Fifty Years of Canadian Commodity Taxation: Key Events and Lessons for the Future

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PRÉCIS

Les impôts sur la consommation, c'est-à-dire les impôts prélevés sur la vente de biens ou de services, ont exercé un rôle de premier plan dans la fiscalité au Canada au cours des 50 dernières années. Dans l'ensemble, durant cette période, ces impôts ont représenté environ 10% du produit intérieur brut. Cependant, étant donné que les autres impôts, tel l'impôt sur le revenu, ont augmenté par rapport au produit intérieur brut, les impôts sur la consommation ont perdu de leur importance relative dans la composition des recettes publiques.

Les impôts sur la consommation sont de deux types, les taxes de vente générales et les taxes d'accise spécifiques. Le gouvernement fédéral et les provinces prélèvent ces deux genres d'impôts, et les deux ont subi des changements considérables au cours des années. Cet article identifie et discute de six événements particulièrement importants dans l'évolution de l'impôt sur la consommation au cours des 50 dernières années.

1) L'adoption de taxes sur les ventes au détail par les provinces au cours des années 1950 et 1960 a eu lieu à une époque d'augmentation dans les dépenses sociales, et une fois en place ces taxes ne rencontrèrent que peu de résistance. Pour contrer aux objections concernant leur équité, les taxes provinciales sur les ventes au détail comportaient d'importantes exemptions pour les produits considérés comme essentiels.

2) Au cours des dernières années, l'événement le plus important ayant trait aux impôts sur la consommation a été l'instauration de la taxe sur les produits et services (TPS) qui remplaça la taxe de vente des fabricants (TVF) du gouvernement fédéral. Les discussions concernant les options de remplacement de la TVF, qui avaient occupé presque toute la période des 50 années précédentes, reflétaient l'opinion très répandue que la taxe comportait de graves lacunes. La complexité est un des principaux problèmes de la TPS, et on peut l'imputer en grande partie à la décision d'introduire des exemptions importantes.

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3) Le Canada a été à l'avant-plan dans l'instauration de crédits de taxe de vente remboursables. Le recours au régime de l'impôt sur le revenu pour octroyer des crédits soumis à un critère de revenu est une alternative aux exemptions accordées dans un régime de taxe sur les ventes pour répondre aux problèmes d'équité. Dans le cas de la TPS, l'intention au départ était de se servir exclusivement de crédits remboursables pour résoudre la question de la régressivité, mais, en bout de ligne, on a également incorporé d'importantes exemptions dans le système.

4) En recourant aux taxes sur la consommation, le programme énergétique national (PEN) servit à démontrer que des droits d'accise spécifiques peuvent être un instrument politique puissant pour atteindre un objectif que le gouvernement en place considère comme suffisamment important. Pour le gouvernement fédéral, les impôts sur la consommation peuvent être un moyen pour mettre en oeuvre des politiques qu'il serait difficile de poursuivre à partir de programmes de dépenses ou de l'impôt sur le revenu.

5) Si les questions de revenu et les impôts sur l'alcool, le tabac et les carburants pour moteurs ont été des facteurs constants dans les impôts sur la consommation, la liste des taxes d'accise spéciales sur d'autres produits a été modifiée. Durant les premières années de l'après-guerre, les problèmes macro-économiques étaient ceux qui dominaient l'ordre du jour, et les taxes d'accise étaient liées à des objectifs économiques généraux. Au cours des dernières années, les taxes d'accise sont davantage liées à des objectifs spécifiques tels que l'imposition reliée aux avantages, les problèmes de l'environnement et les objectifs de la santé publique, ou bien elles sont utilisées comme des impôts de remplacement.

6) Étant donné que la consommation n'est en général pas très mobile, les impôts sur la consommation ont toujours été considérés comme des impôts qui pouvaient être plus élevés que ceux des juridictions avoisinantes. La révolte contre la taxe sur la consommation au début des années 1990, qui fut caractérisée par une vague d'achats transfrontaliers aux États-Unis et la contrebande, indique que les impôts sur la consommation peuvent être en butte à des contraintes internationales bien plus grandes que ce que l'on avait pensé.

L'article conclut par une discussion sur les perspectives d'avenir. Au cours du débat sur la réforme fiscale des années 1980, on semblait s'attendre à ce que le système fiscal s'oriente nettement vers les impôts sur la consommation. Aujourd'hui cette tendance semble peu probable. Toutefois certains événements à l'étranger, tels que l'adoption d'un impôt à taux uniforme aux États-Unis ou l'élargissement de l'assiette de la TVA en Europe pour y inclure les services financiers, pourrait susciter le Canada à, lui aussi, introduire d'importants changements. Le recours aux impôts sur la consommation (ou à d'autres taxes) comme instruments de politiques gouvernementales bat actuellement en retraite, mais cette tendance est dans une certaine mesure associée à l'influence prépondérante des déficits et de la lassitude généralisée envers les impôts. Lorsque ces facteurs reculeront, les impôts sur la consommation pourraient très bien reprendre leur attrait en tant que mesures pour appliquer des politiques importantes.

Il sera très difficile d'apporter des changements considérables à la TPS en procédant par étapes; la seule option qui semble plausible serait de l'harmoniser avec les taxes provinciales sur les ventes au détail. Nous devons nous attendre à ce que les pressions augmentent en faveur d'une telle harmonisation, et si elle a lieu, le principal problème sera celui de son administration. Étant donné que les capacités des provinces varient, la solution la plus probable sera l'instauration d'un régime national (à l'exclusion du Québec, qui applique déjà sa propre taxe de vente multi-stades) sur lequel les provinces exerceraient un certain contrôle.

ABSTRACT

Commodity taxes—that is, taxes that apply upon the sale of goods or services—have played a prominent role in Canadian taxation over the past 50 years. In aggregate, they have been equivalent to roughly 10 percent of GDP throughout the period. Because other taxes, such as the income tax, have increased relative to GDP, however, commodity taxes have been a declining element in the tax mix.

Commodity taxes can be divided into general sales taxes and specific excise taxes. The federal government and the provinces levy taxes of both types, and both have changed significantly over time. The article identifies and discusses 6 particularly noteworthy events in the evolution of commodity taxation over the past 50 years.

1) The adoption of retail sales taxes by the provinces in the 1950s and 1960s occurred at a time of expanding social expenditures, and these taxes met little ongoing resistance once they were in place. In response to concerns about fairness, the provincial retail sales taxes incorporated significant exemptions for necessities.

2) The most important event in commodity taxation in recent years has been the substitution of the goods and services tax (GST) for the federal manufacturers' sales tax (MST). The search for a replacement for the MST, which went on through almost all of the 50-year period under discussion, reflected a widespread recognition that the tax was badly flawed. Complexity is a major issue with the GST, and this can be largely traced back to the decision to introduce significant exemptions into the system.

3) Canada has been a leader in the use of refundable sales tax credits. The provision of income-tested credits through the income tax system is an alternative to the use of exemptions in a sales tax system to address concerns about the fairness of the latter. In the case of the GST, the initial intention was to rely exclusively on refundable tax credits to deal with regressivity, but in the end the system incorporated major exemptions.

4) The use of commodity taxes in the national energy program (NEP) showed that specific excises can be powerful policy instruments, if an objective is seen as sufficiently important by the government of the day.

Commodity taxes may provide ways for the federal government to implement policies that would be very difficult to pursue with expenditure programs or through income taxes.

5) Whereas revenue issues and the taxation of alcohol, tobacco, and motive fuels have been constant factors in commodity taxation, the list of special excise taxes on other commodities has changed. In the immediate post-war period, macroeconomic issues dominated the agenda, and the excise taxes of the day were related to general economic objectives. In recent years, excise taxes have been associated with more specific purposes, such as benefit taxation, environmental concerns, and public health objectives, or have been used as replacement taxes.

6) Because consumption is not usually very mobile, commodity taxes have historically been seen as taxes that can be higher than those in neighbouring jurisdictions. The commodity tax revolt of the early 1990s, characterized by cross-border shopping and smuggling, indicated that consumption taxes may be subject to international constraints to a greater degree than had previously been assumed.

The article concludes with a discussion of prospects for the future. During the tax reform discussions of the 1980s, the prevailing expectation was that the tax mix would shift significantly toward consumption taxes. This outcome now seems unlikely. Nevertheless, outside events, such as adoption of a flat-tax system in the United States or measures to broaden the VAT base in Europe to include financial services, could lead to major changes in Canada. Although the use of commodity taxes (or other taxes) for policy purposes is currently in retreat, this tendency is to some extent associated with the overriding influence of deficits and a general tax weariness. When these conditions abate, commodity taxes may very well again attract support as a means of implementing major policies.

Significant changes to the GST will be very difficult to implement in an incremental way, and only harmonization with the provincial retail sales taxes appears as a viable option. There will likely be increasing pressure for such harmonization, and if it occurs the major issue will be administration. Since provincial capacities vary, the most likely outcome is a national system (minus Quebec, which already has its own multistage sales tax) with some provincial oversight.

INTRODUCTION

Commodity taxes—that is, taxes that apply upon the sale of goods and services—play an important role in the Canadian tax system. In recent years, they have supplied just over one-quarter of the tax revenues for all levels of government. In the early 1950s, after the first set of post-war adjustments to tax systems, they provided almost half of government revenues. Moreover, they have often been seen as a tax source free of the constraints that international competition imposes on the use of other sources, and hence as one that Canada can use to finance relatively more social services than the United States provides.

This article reviews the history of commodity taxation over the last 50 years. Our emphasis, however, will be less on the details of that history than on the insights that the pressures and events resposible for the present system provide about possible future trends.[1] The present point in time is a very useful one from which to look back at the evolution of the commodity tax system—not only because it is the 50th anniversary of the Canadian Tax Foundation, which has played a pivotal role over the period in supporting research and fostering discussion, but also because it follows a period of significant change in the commodity tax system and in perceptions about the forces at work in the system. Although our discussion covers the whole 50-year period, it stresses the latter part of the period, which has the greater relevance to future developments.

Commodity taxes, once again, are taxes that apply upon the sale of goods and services and that can be regarded as consumption taxes. For the purposes of the article, we group commodity taxes into two major categories: (1) general sales taxes, which apply on a relatively uniform basis to a broad set of goods and services, and (2) taxes in the form of excise levies on specific goods or services. Both the federal government and all of the provinces except Alberta have general sales taxes. The federal government and Quebec levy their general taxes in a value-added form, whereas the other provinces apply retail sales taxes. The major excise levies are those applied to tobacco, alcohol, and motor fuels, but a variety of other taxes of this kind have also been used during the past 50 years. The article does not discuss customs duties (although they are included in some of the statistical information on revenues). Apart from one set of exceptions, the article also does not deal with resource taxes, even where they have taken the form of excise levies applied at the producer level. In general, resource taxes cannot be considered to be associated primarily with domestic consumption of the product.

We start with a brief overview of the commodity tax structure, key issues, and major events, proceed to a brief analysis of government revenues from commodity taxation, and then discuss the key events and trends of the 50-year period. The concluding section makes some observations about the current structure and about prospects for the future.

OVERVIEW OF STRUCTURE, ISSUES, AND MAJOR EVENTS

It is useful to begin by setting out very briefly the structure of the Canadian commodity tax system at the beginning of the 50-year period and its structure at the end of the period. This comparison serves to highlight

[1] The foundation has published a number of monographs that deal with various aspects of commodity tax history in the post-war period. They include J. Harvey Perry, *A Fiscal History of Canada—The Postwar Years*, Canadian Tax Paper no. 85 (Toronto: Canadian Tax Foundation, 1989); and A.J. Robinson, *The Retail Sales Tax in Canada*, Canadian Tax Paper no. 77 (Toronto: Canadian Tax Foundation, 1986).

some of the major developments over the course of the period. It also provides a background against which to introduce the issues that have determined these developments.

An extensive system of commodity taxes was already in place at the end of World War II. The federal government's general sales tax, the manufacturers' sales tax (MST), had been introduced in 1924 as a levy on all goods manufactured in Canada or imported into Canada. The tax rate in the immediate post-war years was 8 percent; it rose to 10 percent in 1951. Five provinces (Saskatchewan, Quebec, British Columbia, New Brunswick, and Newfoundland) had adopted general sales taxes by 1950. They took the form of retail sales taxes applicable on the purchase of tangible personal property for consumption or use in the province. Provincial retail sales tax rates in the post-war period ranged from 2 to 4 percent. In addition, there were a number of excise levies. The main federal excise levies were on cigarettes, alcohol, and gasoline; other excise levies applied to jewellery, watches, amusement devices, playing cards, smokers' accessories, automobiles, radios and television sets, cosmetics, soft drinks, and candies. The rates and coverage of these levies went through a period of turbulence after the war, and in 1954 the rates of many of them were sharply reduced. The provincial governments had significant gasoline taxes that dated from the 1920s and de facto liquor taxes in the form of the markups of the provincially controlled liquor monopolies.

Fifty years later, the federal general sales tax on manufactured goods has been replaced by the goods and services tax (GST), a value-added tax applicable to both goods and services. Certain supplies are either zero-rated (that is, they are taxed at a zero rate, and registrants for the tax are allowed a refund of taxes paid on inputs used in commercial activities) or exempt under the tax. The rate of tax is 7 percent. All of the provinces except Alberta have general sales taxes. Eight of the provinces have retail sales taxes; the Quebec sales tax (QST) is a value-added tax. The retail sales taxes vary somewhat from province to province; in general, however, they apply to supplies of goods, often including producers' goods, but contain significant exemptions. Both the federal government and the provinces continue to apply a variety of special excise taxes to specific commodities. The federal government derives significant revenues from taxes on tobacco, alcohol, and motive fuels. It also levies taxes on jewellery, automobile air conditioners, and air transportation, among other items. The provincial governments levy additional taxes on tobacco, motor fuels, and alcohol; in the last case, the taxes generally take the form of profits of provincially owned liquor distribution monopolies. The provinces also have a further set of special taxes, such as insurance premium taxes, amusement and admission taxes, meals and accommodation taxes, and pari-mutuel betting taxes.

A quick comparison of the post-war and 1995 commodity tax structures identifies several major changes over the period. The federal government has changed the form of its general sales tax, and general sales taxes have become nearly universal among the provinces. Meanwhile, the list of products subject to excise levies has changed significantly. The period has also seen important developments related to commodity taxation that these structural changes do not reveal. We shall discuss the following structural changes and other important developments in detail later in the article:

- The adoption of general sales taxes by the provinces.
- The substitution of the GST for the MST.
- The linking of the commodity tax and income tax systems through sales tax credits.
- The use of commodity taxes in the national energy program.
- Changes in the array of special excise taxes.
- The commodity tax revolt: border shopping and smuggling.

In reviewing these devlopments, it is useful to keep in mind certain basic issues that usually arise whenever a major change in commodity taxation is undertaken. In the case of general sales taxes, there are four such issues: the tax mix, tax-system design, federal-provincial considerations, and fairness.

The tax mix is the distribution of the total tax burden among the various types of tax. General sales taxes are applied to consumption, and thus relatively greater use of a general sales tax increases the relative benefits and costs of reliance on a consumption base in raising revenues. Taxes applied to other bases, such as income (personal and corporate) or employee compensation (payroll taxes), will have different effects on major economic variables such as savings, the supply of labour, and investment. The determination of the tax mix thus involves discussion of the tradeoffs that will arise in relying more or less heavily on a given type of tax. The most obvious occasion for discussions about the tax mix is when fundamental reform of the overall tax system is under way, since the opportunity to alter the mix, in order to achieve specific economic and tax system objectives, is never greater than it is on such occasions. The issue of the tax mix also arises, however, when governments decide to raise or lower taxes and must choose which taxes to alter. As will be seen, the tax-mix issue has been an important factor in the evolution of commodity taxation in Canada.

Tax-system design issues are the considerations that arise in deciding which type of tax to apply and in devising the tax's basic structure. In the case of a general sales tax, there are several specific aspects to this general issue. Will the tax be a multiple-stage tax, such as a value-added tax or a turnover tax? Or will it be a single-stage tax, one that applies at a particular level of trade, such as the retail level, the wholesale level, or the manufacturers' level? Will there be a single tax rate or several rates? Should the tax apply only to goods, or should it apply to services as well? Finally, once the basic form of the tax is established, it still remains to determine the specific scope of the tax. Who will the taxpayers be? Will certain activities, such as non-profit or governmental ones, be outside the scope of the tax?

Like most other aspects of public policy in Canada, the evolution of commodity taxes is heavily influenced by the fact that the jurisdictions of the federal government and the provinces overlap. In the sales tax field the result of this overlapping is that both levels of government levy general sales taxes. This situation raises problems that do not arise in the commodity tax systems of unitary states or in those of federations in which only one level of government applies a general sales tax.

The final basic issue is fairness. Since general sales taxes apply to consumption, and the most generally accepted indicator of fairness is ability to pay, as determined by income, there has been a constant concern that general sales taxes contribute to tax system unfairness. Since savings are proportionately larger at higher income levels, a general sales tax would appear to be regressive by definition. Concern about fairness has permeated the discussions of sales taxation and interacted in significant ways with discussions of the tax mix and tax-system design. Thus concern about the fairness of general sales taxes has acted as a counterbalance to arguments for proportionately greater reliance on such taxes and has also been prominent in policy debates about the need for significant exemptions (and, in the case of the GST, for the zero-rating of supplies).

In the case of excise taxes, the issues are similar but narrower in focus. The raising of revenue has typically been the primary reason for adopting excise levies, and so the use of these has usually been treated as part of the budgetary process rather than as a question of the overall mix of taxes in the system. The direct economic or tax-system implications of a particular selective excise have typically been used as a rationale for raising revenue or, in some cases, as the primary reason for introducing the tax. Use of the tax system for any purpose other than raising revenue in a fair and neutral fashion can be referred to as its use for regulatory purposes. Given their implicit targeting, specific commodity taxes are prime candidates for use in a regulatory fashion. The design of an excise levy is often heavily influenced by administrative or compliance factors, or by its regulatory purpose, if revenue is not the primary consideration. In specific instances, federal-provincial issues and fairness may also be factors.

COMMODITY TAXES AS A REVENUE SOURCE

Taxes on commodities have consistently played an important role as a revenue source in Canada. Figure 1 shows the ratio of taxes on commodities to gross domestic product (GDP) and to total taxes over the period 1955 to 1993.[2] This is a period for which consistent, comparable figures

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[2] The values presented are derived from the annual Organisation for Economic Co-operation and Development (OECD) publication *Revenue Statistics of OECD Member Countries*. That publication refers to taxes on commodities as taxes on goods and services, and its definition of such taxes is somewhat broader than the concept of commodity taxes that we have used in this article (for example, the OECD definition includes customs and import duties, and various licence fees). We retain the term "commodity taxes" in this section, however, in order both to maintain consistency with the rest of the article and to

(The footnote is continued on the next page.)

are available and one that excludes the transition to post-war government finance. The ratios presented cover the revenues of all levels of government—federal, provincial, and municipal and local.

The ratio of taxes on commodities to GDP shows the proportion of national income that governments divert to public purposes through the collection of such taxes. For the period in question, the most striking thing about this ratio is that it was almost the same at the end of the period (at 9.6 percent) as it had been at the beginning (at 9.5 percent). Therefore, the growth of commodity taxes between 1955 and 1993 paralleled the growth of GDP. In short, Canadian governments have not, on the whole, resorted to commodity taxes as a means of increasing their relative claim on resources in the post-war period.[3]

Although the endpoints are very similar, the ratio of commodity taxes to GDP did fall as low as 9 percent around 1960 and rise as high as 11.4 percent in 1981. In revenue terms, the difference between the high and low points is quite significant, amounting to some $17 billion in current dollars. These fluctuations are , however, largely related to specific events during the period or to the evolution of certain taxes over time. For example, the peak in revenues in the early 1980s reflects both the introduction of the federal commodity taxes associated with the national energy program (NEP) and the increase in the value of provincial revenues from non-recurrent resource revenues associated with the energy-price boom.

The pattern in commodity tax revenues over the period has also been the result of trends in some of the taxes included in the aggregate of commodity taxes. Although the ratio of commodity tax revenue to GDP was the same at both ends of the period, the composition of commodity taxes was not. Thus revenues from the federal general sales tax as a percentage of all commodity taxes approximately doubled between 1965 and 1993.[4] This upward trend was an irregular one; it fluctuated with changes in both the tax rate (which changed seven times in the period 1965-1993) and the base. Another significant factor was the introduction during the period of new excise levies (such as the federal air transportation tax, insurance premium taxes, and amusement and admission taxes), which as a group tended to increase in relative importance over time. A reduction in the relative importance of customs duties and taxes related to use (such as licences and permits) tended to offset the effect of this

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[2] Continued . . .
prevent any confusion with the GST. The somewhat broader coverage of the OECD statistics does not materially affect the discussion in this section. The OECD statistics have two advantages: they provide a consistent set of data for the period under discussion, and they can be used directly in international comparisons.

[3] The federal and provincial shares of total commodity tax revenue have also been relatively consistant, at least over the second half of the period. The federal share in the mid-1970s was around 45 percent, and in recent years it has been much the same.

[4] The comparisons in this paragraph refer to the period 1965 to 1993, for which consistent data are readily available, rather than the period 1955 to 1993, for which they are not. It also covers the period over which Ontario levied a retail sales tax.

increase. Small decreases also occurred between 1965 and 1993 in the ratios to total commodity tax revenues of provincial retail sales taxes and the profits of provincial liquor monopolies.

Overall, the change in the composition of commodity taxes reflects wider acceptance of the view that selective excise levies are a source of economic distortion and should not be used for revenue-raising purposes, except where there is a clearly identified policy need for market intervention by the government.

As a share of total tax revenues, commodity tax revenues declined sharply over the 1955-1993 period. In 1955, fully 44.4 percent of Canadian government revenues were attributable to commodity taxes. In 1993, only 26.5 percent of total revenues were from this source. As we have shown, commodity tax revenues have not declined as a proportion of GDP. Their decline as a share of total revenues has followed entirely from the fact that in the course of the period governments turned to other taxes—particularly the personal income tax—to finance the increased role of government. In other words, the tax mix has shifted away from commodity taxes and toward the income tax. Social security taxes (that is, payroll taxes in the form of Canada Pension Plan, Quebec Pension Plan, and unemployment insurance premiums and other levies associated with social insurance and provincial health care) have also grown in relative importance as sources of government revenues.

As figure 1 indicates, however, the decline in commodity tax revenues as a proportion of total government revenues has not been a constant one. Like the fluctuations in the commodity tax revenue/GDP ratio, the fluctuations in this ratio reflect specific events and trends in commodity taxation—and in other forms of tasation as well. Thus the tax mix was strongly affected by the impact of inflation on personal income tax revenues both before indexation was introduced in 1974 and after it was significantly restricted in 1985.

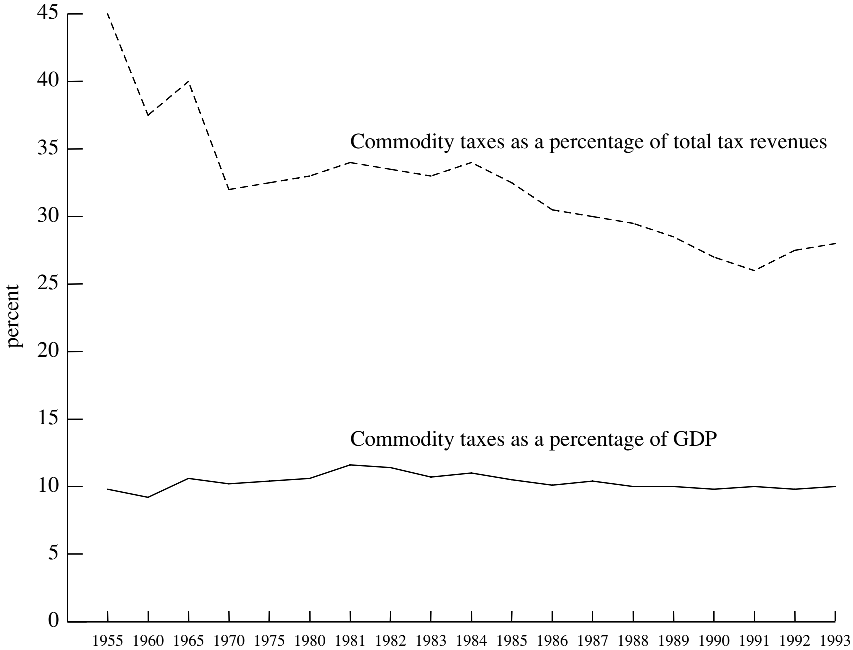
MAJOR EVENTS

Given this background, it is useful to look at six events or sets of events that have played a defining role for the current system of commodity taxation. In each case, we consider the event in terms of its implications for the tax mix, tax-system design, federal-provincial considerations, and fairness. We begin by discussing the key events related to general sales taxes and then turn to those related to excise levies.

The Adoption of Retail Sales Taxes by the Provinces

An important development during the early years of the post-war period was the completion of the occupation of the retail sales tax field by the provinces. Saskatchewan and Quebec had introduced retail sales taxes in 1937 and 1940, respectively. The other provinces, except Alberta, all adopted such taxes in the post-war period; Ontario (in 1961) and Manitoba (in 1968) were the last. It is one of the ironies of Canadian fiscal policy that Alberta, the first province to enter the field in 1936, quickly

Figure 1 Commodity Tax Revenues as a Percentage of GDP and Total Tax Revenues



Source: Organisation for Economic Co-operation and Development, *Revenue Statistics of OECD Member Countries*, various years.

withdrew from it and is now the only province not in it. The original debates about the adoption of these taxes are largely forgotten, but the legacy of these debates lives on in certain current attitudes about general sales taxes and in the bases that were adopted for the taxes.

A noted commentator, John F. Due, looking at the experience of implementation shortly after the majority of the provinces had adopted retail sales taxes, offered this conclusion:

> In general, in all of the provinces in which the taxes have been used, except Alberta [where the tax was repealed as the result of an internal fight within the governing Social Credit party], attitudes toward the tax have passed through the same sequence. The taxes have been proposed by the governments, not to replace other taxes, but to meet actual or prospective deficits, arising in many cases from expansion of social welfare services. Retailers, labor groups, and the government's political Opposition typically opposed the levy at the time of introduction and for a few months thereafter. As retailers became accustomed to the tax their complaints lessened, and other groups soon abandoned the fight. Few elections have been fought over the question of the sales tax, and in no case has a government been defeated primarily because it introduced such a tax. When governments have changed, the new government has carried on the tax because of the obvious need for the revenue. . . . Once the tax has been in operation for

two or three years, virtually all opposition has vanished, and the tax has become a permanent element in the revenue structure.[5]

The retail sales taxes, therefore, were generally adopted as a means of raising revenues to support the substantial expansion of social services in the 1950s and 1960s and were accepted as a necessary cost. Tax mix was not a driving issue: the dominant considerations were the fact that a retail tax represented an available base with significant revenue potential and the fact that, except in certain border communities, a retail sales tax would not significantly affect economic activity in the province.

Fairness was a major issue, and each province attempted to respond to concerns about fairness by adopting tax bases that exempted a set of necessities, including basic groceries. Concerns about revenues, tax rates, and administration meant that producers' inputs were to some degree at least included in the base. Although rates and exemptions have changed over time, the basic systems have remained essentially unaltered since they were introduced (except in Quebec, which moved to a multistage tax after the federal government adopted the GST).

The Substitution of the GST for the MST

The most important event in commodity taxation in recent years has been the federal governments's substitution of the GST for the MST. The debate about substituting some tax—indeed, almost any tax—for the MST raged with varying degrees of intensity through most of the 50-year period under discussion.[6] This debate ended with the introduction of GST in

[5] John F. Due, *Sales Taxation* (London: Routledge & Kegan Paul, 1957), 275.

[6] Indeed, the Rowell-Sirois commission identified and documented many of the problems associated with the MST in 1940 (see Canada, *The Report of the Royal Commission on Dominion-Provincial Relations* [Ottawa: King's Printer, 1940].) In 1956, the Sales Tax Committee recommended movement of the tax to the wholesale level (see Canada, *Report of the Sales Tax Committee* [Ottawa: Department of Finance, 1956]). In 1966, the Carter commission recommended shifting the federal sales tax to the retail level (see Canada, *Report of the Royal Commission on Taxation* [Ottawa: Queen's Printer, 1966]). In 1977, after the release by the government of a discussion paper on commodity taxation and public consultation, the Commodity Tax Review Group proposed that the tax be moved to the wholesale level (see Canada, Department of Finance, *Report of the Commodity Tax Review Group* [Ottawa: the department, 1977]). In 1983, the Goodman committee, which had been appointed to study this shift, instead recommended that the tax stay at the manufacturers' level but that there be changes to remove inequities between domestic and imported goods (see *Report of the Federal Sales Tax Review Committee* [Ottawa: Department of Finance, 1983]). In 1987, the government issued a white paper on tax reform outlining three alternatives for a multistage sales tax (see Canada, Department of Finance, *Tax Reform 1987: Sales Tax Reform* [Ottawa: the department, June 18, 1987]). At the same time, proposals of an interim nature were made that would have changed the tax base by, among other things, applying tax to sales of marketing companies associated with manufacturers and making the wholesale level the relevant point of taxation for a range of products. These interim measures were not implemented. Instead, in 1989, the government indicated that it would be proceeding with a multistage tax, which was implemented in 1991 as the goods and services tax. Of course, the above list comprises only the official documents and reviews. There was also extensive background work by governments and active academic discussion that considered an even broader range of alternatives.

1991, but it was immediately succeeded by a new debate about what to use to replace the GST. Both debates merit some discussion.

To begin with, there was very little disagreement during the period that the MST was badly flawed. It was widely agreed that the tax applied to too narrow a range of commodities, distorted production and distribution systems, produced widely different effective tax rates, distorted investment decisions (because of its imposition on producers' goods), treated imports preferentially, operated under an archaic system of administrative fiat,[7] and was unstable as a result of legal challenges. Many of these problems were recognized in the 1950s, and they became more pronounced over time. Even those who opposed particular proposals for changing the tax did so not because they admired the MST but because they had concerns about the proposed alternatives and the substantial compliance costs that would attend the adoption of interim, second-best measures.

Second, despite its many problems, the tax was able to continue to function reasonably effectively, albeit with growing strains, into the 1980s. What factors accounted for its longevity as a major revenue source in the face of constant criticism? There were, of course, the merits attached to an old, hidden tax, and the natural hesitancy of governments to undertake any major tax system change. This inertia was reinforced by a reluctance to risk introducing a new tax, even as a replacement for an old one, in the absence of either new and popular expenditure initiatives to which it could be linked or significant visible tax reductions elsewhere. Inertia alone, however, does not explain the tax's longevity. There were also several factors that allowed the system to function in spite of its grave weaknesses. The tax applied to a narrow group of taxpayers that benefited to a considerable degree from tariff barriers and, after 1971, a lower corporate income tax rate and other corporate income tax incentives. These taxpayers tended to be relatively cooperative with a tax regime in which considerable administrative effort was made to smooth out competitive anomalies through a system of "notional values" (administratively determined values designed to exclude wholesale and retail markups from the tax base). In any event, the absence of an appeals mechanism made it difficult to resort to the courts to defend positions opposed by the tax authorities. Finally, because of these factors, very little professional activity was directed to planning in order to reduce the impact of the tax.

During the 1980s, however, policy makers realized that the tax was beginning to break down as a reliable, sustainable major revenue source. This decline reflected the erosion of several of the sustaining factors noted above. Tariff protection was being reduced, and competitive pressures were intensifying. Taxpayers were becoming increasingly willing to

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[7] Canada, Department of Finance, *Tax Reform 1987: Sales Tax Reform* (Ottawa: the department, June 18, 1987), 23, indicated that "no fewer than 22,000 special provisions and administrative interpretations of the *Excise Tax Act* have been provided in an effort to achieve a reasonable degree of fairness and equity in the application of the tax."

plan with a view to reducing their tax obligations, and professionals were, accordingly, becoming increasingly involved in the sales tax area. An important factor was the institution in the early 1980s of an appeals mechanism, which led to an increasing number of court challenges. Successful planning by taxpayers created new anomalies in the system and unforeseen revenue leakages for governments. The result was what Harvey Perry referred to as "growing official desperation with the existing tax."[8] Meanwhile, the Department of Finance's analytical effort in respect of commodity taxes (which had amounted to a mere one-half person year in the mid-1970s) was expanded substantially to aid in the development of a viable option.

Factors not directly related to the MST created further pressures on the federal government to reform federal sales taxation. Income tax revenues had been relatively buoyant in the 1960s and 1970s, but by the 1980s there were obvious signs of discomfort with the marginal tax rates being applied. The discomfort was aggravated by international developments that were lowering income tax rates and increasing reliance on commodity taxes (for example, the introduction of VATs in Europe and new multistage taxes in Japan and New Zealand). In 1987, the federal government proposed a comprehensive tax reform plan under which a new multistage sales tax (based on one of three options) would replace the MST. The government saw the introduction of a new sales tax as an opportunity to provide certain personal income tax reductions and thus shift the tax mix toward consumption taxation. This approach was linked to the view, which was in vogue at the time, that a greater reliance on consumption/commodity taxes would bring economic benefits such as higher savings and allow a degree of revenue independence despite the growing international openness of capital markets. Underlying this view was the assumption that capital is more mobile than consumers. As we shall note below, this assumption has been challenged by recent events in Canada.

The public's reaction to the initial proposals for sales tax reform led to the fateful decision to make significant adjustments to the base. The minister of finance announced that a number of important categories of goods, including basic groceries, prescription drugs, and certain medical devices, would not be taxed under the multistage tax. Moreover, taxes paid by municipalities, hospitals, school boards, colleges, and universities would be partially rebated to ensure that there was no increase in these institutions' overall tax burdens. The original intention of extending the tax base to financial services was also abandoned. The base of the tax was thus quite significantly less than comprehensive. This outcome had important ramifications in respect of all four of the basic issues associated with a general tax. First, the proposed personal income tax reductions were abandoned, with the result that the introduction of the GST had

[8] J. Harvey Perry, *Taxation in Canada*, 5th ed., Canadian Tax Paper no. 89 (Toronto: Canadian Tax Foundation, 1990), 119.

relatively little impact on the overall tax mix. Second, the introduction of exemptions immediately raised the substantial design problem of defining boundaries for the tax-free activities. It also meant that the tax rate adopted was higher than it would otherwise have been. Third, the structure adopted faced Canadian businesses with two general sales taxes and two separate sets of exemptions. The result was a complex system that almost inevitably required the federal government to seek accommodations with the provinces in order to simplify the structure. The existence of exempt activities also meant that the tax could not be computed in an invisible manner from the books of accounts of a business. It required calculations at the point of each sale and thus became and remained highly visible. Finally, the structure adopted abandoned the use of refundable sales tax credits (delivered through the income tax system) as the fundamental response to the fairness issue and opted instead for a mixed system of exemptions and tax credits (see the next section).

There are essentially two views of the decision to adopt a narrower base. The first view, and the position of the decision makers of the day, is that the decision was a pragmatic one: it was necessary to narrow the base in order to secure enough support to implement the tax. The second view is that the decision was a critical mistake from which followed the more intractable of the subsequent woes associated with GST. According to this view, any major reform would have provoked significant short-run negative reaction, particularly given that there was increasing dissatisfaction with the government's policies in general. Consequently, the concessions did nothing to rally meaningful additional support for the tax. In fact, they created new opponents. The dual set of exemptions raised substantial compliance problems for small businesses, and certain sectors found themselves at a disadvantage in competition with other sectors; for example, most food for home consumption was zero-rated but restaurant meals were not. It is interesting to note that in both Japan and New Zealand, which opted for quite comprehensive bases in adopting new general sales taxes, opposition faded away very quickly. Had the architects of the GST adopted a broader base and a lower rate, subsequent commentators might have said, as Due said about retail sales taxes, "once the tax [had] been in operation for two or three years, virtually all opposition . . . vanished."[9]

Fairness and the Adoption of Refundable Sales Tax Credits

Concerns about fairness have always presented a fundamental obstacle to the use of general sales taxes. The usual response to these concerns has been to adopt design features that have negative economic and compliance or administrative effects. In the case of the provincial retail sales taxes and the GST, these features have taken the form of exemptions for "necessities" that presumably consume a greater proportion of a low income than they do of a high income. Even with such exemptions, however, general

[9] Supra, footnote 5.

sales taxes are regressive.[10] This fact in itself has been a formidable barrier to any move to increase the use of commodity taxes in the tax mix.

Canada has taken the lead in responding to the regressiveness issue by providing sales tax relief to lower-income taxpayers through the income tax system. In 1978, the federal government began to experiment with the use of refundable tax credits—that is, credits that are claimable through annual income tax filings and that can be used not only to reduce income taxes otherwise payable but also to generate cash payments if the value of the credits exceeds tax otherwise payable. The first federal credit of this type was the refundable child tax credit, but the concept was extended to sales taxes with the adoption in 1986 of the refundable sales tax credit. When the GST was introduced in 1991, a refundable GST credit replaced the refundable sales tax credit. Several provincial tax systems also provide refundable sales tax credits.

The 1987 white paper on tax reform[11] outlined three alternative schemes for a general sales tax, two of which it preferred to the third. The first alternative was a national sales tax, under which there would be a single federal-provincial rate in each province. The white paper tacitly assumed that there have to be exemptions, if the federal government and the provinces were to agree on a common base, but that there would be a single regime in place. The second alternative was a federal goods and services tax "levied at a single rate on virtually all goods and services in Canada."[12] Under this alternative, the refundable sales tax credit would be the sole response to fairness concerns. Although there would be two distinct sales taxes in each province, the federal one would not require a separate tax calculation on each invoice and therefore would not overlap with the retail sales tax calculation at the point of sale. The resulting federal goods and services tax would thus avoid a significant proportion of federal-provincial complexity effects. In the end, however, the government adopted the third alternative, a European-style invoice-and-credit VAT with significant exemptions. The refundable sales tax credits delivered through the income tax system play an important role in limiting regressivity, but they play this role in conjunction with exemptions. We have already pointed out that by confronting businesses with two overlapping sales tax systems the GST both significantly complicated compliance and administration and created a federal-provincial impasse.

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[10] Research for the recent Fair Tax Commission in Ontario concluded that "in 1991, RST [Ontario retail sales tax] paid as a share of average income decreased from 5.3 per cent of income for the 10 per cent of households with the lowest incomes to 2.7 per cent of income for the 10 per cent of households with the highest incomes." Ontario, *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission* (Toronto: University of Toronto Press, 1993), 526.

[11] Canada, Department of Finance, *The White Paper: Tax Reform 1987* (Ottawa: the department, June 18, 1987).

[12] Ibid., at 68.

The National Energy Program Taxes

The national energy program (NEP), introduced in 1980, was designed to provide the federal government with a share of the revenues arising from the increase in energy prices in the late 1970s. It was probably the single most significant use of the tax system in a regulatory fashion that has occurred in Canada.[13] The NEP included a set of special commodity taxes that were intended to raise some $15 billion over the three-year period 1980-1983. A further $10 billion was to be raised through the corporate income tax.

The special taxes of a commodity-tax nature were the following:

• The oil export charge was levied on exports of oil at a rate equal to the difference between the international price of oil and the domestic wellhead price.

• The petroleum compensation charge was imposed on all domestic consumption of crude oil. It was intended to bring the price of domestic oil up to that of imported oil.

• The natural gas and gas liquids tax was imposed on domestic and export sales of natural gas and liquids. Its purpose was to help the federal government achieve its desired share of natural resource revenues.

• The petroleum and gas revenues tax was applied to the net operating revenues of energy producers before the deduction of exploration and development costs, interest, and capital cost allowances. Like the previous tax, it was intended to give the federal government a share of the resource rents associated with the increase in energy prices.

For the purposes of this article, the key factor to be noted is the critical role played in the NEP by taxation in general and commodity-type taxes in particular. One of the authors of the present article made the following points in a paper that discussed the use of the tax system for regulatory purposes:

> While reserving judgement about the objectives of the program, one can safely conclude that use of the tax system was indispensable to the design of the program. Given the provincial ownership of energy resources, taxation was the only instrument available to the federal government to extract an appropriate share of the revenues resulting from the increase in energy prices. The government was prepared to go to any length to overcome the traditional constraints on the use of the tax system. In order to administer the program and monitor its results, it was necessary to impose significant additional information requirements on the resource industry. The new taxes were structured so that they did not run afoul of either the constitutional provision granting immunity to the provincial governments from federal taxation or the non-discrimination requirements under the international tax treaties in respect of income taxes.[14]

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[13] See Satya Poddar, "Taxation and Regulation," in Richard M. Bird and Jack M. Mintz, eds., *Taxation to 2000 and Beyond*, Canadian Tax Paper no. 93 (Toronto: Canadian Tax Foundation, 1992), 71-96, at 83-85, for a more detailed discussion of the tax aspects of the NEP.

[14] Ibid., at 84.

The national energy program is the most extreme example of how commodity taxes can be harnessed for the purpose of pursuing government policy objectives. As the above comments make clear, they have attributes that make them potentially powerful instruments for implementing policies that are designed both to raise significant revenues and to achieve regulatory goals.

The Changing List of Specific Excise Taxes

If one compares the list of excise taxes in place immediately after World War II with the current list, it is clear that, except for alcohol, tobacco, and motive fuels, there has been an almost complete reformulation of the commodities subject to excise levies. This reformulation reflects the fact that even if a given excise is levied primarily in order to raise revenue the selection of the particular commodity to be taxed usually depends upon some rationale related to the nature of the commodity. In some cases, this rationale is rather general and provides only a loose motive for the tax. In other cases, the rationale is very specific; indeed, it may be the primary motive for applying the tax and revenue may be only a marginal (or nonexistent) factor.

Excises that are intended primarily to generate revenues and that do in fact generate substantial revenues tend to become permanent parts of the tax structure—witness the excises on alcohol, tobacco, and motive fuels. These excises apply to products for which demand is relatively inelastic over a fairly broad range of prices and that account for significant levels of consumer expenditures. On the other hand, excises whose revenue-raising function is less important than some other rationale tend to come and go as the issues of the day change.

The following list categorizes special excises according to the rationales that have been cited in support of their application:

- Luxury taxes designed to raise revenue on goods consumed by the wealthy.
- Taxes to ration goods in short supply.
- Taxes applied in lieu of user charges.
- Taxes to provide funds to offset the effects of demerit goods.
- Specific taxes designed to function essentially as an alternative to taxation under a more general tax (either because the effectiveness of the general tax in respect of the good or service is in question or because it is not feasible to apply the general tax in its normal form to the good or service).
- Taxes designed to alter consumption and resource allocation in a particular way.

A look at the excise taxes in a specific period can reveal a good deal about the primary preoccupations of the day. For example, the focus during World War II and for some time thereafter was primarily macroeconomic, and the substantial excises in place at the time were directed to objectives such as rationing and altering consumption for general economic reasons. They were also considered to be a means of raising revenue on "non-essential, luxury" goods. John F. Due observed that

> [d]uring World War II, a number of excises were imposed, many at rates from 25 to 35 per cent, for the purpose of raising revenues and checking consumption, particularly of imported goods. These excises were in large measure regarded as a substitute for an increase in the general sales tax, and a more effective means of checking consumption of articles particularly scarce or regarded as unnecessary. Some of these taxes were cut in 1945, but in 1947, as the result of exchange rate difficulties, rates were raised and many items—virtually all of consumer durables, for example, were brought within the scope of the excises. Rates on automobiles were set as high as 75 per cent.[15]

The specific excises of this era were largely eliminated as these general economic concerns receded under post-war expansion. Over time, however, new excises were adopted in their place. The rationales for these excises tended to have a microeconomic orientation and often reflected environmental, health, benefit, and tax-replacement considerations. The rationales for these taxes, however, are not usually set out in explicit detail in government documents and in some cases are open to debate. Some existing federal excises and their apparent rationales are as follows:

- Jewellery excise tax—luxury taxation.
- Air transportation tax—benefit taxation.
- Automobile air conditioner tax—to affect consumption (that is, to promote energy conservation).
- Automobile weight taxes—to affect consumption (that is, to promote energy conservation).
- Leaded gasoline tax—to affect consumption (that is, to promote protection of the environment).

The big three among federal excise taxes, those on alcohol, tobacco, and motive fuels, have all been affected in recent years by changing views of their roles. To be specific, an increased emphasis on their implications for consumption has accompanied increases in their rates. For example, the largest single increase in the history of tobacco taxation at the federal level, contained in the February 1991 budget, was motivated at least in part by concerns about the effects of tobacco on public health. The shift in emphasis from revenues to public health concerns is evident from the commentary that accompanied the budget measures. The 1991 budget was the first to refer explicitly to the sensitivity of cigarette consumption to price increases, and it stressed the effectiveness of taxes in reducing demand for tobacco.

Provincial governments have enlarged their range of selective excises over time, and the rationales for these taxes reflect considerations similar

[15] Supra footnote 4, at 165.

to those for the federal excises. The provinces, with some exceptions, apply insurance premium taxes, amusement and admission taxes, meals and accommodation taxes, and pari-mutuel betting taxes. In general, the primary purpose of these taxes is to raise revenue, and each of them functions to a greater or a lesser extent as a replacement tax or a benefit tax. There are also some more idiosyncratic taxes, such as Ontario's "gas guzzler tax" and British Columbia's graduated passenger vehicle tax and a legal services tax, that either deal with particular issues of the day or are highly targeted means of broadening the base of the retail sales tax to include particular services.

There are several problems that can arise in the use of selective excises. First, excises sometimes outlive their usefulness in terms of their original policy intent but linger on as "old" revenue-raising taxes. Second, the structure of the tax may be flawed in some serious way, since excises do not generally have to stand the scrutiny to which more general taxes are exposed. Third, if they are very narrow in application, they may be unfair. Two taxes that imbody one or more of these shortcomings are the federal jewellery excise tax and the retail sales tax where it applies to insurance premiums, as it does in Ontario, Quebec, and Newfoundland.

The federal jewellery excise tax is a 10 percent tax on the manufactured value of jewellery that uses the old MST structure. Other, similar excises were eliminated when the GST was introduced, but the jewellery excise was retained. The retention was purely on revenue grounds, since the concept of luxury taxation had been discarded for all other products. The tax's structure exhibits all of the negative features that characterized the MST.

Financial services are generally exempt from taxation under both retail sales taxes and VATs, since as a rule it is extremely difficult or impossible to isolate the value-added or consumption component of the revenue flows in a financial transaction. Apart from payments on a commission basis or a fee basis, none of the identifiable payments in financial transactions represent the appropriate tax base, which is the financial margin earned by the financial institution. In the case of insurance, the appropriate base is the premiums received less the claims paid, since this difference represents the value of the financial service provided by insurers. To apply the retail sales tax rate to the total value of the premium, as some provinces do, results in a tax with a very high effective rate.

The Commodity Tax Revolt: Border Shopping and Smuggling

The use of commodity taxes, in preference to income taxes, often rests on the assumption that consumption is less mobile than either capital or income. There is a general perception that it is becoming increasingly difficult to apply income taxes, particularly taxes on capital or on income from capital. Bird and Mintz, for example, have suggested that the tax mix is likely to be influenced by increasing globalization:

> With growing economic integration . . . , mobile tax bases are likely to become more difficult to tax since such bases either leave the country or

are able to avoid payment of tax altogether. Not only capital income but also certain skilled individuals are highly mobile.[16]

If consumption is in fact less mobile than other tax bases, then commodity taxes should provide governments with a means of sustaining a level of taxation higher than the level in neighbouring jurisdictions, and hence a higher level of services or a greater degree of regulation as well. Canada's experience in the early 1990s, however, indicates that there may be greater constraints on the use of commodity taxes in excess of those in neighbouring jurisdictions than has been supposed. The increase in the federal and provincial tobacco taxes during the 1980s ushered in a period of sharply escalating smuggling of tobacco products from the United States and through Indian reserves. In the eastern provinces, these smuggled goods captured a large and growing share of the market. At the same time, short trips to the United States primarily for shopping purposes increased dramatically. The combined economic benefits of the lower excise taxes on tobacco, fuel, and alcohol and lower general sales taxes in the United States were seen as an important contributing factor to such cross-border shopping trips.

Subsequent shifts in the exchange rate significantly reduced the attraction of cross-border shopping, but it took a very large, coordinated federal-provincial reduction in tobacco taxes to choke off smuggling. It is clear that tax levels were not the only factor behind the cross-border shopping and the smuggling: the exchange rate, public annoyance about the GST, and government unwillingness to police smuggling all played a role as well.[17] Nevertheless, the experience does suggest that consumption of goods and services is increasingly mobile across borders and that consumption taxes may be as much subject to international constraints as income taxes.

GAZING INTO THE FUTURE

The foregoing review of key events and trends over the past 50 years provides a useful perspective from which to make some observations about the current structure and to speculate about likely trends in commodity taxation in the future.

Given the forces currently at work, it appears unlikely that the tax mix will shift in a significant way toward consumption/commodity taxes in the near future. This conclusion is in contrast to the prevalent view a decade ago, when VAT-type taxes seemed to be in the ascendant. Commodity taxes in Canada are roughly double those in the United States, and the events of a few years ago suggest that cross-border shopping and other avoidance/evasion activity is a barrier to any significant increases in these taxes. Moreover, consumption taxes are not popular, and the

[16] Richard M. Bird and Jack M. Mintz, "Future Developments in Tax Policy" (1994), vol. 22, no. 3 *Federal Law Review* 402-13, at 407.

[17] For example, see ibid., at 407-8.

economic arguments for greater use of such taxes are unlikely to overcome the political aversion to them—particularly at a time when widespread tax fatigue has made it very difficult to adjust any tax, even as part of a revenue-neutral package.

Therefore, the expectation must be that the future will reflect the experience of the past 50 years, in the course of which commodity tax revenues remained relatively constant as a proportion of GDP. It follows that the share of commodity tax revenue in total government tax revenues will depend upon the buoyancy of other tax revenues. The strong tax weariness occasioned by rising taxation in recent years (a rise that has taken the form of increases in both the ratio of total taxes to GDP and the gap between Canadian and US tax levels) suggests that tax revenues from other sources are not likely to increase significantly relative to economic activity in the near future. Even payroll taxes, which are lower in Canada than they are in most other industrial countries and therefore have often been cited as prime candidates for further increases,[18] are beginning to meet strong resistance. It is widely agreed that payroll taxes depress employment levels, and the federal government has discouraged further provincial use of them by denying income tax deductibility for payroll tax amounts in excess of current levels.

For the foreseeable future, then, the tax mix is likely to remain very much as it is. It is interesting that the only recent proposal for a major change in the tax mix has largely disappeared from view. The Ontario Fair Tax Commission proposed a shift in the tax mix toward income taxation (some $3 billion more in personal income taxes for Ontarians) as a fundamental part of reforms designed to reduce the funding of education through property taxation. The unpalatable nature of this key ingredient has undoubtedly been a major factor in the failure of these reforms to receive serious consideration.

Although decisions about the tax mix are likely to be middle-of-the-road and are not likely to be inspired by strong new positions on the mix itself, there is a possibility that outside events will prompt a shift toward commodity taxes (or consumption taxes). Two important outside factors that may affect the Canadian commodity tax structure are the US flat-tax debate and European efforts to broaden the VAT base. The proposals for a US flat tax essentially involve a general tax with a consumption base arrived at through the expensing of capital goods. In essence, the flat-tax approach involves a blurring of the distinction between income taxes and consumption taxes in order to deal with the difficulties associated with the taxation of income from capital. The European Community is looking into the potential for broadening the VAT base in certain areas, such as financial services, which are now generally exempt. These initiatives could

[18] For example, ibid, at 412-13, concludes that "[t]he taxes most likely to increase in importance are those that are most difficult to avoid and those that are not large by international standards. In Canada, the most prominent example of such a tax is undoubtedly the payroll tax."

well affect the Canadian tax structure, since they deal with issues that are of equal importance in Canada.

There is at present a retreat from using taxes for any purpose other than raising revenues. This retreat follows worldwide experimentation with their use to achieve economic stabilization, reduce inflation, and provide incentives for economic growth. According to the prevailing view, tax policy has not yet proved to be especially effective in realizing any of these goals. It is likely, therefore, that use of the tax system, including commodity taxes, for policy reasons will be more limited in the future. The point is worth making, however, that views on the effectiveness of the use of taxes for policy purposes are coloured by the associated costs. In the current environment of large deficits and tax weariness, the cost of using tax instruments to achieve policy ends is high. Given reduced deficits, commodity taxes might again be called into use to achieve an objective of overriding importance. The NEP showed that commodity taxes can be mobilized effectively when the objective is a compelling one.

At present, the issue of commodity tax design is largely synonymous with the question of what to do with the GST, which has so far proved resistant to change. The main problem with the current GST design is its complexity. The GST is not the fair and simple tax that the previous government claimed it was when it introduced it. The present government has committed itself to replacing the GST. Although the commitment has sometimes been naively interpreted as a promise simply to eliminate the tax, this is clearly impossible in the current fiscal environment. The government has made it clear that its commitment is to devising an equal-revenue replacement. Its search over the past two years for a suitable replacement, although interesting and informative, has been inconclusive. The government's failure to build a political consensus for any alternative suggests that there is tremendous resistance to any revenue-neutral reform measures in the area of commodity taxation.

Once it became clear that replacement of the GST by the income tax or excise taxes was not viable (given the already high levels of income tax and the structural difficulties associated with extending the excise taxes to other commodities), only two general options remained: to move to a more comprehensive and less visible tax, such as a business transfer tax, or to harmonize with the provinces. The result in either case would have been a system that was simpler than the unpopular GST. The government was, however, constrained to abandon the attempt to substitute a more comprehensive tax owing to concerns that the extensions of the base that would be necessary to allow the tax to be hidden were too sensitive and clashed with the political philosophy behind the commitment. The failure of this initiative is really just another example of how difficult it is to make changes in an incremental way.

Harmonization, then, is effectively the only option left to pursue. There will be increasing pressure on the provinces to move to multistage taxes and harmonize their retail sales taxes with the federal system. The VAT structure is more efficient than the retail tax structure, and the extension of tax to services would reflect the increasing importance of services in the economy and the reduced distinction between goods and services. A broad-based tax structure is the only solution to the pressures raised by the application of different effective tax rates to different business sectors. The complexity of the current system is another important factor pointing toward future harmonization.

There are significant constraints, however, upon the type of harmonization that can be achieved. Governments are reluctant to give up powers, and there is little likelihood that any level of government will abandon any tax field entirely as part of a deal to streamline the structure. Highly restrictive solutions too are not likely to prove viable. The negative reaction to the federal government's "11 percent solution," a proposal to apply a uniform federal-provincial tax across the country and share the revenues, has already made this clear. Harmonization is likely to be achieved only in the same way as it was achieved in the case of the income tax—that is, by adopting a common base but allowing the provinces to apply their own tax rates. This approach would address the difficulty associated with Alberta's position, since it would effectively allow that province to maintain its status quo of no provincial tax.

If a harmonized system is adopted, the major issue will be administration. Since provincial capacities are unequal, the likely outcome is a single administration with some degree of oversight available to the provinces. As in the case of the income tax, however, Quebec is likely to be an exception, particularly given that it has already established a tax administration for its own provincial multistage tax.