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THE GOODS AND SERVICES TAX: 10 YEARS LATER

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INTRODUCTION

The Goods and Services Tax (GST) is now in its tenth year. It was introduced on 1 January 1991 to replace the Federal Sales Tax (FST), which had been in existence since 1924. The GST, the FST which it replaced, and a number of alternatives considered over the years form a complex topic which has many ramifications and has raised a number of controversial issues, several of which have yet to be resolved.

This study takes a closer look at this question by: summarizing the general operation of the GST; providing a brief history of the events and discussions that led to its introduction; describing the attempts made to harmonize the GST with provincial taxes; examining certain alternatives that have been considered, as well as the reasons why those alternatives were not adopted; and summing up the situation to date.

HOW THE GST WORKS

A. Taxing Mechanism

The GST is a sales tax which applies to final consumption at a fixed rate of 7%. Whereas the former FST was a hidden tax on the *manufacture* of *goods*, including those exported for foreign consumption, the GST is a visible tax on the *value added* at each stage of production and distribution of *goods* and *services* – which makes it a *multi-stage tax* – and applies only to consumption within Canada.

The GST takes into account the cost of *inputs* – the factors used in manufacturing or production – at each stage of the process to avoid double taxation. Input tax credits enable partnerships, businesses and self-employed workers to recover all GST paid on goods and services purchased for business purposes by deducting them from their GST payments. Final consumers are not entitled to such credits, which means that they pay all the GST on every item purchased. The GST is thus a multi-stage tax on final consumption.

Table 1 illustrates the application of the GST and input tax credits at each stage of a production process leading to the purchase of a good (a kitchen stove) by a consumer and shows how it is ultimately the consumer who pays the GST.

Table 1 – Example of the application of the GST at the various stages of a production process

Stage	Transaction	GST (7%)	Input tax credit (7%)	GST paid
Mining company	Sales: $100	GST collected: $7	–	$7
Iron and steel business	Purchases: $100 Sales: $300	GST paid: $7 GST collected: $21	$7	$14
Kitchen stove manufacturer	Purchases: $300 Sales: $400	GST paid: $21 GST collected: $28	$21	$7
Retailer	Purchases: $400 Sales: $700	GST paid: $28 GST collected: $49	$28	$21
Purchaser	Purchases: $700	GST paid: $49	–	–
Total GST paid to government				**$49**

When the government introduced the GST, it decided to exempt two classes of goods and services: *zero-rated* goods and services, i.e., goods and services taxed at a nil rate, but which nevertheless grant entitlement to input credits (for example, exports, basic food products and medical equipment); and goods and services that are simply *tax-exempt*, i.e., which do not grant entitlement to input tax credits (for example, residential rents, day care services, public transit and medical care).

It is the class of a good or service which determines whether it grants entitlement to input tax credits. A dentist, for example, is not allowed to claim input tax credits in order to obtain a refund of the GST he/she has had to pay to purchase various items or to pay his/her rent or hydro bills because dental care belongs to the tax-exempt services class.

Approximately 2,411 million businesses are *registered*, i.e., they collect the GST from their customers, deduct input tax credits, and pay the difference to the government. Small businesses with annual sales under $30,000 may elect to be subject to the GST or not. If they decide not to, they do not collect the GST on their sales and are not entitled to claim input tax credits.

Apart from the input tax credit, a GST credit is granted to low- and modest-income Canadians which takes into account the number of dependent children. In 1998-1999, the total amount of this credit amounted to $2.85 billion[(1)] for Canada as a whole.

Special rules also apply to charities and certain non-profit organizations, municipalities, hospitals, schools, colleges and universities. These institutions are only entitled to a partial refund of the tax they pay on their inputs.

Lastly, under the *Debt Servicing and Reduction Account Act*, all GST revenues are paid into the public Treasury and constitute the main source of revenue allocated to debt reduction.

B. GST and Provincial Sales Tax

A provincial sales tax (PST) is charged in addition to the GST at the retail sale stage for *goods*, whereas *services* are often tax-exempt. The GST rate and terms of application vary considerably from province to province.[(2)]

Alberta is the only province with a no-retail-sales-tax policy. British Columbia, Saskatchewan, Manitoba and Ontario apply the PST to the selling price and simply add it to the GST, whereas Prince Edward Island and Quebec apply the PST to the total amount of the selling price and the GST.

Newfoundland and Labrador, New Brunswick and Nova Scotia apply a single sales tax of 15% – the harmonized sales tax (HST) – which includes the PST and GST. It is collected by the federal government, which pays those provinces their portion. The HST went into effect on 1 April 1997. Prior to that date, these provinces applied the PST to the total amount of the selling price and the GST.

When the GST went into effect, Quebec became responsible for collecting its own sales tax and the GST under an agreement with the federal government in 1990. Since 1995, the

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(1) The Government of Canada, *1998-1999 Public Accounts of Canada*, Vol. 1, p. 1.16 (http://w3.pwgsc.gc.ca/text/pubacc-e.html).

(2) The section entitled "Harmonization of Provincial Sales Taxes and the GST," more specifically Table 3, contains information on the PST and HST and their rates as well as the effective tax rates of various provinces.

two taxes have been completely harmonized, i.e., they are applied to the same *tax base*.[3] The Government of Quebec receives $92.8 million a year from the federal government to administer the GST.

All GST returns and refund claims from registered businesses, except those of Quebec residents, have been processed in Summerside, P.E.I., since 1993. In his 1999 report, however, the Auditor General of Canada noted that the federal government had begun to decentralize GST processing.[4]

C. Some Figures

Figures on annual GST revenues are published in the *Public Accounts of Canada*. Table 2 contains the latest available data.[5]

Table 2 – Annual GST revenues, 1998-1999
($ billion)

Total amount collected		**50.174**
Less	Refunds	22.162
	Rebates	1.909
	GST paid by departments and agencies	0.907
	HST transfers to the provinces	1.662
Gross revenues		**23.534**
Less	Quarterly tax credits	2.850
Net revenues		**20.684**

Source: Receiver General of Canada

(3) The tax base is the amount on which a tax rate is applied. This is the definition adopted by the Department of Finance Canada (http://www.fin.gc.ca/gloss/gloss-e.html#t).

(4) *1999 Report of the Auditor General*, Chapter 16, p. 16-7, September 1999 (http://www.oag-bvg.gc.ca/domino/reports.nsf/html/9916ce.html/$file/9916ce.pdf).

(5) Government of Canada, *1998-1999 Public Accounts of Canada*, Vol. 1, p. 1.14 (http://w3.pwgsc.gc.ca/text/pdf/v1pa99e.pdf).

The total amount collected ($50.174 billion) includes the share of the three provinces that apply the HST ($1.662 billion). Consequently, the federal government's gross revenues from the GST alone were $48.511 billion before refunds, rebates and other payments. Less all these cash outflows, net revenues amounted to $20.684 billion for the 1998-1999 fiscal year.

The Department of Finance publishes updates on net GST revenues in its monthly *Fiscal Monitor*.(6) The May 2000 issue states that net GST revenues for the 1999-2000 fiscal year (unaudited) had increased 9.8% over those from the previous period to nearly $23 billion. Highly favourable economic conditions have thus, at last, had an impact on retail sales, and imports have expanded, thus substantially increasing the amount of GST collected.

D. The Underground Economy

The underground economy issue always arises in connection with the GST. Various studies conducted in the early 1990s provided estimates of the size of that economy relative to gross domestic product (GDP). One Statistics Canada study estimated this figure at 4.2%.(7) This order of magnitude was confirmed by a team of economists from the Department of Finance, which pegged the figure at 4.5%.(8)

This problem existed long before the GST went into effect, but the tax may have aggravated it. On the other hand, there are no figures to support a direct link between the two, and it should not be forgotten that the recession of the early 1990s – as well as high personal and corporate income taxes, and payroll taxes – all had an influence on the size of the underground economy. A certain amount of caution must therefore be exercised in any attempt to establish a causal link between the GST and the underground economy.

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(6) This document is available online at http://www.fin.gc.ca/purl/fiscmon-e.html.

(7) Statistics Canada gave this figure in the conclusion of its document entitled *The Size of the Underground Economy in Canada*, Study in National Accounting, No. 13-603E, No. 2, June 1994, p. 56. This estimate for 1992 includes activities not measured in GDP and not reported to tax authorities (2.7%) as well as activities measured but not reported (1.5%).

(8) Don Drummond, Mireille Éthier, Maxime Fougère, Brian Girard and Jeremy Rudin, "The Underground Economy: Moving the Myth Closer to Reality," *Canadian Business Economics*, Summer 1994, pp. 3-17.

BACKGROUND TO THE GST'S INTRODUCTION

Although the GST was not introduced until 1 January 1991, studies and debates on the best way to replace the FST date back to when that tax was adopted in 1924. The history of this question may be divided into two major periods: before and after the 1987 White Paper on Tax Reform.

A. 1920 to 1987 – FST and the Search for an Alternative

On 18 May 1920, Sir Henry Rayton, then Minister of Finance, announced that a 1% FST would be introduced and applicable at all transaction levels except retail sales. In his view, as a result of the expenditures required by the First World War and the debt and bankruptcy of a number of railway companies, the federal government's financial needs at the time were such that Ottawa had to introduce a sales tax as a "temporary" measure. This initiative followed the creation in 1916 of the corporate income tax and, in 1917, of the personal income tax. This last measure was also intended to be temporary.

Four years later, popular dissatisfaction led the federal government to introduce, as a replacement measure, a 6% sales tax applying solely to sales by manufacturers. Throughout its existence, this tax was extensively criticized for, among other things: promoting imports to the detriment of domestic production; being applied to a too-narrow base comprising only one-third of goods consumed; and being *regressive*, i.e., affecting all taxpayers regardless of their ability to pay, as well as excessively complex to administer.

In 1937, the Royal Commission on Dominion-Provincial Relations (Rowell-Sirois Commission) criticized consumption taxes for their regressive nature and their application in a cascading fashion to the taxation of inputs used by manufacturers. The Commission thus suggested gradually eliminating the FST because of its imperfections.

In 1956, the Sales Tax Review Committee (Carter Committee) recommended applying the FST at the wholesale level. In the 1956 to 1959 budgets, the government made minor changes to the FST based on the Committee's report.

In 1966, the Royal Commission on Taxation (Carter Commission) recognized that a tax on wholesale transactions would be an improvement over a tax at the manufacturing level. It pointed out, however, that a retail tax would be more neutral because it would apply to a broader tax base including services. The Commission thus proposed that the federal and provincial governments adopt a common tax base for their sales tax, i.e., implement a kind of national sales tax which the provinces would be responsible for collecting. The Commission went even further to suggest that, in return, the provinces should yield some room in the area of direct taxation.

In its 1969 White Paper on tax reform, the federal government stated that it intended to proceed with a restructuring of the FST after reorganizing the income tax system. In 1975, having considered the tax system reorganization completed, the government stated in a Green Paper that it preferred to have the FST apply at the wholesale level. It noted that, in its view, the administrative problems caused by the collection of a national retail sales tax would offset the very minor benefits that could be derived from that tax.

In 1977, the Commodity Tax Review Group published a report in which it recommended that the FST be applied uniformly at the wholesale level. The Group believed that this measure would afford an easy solution to the main problems resulting from the fact that the tax was charged at the manufacturing level. It admitted that a retail tax would be more neutral, but added that the problems caused by integrating such a tax with the nine provincial taxes (Alberta had no PST) would be too hard to overcome.

In November 1981, the Minister of Finance announced his intention to apply the FST at the wholesale level. In April 1982, he published a White Paper explaining the technical details of the new tax, but widespread discontent forced the government to delay its implementation.

Struck in February 1983, the Federal Sales Tax Review Committee (Goodman Committee) concluded three months later that neither an improved tax charged at the manufacturing level nor a wholesale tax would be an alternative. In its view, the government had only three options: a *national* retail sales tax, a federal retail sales tax, or a *federal* valued-added tax (VAT). In its report, it proposed in particular "that the government consider introducing a federal value-added tax and that the provinces [be] invited to participate in its administration."

In November 1984, upon consultation with the provinces, the private sector and concerned groups, the government announced that, for the first time, it was considering introducing a VAT. The Minister of Finance stated in his February 1986 budget that he was studying a business transfer tax and, on 18 July following, announced that his officials were preparing an in-depth restructuring of the Canadian tax system.

B. 1987 to 1 January 1991 – From the White Paper to the GST's Introduction

In June 1987, the Minister of Finance published a White Paper on the overall reform of the tax system in which the government was considering three possible forms of indirect taxation. One was a national sales tax on value added which would replace both the existing FST and the provincial retail sales taxes to combine them into a single national system. According to the White Paper, this solution would afford "an opportunity for the federal government and those provinces choosing to participate to integrate their sales tax systems into a single national system." The other two options proposed were exclusively federal sales taxes: a goods and services tax without exemptions, and a European-style VAT under which certain goods and services would be exempted. The government stated its preference for a national sales tax and announced that negotiations would be taking place with the provinces.

In March 1988, the House of Commons Standing Committee on Finance and Economic Affairs published two reports on the June 1987 reform proposal. The first drew on the New Zealand model and recommended that the national sales tax apply to as broad a tax base possible, including, in particular, food. The second report recommended that the government make negotiations with the provinces a priority with a view to adopting a national sales tax and submit new proposals to that effect as soon as possible.

On 24 April 1989, the Minister of Finance announced that the federal government would proceed alone, without the provinces, in applying a multi-stage value-added tax on goods and services and that the tax would go into effect on 1 January 1991. Negotiations between Ottawa and the provinces on harmonization broke off and the federal government announced that the provinces did not realize there was an urgent need for action.

The provinces then resorted to constitutional arguments to oppose what they considered a federal power grab. The Government of Quebec, for example, immediately denounced the federal decision on the ground that it was unconstitutional. The province contended that the action constituted flagrant interference in a field of taxation traditionally reserved for the provinces. Alberta, Ontario and British Columbia took legal action against the federal government, alleging that it had exceeded its constitutional powers by operating in a taxation field reserved for the provinces and that Ottawa should pay compensation to entrepreneurs who would be collecting the GST on its behalf.

On 8 August 1989, the government tabled a technical paper on the tax in which it stated that the tax rate would be set at 9%.

In November 1989, the Standing Committee on Finance supported the government proposal to replace the FST with the GST. In particular, it recommended that the government: set the rate at 7%; continue to negotiate with the provinces to establish a national sales tax as soon as three or four provinces representing a substantial proportion of the population were prepared to participate; and develop plans, with the aid of interested provinces, to establish and administer a joint organization responsible for collecting the national sales tax.

The provinces continued their vigorous opposition to the adoption of the GST and to the idea of harmonizing it with their respective PSTs. They continued to accuse the federal government of interference in the consumption taxation field, which they considered their exclusive jurisdiction. The provincial governments also did not want to associate with the federal government on the GST, given the political price that would have to be paid at election time for introducing such an unpopular tax.

However, a few months before the introduction of the GST, the provinces gradually seemed to abandon the arguments on which they had based their opposition. The federal government continued negotiations with Quebec, Saskatchewan, Manitoba and Prince Edward Island until the GST went into effect.

On 30 August 1990, the Quebec and federal governments announced the signing of an agreement under which Ottawa would transfer to the province full responsibility for administration of the GST in Quebec, and the Government of Quebec would harmonize its provincial sales tax base with that of the federal tax. The new QST was introduced in two stages, on 1 January 1991 for personal property, and on 1 July 1992 for services and real property.

This would be the only agreement which the federal government would manage to reach before the GST was introduced on 1 January 1991.

HARMONIZATION OF PROVINCIAL SALES TAXES AND THE GST

A. 1 January 1991 to 1 April 1997 – From GST to HST

Support for the introduction of the GST was far from unanimous. The tax's unpopularity, which may be explained in part by its sudden visibility compared to the former FST, and the fact that it was introduced during hard economic times, made it a prime target for the opposition parties.

In early 1991, the provinces appeared to be less reluctant to harmonize their respective sales taxes with the GST. Some implied they might be on the verge of reaching an agreement with Ottawa. In February 1991, the Saskatchewan government said it would harmonize its sales tax with the GST starting in 1992. Up to the fall of 1991, even though the provinces' intentions continued to fluctuate, an apparent change of attitude suggested that most of them would have no choice but to join the movement to harmonization started by Quebec and Saskatchewan. However, the NPD government elected in Saskatchewan in October 1991 made it known that it was abandoning the harmonization plan. In April 1991, Nova Scotia also indicated that it would not harmonize its sales tax with the GST.

After believing that harmonization would become a reality, Ottawa suddenly saw the climate deteriorate toward late 1991 and, until the end of 1993, there seemed to be little likelihood that the provincial and federal taxes would be harmonized. In June 1992, the Supreme Court confirmed that the GST was constitutional.

During the 1993 election campaign, the Liberal Party of Canada – which then formed the official opposition – announced it would replace the GST with a new tax. Once elected in November of that same year, it directed the House of Commons Standing Committee on Finance to consider alternatives to the GST.

On 20 June 1994, the Finance Committee published its recommendations.(9) In its report, it suggested that a VAT (a kind of improved GST) be introduced across the country, asserting that integration of the federal and provincial sales taxes was the solution to the problems caused by the existing GST. In addition to simplifying collection for small businesses

(9) Standing Committee on Finance, *Replacing the GST: Options for Canada*, June 1994.

through a business transfer tax,[10] the Committee's proposal would make it possible to integrate the federal and provincial tax systems completely.

The national VAT would thus have a federal component and a provincial component. It would ideally have applied to a single tax base across the country – except in Alberta, which had no PST – and have a single set of standard rules. The Committee believed at the time that the provinces would agree to harmonize their respective sales taxes with the proposed new national tax because of the benefits afforded by a national VAT, particularly: a simplified tax system; reduced administrative and compliance costs; less bureaucracy as a result of the elimination of one complete order of government; and various economic benefits.

The Committee thus proposed a national VAT of 10%, with 40% of revenues going to the federal government and 60% to the provinces, and a standard tax on income (of 1.25% to 1.5%) to offset the shortfall in revenue. That August, the federal government proposed a VAT of 11% and, in October, one of 12% (5% for the federal government and 7% for the provinces), together with a standard 1% tax on disposable personal income and compensatory measures in the field of excise taxes.

In each case, the proposal was for one national sales tax, levied on the same base across the country, which would have been collected by the federal government. The provinces would no longer have had to spend the annual $300 million to collect the provincial sales tax. Businesses would have seen their compliance costs substantially reduced, because they would no longer have had to deal with two tax authorities. To avoid putting too great a strain on provincial revenues, the federal government planned to introduce sales tax credits for production inputs gradually over a period of three years. To induce the provinces to harmonize their respective taxes with the GST, the federal government offered those that agreed to do so greater room to manoeuvre in the areas of personal and corporate income tax.

The provinces rejected all these federal proposals. For some provinces, the loss of revenue following harmonization would be too great. In addition, harmonization would mean a transfer of the corporate tax burden to consumers, an idea generally opposed by the provinces. From October 1994 until the end of 1995, there was no public movement on harmonization.

Some believe that the election in Ontario in June 1995 of a Conservative government that had promised to harmonize the systems would be the catalyst for harmonizing

(10) See "Business Transfer Tax" section later in this paper.

sales taxes across Canada. However, in March 1996, Ontario announced that the province had been unable to reach an agreement with the federal government. That same month, the federal government accepted the Committee's recommendation on introduction of a national VAT.

On 23 April 1996, the federal government announced that it had signed an agreement with Nova Scotia, New Brunswick, and Newfoundland and Labrador to harmonize those provinces' sales taxes with the GST. Six months later, the parties signed detailed agreements under which a new HST of 15% would be introduced in the three provinces on 1 April 1997.

B. Compensation for Declining Revenues

Under those agreements, the federal government undertook to pay $961 million over four years ($349 million in each of the first two years, $175 million in the third year, and $88 million in the fourth year) to the three provinces to offset half of the loss in revenue caused by harmonization.

To induce the provinces to adopt the HST (at a rate of 15% in the Atlantic provinces and 14% elsewhere in Canada), the federal government had offered to pay such compensation if the loss in revenue exceeded 5%. This "adjustment assistance" was based on a formula that applied to all Canadian provinces and covered all of the difference for the first two years, 50% in the third year, and 25% in the fourth year.

Under this formula, Quebec, Ontario and British Columbia would not see their revenues from their respective sales taxes reduced by more than 5% under a harmonized system of 14% or 15%. As a result, they would not have been entitled to assistance if they had agreed to harmonization under the letter of understanding of 23 April 1996. Saskatchewan, Manitoba and Prince Edward Island, on the other hand, would have been entitled to assistance and, if they had signed the letter of understanding, the federal government would have paid them $540 million, for a total of $1.5 billion for Canada as a whole. The western and Maritime provinces opposed the proposed compensation, deeming it unfair.

C. Current Situation

Table 3 provides a summary of the current situation and the changes arising from the HST's implementation in April 1997. It shows the effective date of the PST in each province, the rate of the tax and the effective tax rate (including PST and GST) at 31 March 1997, immediately prior to the introduction of the HST in January 2000.[11]

Table 3 – Provincial sales tax and effective tax rate, by province (as a percentage)

Province	PST effective date	PST		Effective rate (PST and GST)	
		31 March 1997	1 Jan. 2000	31 March 1997	1 Jan. 2000
Newf.	1950	12	8	19.84	15
N.S.	1959	11	8	18.77	15
N.B.	1950	11	8	18.77	15
P.E.I.	1960	10	10	17.7	17.7
Que.	1940	6.5	7.5[12]	13.955	15.025
Ont.	1961	8	8	15	15
Man.	1968	7	7	14	14
Sask.	1937	7	6[13]	14	13
Alta.	1936[14]	n/a	n/a	7	7
B.C.	1948	7	7	14	14

D. Provinces' Reasons for Opposing Harmonization

Despite the agreements signed by three of the Atlantic provinces and Quebec, the other provinces are still reluctant to accept harmonization. Except perhaps for Prince Edward Island, no other province appears likely to harmonize its sales tax with the GST in the near future. The provinces are opposed to harmonization for a variety of reasons.

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(11) It is assumed here that the two taxes have the same tax base, i.e., all goods and services are subject to both taxes. However, this is not the case in all provinces.

(12) On 1 January 1998, Quebec increased the QST rate from 6.5% to 7.5%.

(13) On 27 March 1999, Saskatchewan lowered its sales tax rate from 7% to 6%.

(14) In *Taxation in Canada*, 5th ed., Canadian Tax Paper No. 89, Toronto, Canadian Tax Foundation, 1990, p. 174, Harvey Perry reports that Alberta was the first province to introduce a retail sales tax, but that it eliminated it the following year.

Immediately after discussions on the GST ended in April 1989, the provinces denounced the federal decision as unconstitutional, maintaining that a tax on goods and services represented flagrant interference in a field of taxation traditionally reserved for the provinces. It was generally conceded, however, that the federal government had unlimited taxing powers and that it could employ a method of taxation already used by the provinces. In June 1992, the Supreme Court confirmed that the GST was constitutional. This decision notwithstanding, the provinces continue to oppose harmonization for five reasons.

First, the provinces are reluctant to accept harmonization because this tax is politically very risky. It is obvious that, by going ahead with harmonization and broadening their tax bases, the provinces would incur part of the political cost associated with the GST. This argument still serves to justify the provinces' continued opposition to harmonization.

Second, by agreeing to harmonize their respective sales taxes with the federal system, the provinces would exempt business production inputs. Harmonization would therefore mean transferring the corporate tax burden to the consumer. This is still a major argument for a number of provinces.

Third, the provinces have always feared giving up significant discretionary powers over fiscal policy in a harmonized system. Because they could no longer set the tax base or rate, they would lose any independence and flexibility with regard to their respective retail sales taxes. In the 1996 agreement, however, the federal government granted the participating provinces increased powers in the fields of individual and corporate taxation.

Fourth, the provinces are also opposed to harmonization for reasons of administrative complexity. Although the federal government has often said that harmonization would result in greater administrative simplicity and reduced compliance costs, Quebec's experience is far from a success and the other provinces have not been inclined to believe federal claims. And yet the agreement signed in October 1996 provides that the federal government, not the provinces, will be responsible for collecting the HST.

There is no doubt that a perfectly harmonized system would make tax collection easier and that compliance costs for businesses (particularly small businesses) would be reduced. For some of them, however, a system that differed from region to region, like that of the HST, would lead to problems and increased compliance costs. Effective tax rates and bases varying from region to region would complicate the tax treatment of interprovincial transactions. Under the last agreement signed, interprovincial transactions not confined to the harmonized provinces appear to be more complex because the tax basis and effective tax rates differ from one transaction to the next depending on the province concerned. In an interprovincial transaction toward a province that has adopted the GST, a business registered in a non-harmonized province is nevertheless required to collect the HST. Conversely, where a transaction occurs in a non-participating province, the business registered under the HST system does not have to collect the provincial share of the HST.

Lastly, the provinces have always claimed that adopting an HST would lead to lost revenue and budgetary problems. Even with a broader base, several provinces would face a decrease in revenue because of having to reimburse production input taxes. To counter this argument, the federal government is promising to compensate the provinces through its adjustment assistance program. In addition, the federal government is granting increased authority in the fields of individual and corporate taxes to the provinces that have signed agreements. Taken together, these measures should help the provinces that have moved to harmonization to offset the shortfall in their revenues, at least temporarily.

E. Future of Harmonization Process

Attempts to harmonize the GST and provincial sales taxes have seen many ups and downs over the years. To date, only Quebec and three Atlantic provinces have agreed to harmonize their provincial sales taxes, but their actions have not induced the other provinces to do the same. One might have believed that Prince Edward Island would be added to the list after the HST was introduced, but it remains the only non-participating province east of the Ottawa River, and it is unlikely that its eventual participation will help change the status quo in the other provinces.

Ontario, however, could play a key role in bringing about the harmonization of sales taxes across Canada, and even the inclusion of the sales tax in advertised prices. It is not unreasonable to believe that the harmonization of Ontario's PST with the GST could act as a catalyst for a number of other provinces.

The federal government seems disinclined to change its position, and the Minister of Finance has admitted that negotiations with the non-participating provinces are at a standstill. Although the government is pleased with the agreements reached with three of the Atlantic provinces, those agreements put it in a delicate situation. It will not find it easy to alter the current proposal to satisfy the other provinces without jeopardizing the administrative benefits of the harmonized system because, for reasons of administrative simplicity, the same rules must apply across Canada. For example, it would be impossible to have one adjustment assistance formula and different tax bases in Eastern and Western Canada.

Apart from that, it appears virtually impossible that a single-rate national sales tax will one day apply all across Canada. At best, the federal government could hope for four regional sales taxes: one for British Columbia, Saskatchewan, Manitoba and Ontario; a second for Alberta and the Territories; a third for Quebec; and a fourth for the Atlantic provinces. However, this situation would not do any more to facilitate the inclusion of the sales tax in advertised prices.

For individuals and corporations, harmonization could also mean higher taxes. Nova Scotia and New Brunswick have already announced new corporate capital taxes. Starting in 2001, once federal adjustment assistance has been exhausted, the three provinces could be forced to increase the 8% provincial component of the HST to offset declining revenues or else find other revenue sources.

ALTERNATIVES TO THE GST

As noted above, the GST has been controversial and not unanimously accepted. Although the government decided not to replace it in 1996, it was not for failing to consider alternatives, but rather because those alternatives seemed to raise even more significant problems. A brief overview of some of those options and related problems is provided below.

A. Business Transfer Tax

The government could have replaced the GST with a business transfer tax (BTT). To date, Japan is the only industrialized country that has opted for this type of VAT.

A BTT is easy to administer: businesses calculate the amount of tax payable by multiplying their total sales by the tax rate, then subtracting their total purchases, also multiplied by the same rate. Because a BTT applies to all transactions and because businesses therefore do not have to distinguish between taxable transactions and zero-rated or exempt transactions, the tax paid or collected on each transaction does not have to be recorded for accounting purposes as is the case with the GST. The result is greater administrative simplicity. In addition, businesses base their calculations on accounting information already available to them, which reduces their compliance costs.

However, these benefits are reduced in a harmonization context, such as that in Canada, in which rates vary from one province or region to the next. In this situation, the destination province of intermediate goods must be traced in order to apply the appropriate rates. However, this requirement violates the principle of business accounting, which is the BTT's strength, and requires instead a collection system based on transactions, thus one similar to that of the GST. In addition, certain goods and services could not be zero-rated or tax-exempt under a BTT. Consequently, to preserve the principle of business accounting and the essence of the BTT, the tax base would have to be expanded, a measure that has proven unpopular and which the government seems disinclined to take.

In short, assuming a very broad tax base and a uniform tax rate across the country, the BTT would be simpler to implement than the GST. A BTT could thus have been a viable alternative if the federal government had agreed to: apply it at the federal level only, i.e., abandon the harmonization of federal and provincial sales taxes in view of the virtually insurmountable difficulty of having the provinces adopt either an HST or, where possible, a uniform rate for the provincial component of the HST; and broaden the tax base.

B. Federal Payroll Tax

Another promising alternative that was proposed was a federal payroll tax (FPT). As the difference between sales and the cost of inputs, i.e., the value added, is virtually equal to wages and other amounts paid to workers,(15) it would be possible to tax the value added by levying a tax on employee wages. In administrative terms, this would be a much simpler option than the GST or the BTT.

In March 1994, Jonathan Kesselman of the University of British Columbia proposed to the House of Commons Standing Committee on Finance that the GST be replaced by a payroll tax which the employer would deduct at source based on gross salary, commissions,

(15) In reality, the economic rent – or yield in the form of dividends and interest – of capital invested or saved would also have to be taken into account.

bonuses, social benefits and pension fund contributions.(16) This tax would be paid by employees and self-employed workers, not by employers. Consequently, an FPT would not have the distorting effects (such as impeding hiring and employment growth) generally associated with payroll taxes such as employment insurance premiums. Kesselman estimated that the FPT rate would have to be set at approximately 3.5% in order to replace net GST revenues.

An FPT would afford numerous benefits. The principle of its application would be very simple compared to that of the GST. The FPT would affect all workers and it would not be necessary to draw complex distinctions between transactions or taxable, tax-exempt or zero-rated goods and services. The FPT would not apply to benefits paid under revenue transfer programs such as family allowances, employment insurance and so on. However, as it would be based on gross remuneration, it would enable Canada to "tax," as it were, Canadians' expenditures in and outside Canada and would apply to social benefits and employer pension fund contributions, which would increase with salary.

However, there are also disadvantages to the FPT. It would apply to the current generation of workers in a disproportionate manner relative to pensioners. One solution to the problem would be to levy a temporary tax on pensions to even out the tax burden. In addition, a poorly designed FPT could also have an excessive impact on self-employed workers if it applied to income regardless of the amount of capital invested in the business to obtain a normal return.

To solve these problems, Kesselman a few months later proposed a new FPT which he called a direct consumption tax.(17) In addition to the payroll tax, there would be a 2.9% tax on the cash flow of incorporated businesses and a source deduction on income such as retirement pensions.

Various reasons may be advanced to explain why the federal government did not opt for this solution, in particular the following two. First, large organizations representing businesses did not really understand the proposal or all its ramifications and accordingly did not support it. Second, Kesselman was the only person to advocate it and found himself somewhat isolated among tax experts, accountants and lawyers in favour of the GST. The FPT was thus not adopted and is unlikely to be selected in future.

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(16) Jonathan Kesselman, "Assessing a Federal Tax to Replace the Goods and Services Tax," Brief to the House of Commons Standing Committee on Finance, 8 March 1994. See also J. Kesselman, "Payroll Tax in Lieu of GST," *Canadian Tax Highlights*, Toronto: Canadian Tax Foundation, Vol. 1, No. 12, 21 December 1993, p. 89, and J. Kesselman, "Replacing the GST or Retreading It," *Policy Options*, June 1994, pp. 41-45.

(17) See Jonathan Kesselman, "Assessing a Direct Consumption Tax to Replace the GST," *Canadian Tax Journal*, Vol. 42, No. 3, 1994, p. 709.

C. New Division of Taxation Powers

Rather than adopt the GST, the federal government could have completely waived its authority over sales and excise taxes in favour of the provinces in exchange for a greater share of personal income tax and exclusive control over corporate taxation. That was the solution proposed by the Carter Commission more than 30 years ago.

Although administratively simple, this option would have exacerbated the problems associated with retail sales taxes. It would likely have promoted the cascading taxation of inputs, which the federal government attempts to correct through input tax credits. It might also have had a negative impact on exports (the GST does not apply to sales outside Canada) and influenced consumer choices as a result of a narrow tax base which would result in higher rates on certain classes of goods.

Conversely, the provinces could have abandoned their sales tax in exchange for greater flexibility in computing their personal and corporate income taxes.

Following the first ministers conference of 21 December 1993, a number of participants said they had discussed a new division of taxation fields which went beyond harmonization of the PSTs and GST. On 26 September 1994, Ontario's Minister of Finance proposed an exchange of taxation fields with Ottawa. Ontario was considering giving up its sales tax in exchange for greater control over and a greater share of income tax, which would have enabled it to easily recover the $7 billion it would have foregone in the federal government's favour because its share of income taxes would have increased whereas the federal share would have declined. British Columbia and Manitoba made the same proposal which, although discussed by a number of provinces, nevertheless remained a dead letter.(18)

The federal government probably dismissed the idea of the provinces completely ceding their sales tax to it because this option, although a promising one, would have resulted in the break-up of the current income tax system and its underlying principles. This situation would have jeopardized one of the objectives of the federal personal income tax: the redistribution of income within Canadian society. According to the federal government, it was precisely because

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(18) On the other hand, in December 1997, following the federal-provincial conference, the federal government announced it was ready to grant the provinces more flexibility in computing their provincial income tax, except, of course, in Quebec, which was already collecting its own income tax. The measures taken to give the provinces more room to manoeuvre were announced jointly by the ministers of Finance and National Revenue in a news release dated 25 January 2000 (News Release 2000-004, http://www.fin.gc.ca/newse00/00-004e.html), entitled *Federal Administration of Provincial Taxes: New Directions* (http://www.fin.gc.ca/fapt/fapte.pdf).

sales taxes have little impact on the redistribution of income that the provinces and not the federal government should occupy most of the sales tax field.

The division of taxing powers between the federal and provincial governments has always involved the question of the redistribution of wealth and income. The federal government believes it is in a better position than the provinces to influence the redistribution of income, particularly among the various regions of the country. In its view, this is a question of national interest and, in a more decentralized income tax system, competition between the various provinces and the lack of coordination might undermine the redistribution of income.

In addition, the federal government's coordination of income tax ensures better allocation of economic resources. For example, a province which lowered its capital tax might drain the capital from other provinces. As well, this federal coordination also permits harmonized collection across Canada, thus reducing administration and compliance costs. It is for all these reasons that the federal government believes it must occupy a significant position in the income tax field. Too great a shift in powers between Ottawa and the provinces could undermine one of the federal government's most important roles.

D. Increase in Personal Income Tax

It was difficult at the time for the federal government to contemplate the significant decline in tax revenues which simple elimination of the GST would have caused, particularly in a context of chronic deficits. The solution thus had to be at least revenue neutral for the government and every new source of tax revenue had to be reliable. Some had suggested simply increasing personal income tax, in particular as a result of its higher degree of progressiveness. As its rate increases based on income, the tax is assessed on taxpayers in accordance with their ability to pay.

However, as Robin W. Boadway and Harry M. Kitchen emphasize in their most recent survey of the Canadian fiscal landscape,[19] marginal tax rates are consistently higher in Canada than in the United States, Canada's main trading partner. As the proposed solution would have expanded that gap, its implementation would probably have met with serious

(19) *Canadian Tax Policy*, 3rd ed., Canadian Tax Paper No. 103, Toronto: Canadian Tax Foundation, 1999, p. 303.

opposition.[20] Among other things, it could have induced very high income taxpayers to leave Canada for the United States, where conditions would have been more favourable for them.

E. Other Options

Another option would have been a national FST which would have applied jointly with the provincial taxes in accordance with the conditions in effect in each of the provinces – a sort of national retail sales tax with variable rates and bases. This kind of tax would obviously have been very complicated to administer and would have aggravated the problems associated with retail sales taxes such as: difficulties involved in exempting inputs in a standard manner (a considerable disadvantage for interprovincial transactions); the cascading effect; the administrative complexity of issuing exemption certificates in view of the varying conditions from province to province; and high rates as a result of a narrower tax base.

The government did not adopt this option or the idea, which moreover has never been accepted elsewhere in the world, of taxing consumption by taking as the tax base the difference between income and the variation in accumulated wealth (unrealized capital gains, for example), i.e., net savings. Although simple in theory, such a tax would be complicated to administer. All taxpayers would have to measure all forms of income, including income from: employment; the sale of assets; gifts and inheritances; reduction in savings levels; and returns on loans. They would also have to report all annual net savings, including all assets acquired and investments of all kinds, together with depreciation and interest payments. The sale of unregistered assets such as numismatic coins would easily escape tax authorities. The administrative complexity and compliance costs of this type of tax would render it inoperative.

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(20) Various informative tax comparisons between Canada and the G-7 countries are provided in the report by Jean-Yves Duclos and Julie Gingras entitled *Mixing It Up: Directions for Federal Tax Reform*, published on 15 June 1999 by the C.D. Howe Institute (see http://www.cdhowe.org/pdf/duclos.pdf).

CONCLUSION

The GST was introduced at a time when Canada was going through a deep recession. The subsequent consideration of alternatives occurred in still difficult economic circumstances also marked by persistently high budget deficits. The 1990s were one of the worst decades for Canadian economic performance.

This type of situation lends itself poorly to tax reform of any kind. The government may find it hard to consider reducing its revenue, and any revenue-neutral reform necessarily works to the disadvantage of certain groups. This was the case with the GST. It was not supposed to generate more net revenue than the FST in effect in 1989, but rather correct various disadvantages and inefficiencies which had been associated with that tax since its introduction in 1924, while favouring exports and eliminating the cascading effect of the sales tax.

Few major changes can be expected with regard to: restructuring or replacing the GST; or pursuing the process of harmonization with the provincial sales taxes. However, voices occasionally speak out calling upon the federal government to make certain adjustments to the GST, to expand its base, for example, and reduce its rate. David Laidler, an economist from the University of Western Ontario, issued an invitation of this kind during the Standing Committee on Finance's 1999 pre-budget consultations.(21) Contrary to the situation prevailing during the two previous decades, when the government constantly faced hard choices in managing ever-increasing debt and finding new revenue sources, those hearings were held in a context of budget surpluses, which participants discussed how to redistribute.

Because cutting personal and corporate income tax appears to be the federal government's priority for the next few years, it is highly likely the debate on the GST's future will resume in the medium term, but this time in an entirely different context.

(21) Hearing of 2 December 1999, in Ottawa. See transcript of proceedings at http://www.parl.gc.ca/InfoComDoc/36/2/FINA/Meetings/Evidence/finaev40-e.htm.

CHRONOLOGY

June 1987 -	White Paper on tax reform.
24 April 1989 -	Negotiations between Ottawa and the provinces on harmonization of the provincial sales taxes and the future federal sales tax were broken off. The Government of Canada abandoned the idea of a national sales tax and decided to act unilaterally.
8 August 1989 -	Technical paper on the GST.
Winter 1989-1990 -	The House of Commons passed Bill C-62.
30 August 1990 -	Quebec announced its intention to harmonize its sales tax with the GST.
Fall 1990 -	Senate debate on the GST.
14 December 1990 -	The Quebec National Assembly adopted amendments to the *Loi concernant l'impôt sur la vente au détail* to include provisions applicable to Quebec as of 1 January 1991.
19 December 1990 -	Newfoundland adjusted its tax base.
21 December 1990 -	A reciprocal taxation agreement on implementation methods was signed by Ottawa and Quebec.
1 January 1991 -	*The GST came into effect in Canada, as did Phase 1 of the new harmonized provincial sales tax in Quebec.*
20 February 1991 -	Saskatchewan announced that it would harmonize its provincial sales tax with the GST.
1 April 1991 -	Phase 1 of harmonization of the Saskatchewan sales tax with the GST came into effect.
9 April 1991 -	Plans to harmonize the sales tax with the GST were unveiled in the Prince Edward Island budget.
8 August 1991 -	The Government of Prince Edward Island announced that the harmonization of the provincial sales tax with the GST would not take place.
22 August 1991 -	The Government of Nova Scotia announced that it would not be harmonizing its provincial sales tax with the GST.
22 October 1991 -	Return to the tax treatment provisions in existence in Saskatchewan prior to 1 April 1991.

24 October 1991 -	Quebec postponed the introduction of its tax on services until 1 July 1992.
14 May 1992 -	The Government of Quebec announced that a 4% sales tax would apply to services.
June 1992 -	The Supreme Court ruled that the GST was constitutional.
1 July 1992 -	The second stage of sales tax reform came into effect in Quebec.
20 June 1994 -	The House of Commons Standing Committee on Finance tabled its report on the GST.
23 June 1994 -	In a declaratory judgement, the Supreme Court ruled in favour of Quebec and granted the provinces the right to introduce a multi-stage tax such as the GST.
29 June 1994 -	The federal government called for the introduction of a 10% national VAT.
August 1994 -	Ottawa proposed a VAT of 11%.
September 1994 -	Ontario proposed to Ottawa that the province would give up its provincial sales tax in exchange for greater control over income tax (British Columbia and Manitoba supported this proposal).
13 October 1994 -	The federal government proposed a VAT of 12%.
9 May 1995 -	Quebec announced that the QST would be fully harmonized with the GST.
23 April 1996 -	The federal government and the governments of Nova Scotia, New Brunswick level, and Newfoundland and Labrador signed a letter of understanding to harmonize federal and provincial sales taxes.
23 October 1996 -	These three Atlantic provinces signed detailed agreements outlining the new HST system that would enter into effect on 1 April 1997. The federal government paid them $961 million in compensation.
March 1997 -	In the face of strong opposition, the three Atlantic provinces applying the HST and the federal government abandoned the idea of including the HST in advertising prices.
1 April 1997 -	The HST went into effect.
1 January 1998 -	The QST was increased from 6.5% to 7.5%.
27 March 1999 -	Saskatchewan lowered the PST rate from 7% to 6%.

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A. Printed Documents

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B. Documents Available Online

The following documents are more recent, and are accessible online. They are cited in, or added here to, the references contained in the text and provide more up-to-date information on certain aspects of the GST.

1. Government Sources

a. Department of Finance

- The technical vocabulary used in this paper is consistent with the definitions used by the Department of Finance Canada, most of which appear in that Department's glossary.(22)

- *Tax Expenditures 1999*(23) presents a series of estimated costs in terms of foregone tax revenues associated with GST deductions and other credits, based on the Department's calculations.

- Because tax changes, including those affecting the GST/HST, are normally proposed at the time the budget is tabled, useful information may be found in the *Budget Plan 2000*,(24) in particular Annex 7. This annex, together with the *Economic and Fiscal Update*(25) (a document that has been submitted to the House of Commons Standing Committee on Finance every fall since 1994), contains an overview of changes proposed to the GST/HST since 1994 with regard to the way it is collected and to the payment of credits granted. For example, certain administrative adjustments were introduced in the 2000 Budget to address costs caused by the collection of GST/HST by exporters. These measures accompanied other

(22) http://www.fin.gc.ca/gloss/gloss-e.html#t

(23) http://www.fin.gc.ca/toce/1999/taxexpe.html

(24) http://www.fin.gc.ca/budget00/pdf/bpe.pdf

(25) http://www.fin.gc.ca/update99/update99-e.pdf

measures relating to various aspects of the administration of the GST/HST (rental properties, duplexes, etc.) without altering the nature of the tax.(26)

- The annex to the *Report of the Technical Committee on Business Taxation* – better known as the "Mintz Report"(27) – contains a brief section examining the idea, which was considered but not adopted by the committee, of a tax on cash surpluses, the tax base of which would have been similar to that of the GST.

b. Other Government Sources

- The Receiver General of Canada's website includes the *Public Accounts of Canada*,(28) which contain a breakdown of expenditures and revenue by allocation and source respectively. The amounts reported for GST purposes over the past fiscal year appear in Volume 1, Chapter 1. A more detailed breakdown is provided in Chapter 3.

- Chapter 16 of the *1999 Report of the Auditor General of Canada*(29) contains a review of the treatment of GST returns and audits, which is essentially handled in Summerside, Prince Edward Island.

- GST rules are enforced by the Canada Customs and Revenue Agency, formerly Revenue Canada, which regularly publishes interpretation bulletins for corporations.(30)

2. Non-Government Sources

- Accounting firms are a useful source of information. For example, KPMG publishes a newsletter,(31) most often in English only, which provides a summary of the most recent noteworthy changes to the GST, HST and provincial sales taxes.

- The Canadian Tax Foundation is a think tank on taxation in Canada. Its newsletter, *Canadian Tax Highlights*,(32) succinctly reports the latest news in the field of taxation and occasionally judgements pertaining to GST interpretation. The Foundation also publishes the *Canadian Tax Journal*.

- The GST is a Canadian VAT. Many countries have long since adopted this type of taxation, with the notable exception of the United States, which does not have a general federal sales tax. Australia also has its own version of the GST. The University of New South Wales offers an advanced taxation program with a particular focus on this issue. It publishes a GST

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(26) http://www.fin.gc.ca/budget00/bpe/bpanc5e.htm

(27) http://www.fin.gc.ca/taxstudy/tsrep_e.pdf

(28) http://w3.pwgsc.gc.ca/text/pubacc-e.html

(29) http://www.oag-bvg.gc.ca/domino/reports.nsf/html/9916ce.html/$file/9916ce.pdf

(30) http://www.ccra-adrc.gc.ca/menu/EmenuKOA.html

(31) http://www.kpmg.ca/tax/salt/vl/shaker/main.htm

(32) http://www.ctf.ca/

researchers guide[(33)] containing a number of hypertext links to sites in Australia and the rest of the world, in particular Canada, to facilitate research on the GST in various contexts.

- The International Bureau of Fiscal Documentation[(34)] is a well-known research institute which employs international tax experts; the Bureau produces high-quality publications, including a periodical providing updates on the VAT around the world. (These publications are not free of charge.)

(33) http://www.atax.unsw.edu.au/guides/guidegst.htm

(34) http://www.ibfd.nl/