except for Ontario at 8%.

<sup>86</sup> See Comprehensive Integrated Tax Coordination Agreement, October 1996. There are separate agreements with each province: see, for example, <http://www.ijcan.org/nl/laws/sta/t-0.01/20060809/whole.html> (accessed on May 22, 2009). It seems unlikely that Ontario will be bound by any of these rules, although the agreement with that province has not yet been finalized.

In the initial agreement some constraints on rate increases (not decreases) in the federal portion were accepted by the federal government also. For example, the federal GST rate could be increased by no more than 0.5% at a time, and if two such increases were made, it would not be further increased unless the rate of the provincial component of the HST had also been increased. The federal government also agreed that it would not make any base change that would reduce the revenues to the HST provinces by more than 1% without their unanimous agreement. Similarly, if any province did not accept a federal base change that would have increased such revenues by more than 1%, the federal government agreed to administer (at no cost) a rebate offsetting such increase.

<sup>87</sup> As Bird, *supra* note 81, shows, six OECD countries have such centrally-determined regional VAT rates. OECD, *Consumption Tax Trends* (Paris: OECD, 2006) incorrectly includes Canada's HST in this category. Of course, when there are 'regional rates' under a central VAT, all the revenue generally accrues to the central fisc. Although in several countries (e.g. Australia, Germany) all or a portion of VAT revenue is redistributed to state (and sometimes local) governments, it is usually done on the basis of an equalization formula. The only exception is Spain, where over a third of the VAT goes to the regional governments (and a small additional share to local governments) on the basis of territorial consumption, as estimated by the National Statistical Institute, thus approximating the destination basis (José Sánchez-Maldonado and J. Salvador Gómez Sala, "The Reform of Indirect Taxation: VAT and Excises," in Jorge Martínez-Vázquez and José Felipe Sanz-Sanz, eds., *Fiscal Reform in Spain* (Cheltenham UK: Edward Elgar, 2007), pp. 291-381).

The GST/HST is clearly an integrated federal-provincial sales tax in the sense that both the federal and provincial components are applied on the same base by the same administration at the same time. However, even if the statutory rates of the federal and provincial taxes were identical, the effective rates of the provincial components of this integrated sales tax imposed on different activities would not necessarily be the same as those of the federal component, nor entirely identical in all the HST provinces. The reason is simply because, as Table 3 shows, the rebates that characterize the Canadian VAT system do not always apply in the same way in different provinces.

Moreover, although not all details are yet finalized, that the Ontario version of the HST, to be introduced in 2010, will include different rebates for all categories than those shown in Table 3: 78% for municipalities, 78% for universities and colleges, 93% for hospitals, and 82% for charities and non-profits.<sup>88</sup> Except for the GST rebate to municipalities, these are considerably more generous than the existing rebates under the GST or the HST. The housing rebate will also be more generous, apparently reflecting the higher house prices, particularly in the Toronto area: 75% of the provincial tax on houses under C\$400,000 will be rebated, with the rebate being reduced for houses between C\$400,000 and C\$500,000. Ontario will also have more 'point-of-sale' zero-rating -- not just for books, but also for children's clothing and footwear, children's care seats and car booster seats, and feminine hygiene products. On the other hand, unlike the other HST provinces, but like the QST, its new tax will restrict ITCs for businesses with taxable sales of over C\$10 million and financial institutions on energy (not used by farms or to produce goods for sale), telecommunications services (other than internet access or toll-free numbers), food, beverages and entertainment, and road vehicles less than 3000 kilograms as well as fuel, parts and certain services for such vehicles. All these deviations from the 'GST norm' will, it seems, be administered free of charge by the federal government.

As Table 3 shows, even within the existing HST provinces there are significant differences. All -- like Québec (see later discussion), but unlike the federal GST -- zero-rate books. All HST provinces follow the GST in providing a 50% rebate for charity, but only Nova Scotia follows the federal model of similar rebates to the MASH sector, and even that province did not follow the 2004 federal increase in the rebate to municipalities. New Brunswick gives a similar rebate to municipalities but Newfoundland gives none. Only Nova Scotia (like Québec) gives any rebates at all on new housing and, again like Québec, it does so in a different way to the federal GST. All HST provinces provide (federally-legislated) rebates for certain financial services (e.g., administrative services subject to tax) to the extent such services are considered to provide services to residents of other provinces and exports from HST provinces.<sup>89</sup>

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<sup>88</sup> This paragraph is based on Ontario Budget, *supra* note 7.

<sup>89</sup> The provincial component of the HST is rebated when goods are removed from the province within 30 days and provincial sales tax has been paid in the destination province. Similarly, when intangible personal property or services are consumed (or used) in non-HST provinces, a rebate is provided.

**Table 3  
Credits and Rebates in the HST Provinces**

	GST	HST		
		NB	NS	NFLD
<b>MUSH Rebates</b> (Municipalities, Universities and public colleges, Schools and Hospitals)	M - 100% <sup>a</sup> U - 67% S - 68% H - 83%	M - 57.14% U - 0% S - 0% H - 0%	M - 57.14% U - 67% S - 68% H - 83%	M - 0% U - 0% S - 0% H - 0%
<b>Charity and Qualifying NPO Rebates</b>	50%	50%	50%	50%
<b>New Housing Rebate</b>	36% with a maximum of C\$6,300 <sup>b</sup>	No rebate	18.75% with a maximum of C\$1,500 <sup>c</sup>	No rebate
<b>New Residential Rental Property Rebate</b>	36% with a maximum of C\$6,300	No rebate	No rebate	No rebate
<b>Point-of-Sale Rebates under the HST</b>	n/a	Books	Books	Books
<b>Other HST rebates related to the 8% provincial portion of the HST (federally legislated)</b>	n/a	- Exports from a harmonized province; - Investment plan and segregated fund rebate - Tourism industry rebate	- Exports from a harmonized province; - Investment plan and segregated fund rebate - Tourism industry rebate	- Exports from a harmonized province; - Investment plan and segregated fund rebate - Tourism industry rebate
<b>Other HST rebates related to the 8% provincial portion of the HST (provincially legislated)</b>	n/a	- Specially-equipped vehicles; - Segregated funds; - Research and development rebate.	- Household energy <sup>d</sup> ; - Fire departments; - Motor vehicle rebate; - Computer rebate; - Heritage properties; - Segregated funds.	- Rebate program for building materials for Labrador homes; - Home heating rebate program <sup>e</sup> .
<b>Low-Income Credit</b>	Yes	No credit	No credit	Yes

**Notes:** (a) When the GST was introduced, the federal rebate for municipalities was 57.14% of the otherwise unrecoverable GST paid by municipalities. The rebate rate was increased to 100% effective February 1, 2004; (b) The rebate is gradually reduced for homes valued between C\$350,000 and C\$450,000 and fully phased out for homes valued at C\$450,000 or more; (c) Rebate is limited to first-time new home buyers. Compared to the GST new housing rebate, no thresholds apply; (d) The *Your Energy Rebate Program* started on December 1, 2006, rebates 8 percent of total home energy costs to the homeowner. For most homeowners, the rebate is automatically taken off the bill by the power company. Budget 2008 modified the rebate slightly to remove non-heating uses of electricity from the rebate; (e) The *Home Heating Rebate Program*, introduced in 2001, was increased from C\$200 to C\$300 for 2008, and will increase to C\$400 for households in coastal Labrador. Electricity and wood users will receive a maximum of C\$200.

**Source:** Information kindly supplied by Canada Department of Finance, November 2008.

The relatively new (2007) Foreign Convention and Tour Incentive Program in the GST is also applied to the provincial component of the HST, with the consent of the provinces concerned. In addition, each province has its own specific rebate provisions, as shown in Table 3, including an additional rebate for certain financial services. For example, Newfoundland and Labrador zero-rates residential building materials used in the sparsely-settled Labrador region; Nova Scotia similarly zero-rates material used for

“heritage properties” and fire departments, and New Brunswick does so for certain research and development activities at universities.<sup>90</sup> Only Newfoundland offers a low-income credit (like the federal GST credit): this provision, like the book rebates, is provincially legislated but federally administered.<sup>91</sup> The other provincially legislated programs listed in Table 3 -- home heating, fire departments, vehicles and computers for the disabled, etc. -- are administered directly by the provinces.

In principle, there is no reason why the “place of supply” (where tax liability accrues) should be different for interprovincial than for international supplies. In fact, however, the rules do differ in Canada in one important respect. The primary criterion used in Canada at the provincial level with respect to the place of supply of services is to attribute supply to the “place of performance” of a service. In other words, if all (or substantially all) of a service is performed in a province then the place of supply is that province, regardless of whether the service is performed for a registered business or a final consumer and regardless of where it is used or enjoyed.<sup>92</sup> If a supplementary rule is needed to apply this criterion, the main one employed is the place of location of the supplier who had direct responsibility for negotiating the service contract. What this means in practice is that the subnational tax on interprovincial services is, in Canada, largely applied on an origin and not a destination basis.

Apparently, this definition was adopted in part because it is sometimes exceptionally difficult to define any unique location for the supplier (or recipient) at the subnational level when both may have establishments located in more than one province that are engaged on one side or the other of particular services: consider a national accounting firm providing services to a multi-province company. Of course, the same problem arises at the international level also but in that case, unlike the case within a country, there are rules defining the location of supplier and recipient because such rules are needed for income tax purposes, and those rules could in principle perhaps also be used for VAT purposes at least to some extent.<sup>93</sup>

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<sup>90</sup> At one time, New Brunswick had a limited rebate program for new housing; it was eliminated in 2000. Similarly New Brunswick had a special C\$100 “rebate” program for energy in 2006; it was renewed in 2007 but abolished in 2008.

<sup>91</sup> It is thus similar to the federal GST credit discussed in note 43 *supra*; however, that similar provincial credits for provincial retail sales taxes may also be administered by CRA as part of administering the provincial income tax on behalf of the province, as in the case of Ontario. As part of its impending move to the HST, Ontario intends to expand its existing refundable sales tax credit of C\$100 to C\$260 per person, with the amounts being reduced, as with the existing credit, by an income-related formula. In addition, the new credit, unlike the present one, will be indexed for inflation. A further sweetener, a special “sales tax transition benefit” of C\$300 for single people and C\$1000 for single parents and couples will be paid in three installments during the first two years of the tax, again reduced by (a more generous) income-related formula.

<sup>92</sup> We are grateful to Satya Poddar for initially calling our attention to this important point. See Canada Revenue Agency, “Place of Supply Rules under the HST,” B-078 (Ottawa: Government of Canada, February 28, 1997), available at <http://www.cra-arc.gc.ca/E/pub/gm/b-078/README.html> (accessed on May 22, 2009).

<sup>93</sup> Actually such rules do not generally seem to be applied at the international level: see Keen and Hellerstein (this volume). In Canada, such rules exist at the provincial level with respect to financial institutions for income tax purposes and are utilized in the process of allocating HST revenue to provinces.

In practical terms, another important consideration relates to input tax credits. Since such credits can be claimed under the HST for taxable activities no matter where the business is located, the place of supply rule applied has the considerable advantage of ensuring no adverse consequences arise from collecting the HST on services rendered to businesses in other provinces. The credits generated against such HST may be offset against GST, exactly like the input credits that arise from the (federal) GST imposed along with the (provincial) HST. In this important sense, the HST is thus a national rather than a “provincial” tax.

This “supply” rule on services makes the provincial VAT (the provincial component of the HST) easier to administer. At the same time, of course, it turns it to some extent into an origin-based tax particularly since, as mentioned, it applies equally to B2B and B2C sales. As we noted in an earlier paper, one reason why this is not considered a major source of distortion (and evasion) is simply because the existence of the overriding federal GST provides an audit control on the reporting of interprovincial supplies for purposes of provincial HST (and QST).<sup>94</sup> This control would of course be even more effective if all provinces applied VATs, since the total tax base reported for federal GST should then be the same as that reported for all provinces combined, and any discrepancy would be quickly apparent. Another reason why no serious problems arise is because, as discussed next, HST revenues are in any case allocated on the basis of destination, not origin.

## **Allocating the Revenue**

As established in the “Comprehensive Integrated Tax Coordination Agreement” that governs the HST, an intergovernmental committee, the Tax Policy Review Committee, is charged with reviewing the HST every five years.<sup>95</sup> More importantly, however, a Revenue Allocation Sub-Committee (RASC) is appointed by this group and is responsible for allocating revenues between the HST provinces.<sup>96</sup> The RASC, which consists of a small number of federal officials and one or two representatives from each province, usually meets twice a year to determine the revenue pool and the allocation amongst provinces. Given the budgetary cycle, an essential task of this group is to project these figures for the forthcoming year: for example, once the 2009 revenue pool is projected (on the basis of the allocation procedure described in Table 4), it is provisionally allocated on the basis of the shares used for the 2007 year.<sup>97</sup> Initially, all three provinces had the same agreement with the federal government, but this was changed when one province (Newfoundland and Labrador) extended the closing date for

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<sup>94</sup> Richard M. Bird and Pierre-Pascal Gendron, “Dual VATs and Cross-Border Trade: Two Problems, One Solution?” *International Tax and Public Finance*, 5 (3, 1998), 429-42.

<sup>95</sup> The Tax Policy Review Committee has one member from the federal government and one from each provincial government.

<sup>96</sup> We are grateful to the federal Department of Finance and especially Brent Johnston for help in understanding the HST allocation process, although we are of completely responsible for what is said here.

<sup>97</sup> Originally, shares were projected on the basis of estimated population but this procedure was altered in agreement with the provinces, one of which (Newfoundland and Labrador) was losing population for much of this period.

adjustments by an additional year in order to ensure that, when revenues expanded, it did not miss out. Since the other two provinces did not change the closing date, each province now has a separate agreement with the federal government although the agreements for the other two provinces (Nova Scotia and New Brunswick) are essentially the same. New Brunswick recently considered raising the rate to 10%, which would of course require a new agreement.<sup>98</sup>

It is important to understand that there is no "tracking" of the revenue collected any particular province.<sup>99</sup> The revenue to be allocated is simply defined as the total GST/HST payable in any particular year, and the annual revenue entitlement -- the share -- that any province receives is then calculated by a formula that in effect allocates the national GST taxable base among all provinces -- not just the HST provinces -- and then applies the tax rate applying in that province to its calculated share of the base.<sup>100</sup> Taxes paid by federal departments and agencies and also by HST provincial departments and agencies are excluded from the revenue pool thus allocated,<sup>101</sup> as are specified refunds and rebates as well as any interest and penalties. No allowance is made for the fact that some reported GST is in fact not paid, nor is any allowance made for the fact that collection efforts may produce further revenue subsequent to the closing date for adjustments discussed later. The federal government can keep such later gains as well as any interest and penalties attributable to GST/HST accounts; on the other hand, it has to 'eat' unpaid GST, which in 2006 amounted to some C\$1.3 billion.

The process of determining the revenue pool, which is carried out by a small group in the federal Department of Finance, is very detailed. Data on the most important part of the tax base are obtained from Statistics Canada, which supplies information on 130 categories of consumption expenditure traced through the input-output base.<sup>102</sup> In addition, Statistics Canada provides some information on financial institutions and on residential construction expenditures (as well as GST and rebates by housing types). The Canada Revenue Agency provides some additional information on financial institutions as well as the amount of GST collected domestically. CRA also provides information on the rebates paid to public sector agencies; this information is used to calculate the "public

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<sup>98</sup> New Brunswick Department of Finance, *A Discussion Paper on New Brunswick's Tax System* (Fredericton: Government of New Brunswick, 2008). The province was unhappy that the existing agreement made it impossible for them to act unilaterally to increase the provincial rate to offset the recent reduction in the federal GST rate (as was suggested by, e.g., Smart and Bird, *supra* note 71).

<sup>99</sup> It is conceivable, however, that this situation might change in the future. One provision of the provisional new Ontario sales tax agreement provides for a joint federal-Ontario panel to be appointed within six months of the implementation of the new tax to examine, among other issues, an alternative revenue allocation framework which, unlike that we next describe in the text, would base the distribution of revenues to the HST provinces on the actual sales in such provinces.

<sup>100</sup> Of course, in non-HST provinces, the applicable 'provincial rate' is zero. See "Agreement regarding Revenue Allocation," Effective December 19, 2003. This is an updated version of Annex A to the 1996 Comprehensive Integrated Tax Coordination Agreement, *supra* note 86.

<sup>101</sup> Such taxes amounted to only about C\$1 million in 2003/04, however.

<sup>102</sup> Finance Canada provides the 'blueprint' for this operation but, as required by the confidentiality requirements governing the statistical agency, Statistics Canada does the calculations and provides only the final numbers to Finance Canada. Input-output tables are calculated every year, but with a three-year lag: e.g. the final 2004 tables and preliminary 2005 tables were released in November 2008.

sector base." The Canada Border Security Agency (CBSA) provides information on GST collected at the border.<sup>103</sup> Finally, the revenue pool is projected on the basis of estimated economic aggregates from a private economic forecasting group (the Conference Board of Canada): this source is used on the grounds that it is more transparently "third party" in nature.

The procedure for calculating the provincial share of revenues in any time period is straightforward but not simple. As shown in Table 4, the tax base is calculated separately for each and every province -- not just the HST provinces -- for five components: consumer expenditures, residential construction, financial institutions, public sector bodies, and taxable supplies other than those included in the previous categories. The appropriate provincial rate is then applied to the estimated base to calculate the provincial share of the revenue pool.

The base thus calculated, which makes up about two thirds of the total tax base, is then calibrated to ensure the estimate is consistent with actual tax revenues.<sup>104</sup> Finally, the annual revenue entitlement for any particular calendar year for a province is adjusted by deducting provincial rebates. The estimated entitlement is then paid to each participating HST province on a monthly basis.<sup>105</sup>

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<sup>103</sup> As mentioned earlier (*supra* note 60), since all rebates are paid by the CRA, it is easy to overestimate the role of the CBSA in collecting the GST. For example, in fiscal 2006, when net GST collections were only C\$14 billion, CBSA collected C\$21 billion in GST. Of course, almost this entire amount is probably (no separate data are maintained on ITCs generated by border taxes) subsequently claimed as ITC and hence reduces the net GST collected by CRA.

<sup>104</sup> For example, actual tax revenues will be lower because there is no allowance in the calculation procedure for the exemption of small suppliers or evasion (to the extent latter is captured in the underlying economic data). As a rule, the reported tax base is considered to be about 95% of the potential base, i.e. the base estimated by the RASC formula is adjusted downwards slightly.

<sup>105</sup> The process of estimating revenue entitlements does not stop with the initial budgetary procedure sketched above, of course. Since the annual estimate must be made at least two months prior to the beginning of the year, at least two revised estimates are made in the course of the year with corresponding adjustments made in subsequent payments. Moreover, the annual entitlements for prior years are subject to re-estimation and adjustment where necessary to reflect more recent data for the prior year, with the last such re-estimate no later than one year and 90 days after the release of the final provincial input-output tables for the calendar year in question. Where such adjustments determine an additional payment is required, such payment is made in 12 equal installments in the following months. If an overpayment has been made, it is recovered by reducing future payments over the next 12 months if the overpayment is less than 7% of the initial estimate for the upcoming year; if the overpayment is greater than 7%, and the province so requests, the repayment may be made over 36 months. In all, this procedure can be quite complicated: for example, with respect to the year 2001, the initial estimate was made in December 2000, with perhaps seven or eight additional estimates and subsequent adjustments in payments in subsequent periods until the last payments for 2001 were finally made at the end of the fiscal year 2006 (that is, in April 2007).

**Table 4**  
**Allocating the HST Base**

1. **Consumer expenditures** (excluding sales taxes) subject to HST are calculated on the basis of purchasers' price data from provincial input-output tables as updated by the more current provincial economic accounts data.<sup>a</sup> These figures may be adjusted (as determined by Finance in consultation with the province) to exclude expenditures that do not form part of the tax base. These adjustments are usually very minor.
2. The **housing** base is calculated separately because housing is treated differently in provincial economic accounts than under the GST: for example, new construction is included in the accounts at the time of construction rather than at the time of supply when the GST is levied. Moreover, the value of land is excluded from the national accounts but the GST is applied to land as well as construction.<sup>b</sup> The gross GST payable on new housing construction, alterations, improvements and transfer costs is then grossed up by the GST rate to estimate the housing base.
3. The **financial sector** base is calculated as the unrecoverable GST -- that is, GST for which no ITC may be claimed -- payable by listed financial institutions (e.g. banks, insurance corporations, credit unions and trust companies) allocated to a province, again grossed up by the GST rate.<sup>c</sup> In effect, this section of the base measures the taxable expenditures of financial institutions related to exempt supplies.
4. Most goods and services provided by the **public sector** are exempt. Since exempt suppliers incur tax on their inputs, public sector suppliers generally receive a rebate under the rebate system in place under the GST/HST. Initially, the rebate rate for each class of institutions was calculated to ensure that their average tax burden would not increase as a result of the introduction of the GST. Subsequently, the rate for municipalities was increased from the initial 57.14% to 100% in 2004. Rebate rates now vary from 50% for charities and nonprofit organizations to 100% for municipalities. The public sector base is thus calculated on the basis of administrative data on the rebates paid to different categories and then grossed up by the product of the GST rate on purchases by each type of public sector body and the applicable rebate rate.<sup>d</sup>
5. Finally, the other (or "**business**") component of the base is calculated in order to capture the unrecoverable GST related to the provision of exempt supplies. As in the case of the consumer base, this information is derived from the detailed provincial input-output tables, adjusting for exempt supplies, exports and other factors. Since input-output tables are only calculated every few years, this base is adjusted by a factor equivalent to the growth in nominal provincial GDP.

**Notes:**

<sup>a</sup> For example, in 2002 gross consumer expenditures were C\$485 billion, which after deducting provincial and federal sales taxes yields net consumer expenditures of C\$455 billion. Finance Canada sends Statistics Canada a detailed blueprint of the tax status of the 727 commodities included in the input-output accounts, and the latter then calculates the tax base by province. For example, in the case of drugs and pharmaceutical products where some items are fully taxable and some are exempt, net expenditures were C\$10 billion and the taxable proportion (nationwide) was C\$3.5 billion. These taxable proportions are then applied to the 130 categories of personal expenditure available in the provincial economic accounts.

<sup>b</sup> For these reasons, Statistics Canada uses information on house sales from the Canadian Mortgage and Housing Corporation as well as other surveys on renovation expenditures and building permits in estimating the gross GST paid on housing.

<sup>c</sup> The allocation of such institutions is determined by Income Tax Regulations or, if not so determined, then by its location.

<sup>d</sup> For example, suppose that 80% of university revenues come from the sale of exempt services (e.g. tuition) and 20% from taxable services (e.g. parking). One could calculate the university tax base from such information; however, it is simpler to calculate that if a university receives C\$10 in GST rebates, and the GST rate is 5% and the rebate rate for universities is 67%, then the tax base is C\$298.51 (C\$10/(67% \* 5%).

For present purposes, only four concluding remarks need to be made about this revenue allocation process. First, the resulting allocation of revenues to the HST provinces is clearly a statistical estimate of the “destination” basis: it is essentially driven by estimated taxable consumption in each HST province. Second, the calculations are actually done for all provinces: however, the tax rate for all non-HST provinces (including Québec) is of course zero. Third, if any HST province changed its rate all that would change would be the rate applied in calculating the provincial share of the tax base. Fourth, with very minor exceptions, this process is completely unrelated to how the HST actually functions.<sup>106</sup>

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<sup>106</sup> One small exception, for example, is that Finance Canada must obtain some specific information on the housing rebate in Nova Scotia from the Canadian Housing and Mortgage Corporation because that rebate is a provincial matter. It is interesting that the information is not obtained directly from the province.

## THE QUÉBEC SALES TAX (QST)

Québec is the only subnational jurisdiction in the world that successfully operates a destination-based VAT -- and has done for some years.<sup>107</sup> The QST applies to the vast majority of goods and services consumed within the Province of Québec and it is substantially harmonized with the federal GST. The story did not begin this way, however. As described earlier, Québec was the only province to follow the federal lead in 1991 by replacing its RST by a new provincial VAT. Under the federal-Québec agreement, Québec was to collect not only the QST but also the federal GST. Initially, some businesses complained that they would be faced with audits by both Québec and federal authorities but such complaints are seldom heard today. In part these initial concerns arose from the fact that the 1991 version of the QST differed from the GST in several important respects. For example, some taxes on business inputs were not refunded (especially those on fuel, telecommunications and automobile repairs). Even some administrative practices differed from the GST such as the tax accounting period. The most important difference is that it was not until July 1992 that the QST was extended to cover most services and immovable (“real”, under GST) property. By 1996, however, many of the initial differences from the federal GST had been removed and the two taxes were imposed on similar though not identical bases.

### Key Features of the QST

The QST is a destination-based credit-invoice VAT that subjects most goods and services consumed in Québec to tax at a statutory rate of 7.5%. On March 19, 2009, the provincial government announced its intention to raise the QST rate to 8.5% in 2011. Unlike most other sales taxes in Canada, the QST applies on the GST-inclusive price of goods and services.<sup>108</sup> Assume a retail sale to a final consumer of \$1000 that is taxable under both GST and QST: then, the GST at a rate of 5% amounts to \$50 and the QST at a rate of 7.5% amounts to \$78.75 ( $\$1050 \times .075$ ), for a total tax take of \$128.75. Goods and services that are produced and consumed in Québec or imported in the province are subject to tax. Transactions conducted in the province are also subject, usually at the same time, to the GST at the 5% rate. Both taxes are collected at the point of sale, and their amounts are shown separately on the invoice.

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<sup>107</sup> The Brazilian state VATs, which have been in operation much longer (since 1967), are origin-based (actually, hybrid origin). In the case of India, where Indian state VATs have for the most part only been in operation for a few years, as yet the treatment of interstate trade is not clear: they too are in effect probably best thought of at present as being essentially origin-based. For further discussion, see Bird, *supra* note 81.

<sup>108</sup> The only other province in which this is true is Prince Edward Island, which levies an RST.

For the most part, the QST base is identical to that of the GST.<sup>109</sup> For example, QST-exempt supplies include:

- Daycare and education (primary, secondary, post-secondary);
- Hospital, clinical, medical and dental care, and nursing home care;
- Housing (used and residential rentals);
- Legal aid;
- Municipal services, including public transit; and
- Recreation (public-sector programs for children of 14 and under).

Supplies zero-rated under the QST include:

- Books (if they have an ISBN);
- Exports (both interprovincial and international) of goods outside Québec;
- Exports to non-residents of services or intangibles;
- Farming equipment and supplies, and farm produce;
- Financial services;
- Fishing equipment and fish;
- Freight in or out of Canada/Québec;
- Groceries (“basic” only);
- Medical devices and prescription drugs; and
- Travel in or out of Canada with origin or destination in Québec.

The treatment of trade under the QST is not straightforward. Ignoring minor exceptions, however, the story is as follows. Exports of goods (“corporeal movable property”, equivalent to ‘tangible personal property’ for GST purposes) are zero-rated if exported outside Québec, whether to another province or outside Canada. Exports of services to non-residents of Québec are also zero-rated unless either one of the following conditions apply: the sale is made to an individual who is a non-resident of Canada but is in Canada when he or she orders the service, or the service is provided to an individual during his or her stay in Canada. In these two cases, both the GST and QST apply and services are deemed to be consumed in Québec. In effect, in these cases exports of services to non-residents of Québec are effectively taxed on an origin basis.

Imports of goods into Québec from abroad are generally subject to both GST and QST. For non-commercial imports both taxes are collected by customs (CBSA) from the importer on goods imported into Canada from abroad. As a result, non-commercial imports from outside Canada entering Québec bear both taxes. Goods imported from elsewhere in Canada by Québec residents who are not registrants are subject to QST on a self-assessment basis. However, if the person importing the goods is a registrant for QST purposes and if the imports are for use exclusively in commercial activities, then no QST is payable, provided the registrant would have been eligible to claim an input tax refund

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<sup>109</sup> As noted below, apart from the QST treatment of interprovincial trade and books, the most important difference is the treatment of financial institutions, which are exempt under GST but zero-rated under QST. Most items (e.g., ‘basic groceries’) are defined similarly.

(ITR) had tax been paid. Revenu Québec may of course request purchase and sale invoices to substantiate such transactions. This treatment of interprovincial imports is similar to the deferred payment system that is now applied in the EU.<sup>110</sup>

Finally, when non-commercial imports of services or incorporeal (intangible) property are made from non-resident vendors who are QST registrants, those vendors are of course responsible for the collection of the GST and QST.

### **How Different from the GST Base?**

Despite the progressive harmonization of the QST following the GST over time, several differences between their bases remain today. The most important such differences are summarized in Table 5; a few are worthy of further discussion. In particular, a holdover from the early days of the tax is that input tax refunds (ITRs) with respect to QST -- the equivalent of input tax credits (ITCs) under the GST -- are still denied to registered businesses under particular circumstances.<sup>111</sup> “Large businesses”, which are defined as having taxable sales (excluding the sales of financial services) over C\$10 million during a given fiscal year, are denied ITRs with respect to the following goods and services:

- Light motor vehicles meant to be driven on public roads (e.g., small service vans), including property and services relating to such vehicles;
- Fuel used to supply the engines of the above vehicles;
- Various energy sources, unless used to produce movable property intended for sale;
- Telephone and other telecommunication services, with the exception of the Internet and 1 800, 1 888, and similar services; and
- Food, beverages, and entertainment services not fully deductible under the [Income] *Taxation Act*.

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<sup>110</sup> Note that it does not matter from the perspective of the QST if the exporting province has an RST or is a member of the HST system: in either case, the shipment of goods is zero-rated. However, if a GST registrant in any province, including Québec, ships to a customer in an HST province, the tax rate applied is of course the HST rate, not the GST rate. In effect, apart from rebating input taxes on interprovincial exports, Québec acts in exactly the same way as a province with an RST, or no sales tax at all. It applies the federal tax, including the provincial component imposed as the HST, on out-of-province supplies that are not exported abroad but does not apply its own tax. Fraudulent interprovincial transactions are not seen as a big problem: if zero-rated interprovincial exports are re-imported into the province by QST registrants for commercial purposes, as noted in the text, there would normally be no tax anyway and if they are imported by non-registrants they are supposed to be self-assessed. The existence of the GST makes it relatively easy to verify such imports by registrants; the problems in dealing with imports by non-registrants are exactly the same as those with an RST.

<sup>111</sup> As noted earlier (*supra* note 74), Ontario intends to impose similar restrictions under its new HST. Although the agreement is not yet finalized, it appears the federal government has agreed to implement this provision at no cost to the province for a period of five years (followed by a three-year phase-out) provided the scope of the ITC restrictions does not exceed that presently in force under the QST.

The C\$10 million threshold for large businesses is fairly low; it applies to all business sectors. However, most financial institutions are deemed large businesses, regardless of the value of their taxable sales, for the purposes of ITR entitlement. Given the concentration of the Canadian financial sector, the C\$10 million threshold is especially low for financial institutions so presumably most of them would be large businesses anyway. This “large business” provision evidently is intended to protect QST revenues. However, it does so at a cost, both imposing some tax on business inputs and creating some incentive for businesses to inefficiently split operations to avoid the threshold.

This is not the only peculiar aspect of the QST treatment of financial institutions. Indeed, the treatment of the financial sector is fundamentally different in the QST and the GST.<sup>112</sup> Under the GST, most services provided by financial institutions are exempt. The same rule applies to the provincial component of the HST, although, interestingly, the relevant tax is imposed on the basis of where supplies of financial services are made rather than where inputs are purchased. In contrast, financial services are zero-rated under the QST, which means that Québec financial institutions can recover the QST they pay on most of their inputs. The rationale for this favorable treatment was presumably to improve the attractiveness of basing the headquarters of financial institutions in Québec, particularly relative to neighboring Ontario (which still has an RST under which significant inputs to such institutions -- e.g. computing equipment -- are taxed).

However, two other features of the Québec system act to reduce the beneficial effects of this zero-rating for financial institutions. First, as noted above, most financial institutions are, regardless of their size, considered to be “large businesses” and hence subject to the long-standing general restriction on the extent to which large businesses can claim certain input tax credits, as listed above. Since the definition of a financial institution for the purposes of this rule is quite broad, these restrictions would apply to virtually the entire sector. Second, the Québec government imposes a special compensatory tax on the wages and paid-up capital of listed financial institutions.<sup>113</sup> This tax was originally intended to offset the negative revenue effects of zero-rating, although it clearly does so imperfectly and at the cost of considerable additional complication in terms of compliance and administration, and economic efficiency.

Another notable area of base discrepancy includes tax rebate rates in the MASH sector.<sup>114</sup> There are differences with respect to treatment of the real estate sector and administrative procedures and definitions as well but cataloguing those here would take us too far afield: for some examples, see Table 5.

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<sup>112</sup> See, for further discussion, Pierre-Pascal Gendron, “VAT Treatment of Financial Services: Assessment and Policy Proposal for Developing Countries,” *Bulletin for International Taxation*, 62 (11, November 2008), and Schenk (this volume).

<sup>113</sup> The rates of this tax is 2% on wages paid in Québec plus 0.25% of Québec paid-up capital for banks, loan and trust corporations, and corporations trading in securities; 0.35% of premiums payable to insurance corporations; 2.5% of wages for credit unions; and 1% for other listed financial institutions. This tax is collected with the corporate income tax.

<sup>114</sup> See Table 5. For a thorough discussion, see Gendron (this volume).

**Table 5**  
**Some Differences between GST and QST**

**Tax Base**

1. QST is applied to sales price including GST. Rate of 7.5% = 7.875% on price excluding GST.
2. QST does not apply to trade-in motor-vehicles sold to registered dealerships but instead zero-rates such sales; GST is applied to such sales (though of course registrant can claim ITC).
3. GST applies to sales to federal government; QST does not. (Sales to Québec government are exempt from both.)

**Registration**

4. Must register for QST before making first taxable sale in province; under GST must apply for registration within thirty days after making first taxable sale in Canada.
5. Must register for QST regardless of annual total of taxable sales and regardless of whether registered for GST if engaged in sale of alcohol or retail sale of tobacco products, fuel, new tires, and sale or long-term leasing of new or used road vehicles.

**Zero-Rating**

6. QST zero-rates provision of financial services (exempt under GST).
7. QST effectively zero-rates sales of printed books. (GST on such items is rebated to MASH bodies)
8. QST zero-rates services supplied outside of Québec.

**Rebates for MASH Sector**

9. Until recently, QST rebate rate (corresponding GST rebate in parentheses) was 0% (100%) for municipalities; however, the rate is supposed to be progressively increased to 100% by 2013.
10. Rebate rates are 47% (68%) for schools.
11. Rebate rates are 47% (67%) for universities and public colleges.
12. Rebate rates are 51.5% (83%) for hospitals. (Both taxes give 50% rebates to charities and other qualifying non-profit organizations, and give hospital rebate to such organizations when they provide similar health care.)

**Rebates for Housing**

13. Thresholds for housing rebates are different: Full 36% rebate of GST if price of new residential unit < C\$350k decreasing to zero if > C\$450k; of QST if unit < C\$200k decreasing to zero if > C\$225k.

**Large Businesses**

14. Under QST, large businesses -- those with taxable sales (excluding sales of financial services) exceeding C\$10 million in previous fiscal year -- do not receive ITRs (input tax refunds, the QST terminology for what are called ITCs or input tax credits for GST) for vehicles under 5,000 Kg. or services, parts and fuel for such vehicles; or for electricity, gas or fuel except when used to produce taxable property for sale; or for telecommunications services except internet access and 800-type services; or for food, entertainment etc that are only 50% deductible for income tax purposes.

**Financial Institutions**

15. In addition to being zero-rated, for QST, all financial institutions (banks, credit unions, insurers, investment plans, etc.) are considered large businesses and hence subject to the ITR limitations just noted.
16. Under GST, financial institutions can claim input tax credits (ITCs) only for operating expenses 100% incurred in course of commercial activities; under QST, threshold is 90%. Under GST, financial institutions can claim ITCs for capital property of any sort only on the share of property used in commercial activities (taxable sales); under QST, however, usual rules apply (for immovables, 100% claim if > 90%; none if < 10%; % of use in-between); for passenger vehicles and movable property, none if < 50%; 100% if over.

**Tourism**

17. Since 2001, there has been no 'tourist rebate' of QST; however, the funds 'recovered' on this account are apparently earmarked for Tourisme Québec for purposes of tourism promotion.

**Incentives**

18. March 2006 budget announced refund of QST up to max of C\$1000 for sale or leasing of hybrid vehicles until January 1, 2009.

*Note:* The information in this table was obtained from several provincial and federal websites in October 2008, supplemented by information kindly provided by Finances Québec: it may not be complete or fully up-to-date. This summary is not intended to be exhaustive.

## Administration and Enforcement

As noted earlier, Revenu Québec (RQ) administers the GST on behalf of the federal government on Québec's territory, in addition to the QST. Under the terms of the agreement, RQ receives and processes applications for registration under the GST/HST system from all persons carrying on commercial activities in Québec. (Businesses registered for the GST are automatically registered for the HST, and GST registration covers the activities of any business in all 10 provinces.) After registration, all taxable persons continue to deal with RQ for all GST/HST-related matters including returns, remittances, rebate applications, audits, investigations, interpretations of laws and regulations, notices of objection, tax collection, and unfilled returns.

This administrative model is unique in the world and reflects a number of specific conditions. The Québec and federal governments have a history of sometimes stormy relations with breakthroughs achieved through tough negotiations and subsequent cooperation.<sup>115</sup> In this instance, it appears that both provincial administration and the QST's GST-inclusive base were presented by the Québec government as necessary conditions for harmonizing with its tax with the GST.<sup>116</sup> Perhaps reflecting the fact that overall taxation levels in Québec are high in relation to the Canadian average, RQ had over the years become a sophisticated and aggressive tax authority. Hence, the federal government, which desperately wanted some province to publicly support its initial move to a VAT, probably assumed, correctly, that it was unlikely to lose in revenue terms by accepting these conditions. Indeed, the quality of RQ as a tax administration and its detailed knowledge of its taxpayer population, when added to the economies of scale from collecting two taxes together rather than separately, made the package an attractive one. With good information exchange, hitching the QST to the GST may well have helped both governments protect their revenues.

The CRA pays RQ a fee for collecting, administering and remitting the GST to the federal government.<sup>117</sup> Some of the key terms and conditions of this arrangement are codified in the *Memorandum of Understanding on Tax Information Exchange with Revenu Québec* ("Memorandum") signed on August 24, 1988.<sup>118</sup> This is essentially a

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<sup>115</sup> For an examination of the changing nature of tax and other dimensions of federal-provincial relations over time, see e.g. Richard M. Bird and François Vaillancourt, "Changing With the Times: Success, Failure and Inertia in Canadian Federal Arrangements, 1945-2002," in Jessica S. Wallack and T. N. Srinivasan, eds., *Federalism and Economic Reform: International Perspectives* (Cambridge: Cambridge University Press, 2006), pp. 189-248.

<sup>116</sup> Reportedly, one reason why Québec insisted on its 'sole administration' was the determination of the (separatist) government that the provincial government should as much as possible be "the face of government" to the people of the province.

<sup>117</sup> See *supra* note 70.

<sup>118</sup> The CRA has a number of formal agreements with RQ which relate to the provincial administration of the GST/HST, including one on auditing. Seven such agreements are listed in CRA, *The Canada Revenue Agency: The First Five Years*, Annex B. With respect to the Memorandum of Understanding on Tax Information Exchange, an internal audit summary and evaluation by the CRA in 2006 is available at <http://www.cra-arc.gc.ca/gncy/ntrnl/2006/xchng-eng.html> (accessed on May 22, 2009) which provides some useful information. Most interestingly, this internal audit was carried out at the request of RQ which had earlier carried out its own internal audit of this particular Memorandum. For example, 65 types of

document that sets out the rules with respect to administrative cooperation between the CRA and RQ.<sup>119</sup>

In addition to exchanging tax information with the CRA for the purposes of administering both taxes in Québec, RQ maintains an up-to-date, bilingual, and generally user friendly Internet site to assist with administration, enforcement, and taxpayer education. Many guides and forms are easily accessible from the site.<sup>120</sup> Forms contain information that allows RQ to track information and tax across the GST/HST-QST system. For example, the form for detailed tax calculations requires the GST Account Number, a QST identification number, and a Québec business number. In addition to those enterprises that must register for GST, still others must register for QST (see Table 5).<sup>121</sup> One unusual feature found on the site is a list of QST cheaters, with name, trade name, address, type of business, and fraud amount revealed for all to see.<sup>122</sup> Businesses in the restaurant, construction and home renovation, and services sectors consistently get top billing. While one may question the appropriateness of this practice from a privacy perspective, it appears to be effective. The practice is tied to a public ‘fairness campaign’ conducted by the Québec government under which tax evasion is portrayed as undermining fairness for all and hence to be discouraged on that basis rather than on the basis of revenue losses and the accompanying economic inefficiency.

The benefit RQ derives from its arrangement with the CRA exceeds the administrative fee it receives from the CRA.<sup>123</sup> The initial agreement to impose QST on the GST itself created a small permanent stream of additional revenues for the Québec treasury. Moreover in light of the size and service-intensity of the Quebec economy the shift to (approximately) the GST tax base also increased both revenue and revenue-

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information are sent by CRA to RQ and 31 types of information are received by CRA from RQ. The audit revealed a number of shortcomings in the existing procedures -- including a variety of security lapses -- and recommended more oversight as well as periodic revision of such agreements; the Memorandum itself has not been reviewed since 1993. Unfortunately the available documentation provides no information on the performance of the information exchange activities conducted under the Memorandum.

<sup>119</sup> Québec is also a party to an agreement with the Canada Border Services Agency (CBSA) whereby the latter collects the QST along with the GST on certain imports of goods by final consumers (or non-registered firms), primarily by post, from outside Canada. See Canada Border Services Agency: Non-Commercial Provincial Tax Collection Program, Memorandum D2-3-6 (Ottawa: Government of Canada, April 30, 2004), available at <http://cbsa-asfc.gc.ca/publications/dm-md/d2/d2-3-6-eng.pdf> (accessed on May 22, 2009). All provinces but one (Prince Edward Island) appear to have similar agreements with the CBSA, again illustrating that from a federal perspective it does not matter what type of sales tax they impose.

<sup>120</sup> See <http://www.revenu.gouv.qc.ca/eng/ministere/> (accessed May 22, 2009). As is also true with respect to the (quite good) CRA website, however, some forms are, apparently for security reasons, still not easily downloadable from the web.

<sup>121</sup> In addition, for various purposes -- for example, in order to advertise legally -- even more firms must also obtain a business registration number. Historically, this number was issued by a different office but it too is now issued and managed by RQ.

<sup>122</sup> On tax evasion in general, see Revenu Québec, *Fight against Tax Evasion* (Québec: Gouvernement du Québec), available at [http://www.revenu.gouv.qc.ca/eng/ministere/evasion\\_fiscale/](http://www.revenu.gouv.qc.ca/eng/ministere/evasion_fiscale/) (accessed on May 22, 2009). For examples of RQ press releases on specific evaders (in French) see [http://www.revenu.gouv.qc.ca/eng/ministere/centre\\_information/communiqués/ev-fisc/2009/](http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/ev-fisc/2009/) (accessed May 22, 2009).

<sup>123</sup> See *supra* note 70.

elasticity. RQ has a direct incentive to collect and enforce the GST since the QST base grows when GST collections grow. This benefits both parties.

In practice, how well does this all work? Unfortunately, there appears to be no publicly available assessment of the arrangement by either government. All that is publicly known is that RQ has harmonized its management systems fully with the new GST management system used by the CRA. This effort began in 2002 and was completed in April 2007.<sup>124</sup> On the whole, RQ seems to be doing a good job, not least with the QST. During fiscal year 2007-08, for example, 616,052 entities were registered for QST compared to the 588,489 entities registered for GST in Québec.<sup>125</sup> That year, RQ received C\$129.2 million from the CRA to administer the GST on Québec's territory, an amount that includes funds for the processing of disputes. The administrative fee works out to about C\$220 per GST registrant.<sup>126</sup>

During 2007-08, a total of C\$16.5 billion was reported as gross QST collected on taxable sales. After allowing for refunds of C\$5.3 billion, however, net QST revenues amounted to 21.7% of total taxes and 14.3% of total revenues; in comparison, income taxes were 62.1% of total tax revenues and 41.3% of total revenues. In the same year, gross GST collections by the province were only C\$8.2 billion or about half the size of QST collections. Moreover, while QST refunds were 32.3% of gross QST collections, GST refunds, at C\$4.7 billion, were markedly higher at 56.3% of gross GST collections. The higher ratio for GST undoubtedly in part reflects the fact that its ITC and rebate provisions are more generous than the ITR and rebate provisions under the QST, but it probably mainly reflects the fact that ITC arising from GST collected (by the federal government) on international imports by GST registrants are offset against domestic GST collections (such as those reported by RQ). While the QST also provides such offsets, the GST data reported for the province may include ITC claimed by registrants based in Québec for imports that were not directed to that province. Finally, Québec, like the federal government, provides an offsetting income tax credit for the QST which amounted to C\$467 million in 2007-08.

Administrative functions (*contrôle fiscal*) at RQ are organized around six activity groups: 'non-filers', assessment, audit, investigations, research, and special projects. All activities combined yielded the province almost C\$1 billion in extra revenues from consumption taxes. Although we do not have data on QST recoveries, since RQ recovered C\$492 million in extra GST revenues, it seems probable that the QST accounted for much of the reported recoveries of consumption taxes (close to \$1 billion, or almost half total tax recoveries) in 2007-08. Similarly, C\$2.8 million in fines were collected with respect to the GST, compared to C\$24.7 million for the QST and other provincial taxes.

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<sup>124</sup> This information and the raw figures used in the calculations that follow come from Revenu Québec, *Rapport annuel de gestion 2007-2008* (Québec: Gouvernement du Québec, 2008), available at [http://revenu.gouv.qc.ca/documents/eng/publications/adm/ADM-500\(2008-10\).pdf](http://revenu.gouv.qc.ca/documents/eng/publications/adm/ADM-500(2008-10).pdf) (accessed on May 22, 2009).

<sup>125</sup> See Table 5 above for what are presumably the major explanations for this difference.

<sup>126</sup> As noted at *supra* note 70, these figures are those from RQ; CRA shows somewhat different figures.

RQ uses a target system to track administrative performance. In that respect, activities in audit and non-filers yielded higher than expected revenue recoveries, although again we are unable to break out data for the QST alone. In total, these activities yielded almost C\$80 million in 2007-2008, an amount almost double the target. Efforts were focused on financial transactions and investments, real property transactions, and construction. In the latter sector, tax credit applications and undeclared work were the main areas of focus. Another focus was on the restaurant sector, with an emphasis on having businesses hand over receipts to customers and booking sales through RQ-approved software. In total, in 2007-08 RQ obtained 1,068 convictions of taxpayers or registrants, as publicized aggressively on its web site.

Another way to approach performance is to consider the extent of tax evasion in Québec. According to another official source, the estimated revenue forgone by Québec due to tax evasion in 2002 was C\$1.78 billion for income tax (or 7.2% of income tax collected) compared to C\$552 million (or 7.8%) of QST collections.<sup>127</sup> QST evasion thus accounted for slightly over 20% of estimated total evasion and total consumption tax evasion for 30% of total losses. In terms of revenue, consumption tax evasion was 7.8% of revenues collected, or a bit more than the 7.2% evasion estimated for income taxes.<sup>128</sup>

The most important sectors of activity, in decreasing order of lost revenue due to underground (but not illegal) economic activity, are:<sup>129</sup>

- Construction, including renovation;
- Restaurants;
- Alcoholic beverages;
- Tobacco products;
- Personal services (miscellaneous); and
- Motor vehicle maintenance, including parts.

Of all broad sectoral combinations, small businesses operating in the services sector exhibit the highest risk of tax evasion. Neither in public documents nor in discussion with officials did there appear to be evidence of any serious problems at the interprovincial level akin to the ‘carousel fraud’ so much discussed in the EU.<sup>130</sup>

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<sup>127</sup> These figures exclude estimated evasion of excise duties on alcohol and tobacco of C\$208 million: despite the existence of many special rules (e.g., mandatory registration regardless of sales) pertaining to those sectors and their parallel indirect tax regimes, it is striking to see that such losses are relatively as large as those estimated for the QST. Finances Québec, *L'évasion fiscale au Québec: Sources et ampleur*, Études économiques, fiscales et budgétaires, Vol. 1, No. 1 (Québec: Gouvernement du Québec, April 22, 2005), available at [http://www.finances.gouv.qc.ca/documents/EEFB/fr/eeFB\\_voll\\_no1.pdf](http://www.finances.gouv.qc.ca/documents/EEFB/fr/eeFB_voll_no1.pdf) (accessed on May 22, 2009).

<sup>128</sup> These estimates are rough not only because of the inevitable uncertainty of all estimates of evasion but also because there is a small (three-month) timing discrepancy between the public accounts data for the denominator (revenues) and the study data for the numerator (taxes evaded).

<sup>129</sup> The first two sectors listed are also the first two listed in a 2007 CRA study of The Underground Economy (cited in UK National Audit Office, *supra* note 65).

<sup>130</sup> See Keen and Hellerstein (this volume), and Cnossen (this volume). For an interesting discussion of the kind of fraud that has been observed in Canada, see Richard T. Ainsworth, “Tackling VAT Fraud: Car Flipping and Computer Chips on a Carousel,” *Tax Notes International*, 46 (3, April 16, 2007), 267-80.

## Summing It Up

The present system may not be neat, but Québec's experience does demonstrate that there is no reason why other provinces, should they decide to adopt an independent VAT (rather than one like the HST that is rigidly linked to the federal tax and collected by the federal government on behalf of the province), cannot do so, with or without any type of prior agreement with the federal government.

Although in many ways the Québec experience is unique not only in Canada but in the world, it does support at least four lessons that seem worth considering in the US context also:

- First, some (but not unrestrained) base diversity, while of course not ideal in terms of compliance cost, cannot only be tolerated by taxpayers but managed by a single administration administering both federal and subnational VATs.
- Second, subnational jurisdictions can successfully administer a destination-based VAT, essentially by emulating what the EU does rather than what it has been saying in recent years.<sup>131</sup>
- Third, while Canadian governments could undoubtedly make the present system work better, many of the highly publicized administrative problems currently bedeviling EU VATs (such as carousel fraud) do not arise to the same degree with respect to subnational VATs in Canada precisely because there is an overriding federal GST.<sup>132</sup>
- Finally, although again Canadian practice is far from ideal, it does demonstrate that a subnational VAT can co-exist with other subnational sales taxes, whether such taxes take the form of VATs or RSTs, without any serious problems.

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Although Ainsworth draws some interesting parallels between some Canadian fraud cases and the EU 'carousel fraud' cases, it is noteworthy that the cases he highlights have little to do with subnational VATs as such. Rather, they essentially exploited two problematic aspects of the federal GST, one related to the fact that a new registrant is not required to file a GST return for 18 months and the other hinging in part on the fact that Treaty Indians are entitled to purchase free of GST (see *supra* note 4). The main connection of these frauds to the existence of the HST was that by locating one fictitious vendor in the chain in an HST province, the refund claimed from the federal government was higher than it would otherwise have been.

<sup>131</sup> Our position on this issue is very similar to that of Sijbren Cnossen, "VAT Coordination in the European Union: It's the Break in the Audit Trail, Stupid!" Draft Paper, August 2008; see also Cnossen (this volume).

<sup>132</sup> This point was first made in Bird and Gendron, *supra* note 94. A further decade of experience has reinforced its relevance.

## PROVINCIAL RETAIL SALES TAXES (RST)

In the previous two sections, we have discussed some aspects of how two quite different sorts of subnational VAT now operate in conjunction with the federal VAT in Canada. Here we consider a question that, although it has been little considered in the literature, is perhaps the most directly relevant and immediately important from the US perspective: How the federal VAT interacts with provincial RSTs. Our answer, supported by Canadian experience, is that it does not. As Tables 6 and 7 show, at present the RSTs in the five provinces that still have such taxes vary significantly in a number of ways. Ascertaining tax status is complex as the system is riddled with exceptions of all sorts.

**Table 6**  
**Retail Sales Taxes (RSTs) in Canada I: Rates and Overview**

Province	Rate (%)	Sales Tax (% of Revenues)	Consumer Exemptions <sup>a</sup>	Producer Exemptions <sup>b</sup>	Treatment of Services <sup>c</sup>
British Columbia	7	11.8	Most nonprescription drugs and medical supplies; automobiles using alternative fuels; pollution control products; magazines and periodicals; candy, confections and soft drinks	Production machinery and equipment; all production consumables; some aquaculture items	Exempts local telephone service, basic cable, and 1-800 lines; exempt labor services if shown separately on bill of sale. Taxes nonresidential use of natural gas, fuel oil and electricity
Saskatchewan	5	10.0	Most nonprescription drugs and medical supplies; some adult clothing and footwear; magazines and periodicals; candy confections and soft drinks	All production consumables; equipment used in mineral exploration	Taxes flyers and advertising materials inserted into newspapers; taxes electricity except for farm and residential use
Manitoba	7	11.6	Most nonprescription drugs and medical supplies; magazines and periodicals; candy, confections and soft drinks	Some production consumables	Taxes natural gas, electricity and coal except for heating residential and farm buildings
Ontario	8	15.5	Some footwear	Production machinery; all production consumables; farm building materials	Exempts motor vehicle insurance premiums
Prince Edward Island	10	13.4	Most nonprescription drugs and medical supplies; all clothing and footwear; magazines and periodicals; some candy	Production machinery	Taxes laundry and dry cleaning services

<sup>a</sup> In addition, all exempt food, prescription drugs, medical appliances, most books and children's clothing as well as insulation materials and energy conservation items.

<sup>b</sup> All provinces exempt farm machinery, equipment, fertilizer, etc and most commercial fishing gear.

<sup>c</sup> All tax hotel and motel accommodation but most exempt utility services; except as noted most tax telephone and telecommunications, prepackaged software, insurance services and labor services to install and maintain taxable property

*Source:* Karin Treff and David B. Perry, *2007 Finances of the Nation* (Toronto: Canadian Tax Foundation, 2008).

**Table 7**  
**Retail Sales Taxes (RSTs) in Canada II:**  
**Tax Status by Province and Transaction Type**

Transaction Type	British Columbia	Saskatchewan	Manitoba	Ontario	Prince Edward Island
<b>Business</b>					
Good for resale/lease	Exempt	Exempt	Exempt	Exempt	Exempt
Raw materials	Exempt	Exempt	Exempt	Exempt	Exempt
Production equipment	Exempt <sup>a</sup>	Taxable	Taxable	Exempt <sup>a</sup>	Exempt
Farming equipment/supplies	Exempt	Exempt	Exempt	Exempt	Exempt
Fishing equipment/supplies	Exempt	Taxable	Exempt	Exempt	Exempt
<b>Personal</b>					
Basic groceries	Exempt	Exempt	Exempt <sup>b</sup>	Exempt <sup>b</sup>	Exempt <sup>b</sup>
Books, magazines <sup>c</sup>	Exempt	Exempt	Exempt <sup>d</sup>	Exempt <sup>d</sup>	Exempt <sup>d</sup>
School supplies	Exempt	Taxable	Taxable	Taxable	Exempt
Children's clothing	Exempt	Exempt	Exempt	Exempt	Exempt
Prescription drugs	Exempt	Exempt	Exempt	Exempt	Exempt
<b>Business and personal</b>					
Sale or lease of goods	Taxable	Taxable	Taxable	Taxable	Taxable
Repair/maintenance of goods	Taxable <sup>e</sup>	Taxable <sup>e</sup>	Taxable	Taxable <sup>e</sup>	Taxable
Prepared meals	Exempt	Exempt	Taxable	Taxable <sup>f</sup>	Taxable
Parking	Exempt <sup>g</sup>	Exempt	Exempt	Taxable <sup>g</sup>	Exempt
Legal services	Taxable	Taxable	Taxable	Exempt	Taxable
Telecommunication services	Taxable	Taxable	Taxable	Taxable	Taxable

**Notes:**

- a) In British Columbia and Ontario, production equipment is exempt only if it is used by qualified manufacturers or producers.
- b) In Manitoba, Ontario, and Prince Edward Island, carbonated beverages, snack foods and candy are subject to tax.
- c) The definition of exempt publications and books vary by province.
- d) In Ontario and Prince Edward Island, magazines are exempt only if they are purchased by subscription. Magazines are not exempt in Manitoba.
- e) In British Columbia, Saskatchewan, and Ontario, repairs to exempt items are excluded from the tax base.
- f) In Ontario, prepared meals costing C\$4 or less are exempt.
- g) Non-residential parking within the greater area of Vancouver (British Columbia) is taxable, while residential parking in Ontario is exempt.

**Source:** KPMG, *Tax Facts 2008-2009* (Canada: KPMG LLP, 2008).

The variations and complexity illustrated by Tables 6 and 7 are, of course, quite familiar to anyone who is familiar with similar state taxes in the United States. The similarity between RSTs in the two countries is not surprising since, as in a number of American states, the first retail sales tax in Canada – introduced in Alberta in 1936 – was an emergency measure introduced to cope with the effects of the depression on provincial finances. Although this tax was abolished in 1937 (and Alberta has never re-introduced it), the similar tax introduced for the same reason in the neighboring province of Saskatchewan in 1937 still exists. Although Québec introduced a provincial retail sales tax in 1940, the other provinces did not introduce RSTs until after the war, beginning with British Columbia (in 1948) and concluding with Manitoba (in 1967).<sup>133</sup>

As mentioned earlier, suppliers shipping from any province to any HST province charge provincial HST as well as federal GST on such shipments and remit the corresponding amounts to the relevant GST/HST administration (i.e. the CRA for suppliers outside Québec and RQ for those in Québec). The situation is different in Québec, which, like the RST provinces, in principle requires purchasers in the province to self-assess and remit tax if it is not collected by the vendor. Québec, British Columbia and Manitoba expect out-of-province vendors selling into the province to register for provincial sales tax purposes and to collect and remit to the respective provincial governments the tax due.<sup>134</sup> At the other extreme, Saskatchewan and Prince Edward Island encourage such vendors to register voluntarily but have no legal requirements for them to do so. Ontario applies a “business presence” test, requiring out-of-province vendors to register for RST only if they have e.g. a branch office, warehouse, storage facilities, post box, employees or agents in Ontario. Such provisions seem unlikely to be any more effective than the similar provisions found in many US states.

Indeed, on the whole for a predominantly American audience the best way to describe Canadian retail sales taxes is simply to refer them to any critical paper on the similar taxes in the United States. As Charles McLure recently noted in an interesting paper, the existing RSTs in Canada, as in the US, violate almost all the principles of good sales taxation.<sup>135</sup> For example, the system is complex, many sales to consumers are exempt, many sales to business are taxed, the destination principle is seriously violated, and there is almost no cooperation between federal and provincial tax administration. We agree. However, we do not agree with McLure's characterization of the HST in the paper cited since he seems to consider it to be deficient primarily because he believes all provinces taking part in the system must apply the same rate. As pointed out earlier, this is not the case, as the recent discussion in New Brunswick and Saskatchewan has once

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<sup>133</sup> See Due, *supra* note 9, and A. J. Robinson, *The Retail Sales Tax in Canada* (Toronto: Canadian Tax Foundation, 1986), p. 4.

<sup>134</sup> In British Columbia and Manitoba, out-of-province sellers are expected to register if they meet all four of the following criteria: (1) they solicit sales in the province by any means; (2) they accept purchase orders in any form that originate in the province; (3) they sell goods to purchasers located in the province; and (4) they deliver goods in any way to a location in the province. See Susan Ward, “Charging Provincial Sales Taxes on Online Sales,” available at <http://sbinfocanada.about.com/od/pst/a/PSTecommerce.htm> (accessed on May 22, 2009).

<sup>135</sup> Charles E. McLure, Jr., “Harmonizing the RSTs and GST: Lessons for Canada from the Canadian Experience,” *Tax Notes International*, 45 (5, February 5, 2007), 442.

again brought to public attention.<sup>136</sup> HST provinces, like all other provinces with sales taxes, have full power and responsibility to set their own tax rates. That the three provinces now in the HST system initially agreed to set a uniform rate for the first four years -- and have since maintained that same rate -- was their choice, as is the recent decision by Ontario to enter the HST system with the same rate. The current agreement with the federal government is not set in stone, and can be renegotiated by any province, as Newfoundland has done in the past and as Ontario is currently in the process of doing.<sup>137</sup> Of course, as with any agreement, both sides -- the federal government and the province -- would have to agree, but as we have discussed earlier, there is no technical or legal obstacle to imposing different rates in HST provinces if agreement can be reached.

To sum up, Canadian experience shows that provinces (or states) can do four quite different things when the federal government introduces a VAT:

- In their own interests, states should probably consider moving to a "clean" consumption tax base, encompassing a broader range of final consumption and excluding business inputs. One way to do this -- the way used by most national governments -- is to adopt a destination-based state VAT. As the QST shows, this can be done.
- A quite different approach would be to apply state sales taxes on the federal VAT base. It would be easier to do this if the tax were administered by the federal government, and it would be easier for the federal government to do this if the rates were uniform: in short, the HST. But neither federal administration nor uniform rates are necessary -- or necessarily wholly desirable -- features of such a system.
- Much the same objective might perhaps be to adopt a VAT-like base (excluding business inputs) but to administer it like any other RST. No one seems to have done this, but it is certainly technically feasible and, like the two Canadian systems, would be considerably simpler in the presence of a good federal VAT.<sup>138</sup>
- Finally, states can, if they choose, stay with their existing highly imperfect "retail" sales taxes. Again, as Canadian experience over the last 15 years demonstrates, states that for some reason want to discourage investment and exports in this way are certainly free to continue to do so.

In a sense, the key reform is simply to move the RST as close to a VAT-type base as possible. The easiest way to do so, of course, is to make it a VAT. Two key questions need to be faced by any province in this respect. The first is the effect on revenue. Canadian experience suggests that this is not likely to be a big issue.<sup>139</sup> The second question, however, is political -- how to sell the change. Canadian experience suggests that this may be more difficult.

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<sup>136</sup> See *supra* notes 73 and 98.

<sup>137</sup> See text *supra* at notes 74 and 97.

<sup>138</sup> For further discussion of essentially this approach, see McLure (this volume) and Duncan (this volume).

<sup>139</sup> See, for example, the discussion in Smart, *supra* note 75.

### THREE LESSONS FROM CANADIAN EXPERIENCE

In this section, we draw on the preceding sections to bring out three basic lessons from Canadian experience. The first and most important point is that from the point of view of a federal VAT it does not really matter what form the provincial sales taxes take. Whether such taxes are independent VATs (the QST), subordinate VATs (the HST), independent RSTs (of the usual form or the as yet hypothetical “zero-rating” B2B variety), or there is no provincial sales tax at all simply does not matter with respect to designing or operating a federal VAT.

Of course, the less ‘coordination’ there is between sales taxes in subnational jurisdictions and any federal tax (or for that matter between different subnational sales taxes) the higher the administrative costs for governments and the higher the compliance costs for businesses. Nothing is free, however. Provincial governments may choose to impose such costs on their businesses and residents in order to retain some desired degree of fiscal autonomy. Indeed, such autonomy may even in some instances provide an external benefit in the form of innovations by independent decision-makers to improve the efficiency of sales taxes. In Canada, one such example might be Québec’s different -- and in some ways preferable -- treatment of financial services.

In contrast, the second lesson from Canadian experience is that the precise nature of subnational sales taxes matters a great deal to subnational governments themselves for a number of reasons:

- First, it makes a very considerable difference in economic terms to a province whether it has a VAT or an RST. Canadian experience appears to demonstrate the economic advantages of provincial VATs fairly conclusively.<sup>140</sup> Nonetheless, if provinces want to continue to discourage economic activity by using an RST, they can, it seems, be allowed to do so without harming anyone much except themselves and their residents.<sup>141</sup>
- Second, if a province decides to impose a VAT, it is a quite separate decision whether it should be administered jointly or separately with the federal VAT and by whom. The argument for a single administration is strong on administrative and compliance cost grounds, but which path is chosen in terms of administration is largely a political choice with no important economic consequences.<sup>142</sup>

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<sup>140</sup> For detailed discussion of the economic reasons why provinces should consider moving to value-added taxes, see Smart and Bird, *supra* notes 34 and 71 and Smart, *supra* note 75.

<sup>141</sup> As noted earlier, conventional (bad) RSTs penalize investment and growth and have other distorting economic effects: see, for example, Smart and Bird, *supra* note 34.

<sup>142</sup> However, some economic consequences would obviously ensue if subnational governments chose to compete by administering federal taxes less effectively: as experience in Germany (where the states enforce -- to varying degrees -- federal taxes) suggests, this is particularly likely to be a problem when some of the costs of doing so are borne by non-residents through the operations of a federal equalization system: see Christian Barette, Bernd Huber, and Karl Lichtblau, “A Tax on Revenue. The Incentive Effects of Equalizing Transfers: Evidence from Germany,” CESifo Working Paper Series No. 333 (Munich: CESifo, September 2000).

- Third, whatever provinces may decide to do with respect to tax base and tax administration, they clearly have much to gain from developing mechanisms and institutional means of fostering close interprovincial and federal-provincial sales tax cooperation. Although it would likely be more effective and desirable for the federal government to take the lead in this respect, the key point is that those who have the most to gain or lose are the provincial governments, not the federal government.

Indeed, the third lesson from Canadian experience is simply that federal cooperation, while not essential, can nonetheless provide some critical support to any subnational sales tax and may perhaps -- if the federal government so chooses -- also provide some encouragement to improve those taxes from both an economic and administrative perspective. Federal cooperation may, for instance, supply two important supporting props to provincial sales taxes:

- First, the federal government controls the international border. Hence, if provinces want to tax imported goods flowing to the residents, they need federal cooperation to do so. Note, however, that it does not matter what kind of provincial sales tax is imposed: as noted earlier, the federal government in Canada collects provincial sales taxes of all varieties at the border (for noncommercial imports) under certain conditions.<sup>143</sup>
- Second, and more importantly, the existence of sales taxes at a higher level of government in principle (and to some extent in practice) makes it simpler for provinces to tax their own residents effectively in the face of extensive interprovincial trade in goods and services. Such federal-provincial cooperation is automatic in the case of the HST. It can be achieved to a substantial extent through close cooperation between the federal and provincial tax authorities as the case of the QST demonstrates. However, it does not work with respect to the existing RSTs in five provinces essentially because the bases of these taxes are totally different than the base of the GST.<sup>144</sup>

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<sup>143</sup> Of course, under any system such 'border controls' are not very useful with respect to B2C services.

<sup>144</sup> In principle, if the tax base imposed on retail consumers under an RST were exactly the same as the tax base imposed on retail buyers under the GST presumably this disadvantage of the RST approach would be removed. However, as discussed in detail in Bird and Gendron, *supra* note 2, it is extremely difficult to impose an RST on exactly the same base as a VAT -- or at least no one, anywhere, has yet managed to do so.

## WHAT MAY THE UNITED STATES LEARN?

To conclude, consider briefly to what extent the lessons we derive from Canadian experience might perhaps be applicable to the case of the United States if a US federal VAT were to be adopted. Canada offers three very different models of how subnational sales taxes might be structured if such a tax were imposed, each of which appears to warrant closer consideration from the US perspective.

To recapitulate:

- The Québec Sales Tax (QST) and the federal VAT (Goods and Services Tax, or GST) constitute an operational “dual VAT” system with essentially none of the problems usually associated with such systems. The rates of the two taxes are set independently by the respective governments. The tax bases are also determined independently, although they are essentially the same. From the beginning, both taxes have been collected by a single administration -- that of the province. Taxes on interprovincial sales from one business to another are basically handled by a zero-rating (deferred-payment) system similar to that now applied in the EU.<sup>145</sup>
- Three small provinces impose value added taxes (the HST -- Harmonized Sales Tax) on the same base as the federal GST. These provincial taxes are administered by the federal government and the revenues distributed to the provinces on the basis of estimated taxable consumption in each province. Interprovincial sales are dealt with in the same way as under the QST. Although all HST provinces currently impose the same rate as part of the agreement, this is not a necessary condition for this system to operate.<sup>146</sup>
- Do nothing. Six provinces have not made any significant changes in their RSTs (or, in the case of Alberta, non-RST) in the last 15 years: the existence of the federal GST has simply been ignored by these provinces.

With good tax administration it is thus perfectly feasible to operate a VAT at the subnational level on a destination basis. In principle, it is immaterial whether there are two separate administrations or one; or, if there is one, which level operates it. Clearly, a single central administration and a common base (as with the HST) is likely to be more administratively and economically efficient, but this degree of convergence in this respect is less essential than a high degree of intergovernmental cooperation e.g. through unified audit or at least through a uniform VAT registration system and good information exchange. Most importantly, from the perspective of improving accountability, each taxing government should be able independently to determine its own VAT rate (although, as mentioned, this is not how the HST system in Canada currently operates).

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<sup>145</sup> See the earlier discussion of the key features of the QST.

<sup>146</sup> For further discussion of this last point, see also Smart and Bird, *supra* note 71. See also Table 3 and discussion for illustrations of the provincial variations already existing within the HST system.

Achieving a “coordinated” two-level sales tax structure requires considerable effort. First, basic political agreement has to be secured between governments with different interests. Second, an appropriate legal framework to implement that agreement has to be worked out. Third, an appropriate administrative structure must be agreed. Fourth, to make the system work over time, appropriate oversight and cooperation systems between governments need to be developed and put into place. The result of about a decade of discussion of all these matters in Canada was the two quite different ways of coordinating some provincial-federal sales tax systems described above. Another decade has led yet another province, Ontario, to decide to enter the HST system under, more or less, its own terms. However, even after these systems have been working successfully for over a decade, five of Canada’s 10 provinces have signed on to neither of them. That they have not done so has, we have argued, harmed the residents of those provinces. It has not, however, hampered the functioning of the VATs either at the federal level or in those provinces that have them (whether in the form of QST or HST), in any way at all.

On the whole, even taking into account the existence of numerous local sales taxes in some US states, we think that these lessons should be broadly applicable to the US case. In other words, if the US federal government wants to adopt a VAT for its own reasons, from an economic or administrative perspective it can do so regardless of what the states do or do not do with respect to their sales taxes. Of course, as in Canada, the politics of this “intrusion” into a longstanding and important state tax base would definitely come into play.

The federal government might therefore want to consider offering to cooperate with and support states that want to similarly strengthen and improve their own sales taxes by (essentially) moving to the same tax base at the retail level. Such cooperation might extend to collecting the state tax if the base were essentially identical and the tax administered like a VAT. This is essentially the HST solution without the unnecessary requirement of uniform rates. If the base were identical but a state wanted to maintain a separate administration, then a cooperative agreement strengthening state taxation might nonetheless be reached. This is essentially the QST solution without the unnecessary condition of state administration of the federal tax. From this perspective it does not matter whether the state tax is a VAT (like the QST), an RST, or a hypothetical “VAT-like” RST like that set out in McLure (this volume): all that matters is simply that the same base is taxed.

Such cooperation might extend not only to collecting state taxes on (non-commercial) imports at the international border (as is done in Canada) but also to extensive and continual exchanges of information about cross-border internal trade both between federal and state administrations and also between different states, since all will have essentially the same base. While both states that move to a VAT-base or an equally ‘clean’ RST-base have much to gain economically by doing so, some may not choose to do so. That is their choice, and they should be free to make it.

Finally, while general local sales taxes -- which do not exist in Canada -- are no doubt a complication, they do not necessarily create insuperable problems. If a state has a 'clean' (VAT-like) sales tax base, it can, if it wishes to do so, allow localities to impose surtaxes and administer them with the state tax, although we doubt that such a policy would be a particularly good idea. Indeed, conceivably if a state had decided to impose its tax as a surcharge on the federal tax and to have it administered federally, even the federal government could administer such local surcharges although again such complication is unlikely to make much sense. We argued earlier that provincial sales tax reform (or its absence) had no technical or economic consequences for federal sales tax reform. Similarly, even if local governments want to maintain their present sales taxes, regardless of what the state does, they can -- if the state permits -- probably do so, at least if the rules of the game ensure that their citizens are those who will mainly pay the price (e.g., by requiring uniform taxation to avoid excessive tax exporting). If the rules are set so that those who make the decisions bear most of the costs, then if local citizens have the power to impose independent local sales taxes, presumably they can do so if they wish. The results may be economically inefficient and administratively costly, but, just as at the state level, it is their choice.