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in a Federal Country**

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The GST/HST: Creating an Integrated Sales Tax in a Federal Country

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Abstract

Canada is not a country with a reputation for bold experimentation. However, Canadian experience demonstrates conclusively that an invoice-credit, destination-based value-added tax (VAT) is workable at the subnational level, with both federal and provincial governments retaining full control over the rates of their sales taxes as well as retaining a surprising degree of policy freedom with respect to the base of the tax. As this paper shows against the background of a concise history of sales taxation in Canada, it has taken decades of federal-provincial negotiations to produce the present substantially integrated national and provincial sales tax system. Moreover, the process not yet complete and the results are far from perfect. Nonetheless, Canada has shown that not only can VATs be introduced at the subnational level but that they can work surprisingly well – at least in a country with an over-riding national VAT.

Key words: Canada, VAT, subnational taxes, intergovernmental fiscal relations

JEL codes: H25, H71, H77

1. Introduction

Canada is not a country known around the world for its revolutionary spirit. When it comes to sales taxes, however, Canada has turned out to be not simply a bold innovator, but at the forefront of what may turn out to be a tax revolution in some respects. For decades prior to (and even after) the introduction of the federal Goods and Services Tax (GST) in 1991, tax experts at the OECD, the IMF, and elsewhere—including me (Bird 1993)—had argued almost unanimously that the invoice-credit, destination-based value-added tax (VAT) pioneered in the European Union was inherently a central government tax that simply could not work properly at the subnational level of government.¹ However, Canada's experience over the last two decades demonstrates conclusively that this view is incorrect; not only can it be done, but it has been done, and done well. India, Brazil and even the European Union can arguably learn from Canadian experience. Nor is this the only feature of Canada's current sales tax system worthy of study and perhaps even emulation elsewhere. Other papers in this symposium will discuss how the sales tax system forged in Canada's political fires over the last few decades may, and probably should, change further in the future. Before thinking about changes, however, it is perhaps a good idea to consider carefully what we have already done, why we did it, when and how we did, and to sketch in broad terms what the results to date have been.

Section 2 of the paper outlines the prolonged and traumatic emergence of the GST from the ashes of the long-standing federal manufacturer's excise tax (MST) and notes some ways in which Canada's GST differs from VATs in other countries. Since the most distinct feature of the VAT in Canada is clearly the extent to which it has become a provincial as well as federal tax, Section 3 then discusses the (almost) parallel evolution of the Quebec Sales Tax (QST) as well as the development and expansion over time of the Harmonized Sales Tax (HST) in a number of other provinces. Finally, Section 4 concludes with a brief evaluation of Canada's significant contribution to one of the biggest fiscal stories of the last half century—the emergence of the VAT as a major tax around the world—and a few speculations about possible future developments.

2. The GST: Its Gestation, Birth, and Effects

Contrary to what some Canadians may still think, the GST did not spring forth full-blown from the mind of former prime minister Brian Mulroney. On the contrary, its appearance on the political scene in the late 1980s was the result of decades of increasingly unhappy experience with other forms of federal sales taxation, notably the manufacturers' sales tax (MST). Similarly, the combined federal and provincial version of the GST, the HST (the adoption of which seems to have hit many citizens in British Columbia out of the blue in 2010), was the culmination of two trends—increasing recognition of the inefficiency of the 50-year-old provincial retail sales tax (RST) and growing awareness of the benefits that federal and provincial governments, as well as citizens in general, have to gain from a more integrated national sales tax system.

To set the stage, several points may be noted. First, in 2011 six out of 10 provinces encompassing about 80 percent of Canada's population imposed some form of provincial VAT on a base that is, in all but minor ways, now harmonized with that of the federal GST. Second, and perhaps surprising to some, there has been no significant increase in the composition of

¹ An important exception, however, was Cnossen (1983), whose argument that what were essentially "subnational" VATs (the different member country VATs in the European Union) could work satisfactorily without border controls has proven to be correct—at least in Canada.

revenue as a result of this major change in the way in which consumption is taxed. In 1989-90, the federal MST yielded 15.2 percent of federal taxes, or 2.7 percent of GDP; in 2010-11, the equivalent figures for the federal GST were, respectively, 12.0 percent and 1.7 percent (Department of Finance 2011). Similarly, at the provincial level, where general sales taxes accounted for only 13.7 percent of own revenues in 2009 (Canadian Tax Foundation 2011) compared to 14.1 percent in 1989-90 (Statistics Canada 1992), the figures hardly suggest that any kind of fiscal revolution has been spearheaded in Canada by sales tax reform in recent decades. Despite the heated political rhetoric heard, usually at election times, about sales tax issues, perhaps the best way to characterize the GST (and its running mate, the HST) is thus simply as an economically desirable fiscal reform that has had surprisingly little effect on the level or structure of government revenues. In short, the GST/HST story in Canada—as in most countries (Keen and Lockwood 2006)—has not resulted to any significant extent either in higher taxes or bigger governments, but rather in governments being able to finance their expenditures in economically less damaging ways.²

Although it has had little impact on the level or composition of government revenue, VAT in the form of the GST 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 (Bird 1994). One result of all the initial opposition was that from the beginning the GST has had certain characteristics that are not particularly desirable from a technical perspective (Smart 2012). Another result was the rather peculiar arrangement made with the province of Quebec 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 (New Brunswick, Nova Scotia, and Newfoundland and Labrador) a uniform provincial VAT, the HST, essentially on the same base as the GST at eight percent—a rate substantially below the retail sales tax (RST) rates (10 percent, 12 percent and 12 percent respectively) formerly in place in these provinces.

After the initial turbulence died down, however, for a decade or so it appeared that the GST had become a stable and accepted part of the Canadian tax system. Then in 2006, the 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 seven percent rate initially imposed in 1991 to six percent in 2006, and then to the current rate of five percent in 2008. In 2010 something else new and important happened when Ontario and British Columbia joined the HST system, while maintaining their provincial rates at the previous RST levels of eight percent and seven percent respectively. In addition, in 2010 Nova Scotia raised its former eight percent rate to 10 percent. But these developments were not the end of the story. In 2011, following a bitter political fight that pivoted to a considerable extent on the issue of the HST, British Columbia's new government decided to replace the HST in 2013 by, in effect, the same old RST which the HST had replaced in 2010. If this actually happens, as now seems likely, then British Columbia will become only the sixth jurisdiction in the world—and the first in the developed world—to abolish a VAT once one was in place.³ Since every other jurisdiction that abolished its VAT soon imposed one again, perhaps over time the VAT seesaw will again swing the other

² True believers in the “Leviathan” tax model (Brennan and Buchanan 1980) would expect less economically costly taxation to result in larger governments and, in all likelihood, more “wasteful” expenditure, but there is little evidence in support of this assertion. Kenney and Winer (2006), for example, show that although governments make more use of relatively less costly taxes, this does not necessarily imply a larger government share in total.

³ Its predecessors in the retreat from the VAT were Belize, Ghana, Grenada, Malta, and Vietnam (Bird and Gendron 2007). All have subsequently reintroduced the tax.

way on the West Coast. In any case, the loss of BC from the HST roster has been offset by another important recent development in 2011, namely, that, after maintaining its own separate QST system for two decades, Quebec has, in effect, now agreed to adopt the same tax base as the HST in 2013, although it will continue, as now, to administer both the federal and provincial sales taxes within the province.⁴

A. The Evolution of the GST

To begin at the beginning, Canada first introduced a federal sales tax in 1920 in the form of a one percent turnover tax, applied to all sales except those at retail. The aim of the new tax, which was largely modelled on several similar taxes in Europe, was essentially to pay off the debts incurred as a result of the First World War (Due 1957). Although one fiscal historian labelled the introduction of the tax “a quick, easy delivery” (Gillespie 1991), 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 six percent tax on sales by manufacturers — the so-called manufacturers’ sales tax (MST).⁵ Although there was little or no public discussion of any of these early sales taxes, all of which were essentially invisible to final consumers, this tax too proved to be so unpopular with manufacturers that, in response to their continuing complaints, the rate of the MST was gradually lowered to a token one percent in 1930, with the apparent intention of abolishing it the next year. However, the Depression intervened, and the ensuing increases in fiscal deficits soon led to an increase of the basic MST tax rate to eight percent in 1936, the year in which the MST yielded an all-time high of 31 percent of federal revenue (Due 1957).

Despite the revenue importance of the MST, the Rowell-Sirois report at the end of the 1930s recommended the elimination of this tax for two reasons: its regressivity and the “cascading” that resulted from taxing inputs (Report 1940). Although no attention was paid to this recommendation at the time, the rate of the MST was not further raised during the Second World War, in part to hold down price (and hence wage) increases. Soon after the war, however, the rate began to creep up again. Unsurprisingly, so did the volume of complaints about the structure and operation of the tax from manufacturers. This time the response, in 1955, took the form of establishing what turned out to be the first of many committees intended to recommend reforms for the MST. This pioneering committee’s basic recommendation was to move the MST forward to the wholesale level, largely in order to respond to business complaints about the increasing 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 (Report 1956).⁶ While nothing was done in response to this report, it turned out to be

⁴ Although having two administrations (the federal government and the Quebec government), for what is argued here to be now in most respects one tax undoubtedly makes both administrative and compliance costs higher than they would otherwise be, it is not evident that there has been any significant reduction in compliance levels as a result.

⁵ Although the tax is legally called an excise tax, in fact it has always been imposed on all domestic sales by manufacturers and importers.

⁶ As Gillis (1985) notes, another persistent business complaint from domestic manufacturers was that their MST base unfairly included costs, such as advertising, that were not incorporated in the MST base of competing importers.

only the first in a series of subsequent official reports that recommended various reforms in the sales tax.⁷

The first such report was that of the Carter Commission a decade later. The Commission, after discussing briefly the possibility of a value-added tax, concluded that the best road to pursue would be to introduce an integrated “national” retail sales tax under which the provinces would administer a combined federal and provincial tax (Report 1966). In response, the government of the day stated that, although it intended to restructure the federal sales tax, it wanted first to deal with the income tax. Given the scope of the income tax reform finally adopted in 1971, it is not surprising that, in the end, another decade passed before the first official discussion paper on the sales tax reform finally emerged (Department of Finance 1975). In essence, this study supported the recommendation of the report of the 1956 sales tax committee to move to a wholesale level tax, as did another report two years later (Department of Finance 1977). Although both these reports recognized, as had the Carter Commission, 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.

As time went on, however, the federal government changed its tune. Although immediately preceded by yet another report that favoured a wholesale tax (Department of Finance 1982), an important report in 1983 concluded that there were three alternatives that should be considered as possible replacements for the MST: an integrated national retail sales tax (as had been recommended by the Carter Commission), a separate federal retail sales tax, or a federal VAT (Department of Finance 1983). Moreover, even if a purely federal VAT were to be introduced, this report urged that provinces should be “encouraged to join in the administration of such a tax (p.58).” All in all, it did not come as too much of a surprise when the new Progressive Conservative government officially announced in November 1984 that it was considering replacing the MST by a VAT.

One reason it was not a surprise is because by the 1980s, perceptions of sales taxation had changed for a number of reasons. Not only were consumption taxes, and especially VATs, being viewed more favourably in large part owing to their adoption in the European Union, but the federal deficit —almost eight percent of GDP in 1984— was increasingly worrying the federal government. One result was that tax rates, especially that of the MST, began to creep upward over the next few years. Simply in order to sustain sales tax revenues, it proved necessary to raise the basic MST rate several times: from nine percent to 10 percent in 1984, 11 percent in January 1986, 12 percent in April 1986, and finally, in 1989, to 13.5 percent (Bird, Mintz, and Wilson 2006).⁸ In addition to these rate increases, by the end of the 1980s the base of the MST had been moved forward on an industry-by-industry basis to encompass more and more of the distributive sector, largely through administrative rulings. However, many of these base changes were increasingly being successfully challenged by taxpayers with the result that, despite the 50 percent increase in the tax rate over the last five years, it was becoming more and more difficult to maintain revenue from the MST simply by raising the rate on a shrinking base. Still, since most citizens did not know the tax existed —and 15 percent of revenue from an invisible tax was no small gift— 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 with a VAT.

⁷ A useful brief review of the various reports is provided in Domingue and Soucy (2000).

⁸ The MST rate for building materials was also increased, from five percent to nine percent over this period, while the rate for alcohol and tobacco rose from 12 percent to 19 percent. Further, the MST base was expanded to include most telecommunication services in 1983 (initially at a rate of six percent, later raised to eight percent).

In addition to the simple desire to maintain revenues, another important factor that shaped this decision was increasing concern about the undesirable economic effects of the MST. Almost one-half of the revenue collected from this tax came not from consumption, but rather from taxes on such business inputs as the purchase of investment goods. These input taxes then cascaded through the system and were incorporated in the price of such exempt items as food as well as in export prices (Kuo, McGirr and Poddar 1988). Moreover, the significant taxes imposed on capital goods by the MST raised the cost of capital and discouraged investment in physical capital. A federal 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 favour imports. Moving to a VAT had the advantages of both reducing the taxation of business inputs and treating exports and imports more neutrally.⁹

Earlier indications of government intentions had suggested that although the MST was likely to be replaced by a VAT, the new sales tax might take the form either of a business transfer tax (an accounts-based subtraction-method VAT) or the more familiar (European-style) credit-invoice VAT (Mintz 1995). 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 (Department of Finance 1987). Although the 1987 reform proposals encompassed both income and sales tax reforms, and income tax rates were soon reduced, in the end the federal government postponed sales tax reform until after the 1988 election, thus foregoing any chance to present a comprehensive tax package in which what were (at least in appearance) sales tax increases could be offset by income tax reductions. Moreover, by the time sales tax reform returned to the policy agenda in 1989, it had become clear that there was no support for an integrated national sales tax. In the end, therefore, the federal government decided to introduce its own invoice-credit VAT—called the Goods and Services Tax (GST)—to replace the MST (Department of Finance 1989).

B. Enter the Provinces

One important reason for this decision was simply because the federal government was not alone in the sales tax field. Interestingly, the first subnational sales tax in Canada was actually a local retail sales tax (RST) imposed in Montreal in 1935. The first provincial RST was not imposed (in Saskatchewan) until 1937. When Quebec imposed a similar RST in 1940, it not only left the Montreal tax in place, but also introduced a similar tax in Quebec City (Perry 1955). Subsequently, the municipal sales tax (at rates of one or two percent) spread to a number of other municipalities in Quebec, until it was finally abolished by the province in 1964 (Johnson 1974). Other provinces did not introduce RSTs until after the war, beginning with British Columbia in 1948 and concluding with Manitoba in 1967 (Robinson 1986). By 1989, just prior to the introduction of the GST, there were no general local sales taxes in any province, as is still the case today. In contrast, by 1989 all provinces except Alberta had entered the sales tax field, levying RSTs at rates ranging at the time from seven to 12 percent.

Since the GST operates very differently than the RST, it appears 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. To most Canadians, the proposed GST thus looked like a new—and very unwelcome—federal addition to the familiar provincial RST.

⁹ For a contemporary (and less favourable) assessment of the economics of substituting a VAT for the MST, see Whalley and Fretz (1990). See also the interesting subsequent assessment in Kesselman (1997), chap. 8.

Unsurprisingly, provincial reaction to the federal proposal was also both immediate and largely negative. Three 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, Quebec too declared that it considered the decision to be unconstitutional. In 1992, the Supreme Court ruled in favour of the federal government. Long before then, however, negotiations on a possible joint sales tax approach had begun with several provinces, including Quebec. Interestingly, Prince Edward Island, Manitoba, and Saskatchewan also entered into negotiations with the federal government, although to this day none of these provinces has entered into any arrangements with respect to sales taxation (except with respect to certain imports of goods from other countries).¹⁰

On January 1, 1991, Canada finally laid its antique manufacturers' sales tax to rest and followed most countries around the world by introducing a new federal VAT, the GST. 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 perceived regressivity of the tax. The case for reforming the federal sales tax was undoubtedly strong and the government had been committed to do so for some years. Nonetheless, it is not clear why this particular government, unlike so many previous governments, actually decided to take this leap. Equally, it is far from clear why it agreed to the unusual arrangements made with Quebec in 1991, not only to change its own RST into a VAT closely modelled on, but not identical to, the federal GST, but also to administer the federal GST in the province. As discussed below, the reasons may have been both to ensure that at least one province would simultaneously adopt a VAT and perhaps also to show some responsiveness to the increasingly strong political demands from Quebec for more policy autonomy.¹¹ In any case, the deeds were done. The consequences soon followed.

The replacement of the MST was originally proposed in 1987 as part of a comprehensive reform of the federal income and sales taxes. Unfortunately, although income taxes were indeed reformed (and rates reduced), sales tax reform did not occur until several years later. Unsurprisingly, when it did arrive, the GST was seen for the most part as simply yet another tax grab by the federal government. The common perception that the GST was a new and regressive federal tax that would produce large new revenues for the federal government was undoubtedly a key reason why the GST proved so unpopular.¹² This issue added considerable political heat to the fire already set alight by the concurrent 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 new Senators in order to force through final legislative approval. The ruling Progressive Conservative party paid the price in the 1993 election, however. 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.¹³

In the circumstances, it is not surprising that one of the campaign promises of the newly elected Liberal government was to replace the VAT with some other form of consumption tax, which

¹⁰ PEI does not have any such agreement, however. For details, see CBSA (2010, 2010a).

¹¹ For discussion of changing federal-Quebec relations in tax and other fields over the years, see Bird and Vaillancourt (2006).

¹² For a more detailed discussion of the initial controversies about the GST, see Bird (1994).

¹³ There were, of course, other issues than the GST—notably opposition to NAFTA— that produced this dire result. For a useful appraisal of the politics of GST adoption in Canada and elsewhere, see Eccleston (2007).

they originally thought might take the form of the business transfer tax (Mintz 1995). In the end, however, the Commons Finance 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 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. The Committee therefore recommended that the federal GST should instead be replaced by a harmonized federal-provincial sales tax (Standing Committee 1994). In 1996, after long negotiations, three provinces (New Brunswick, Nova Scotia, and Newfoundland and Labrador) finally agreed, in return for a substantial initial payment from the federal government, to replace their RSTs with a new provincial VAT called the Harmonized Sales Tax (HST) imposed on the same base as the GST.¹⁴ The federal government then declared victory, claiming that, as initially promised in its election campaign, it had indeed replaced the GST— by the (renamed but, at the federal level, identical) GST/HST. After vigorously attacking the GST during its ultimately successful 1993 election campaign, the Liberal government in the end thus not only kept the tax but also persuaded three other provinces to sign on to a form of provincial VAT that was, unlike the provincial VAT in force since 1991 in Quebec, applied by the federal government directly to the same base as the federal GST.

When the new HST came into force in 1997, Canada had thus given birth to not one but three variants of VAT — the federal GST, the essentially identical provincial HST collected by what is now the Canada Revenue Agency (CRA), and the increasingly similar QST collected, together with the federal GST, by the Quebec Ministry of Revenue (Revenu Quebec, RQ). Five provinces —Prince Edward Island, Ontario, Manitoba, Saskatchewan, and British Columbia— continued to impose RSTs, with PEI (like Quebec) actually including the GST in the base of its provincial tax. Finally, Alberta, floating on a sea of oil, continued to soldier on without any form of general sales tax, as did the three northern territories, which depend almost entirely on federal transfers.

C. Was It Worth the Effort?

Developments in provincial sales taxation are considered further in Section 3 below. Before turning to this issue, however, it is worth first considering briefly whether the administrative and political effort of moving to the GST was worthwhile. 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 —without, however, substantially increasing revenues¹⁵— and to improve economic performance by reducing the hidden taxation of exports and investment. Even the new government that came to power after the 1993 election, although it had explicitly campaigned on a platform of eliminating the GST, in the end did little more than to change the name of the tax to the present GST/HST. The GST, it seemed, was here to stay.

¹⁴ The compensatory payment to the HST provinces was intended to offset approximately one-half of the initial estimated revenue loss, since 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 five percent of existing revenues: 100 percent for the first two years, 50 percent in the third year, and 25 percent in the fourth year.

¹⁵ 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 GST revenue. As Bird (1994) notes, it also appears to have had little visible effect upon the unfavourable initial perception of the tax by many Canadians at the time. British Columbia recently attempted along similar lines —but unsuccessfully— to deflect criticism of its new HST by earmarking HST revenues for health spending.

One result of its difficult birth, however, was that the GST in some respects is not as good a tax as it might be. For instance, from both an administrative and economic perspective, it is arguably inferior to the new model comprehensive GST that had been implemented in New Zealand in 1986.¹⁶ At one point, the Standing Committee on Finance 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 (Standing Committee 1988). In the end, however, Canada chose to take a very different route, one that both narrowed the base and considerably increased the costs and complexity of the GST.

Canada's GST is hardly unique in being an uneasy compromise between political expediency (basic groceries, special small business rules, etc.) and conceptual perfectionism (the treatment of fringe benefits, sales by non-residents, etc.). But the GST *is* unique in several respects, most obviously in the simple fact that everyone in Canada sees it, all the time. The high political visibility of the GST meant that most Canadians thought of it as a new tax, in part because the previous federal sales tax had been invisible to the public. Although the GST law allowed registered firms to quote either tax-exclusive or tax-inclusive prices, in virtually every case retailers treated the new GST exactly like the existing RST, by adding it onto the price at the cash register so that Canadians got the bad news every time they had to dig into their pockets to pay the tax. Such "separate quotation" of the GST constantly reminds people of its existence, and may hence to some extent make it more difficult to expand the level of government activities (Bird 2010). Chetty, Looney and Kroft (2009) argue that tax-exclusive pricing may also, if consumers decide their purchases on the basis of the ex-tax price shown on the price sticker rather than the amount rung up on the cash register, lead them to make inferior consumption decisions. In any case, the high visibility of the GST, and perhaps even some desire to restrain federal spending, likely figured among the reasons why the new Conservative government, when it finally returned to power after over a decade of post-GST exile in the political wilderness, chose to cut this tax rate in 2006 and 2008.

Canada's GST stands alone among the over 150 VATs in the world in rejecting tax-inclusive pricing (Bird 2010). How did this happen? For constitutional reasons —since provinces are restricted to levying only direct taxes (Alarie and Bird 2011) — provincial retail sales taxes are imposed as taxes on purchasers rather than sellers. Separate quotation of the RST in part reflects this legal requirement, in addition to mirroring the common US practice of separate quotation of such taxes, with which many Canadians were familiar. The federal GST is under no such constraint, however. The main reason the GST law provides for either tax-inclusive or tax-exclusive pricing is presumably because, under the constitution, provinces have power over property and civil rights, which clearly includes power over advertising and posting prices (Sherman 2009). Another reason may have been simply to avoid further public attacks on the federal GST initiative as a hidden tax.

Whatever the reason for including the tax-exclusive pricing option, it has always been clear that the original federal intention was eventually to move towards a system of tax-inclusive pricing (as in the EU VAT), with GST shown separately on the receipt or invoice, but included in the posted price, rather than tax-exclusive pricing (as in the RST). In the real world, however, given the extensive and highly negative publicity accompanying the introduction of the GST, it is not surprising that, when vendors were given the option of tax-exclusive pricing, almost all of them

¹⁶ For a detailed discussion of the current GST in New Zealand, which like all taxes has its problems, see Krever and David White (2007).

chose to do so.¹⁷ Whatever the story, tax-exclusive pricing continues to prevail in Canada — although, as suggested in Section 4, this may perhaps change in the future.

Canada's GST is also distinct in a number of other ways. For one thing, Canada adopted a unique double dip approach to dealing with the issue of sales tax regressivity when it both zero-rated basic foods and provided an income tax credit intended to offset the perceived regressivity of the GST. 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-MST substitution in the first place.¹⁸ In any case, to the extent regressivity was considered a problem, the logical approach, in view of 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 a level providing a more than sufficient offset to any conceivable additional regressivity that might arise from the introduction of the GST. Indeed, the inclusion of this credit as part of the sales tax reform packages appears to have assuaged the regressivity concerns expressed by such social policy advocates as Battle (1999). However, few ordinary 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 as a food tax continued to mount.

The outcome was an almost comical situation in which, at the moment when the entire implementation package for a GST that did tax food was ready to be launched at the end of 1989, the government of the day unexpectedly decided that food —specifically something called “basic groceries”— was not to be taxed. Although the GST credit intended to offset the now non-existent tax on food remained in place, the result of this sudden about-face was that everyone involved in preparing for the introduction of the tax had to go back to the drawing board, decide —rather arbitrarily (e.g., five doughnuts are taxable but six or more are exempt)— 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, is not particularly progressive in its incidence, since it benefits everyone who eats regardless of income level.¹⁹ This double dipping (credit plus zero-rating) not only subsidizes high-income eaters, but introduces still more complexity into what, in perhaps a slightly overwrought moment, I once called “probably the most complex VAT law in the world” (Bird 1994a).

Another result of the strong political feelings aroused by the GST was that it proved difficult to live up to the common advice from VAT experts to the effect that the most important year for any VAT administration is the first one, during which —at least ideally— every VAT registrant

¹⁷ At the time the HST was introduced in 1996, the federal government again attempted to move to tax-inclusive pricing but again responded to public pressure by backing down (Murrell and Yu 2000).

¹⁸ The issue is obviously a complex one, and subject to considerable dispute, as evidenced by the early conflicting analyses of Grady (1990) and Gillespie (1991a). The issue of GST regressivity has subsequently been revisited a number of times in the literature without throwing all that much more light on it. Two recent contributions suggest that replacing the RST by the HST in several provinces in 1996 had little distributional impact (Smart and Bird 2009) and that the GST and QST are roughly proportional in Quebec, with the small regressivity in the bottom income quintile being more than offset by the federal and provincial credit (Godbout and St-Cerny 2011).

¹⁹ The estimated revenue cost of zero-rating basic groceries (\$3.34 billion in 2010) is almost as high as that of the GST credit (\$3.85 billion). See Department of Finance (2011a). Interestingly, a 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” (Maynard and Nault 2005). Earmarking always seems an attractive solution to funding problems to those concerned with particular policy questions.

should be visited by 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 the enterprise aware that somebody is watching it (Tait 1988).²⁰ It would have been difficult in any case to meet this requirement, both because of the extremely wide net cast by the new GST, which went much further than most VATs in sweeping into the tax base thousands of entities (especially in the non-profit and public sectors) that previously had had little or nothing to do with the tax department, and the relatively few well-trained officials available for the task. In addition to these initial problems, however, although it is (unsurprisingly) difficult to document, it appears that the strong visceral and visible public dislike of the tax may have led to a conscious decision by the new government not to enforce the GST very rigorously.

In any case, one immediate consequence of the introduction of the GST, encouraged by the way exchange rates were moving at the time, was a marked increase in cross-border shopping (Boisvert and Thirsk 1994). Most Canadians live within a driving time of one to two hours to the United States, and in those days, when the Canada-US border was becoming thinner and not thicker, as it has since 2001, many took advantage of the relative cheapness of buying south of the border. For this and other reasons, some analysts even argued that the result of introducing the GST in Canada may well have been to increase tax evasion rather than to reduce it, as the experience of other countries had suggested might occur (Spiro 1993).²¹ While most of the initial administrative difficulties and lapses were overcome with time, even almost a decade after the introduction of the GST, the Auditor General of Canada (1999) was still pointing out serious flaws in GST administration, particularly with respect to audit.²² On the whole, however, by international standards Canada's GST administration has generally been good, with most of its initial (and current) problems apparently being more attributable to problems arising from tax design rather than to bad management.²³

Some of the complexity of the GST reflects what I have elsewhere called Canada's "rebate model" (Bird 2009). In addition to the case of food (discussed above) and the financial sector, which is basically exempt (as in the European Union) although the GST taxes more fee-based services than do most EU countries (Gendron 2008),²⁴ special treatment is provided for many other activities, including small businesses, non-profit organizations, charities, the public sector, housing, and financial services. 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

²⁰ Smith (1992) provides a much more positive account of the success of the GST launch than the version in the text because he focuses, understandably, almost entirely on the extensive and largely successful administrative reorganization within the revenue agency, a subject not discussed here.

²¹ Bird (1994) reports survey evidence that appears to support the view that the GST may have significantly worsened "tax morale" in Canada. The link between tax morale and tax performance is explored in Bird, Martinez-Vazquez and Torgler (2008).

²² A recent US report (GAO 2008) notes that Canada had difficulty in getting many firms registered prior to VAT implementation. Given the exceptionally wide net that Canada's GST cast, as well as the fact that until the very last minute most Canadians, including many prospective GST registrants, did not believe that the tax would actually be introduced, this problem is easily understandable.

²³ As Firth and McKenzie (2011) emphasize, one of the more regrettable features of bad GST design has been the increasing use of vague retroactive amendments to deal with various problems. Bass and Gendron (2012) similarly note that the fuzziness of the basic law in some respects has given the Canada Revenue Agency (CRA) what is arguably too much administrative discretion in administering the GST.

²⁴ As mentioned later, in contrast the QST zero-rates listed financial institutions (although this is soon to change).

purchases made by public institutions and, more generally, rebates of input tax at prescribed percentages are paid to colleges, schools, and universities.²⁵

Canada's rebate approach to taxing the public and non-profit sectors, as well as real property, is perhaps more logical than the way in which these sectors are handled under the VATs of many EU member states, though less so than that of New Zealand or Australia.²⁶ Some other developed countries with a VAT have some domestic zero-rating for food along the lines of — though usually less extensive than — that for “basic groceries” in Canada. However, few if any have refundable (and hence non-wasteable) income-linked VAT credits administered as part of their personal income tax systems. Similarly, some countries also have some form of rebate (usually called refund) system for foreign visitors, as Canada did until recently.²⁷ None, however, appears to have used the rebate approach as enthusiastically as Canada has done. The 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.

Some of the most complicated sections of the GST deal with issues that receive virtually no mention in most discussions of VAT, notably the taxation of the public sector, non-profit organizations and charities. The complications with respect to the public sector at first glance may seem surprising since constitutionally under Section 125, “no land or property belonging to Canada or any province shall be liable to taxation.” This provision appears to imply that the GST should simply not be applied to supplies by either the federal or provincial governments or their agents (such as Crown corporations). Nonetheless, the federal government in fact not only subjects purchases by federal departments, agencies and corporations to the GST, presumably in part in order to simplify the administration of the tax by vendors, but also charges tax on its own taxable supplies.²⁸ However, sales to the provinces (and provincial corporations) are zero-rated.

²⁵This 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 percent 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 percent by an associated hospital, the rebate of input tax may be based on the higher (83 percent) rebate for hospitals.

²⁶ For recent discussions of various treatments of the public sector and housing sectors in various countries, see Gendron (2010) and Poddar (2010). Smart (2012) discusses these issues in Canada, while Firth and McKenzie (2011) critically review the present GST treatment of the financial sector.

²⁷ In 2006, the government decided to end the rebate for tourist expenditures in 2007. This policy change was perhaps motivated in part by an internal audit study (Canada Revenue Agency 2006) that found that in the 2004-05 fiscal year, over 622,000 visitor rebate claims for a total of \$59 million were processed and that these claims accounted for over two-thirds of the total rebates processed but less than two percent of the amount of rebates. Substantial GST incentives are still offered to both foreign conventions and tourist packages, however. With the GST, as with most taxes, once you give something away, it is very hard to take it (completely) back.

²⁸ Taxes on such purchases, however, are then remitted by ministerial order. The HST provinces similarly pay GST on their purchases. 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 agrees to pay RST on its purchases if the province or territory had such a tax (Nunavut does not). Presumably the federal government attempts to negotiate such arrangements through the reciprocal tax agreements related to GST that it has with all provinces in part to simplify administration, since from the perspective of vendors, it is obviously simpler to be able to apply tax than to deal with exemptions. Another reason might perhaps be to face governments with the real (tax-included) relative prices of different inputs. Such agreements are needed in any case to deal with a variety of other issues, such as the

On the other hand, the important public sector institutions included in the so-called MASH (municipal-academic-school-hospital) sector are not zero-rated but instead exempted, which means that, unlike provincial governments, these institutions are subject to tax on business inputs. To offset this tax burden, a partial refund (rebate) of taxes on inputs purchased by the MASH sector was established, with the aim of keeping such institutions more or less in the same relative position as they had previously been under the MST (which was embodied in the prices of their inputs). Although the refunds varied by type of institution, on average they amounted to roughly two-thirds of input taxes paid by the sector.²⁹

In addition, special treatments are applied to a number of small businesses. For example, the so-called Quick Method permits certain businesses to calculate their GST liability by multiplying their taxable sales by a stated rate, rather than reporting separately the output tax due and the input tax credits claimed. The rate is, for instance, 1.8 percent for small retail businesses compared to the basic GST rate of five percent. Different rates are set for retailers and wholesalers and (at less favourable rates) for service businesses. These presumptive rates may perhaps have initially been based on some studies of the average ratio of taxable inputs in such businesses, although if so, such studies have not been made public. In any case, the result of applying such presumptive rates is that, for those taxpayers (and their customers and suppliers), the GST is no longer a VAT, but simply a lower rate (and cascading) gross receipts tax similar to Canada's original 1920 turnover tax. Additional special systems exist for certain qualifying non-profit or public organizations and for businesses that can use a simplified method of accounting for input tax credits. Since less than five percent of GST taxpayers use any of these simplified accounting systems (Canada Revenue Agency 2004), one has to wonder whether much of this complexity in the system serves any great economic or political end.

In summary, the GST is both highly visible to consumers and far from a simple tax for many GST registrants. The original law was long and complicated, partly because the need for compromise resulted in many of the special treatments of different sectors and activities already mentioned. It was also complex because a good many aspects of the income tax law —such as the treatment of automobile benefits provided to an employee— were carried over to the GST (Bird 1994a).

Although some of this initial complexity was reduced over time, new complications and obscurities have crept in, 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. Some of this complexity may reflect the apparent fact that Canadians, unlike Europeans but much like Americans, appear unwilling either to leave the details to regulations or to deal with many problems by broad definitions subject to administrative interpretation. But a good deal of it derives from the fact that the scope of the GST was deliberately designed to be more comprehensive than that of most European VATs, as shown by the extent to which it attempts to encompass the (inherently not revenue-

characterization of financial services in Quebec and whether hospitals in particular provinces are considered part of the provincial public sector or not.

²⁹ This is simply the (approximate) average of the percentage rebates allowed for the various components of the MASH sector. Given the huge and varied collection of VAT registrants in Canada lumped together as non-profits, the 50 percent rebate such entities receive seems more likely to be a compromise between 0 percent and 100 percent, rather than based on any careful study. Interestingly, as of 2009 the same (arbitrary) rate applied in all the provincial VATs, although in other sectors, most provinces apply rebates that differ from the federal GST rebate, as well as those in other VAT provinces. The appeal of a good compromise unblemished by any factual basis should not, it seems, be underestimated. Similar, but not identical, treatments apply with respect to various public-interest activities, as well as to housing, in the HSTs applied in different provinces (Bird and Gendron 2010).

productive) activities of non-profit and public sector organizations. As Smart (2012) suggests, it is perhaps time to rethink whether much of this complexity serves any purpose — unless, perhaps the resulting increased degree of discretion in administering the tax that complexity gives the CRA is considered desirable.

3. Provincial Sales Taxes: From RSTs to HST

The main economic benefit of the GST is that it frees most business inputs from tax. However, many people do not see this as an improvement, perhaps because they think that if business pays the tax, that means they —the public— do not. Hidden taxes may be economically distorting, but they often appear to be more palatable politically than visible ones. The GST was initially criticized not only as a new tax on transactions, but also because it expanded the tax base to encompass a much broader range of consumer services. The prices of manufactured goods, like automobiles, may have gone down a bit over time, but people were understandably much more aware of the fact that the price of eating at a restaurant or having one's hair cut went up. Moreover, for many small businesses and especially for the many small service firms that, for the first time, had to deal with the federal sales tax, the GST constituted a new and unwanted additional compliance burden.³⁰ In addition, as already discussed, a wide variety of public, charitable, and non-profit organizations that had previously escaped both the income tax and the RST were now faced with coping with the intricacies of the GST. Finally, and most importantly, the 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 lives.

A. The Quebec Sales Tax

In this setting, it is not too surprising that, although several early official reports discussed different ways in which federal and provincial sales taxes might work together, in the end none of these paths was followed. Nonetheless, apparently desperate to get some province on board the GST train, the federal government finally managed to strike a rather curious deal with Quebec, so that when the GST was introduced at the federal level in 1991, Quebec simultaneously replaced its RST by a new provincial VAT, the Quebec Sales Tax (QST).

Under the federal-Quebec agreement, Quebec 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.³¹ The HST path of a combined federal and provincial tax, administered federally, was undoubtedly the preferred federal approach. However, the federal government probably accepted this very different arrangement with Quebec, not only because of its rather strained relations with the province at the time, but also in an attempt to induce other recalcitrant provinces to hop on (some variant of) the GST bandwagon.

³⁰ A concession was made to the inevitable complaints of the millions of small businesses (less than \$2 million in sales) that, for the first time with the GST, had to deal with the federal sales tax administration by providing a special one-time subsidy (maximum C\$1000) 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 that have adopted VATs (cf. OECD 1988). Similarly, when Ontario decided to move from an RST to an HST, part of its initial package was a transitional credit of up to \$1000 for businesses with less than \$2 million in taxable sales. As with the GST credit to individuals, however, it is not clear that those who benefited from these measures were any happier with the tax changes as a result.

³¹ This fee is negotiated annually.

In any case, the result was that for 20 years, Quebec has been the only subnational jurisdiction in the world to operate a destination-based VAT.³² The QST is a destination-based, credit-invoice VAT that subjects most goods and services consumed in Quebec to tax at a statutory rate, currently, of 9.5 percent. However, since unlike most provincial sales taxes, the QST applies on the GST-inclusive price of goods and services, its effective rate is 9.975 percent. Goods and services that are produced and consumed in Quebec 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 five percent rate. Both taxes are collected at the point of sale, and their amounts are shown separately on the invoice.

The QST applies to a base that is now substantially harmonized with that of the federal GST. However, the story did not begin this way. Initially, 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 and some aspects of the registration process. The most important initial difference was that it was not until July 1992 that the QST was extended to cover most services and real property (Mintz, Wilson and Gendron 1994). 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.

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 (Gendron 2008). This means that financial institutions can recover the QST they pay on most of their inputs. The rationale for this favourable treatment presumably was to improve the attractiveness of basing the headquarters of financial institutions in Quebec, particularly relative to neighbouring Ontario (which, until it adopted the HST in July 2010, taxed significant inputs to such institutions — for example, computing equipment). Two other features of the QST, however, reduce the beneficial effects of this zero-rating for financial institutions. First, as noted below, most financial institutions are subject to certain restrictions on their ability to claim ITRs. Second, the Quebec government imposes a special compensatory tax on the wages and paid-up capital of listed financial institutions (as, interestingly, does France). This tax originally was 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, as well as economic efficiency. As discussed below, the current treatment of the financial sector in Quebec is due to change substantially in 2013.

The treatment of trade under the QST is not straightforward. Ignoring minor exceptions, goods are zero-rated if exported outside Quebec, whether to another province or outside Canada. Exports of services to non-residents of Quebec are also zero-rated, unless the sale is made to an individual who is a non-resident of Quebec but is in Quebec when he or she orders the service, or the service is provided to an individual during his or her stay in Quebec. In these two cases, both the GST and QST apply and the services are deemed to be consumed in Quebec. Imports of goods into Quebec from abroad are subject to both GST and QST. For non-commercial imports, both taxes are (like most provincial sales taxes) collected by the Canadian Border Security Agency (CBSA). Goods imported from elsewhere in Canada by Quebec

³²Technically the VATs applied by EU member states operate similarly to subnational VATs in the context of the European single market. The only true subnational VATs other than in Canada, however, are in Brazil and India. The Brazilian state VATs, which have been in operation much longer, are entirely origin-based. In the case of India, where state VATs for the most part have only been in operation for a few years and there is no encompassing national VAT, as yet the treatment of interstate trade is not clear, but for the most part they appear to be essentially origin-based (Bird 2010a).

residents who are not registrants are subject to QST on a self-assessment basis. If, however, the person importing the goods is a registrant for QST purposes and 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 (ITR) —the equivalent of the GST's input tax credit (ITC)— had tax been paid. In effect, the treatment of interprovincial imports is thus similar to the deferred payment system now applied in the European Union.

What all this means is that, apart from rebating input taxes on interprovincial exports, Quebec acts in exactly the same way as a province with an RST, or no sales tax at all. Although as administrator of the federal tax in Quebec it applies the GST/HST on out-of-province supplies, it 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, there would normally be no tax anyway, and if they are imported by non-registrants they are supposed to be self-assessed. The latter provision is unlikely to be any more successful than the similar use-tax provisions found in most RSTs; on the other hand, it is also unlikely to be any less successful.

Despite the progressive harmonization of the QST and GST bases over time, one important difference is that from the very beginning, input tax credits have been more limited under the QST than under the GST, with restrictions applying in particular to large businesses (annual taxable sales over \$10 million). Not only is this threshold fairly low, but most financial institutions are deemed large businesses. This large-business provision evidently is intended to protect QST revenues. It does so at a cost, however, both imposing some tax on business inputs and creating some incentive for businesses to inefficiently split operations to avoid the threshold. As noted below, Ontario has recently imposed similar restrictions under its new HST, as did BC. Rather astonishingly, the federal government agreed to implement this provision for these provinces at no cost to them for a period of five years (followed by a three-year phase-out), provided the scope of the ITC restrictions did not exceed that presently in force under the QST. Such restrictions are clearly undesirable in principle since they counteract one of the major economic benefits of moving to a VAT. Presumably, they are motivated largely by revenue considerations — although no one seems to have estimated either the revenue gain or the economic cost associated with ITC restrictions, let alone their net effect in welfare terms.

The Quebec administrative model, under which the provincial government administers both the provincial and (for a fee) the federal VAT, is unique in the world. For example, Revenu Quebec (RQ) registers GST payers in the province, as well as registering a slightly larger population of QST registrants.³³ The emergence, and acceptance, of this dual system reflects a number of specific conditions. The Quebec and federal governments have a history of sometimes-stormy relations, with breakthroughs achieved through tough negotiations and subsequent cooperation. In this instance, it appears that both provincial administration and the QST's GST-inclusive base were presented by the Quebec government as necessary conditions for harmonizing its tax with the GST. The first of these conditions appears to have resulted from the determination of the (then-separatist) government that the provincial government should as much as possible be the face of government to the people of the province; the second was presumably motivated by revenue considerations.

Perhaps reflecting the fact that overall taxation levels in Quebec are high in relation to the Canadian average, RQ had over the years become a relatively sophisticated and aggressive tax authority. Hence, the federal government, which desperately wanted some province to publicly

³³ In 2007-08, for example, 616,052 entities were registered for QST compared to the 588,489 entities registered for GST in Quebec.

support its initial move to a VAT, appears to have assumed, probably correctly, that it was unlikely to lose in revenue terms by accepting these conditions. The quality of RQ as a tax administrator and its detailed knowledge of its taxpayer population, when added to the economies of scale from collecting two taxes together rather than separately, perhaps made the package a not unattractive one. Indeed, with good information exchange, hitching the QST to the GST may well have helped both governments protect their revenues. RQ's benefit from this arrangement likely exceeds the administrative fee it receives from CRA, not least because the initial agreement to impose QST on the GST itself created a small permanent stream of additional revenues for the Quebec treasury. Moreover in light of the size and service-intensity of the Quebec economy, the shift over time to (approximately) the GST tax base probably increased both the revenue and the revenue-elasticity of the provincial tax system. In addition, since RQ both has better knowledge of the local tax base and a direct incentive to collect and enforce the GST, because the QST base grows when GST collections grow, both parties may have benefited in revenue terms from this arrangement to some extent.

Unfortunately, there appears to be no publicly available assessment of how well these arrangements have worked. All that is known is that between 2002 and 2007, RQ fully harmonized its management systems with the new GST management system used by CRA. Given this, and the recent Ontario and BC agreements discussed below, it is perhaps not surprising that Quebec too has now chosen in effect —though not in name— to adopt the HST base in 2013. Given the current federal government's campaign pledge to strike a deal with Quebec with respect to sales taxes, and to pay \$2.2 billion for doing so, the province's decision to move its tax base even closer to the GST base —including both a change to the exemption approach to financial institutions (and a phase-out of the present complementary tax on such institutions), as well as a gradual phase-out of its input credit restrictions (more or less matching the Ontario arrangements discussed elsewhere)— as well as to cease including GST in the QST tax base is understandable.³⁴ Equally understandable, however, is Quebec's intention to continue administering both the federal and provincial sales taxes in the province and to retain its separate QST rather than becoming a participating province in the HST system. Although some important details about the new system remain unclear, the interesting and unique Quebec experiment with a largely independent provincial VAT is now over except in three (important) respects: the QST remains solely a provincial law; it is administered solely by the provincial government; and the amount of sales tax revenue yielded by the QST depends on the amount actually collected in Quebec and not, as in the case of the HST provinces discussed below, on a federally administered revenue allocation system. Nonetheless, with the increased harmonization of the QST and GST bases and administrations, another important step has now been taken towards implementing an integrated national sales tax system.

Quebec's experience over the last two decades demonstrates that there is no reason in principle why other provinces could not also decide to adopt an independent VAT, rather than one like the HST that is not only rigidly linked to the federal tax —as the QST will be beginning in 2013— but also collected by the federal government with the revenue accruing to the province being allocated on the basis of estimated taxable consumption in the province. Indeed, although in many ways the Quebec experience is unique not only in Canada but in the world, it supports several other conclusions. First, some (but not unrestrained) base diversity, while of course not ideal in terms of compliance and administrative cost, can not only be tolerated by taxpayers but can even be operated effectively by a single administration (whether federal or

³⁴ The current 8.5 percent QST rate was increased to 9.5 percent on the GST-inclusive base in 2012, or an effective rate of 9.975 percent on the GST-exclusive tax base; the tax-exclusive rate under the new system in 2013 will be 9.975 percent.

provincial) administering both federal and provincial VATs. Second, subnational jurisdictions can successfully administer a destination-based VAT. Although the member states of the European Union, whose VATs are technically similar to those in Canada's provinces in terms of how they treat trade within the broader single market (the EU or Canada, as the case may be), have been much concerned with evasion in recent years, many of the problems encountered (such as carousel fraud) are less likely to arise to the same degree with respect to provincial VATs, precisely because there is an overriding federal GST.³⁵ In short, although the Quebec experience definitely needs more detailed study than it seems to have received, and the QST was far from ideal in a number of ways, at the very least the last 20 years have demonstrated conclusively that, at least in the presence of an over-riding federal VAT, a relatively independent provincial VAT can co-exist with other provincial sales taxes, whether such taxes take the form of VATs or RSTs, without encountering insuperable problems.

B. The Harmonized Sales Tax

Interesting as Quebec always is in comparative context, the QST has in the end turned out to be a deviation from the main storyline in provincial sales taxation since the introduction of the GST. Following the election of a Liberal government in 1993, the House of Commons Standing Committee on Finance, in line with a campaign promise of the winners, began to consider alternatives to the GST. The resulting report proposed full integration of the federal and provincial sales taxes through a 10 percent VAT with distinct federal (four percent) and provincial (six percent) components (Standing Committee 1994). However, it shortly became evident that such an integrated tax was unwelcome to the provinces, essentially for two reasons — the expected revenue loss and the increased visible provincial tax burden that would be imposed on consumers. Although discussions continued, nothing happened until 1996 when, after characteristically prolonged and convoluted federal-provincial negotiations, three Atlantic provinces (New Brunswick, Nova Scotia, and Newfoundland and Labrador) agreed to replace their RSTs by provincial VATs levied at a uniform rate of eight percent.

Why the federal government insisted that all HST provinces apply the same rate is unclear, since there is no technical necessity for such uniformity. Indeed, the original federal proposal was based on the assumption that the HST rate would be 15 percent in the four Atlantic provinces, but only 14 percent elsewhere in the country. It was thus clear from the beginning that, despite the uniform eight percent rate initially agreed by the initial HST provinces, the integrated GST/HST did not require uniform provincial sales tax rates either technically or legally. Nonetheless, the original HST agreement bound the three provinces to maintain a uniform rate, although it also made it clear that the rate was determined by them and not by the federal government.³⁶ All three provinces had to agree before the rate could be lowered,

³⁵ A full discussion of the EU situation may be found in European Commission (2011). For an interesting discussion of the kind of fraud that has been observed in Canada, see Ainsworth (2007). Although Ainsworth draws some 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. (Incidentally, Canada's treatment of aboriginal groups under the GST is both a major administrative — and compliance — complication and yet another unique feature of its GST.) The main connection of these frauds to the existence of the HST is that, by locating one fictitious vendor in the chain in an HST province, the refund claimed from the federal government was higher than it otherwise would have been. The amounts involved appear to be small.

³⁶ Interestingly, in the initial 1996 agreement the federal government accepted some constraints on rate increases (not decreases) in the federal portion of the combined tax. For example, the federal GST rate could be increased by

presumably in order to reduce the possibility of tax competition between these relatively small neighbouring jurisdictions in the form of cross-border shopping. On the other hand, and perhaps somewhat surprisingly, only two out of three provinces had to agree in order to raise the rate. In 2008 New Brunswick considered raising the rate to 10 percent to offset the recent reduction in the federal GST rate (New Brunswick Department of Finance 2008). However, it hesitated to do so, in part because it appeared that it would have to negotiate a new sales tax agreement with the federal government.

One reason for the initial federal concern with provincial HST rates may have been the possible danger for federal revenue if explicit vertical-rate competition between the two levels of government was permitted.³⁷ On the other hand, the three original HST provinces in Atlantic Canada are provinces of below-average per capita income, which receive equalization grants from the federal government. Although the calculation of consumption tax capacities under equalization is different than the calculation of revenue shares under the HST, the fact is that the resulting transfers are largely offsetting. The consequence is that if the revenues allocated to a province under the HST allocation formula increased as a result of a rate increase, then at least some of this gain would be offset by a reduction in equalization grants, owing to the fact that there would also be at least some increase in its measured fiscal capacity, with this reduction being greater the larger the province. Although this offset would not amount to much in the case of small provinces (since fiscal capacity is measured using the national average provincial consumption tax rate), it is not insignificant for larger provinces like Ontario. This may be one reason why the federal government has been less concerned with the level of provincial rates in the recent expansion of the HST to large provinces.

Another aspect of the interconnection between the way HST revenue is allocated and the equalization system is that there is a larger direct offsetting impact on any province if its HST share increases as a result of an increase in its share of total national consumption.³⁸ This fact has perhaps made equalization-receiving provinces more content to accept that sales tax revenues are shared based on federal calculations rather than paid on a true derivation basis. It is therefore perhaps not a coincidence that Ontario negotiated its accession to the HST in 2009, the year after it qualified for equalization grants for the first time in history. On the other hand, British Columbia is the only HST province never to have received such grants. Again, it may not be a coincidence that it is also the only province to have pulled out of the HST after implementing it.

Regardless of the weight one attaches to these arguments, the fact remains that, when the three provinces originally in the HST system initially agreed to set a uniform rate for the first four years—and maintained that same rate for the next 15 years—it was their choice to do so, as was the recent decision by Ontario to enter the HST system with the same rate. In fact, despite the concerns expressed as recently as 2008 by New Brunswick, it is now clear that, like any intergovernmental arrangement, the sales tax agreements with the federal government can be renegotiated by any province, as Ontario, British Columbia and Nova Scotia have all recently

no more than one half of one percent 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 one percent without their unanimous agreement. Similarly, if any province did not accept a federal base change that would have increased such revenues by more than one percent, the federal government agreed to administer (at no cost) a rebate offsetting such increase.

³⁷ The following arguments are based largely on Smart and Bird (2012).

³⁸ Note, however, that since QST revenues are the actual revenues collected by the province and not determined by the revenue allocation formula, this factor does not come into play with respect to Quebec.

demonstrated. Of course, as with any agreement, both sides —the federal government and the province— must agree, but as discussed earlier, and as events in 2010 clearly demonstrated, contrary to what some had suggested (McLure 2007), there is no obstacle to imposing different rates in HST provinces nor (or so it seems) even in exiting from the HST system, provided agreement can be reached between the federal and provincial governments.

Of course, that it is possible to do such things does not mean that they are sensible. Recently, for example, Boadway (2011) has expressed concern that one result of the current HST rate differentiation might be increased tax evasion along the lines seen in the European Union. However, he noted that (as Bird and Gendron (1998) had argued) the existence of an overriding federal tax in Canada reduced this danger. Actually, as Cnossen (2011) and others have emphasized, since almost exactly the same problems arise with differential RSTs, it is not clear why the increased uniformity of bases under the HST, even if some minor rate differences persist, will exacerbate rather than reduce them.

In any case, unlike the QST, the new provincial portion of the HST was from the beginning levied on the same base as the federal GST. Moreover, the federal government collected both federal and, at no cost to the provinces, provincial VATs under the HST. Combined with the initial compensation payment and the economic benefits of moving to the HST (Smart and Bird 2009a), this seems like a pretty good deal. Until 2009, however, no other province proved willing to accept the restrictions of the HST agreement.³⁹ Nor did any province choose to take sales tax reform in its own hands in the more independent Quebec-style, that is, by adopting a provincial VAT that is less closely tied to the federal GST system.

It thus came as somewhat of a surprise to many when Ontario announced in March 2009 that it intended in 2010 to replace its existing eight percent RST by an eight percent provincial HST imposed on essentially the same base as the federal GST.⁴⁰ There appear to have been at least three reasons for the provincial decision. 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 (Smart 2007).

Second, for (unclear) reasons of its own, the federal government gave Ontario what looks to be a very good deal. Not only did Ontario receive a special additional federal payment of \$4.3 billion (\$3 billion on introduction of the tax, and \$1.3 billion one year later), but the federal government will, as in the other HST provinces, cover all the costs of administering the tax. The formula used in 1996 was clearly not used in determining the payments made to British Columbia and Ontario when they agreed to join the HST, since in both cases the provincial sales tax rate under the HST remained the same as their previous RST rates, unlike the substantial reductions in rates that occurred in the original HST provinces. The Minister of Finance, Paul Martin, made it clear in 1996, when he rejected Quebec's request to receive a payment of C\$1.9 billion to compensate it for its earlier adoption —in a quite different way— of a provincial VAT, that “the formula would not have given Quebec any right to a payment in 1990, nor does it do so today. Ontario, Alberta and British Columbia would also not qualify for adjustment assistance.”⁴¹ In politics as in life, however, time can change all things. Rate

³⁹ An official report in Saskatchewan (2005) recommended that, provided it received adequate compensation, the province should essentially sign up for the HST — although at a lower rate (five percent). However, nothing came of this.

⁴⁰ Of course, numerous outside reports had suggested earlier that Ontario should convert its existing RST to a VAT with the same base as the federal GST (e.g. Dungan et al. 2008).

⁴¹ Can. Dep't of Fin., News Release 1996-039, available at <http://www.collectionscanada.gc.ca/webarchives/20071122073253/http://www.fin.gc.ca/news96/96-039e.html>.

reduction and consequent revenue loss was the stated rationale for the compensatory payments to the original HST provinces in 1996, but neither rationale applied to Ontario (or BC) in 2010. Although no clear statement as to why these provinces deserved to be paid for doing something so clearly in their own economic (if not political!) interest appears to have been made public, perhaps the reasoning may have been along the following lines. First, although no one is likely to say so out loud given regional sensitivities, what is good for big provinces like Ontario and BC in terms of encouraging increased economic activity is, on the whole, likely to be good for Canada. Second, in the post-2008 period, giving a major boost to private investment through reforming provincial sales taxes, and hence reducing the cost of investment, may have been as good or better a way to use federal stimulus payments than, for example, refurbishing still more local libraries or arenas.

In any case, in order to seal the deal the federal government also accepted more base deviations from Ontario (for example, zero-rating for children's clothing and other items) as well as BC than it had done for the original (much smaller) HST provinces. Moreover, the new HST provinces were also allowed (for five years, followed by a three-year phase-out) to impose restrictions on input credits provided they are similar to and no greater than those already in place in the QST. Third, in the case of Ontario at least, by imposing the eight percent rate of its existing RST, the province received more revenues than from its previous RST rate of eight percent (Dungan et al. 2008). More money, less administrative outlay, better economic outcomes; what's not to like?

Like Ontario, BC converted its existing seven percent RST to a seven percent VAT in 2010 in exchange for much the same package — a payment (\$1.6 billion), free federal administration, and considerable freedom to design its own consumer rebates, as well as limited authority to restrict ITCs. However, unlike Ontario, the introduction of the HST in BC led to major political problems and, in the end, the resignation of the provincial premier, Gordon Campbell. His successor then, as promised, held a referendum in 2011 in which 55 percent of those voting favoured scrapping the HST. Subsequently, the government announced its intention to reinstate essentially the previous RST in 2013. This decision was both economically damaging and has created an administrative nightmare. Nonetheless, it appears BC is about to join the very short list of those who have tried the VAT and then dropped it. Whether it will subsequently see the VAT light and try it again —as has almost every other jurisdiction that abolished it— remains to be seen.

Canada is one of only three countries with subnational VATs —the others, also federal countries, are Brazil and India— and the only one in which subnational governments have the choice of whether or not to impose their own VATs. As of 2011, six provinces had chosen to do so, albeit in slightly different ways. Three (New Brunswick, Newfoundland and Labrador, and Ontario) impose the provincial component of the HST at a uniform rate of eight percent. Two (Nova Scotia and British Columbia) impose provincial HST rates of 10 percent and seven percent, respectively. And Quebec levies an independent VAT, the QST, which includes the federal GST in its base and is administered, together with the federal GST, by the province. However, this picture is scheduled to change again in 2013, with British Columbia reverting to the RST and Quebec essentially unifying its base with that of the GST.

Quebec was understandably upset by the federal agreements with Ontario and British Columbia, both of which received substantial compensatory payments although neither —unlike the Atlantic HST provinces in 1996— reduced their tax rates. As mentioned earlier, Quebec received no such payment when it introduced the QST (although it does receive compensation for its costs in administering the GST) and moreover, unlike the HST provinces, it also bears all the costs of administering its own sales tax. The federal government bears all such costs in the

HST provinces so long as they adhere to the GST base, although it has always covered the costs of administering some provincial rebate schemes in the Atlantic provinces (Bird and Gendron 2010).⁴² In the recent agreements with Ontario and British Columbia, however, the federal government has gone much further by agreeing to administer all the deviant provincial provisions, both zero-rating (up to an overall level of five percent of the estimated tax base) and ITC restrictions. Although not all details are yet clear, the new federal-Quebec arrangements are likely to follow much the same pattern, including perhaps some adjustment in the compensation paid the province for administering the federal GST.

On the whole, however, what is clear is that the GST/HST (including the Quebec variant) is now, in effect, 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. Quebec's impending changes will, in fact if not in name, mean that it, like Ontario, will effectively constitute an important part of this system, in which provincial rates will vary in 2013 from eight percent in Ontario, New Brunswick and Newfoundland and Labrador to 9.975 percent in Quebec and 10 percent in Nova Scotia. Even if the statutory rates in every province were identical, the effective rates of the provincial components of this integrated sales tax imposed on different activities are neither necessarily the same as those of the federal component, nor entirely identical in all provinces in the system. The reason is simply because the rebates that pervade the Canadian VAT system do not always apply in the same way in different provinces. The differences between the initial HST provinces described in detail by Bird and Gendron (2010) have become even more important under the new arrangements with Ontario, Quebec and (temporarily at least) British Columbia.

Unlike the federal GST, for example, all three original HST provinces (like Quebec) zero-rate books.⁴³ All three also follow the GST by providing a 50 percent 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 Quebec) gives any rebates at all on new housing and, again like Quebec, it does so in a different way to the federal GST. All HST provinces provide (federally legislated) rebates for certain financial services (for 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, but in addition, each province has its own specific rebate provisions. For example, Newfoundland and Labrador effectively 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. Interestingly, only Newfoundland (like Quebec) offers a low-income credit like the

⁴² The Canada Revenue Agency (CRA) administers some of the provincial rebate schemes. However, some —such as 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.

⁴³ To clarify a possible point of confusion, zero-rate is the accepted terminology for allowing full ITCs for a good or service that is not subject to any positive VAT rate on final sale. In Canada, such zero-rating is accomplished in three different ways. First, as in the HST examples cited in the text, a province can zero-rate something from its provincial tax by rebating it —which actually means not collecting it— at the point of sale. In the case of the MASH sector, however, which for the most part does not in any case sell its output, the same objective —refunding VAT on inputs— is accomplished by actual rebates (payments from government budgets). In this instance, the rebate is the instrument used to achieve the zero-rating. To confuse matters further, there are also many other types of GST rebates, as well as actual zero-rating for basic groceries and exports (Bird 2009).

federal GST credit. This provision, like the book rebates, is provincially legislated but federally administered.⁴⁴

The impending, greatly increased degree of integration between the QST and the GST is unlikely to reduce such interprovincial differences in effective tax rates, with the important exception of the resultant (gradual) elimination of the present QST input tax credit restrictions, which are to be phased out similarly to those in Ontario. It is likely that, as in the Ontario case, existing provincial variations from the GST norm with respect to matters such as housing will be carried over into the new system. In Ontario, for example, the public sector rebates are 78 percent for municipalities, 78 percent for universities and colleges, 87 percent for hospitals, and 82 percent for charities and non-profits. With the interesting exception of the GST rebate to municipalities,⁴⁵ these levels are considerably more generous than the existing rebates under the GST or those in the original HST provinces. The housing rebate will also be more generous, apparently reflecting the higher house prices, particularly in the Toronto area; 75 percent of the provincial tax on houses under \$400,000 will be rebated, with the rebate being reduced for houses between \$400,000 and \$500,000. Ontario also has more point-of-sale zero-rating — not just for books as in the other HST provinces, but also for children's clothing and footwear, children's car seats and car booster seats, and feminine hygiene products. On the other hand, unlike the original HST provinces, but like the QST, Ontario restricts ITCs for businesses with taxable sales of over \$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 3,000 kilograms as well as fuel, parts, and certain services for such vehicles. All these deviations from the GST norm will be administered free of charge by the federal government. While details are not yet available, it would be astonishing if Quebec accepted anything less than a similar degree of freedom in base variation than that already agreed with Ontario (and BC).

Conceptually, of course, all such deviations may be considered undesirable. For example, Boadway (2011) cites in particular some of Ontario's sillier provisions with respect to end-point rebates for children's clothing and so on. While the argument that all such distortionary deviations from a uniform base are undesirable has obvious merit, as Winer (2011) stresses there may be an important distinction between what is economically optimal and what is politically feasible. There is no question that the opposition to the HST in Ontario would have been much stronger had these concessions not been carried over to the HST. In effect, the relevant question is thus whether a five percent base deviation at some cost is better or worse than the 30 percent or more deviation implicit in the previous RST base at, in all likelihood, an even higher cost. To the extent that provincial governments consider base deviations in existing sales taxes as necessary politically, they are unlikely to be willing to give them up as part of the price for a better sales tax. On the other hand, since the absolute value of such deviations from

⁴⁴ Similar provincial credits for RSTs may also be administered by CRA as part of administering the provincial income tax on behalf of the province, as was the case of Ontario. As part of its move to the HST, Ontario increased its existing refundable sales tax credit to up to \$260 per person. In addition, the new credit, unlike the previous one, is indexed for inflation. As an additional sweetener, a special sales tax transition benefit of \$300 for single people and \$1000 for single parents and couples was paid in three instalments during the first two years of the tax. As with the sales tax credit, these payments are again reduced by (a more generous) income-related formula and, as with such credits in general, it is unlikely any citizens think about these things when they face the HST on consumer purchases.

⁴⁵ When the GST was introduced, the federal rebate for municipalities was 57.14 percent of the otherwise unrecoverable GST paid by municipalities. The rebate rate was increased to 100 percent in 2004. Interestingly, Quebec agreed in 2005 to increase its QST reimbursement to municipalities, reaching 100 percent by 2014.

the GST base is, by agreement, restricted to no more than five percent of the estimated tax base, the federal government is presumably willing to pay this price in terms of increased administrative complexity and reduced economic efficiency, in order to achieve the benefits of improving Canada's tax system by moving to a better form of sales tax than the RST. On the other hand, it is impossible to think of any good reason for the limitation on ITCs in Ontario, BC or the impending Quebec agreements, although in all cases the provinces have already agreed to phase out this especially undesirable base deviation.⁴⁶

A final important technical issue with provincial VATs deserves mention — the question of how to determine the place of supply (where tax liability accrues). In principle, there is perhaps no great reason why this rule should be different for interprovincial than for international supplies. In fact, however, the rules did differ in Canada until recently in one important respect. The primary criterion used at the provincial level with respect to the place of supply of services was 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. If a supplementary rule was needed to apply this criterion, the main one employed is the place of negotiation of the supply, unless all (or substantially all) of the service is performed outside that province. What this meant in practice was that the subnational tax on interprovincial services was, in fact, often applied on an origin and not a destination basis.

Apparently, this definition was adopted in part because sometimes it is 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. Although the income tax rules used to allocate tax base with respect to financial institutions are utilized in the process of allocating HST revenue to provinces (Bird and Gendron 2010), these rules are not used to define place of supply. This issue also comes up with respect 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 has thus always been a national rather than a provincial tax.

In short, in some respects, the supply rule on services applied until 2010 made the provincial component of the HST easier to administer. At the same time, however, this rule to some extent turned the VAT into an origin-based tax, in part because it applies equally to business-to-business and business-to-consumer sales. When Ontario and BC joined the HST in 2010, the place-of-supply rules were therefore changed with the intention of treating goods and services more symmetrically, by shifting the place of supply with respect to services to a considerable extent from an origin to a destination basis. As Ruffalo (2011) notes, however, in some respects the new rules raise questions with respect to some aspects of both implementation and fairness, and many details remain to be worked out.

⁴⁶ Some justifiable reasons for limiting input credits may perhaps be either as a practical matter (to restrain such consumption through the business with respect to private transportation, alcoholic beverages and the like) or as a way to achieve such policy objectives as restraining the use of fossil fuels. In the latter case, however, a more direct and transparent approach, such as increasing fuel excises would clearly be preferable. Similarly, the existing provincial credit restrictions are clearly not designed to achieve the first objective mentioned, since they are imposed not on smaller businesses where such abuses are more likely, but only on larger businesses.

The basic idea of moving to a destination basis, to the extent possible, is clearly desirable from a neutrality perspective, as well as to put suppliers in different provinces on as equal a footing as possible with respect to interprovincial exports. However, the prior system may not have been a major source of distortion (or evasion) for two reasons. First, as Bird and Gendron (1998) noted, the existence of the overriding federal GST provides an audit control on the reporting of interprovincial supplies for purposes of provincial HST (and QST). Of course, such control would be even more effective if all provinces applied HST, since the total tax base reported for federal GST should then be the same as that reported for all provinces combined, and any discrepancy quickly would be apparent. Second, perhaps the main reason no serious distortionary problems seem to have arisen is because, as Bird and Gendron (2010) discuss in detail, HST revenues are allocated on the basis of destination, not origin. The revenue collected in any particular province (or with respect to any particular transaction) is not tracked, but is instead defined as the total GST/HST payable in any particular year, with the annual revenue entitlement—the share—that any province receives being 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 applicable to that province to its calculated share of the base. The approach taken to revenue allocation is highly pragmatic. For example, taxes paid by federal departments and agencies (likethose paid by provincial departments and agencies) are excluded from the revenue pool thus allocated, as are specified refunds and rebates, as well as any interest and penalties. Nor is any allowance made to account for the facts that some reported GST is not paid, and that collection efforts may produce further revenue subsequent to the closing date for adjustments. The federal government simply keeps such later gains, as well as any interest and penalties attributable to GST/HST accounts; on the other hand, it also has to eat any unpaid GST/HST in determining the HST allocations.

The allocation of revenues to the HST provinces is thus a statistical estimate of the destination basis, essentially driven by estimated taxable consumption in each HST province. This system can easily accommodate revenue autonomy, since if any HST province changes its rate, all that would change is the rate applied in calculating the provincial share of the tax base. With very minor exceptions, how the revenue is allocated is completely unrelated to how the HST actually functions. However, it is conceivable that this system may change. A provision of the 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 that would base the distribution of revenues to the HST provinces on the actual sales in such provinces. Although such a system would make questions like the place-of-supply rule much more important and, perhaps, concerns about interprovincial tax evasion more serious, nothing has yet been made public about such discussions.

4. Looking Back... and Forward

Viewed as a whole, Canada's sales tax system at both the federal and especially the provincial level is still far from perfect. However, Canada's experience with the GST/HST, as well as the QST, has conclusively demonstrated that three previously much-doubted propositions appear to be correct. The *first proposition* is that from the point of view of a federal VAT, it does not really matter what form provincial sales taxes take. Whether such taxes are technically independent VATs (the QST), subordinate VATs (the HST), independent RSTs, or there is no provincial sales tax at all, it simply does not matter with respect to designing or operating the GST. Of course, the less coordination there is between federal and provincial sales taxes, the higher the administrative costs for governments and the higher the compliance costs for businesses. Nothing is free, however, and a certain degree of less-than-complete harmony may be one of

the many prices paid for federalism. Some provincial governments may choose, as Quebec did in 1991, and BC has just done, to impose still more costs on their businesses and residents in order to retain some desired degree of fiscal autonomy. However, the freedom to make choices that experts may think mistaken is an important aspect of political democracy in a federal setting.

In contrast, the *second proposition* that Canadian experience suggests is that the precise nature of provincial sales taxes matters a great deal to provinces and their residents. As many have long argued, from an economic perspective the key reform needed in provincial sales taxes is simply to move as close to a VAT-type base as possible. The easiest way to do so, of course, is to make the tax a VAT like the QST or, even better, the HST. However, two key questions need to be faced by any province that does this. The first is the effect on revenue, although Canadian experience suggests that this is not likely to be a big issue. The second and more difficult question, however, is political — how to sell the change. As British Columbia has recently demonstrated, this is not always an easy task. Canadian experience appears to demonstrate the economic advantages of provincial VATs fairly conclusively (Smart and Bird 2009a). Nonetheless, if provinces want to continue to discourage economic activities by using an RST, they can, it seems, be allowed to do so without harming anyone much except themselves and their residents.

Even if a province decides to impose a VAT, as Quebec did in 1991, it is a quite separate decision whether such a tax should be administered jointly or separately with the federal VAT and by whom. The argument for a single administration is strong on cost grounds, but which level of government does what is largely a political choice with no important economic consequences. Of course, should provinces choose to compete by administering federal taxes less effectively, some economic consequences obviously would ensue, particularly when some of the costs of provincial actions are borne by non-residents (Baretti, Huber and Lichtblau 2000).

Whatever provinces decide to do with respect to the tax base and tax administration, they 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 from such cooperation are the provincial governments, not the federal government.

Indeed, the *third proposition* emerging from Canadian experience is simply that federal cooperation can provide critical support to provincial sales taxes and may perhaps also provide some encouragement to improve those taxes from both an economic and administrative perspective. Federal cooperation may 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 their residents, they need federal cooperation to do so. Note, however, that this is unaffected by what kind of provincial sales tax is imposed. At present, for example, the federal government collects provincial sales taxes of all varieties at the border (for non-commercial imports) under certain conditions. 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. It does not work, however, with respect to the remaining provincial RSTs, both because the bases of these taxes are totally different than the base of the GST and because there is no cooperative tax administration agreement in place.

A single uniform national sales tax, perhaps with all proceeds allocated to the provinces, would clearly be much simpler than the present Canadian system. Australia has such a system, although it allocates the revenues in accordance with an equalizing formula rather than attempting to do so on a destination basis, as Canada's HST revenue allocation approach does. As Bird and Smart (2010) discuss, in effect Australia has given a much higher priority to simplicity and central fiscal dominance than to attempting to develop more fiscally responsible and relatively autonomous state governments.

Canada has, perhaps more through necessity than choice, struck a different balance. Of course, achieving an acceptable degree of coordination in a two-level sales tax structure requires considerable effort. First, basic political agreement has to be secured between governments with different interests and, in some cases, very different circumstances. Second, an appropriate legal framework to implement that agreement has to be worked out. Third, an appropriate administrative structure must be agreed on. Fourth, to make the system work over time, appropriate oversight and cooperation systems between governments need to be developed and put into place.

The first decade of discussion of these matters in Canada produced the quite different QST and HST approaches. Another decade has resulted in three more provinces, Ontario, Quebec and—at least temporarily—British Columbia, deciding to adopt the HST tax base, albeit, within limits, more or less on their own terms. Step by step, Canada has thus moved slowly, but perhaps inexorably, toward the kind of (roughly) integrated federal-provincial sales tax system envisaged long ago in some of the earliest studies of this question. Looking forward, it seems likely that this progress will continue, with every province with an RST—even perhaps British Columbia once the current political scars heal—at some point deciding to join the HST system. Of course, if some provinces choose to stick with the tried, true and defective RST, the world will not come to an end. Instead, because the main harm will be borne by their own residents, those residents can, if they wish, change the system, or move—which is more or less how a federal system is supposed to work in any case.

To conclude, it may be worth mentioning that Canada's unique two-level VAT system might be more easily integrated and improved (from an economic and technical perspective), and perhaps even more readily accepted politically if another unique feature of that system—the separate quotation of the tax—were to be replaced by the normal tax-inclusive pricing structure of most VATs in the world. While no one seems to be talking about it, this important change is by no means impossible. While from some perspectives there are, as Bird (2010) argues, good political economy reasons to favour the present highly visible GST/HST system, governments—and perhaps even most citizens—might nonetheless for various reasons prefer to move to tax-inclusive pricing (Millar 2010). As Sherman (2009) discusses in detail, the present GST/HST law provides that tax-inclusive pricing may be made mandatory in the HST provinces by a simple federal order-in-council, once 51 percent of the population in provinces with sales taxes is in HST provinces. When Ontario and British Columbia joined the HST in 2010 that option became open, and it remains viable even with BC's impending departure from the HST system. Although no reference to tax-inclusive pricing appears in the recent provincial sales tax agreements, those interested in the future of sales taxation, both federal and provincial, in Canada would seem well advised to keep a close eye on this issue.⁴⁷

⁴⁷ Parenthetically, the issue of GST visibility has recently been raised in a quite different context in connection with a proposal for an optional local GST earmarked for specific projects (Vander Ploeg 2011). Although Dalhby's (2011) critical discussion of this option makes many good points, it does not comment on the interesting way in which this

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