The Evolution of Indirect Taxes

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ABSTRACT
Indirect taxes have long maintained a somewhat painful position in the hearts of Canadians. In some cases, they have been in place longer than the country itself, while the introduction of the much-maligned goods and services tax and its cousin, the harmonized sales tax, are still relatively recent developments. Loved or hated, they are a part of the Canadian fiscal portfolio that is unlikely to change, because the increased Canadian reliance on these taxes reflects trends already apparent elsewhere in the world. This article traces the history of indirect taxes in Canada and elsewhere, and looks ahead to see how they are likely to fare in the world’s economy in the years to come.

KEYWORDS: INDIRECT TAXES ■ CONSUMPTION TAXES ■ GOODS AND SERVICES TAX ■ HARMONIZED SALES TAX ■ VALUE-ADDED TAX ■ COMMODITY TAXES

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INTRODUCTION
During the last 25 years, countries all over the world have made significant investments in fiscal stimulus. These expenditures have had important results in alleviating a world recession, but, in combination with falling tax revenues, they have also resulted in historic deficits in many countries. Governments now need to balance their books; a broader tax base, higher taxes, and a stronger focus on tax enforcement seem inevitable. But which taxes will be identified as a possible source of increased revenues? Many believe that indirect taxes on consumption, such as value-added tax (VAT), goods and services tax (GST), and excise taxes, will play a major role.

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Interestingly enough, until recently, the trend has been in the opposite direction. According to a 2007 policy brief issued by the Organisation for Economic Co-operation and Development (OECD), the share of tax revenue contributed by taxes on consumption in member countries declined from above 38 percent in 1965 to below 32 percent in 2005.¹ This was a shift in tax burden rather than a reduction, with the fall in the share of taxes on consumption being balanced by an increase in the share of taxes on income—in particular, a significant increase in the share of social security contributions. In the same period, however, VAT/sales taxes as a percentage of global taxes on business grew from above 25 percent to close to 40 percent.

We have also seen a change in the nature of indirect taxes. Previously, consumption tax revenues mainly came from taxes on specific goods and services, such as excise taxes. But today, the majority of indirect tax revenues come from general consumption taxes such as VAT and GST. Since 2000, general consumption taxes alone account for around 15 percent of total taxation in the majority of OECD member countries, and in some countries, such as Hungary and New Zealand, VAT/GST receipts now account for more than 26 percent of total tax revenues.²

The shift from taxes on income to taxes on consumption in the current economic environment was openly acknowledged at the OECD’s high-level conference on VAT held in Lucerne, Switzerland on September 9 and 10, 2009. The meeting brought together senior tax policy officials from 25 OECD member countries, the European Commission, and five non-member countries to discuss the role of consumption taxes in today’s global economy, how these increasingly important taxes might develop in the years ahead, and how their operation may be improved. The OECD’s report on the conference noted, “Tax revenues will be important as countries seek to rebalance their books. Revenues from corporate taxes are likely to take a significant time to recover and there will be an increased reliance on other forms of taxes.”³

If the balance of taxation is shifting toward indirect taxes, governments will face important tax policy decisions. They may need to broaden the scope of these taxes or increase their rates. And they may need to modernize and simplify their VAT/GST tax legislation, their administrative practices, and their compliance rules if consumption taxes are to play this crucial economic role effectively. Taxpayers will also need to consider the likely impact of this trend on the tax life cycle of compliance, liability, planning, and controversy.

The shift in focus toward indirect taxes began in the late 20th century, as many countries adopted VAT and similar taxes, and it has gained momentum as a result of the global recession. Consumption taxes are being called on to cover record budget deficits caused by reduced direct tax revenues and the cost of fiscal stimulus packages.

² Ibid., at 3, figure 1.
Canadians, for their part, have had a long relationship with sales taxes, as we will show in the historical review that follows.

THE CANADIAN EXPERIENCE—A HISTORICAL OVERVIEW

The Canadian Constitution Act, 1867,\(^4\) provides for a division of powers between the federal Parliament and the provincial legislatures. While the provincial legislatures are restricted to the imposition of direct taxes within provincial boundaries, the federal Parliament has the power to raise money by “any Mode or System of Taxation.”\(^5\) As a result, the Canadian government has always been able to levy a variety of different types of sales tax, including a manufacturers’ tax, excise tax, a wholesale tax, or—as we know all too well—a VAT (the GST). Seizing upon that authority, the government has explored many of these options.

For more than 50 years after the country was formed, customs and excise duties provided the bulk of federal revenues. The Excise Act (which still exists today alongside its cousin the Excise Act, 2001) is in fact one of the oldest statutes in Canada, existing in some form even before Confederation. Under it, the government placed taxes and duties on liquor, beer, and tobacco products, and these, of course, remain today.

A sales tax at the federal level was originally introduced in 1920. This “temporary” 1 percent turnover tax applied at every level except the final retail stage, and it was levied in part to deal with the considerable debt generated by Canada’s participation in the First World War.

In 1924, the turnover tax was replaced with a 6 percent manufacturers’ sales tax, which would remain in place in some form for over 60 years. This was a single-stage federal sales tax (FST) that generally applied to a manufacturer’s sale of goods manufactured or produced in Canada, or to the duty-paid value of goods imported into the country. The tax achieved the government’s objective, in that it produced sufficient revenues, but it was not without its problems, including the following:

- The FST was a cascading tax. Because manufacturers paid the tax on inputs that they acquired for use in manufacturing or producing other goods, but could not recover that tax, it became embedded at each successive stage.
- Because the FST applied only to manufacturers (some 70,000 at the time the tax was eventually replaced), it seemed to unfairly target the Canadian manufacturing and production sector.
- Valuation problems around the base to which the tax was applied also favoured imports over domestic production. For example, the sales prices for Canadian manufacturers incorporated distribution costs such as advertising, while these were not included in the tax base for comparable imported goods.

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4 Constitution Act, 1867, 30 & 31 Vict., c. 3 (UK).
5 Ibid., section 91(3).
Finally, by the time the FST was abolished, the tax base had been eroded through the implementation of hundreds of exemptions for commodities such as food, books, health products, heating fuels, and most machinery and equipment.

While the federal government appreciated the problems, it could not eliminate the FST altogether, because the country had become dependent on the revenue that it produced. However, the government did undertake to try to improve the application of the tax. To this end, it began a sales tax improvement process that was to last for decades, and would include studies by a variety of committees and royal commissions. The highlights of the review process are summarized below:\(^6\)

- In 1937, the Royal Commission on Dominion-Provincial Relations suggested that the FST should be gradually eliminated.\(^7\)
- In 1956, a federally appointed Sales Tax Committee recommended that major changes be made to the existing manufacturers’ sales tax.\(^8\) Most notably, it recommended that the tax be charged at the wholesale level. While this recommendation was not adopted, minor changes to the tax were made over the course of the next few federal budgets.
- In 1966, the Royal Commission on Taxation (the Carter commission) went so far as to propose that the best solution would be a national sales tax levied at the retail level on a common tax base, payable by consumers and administered by the provinces.\(^9\) However, the proposed tax did not provide a mechanism for the recovery of input tax, and therefore would not have solved the problem of cascading inherent in the existing FST.
- During the 1970s, the Department of Finance undertook its own internal review of the problems posed by the existing tax. In 1977, the Commodity Tax Review Group recommended that the FST should be imposed at the wholesale level,\(^10\) and the 1981 federal budget actually announced the government’s intention to move forward with such a tax.\(^11\) However, the initiative foundered in the face of widespread opposition.
- In 1983, yet another federally appointed sales tax review committee agreed that the existing tax should be replaced; however, it rejected a wholesale tax as

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\(^6\) The summary that follows is largely based on Richard Domingue and Jean Soucy, *The Goods and Services Tax: 10 Years Later*, PRB 00-03E (Ottawa: Library of Parliament, Parliamentary Research Branch, June 15, 2000), “Background to the GST’s Introduction.”

\(^7\) Canada, *Report of the Royal Commission on Dominion-Provincial Relations* (Ottawa: King’s Printer, 1940).

\(^8\) Canada, *Report of the Sales Tax Committee* (Ottawa: Queen’s Printer, January 1956).


\(^11\) Canada, Department of Finance, 1981 Budget, November 12, 1981.
an alternative and instead offered the government a choice among three other options: a national retail sales tax, a federal retail sales tax, or a federal VAT. The committee itself favoured the third option and recommended “that the provinces be encouraged to join in the administration of such a tax.”

In November 1984, following broad-based consultations with the provinces, business, and other interested groups, the government announced that it was considering the introduction of a VAT; then, in February 1986, it announced in the federal budget that it was studying the option of a “business transfer tax.” The latter was conceived as an accounts-based subtraction method VAT: businesses would calculate the amount of tax payable by multiplying their total sales by the tax rate, then subtracting their total purchases multiplied by the same rate. Since the tax would be calculated using existing accounting information, it was promoted as resulting in lower compliance costs. However, largely as a consequence of the complications posed by the need to harmonize taxes with different rates, the idea was abandoned.

By this time, the government recognized that there were other problems with the federal tax system that it needed to address, in addition to the issue of the FST. Accordingly, in July 1986, it announced that the Department of Finance was engaged in drafting proposals for a “comprehensive reform of the federal tax system.”

Thus, by the mid-1980s, the time was ripe for significant changes to be made to the FST. Various unsuccessful attempts had been made to alleviate problems within the existing legislative framework. Indeed, the tax was popularly referred to as “the tax of 40,000 rulings,” in tribute to the efforts of administrators in what was then the Excise Branch of the Department of Revenue—Customs and Excise, who were charged with the dubious task of keeping a sinking ship afloat.

However, the good men and women of Excise could only do so much, and the death of the FST seemed inevitable.

Comprehensive sales tax reform in Canada eventually had, some might say, unlikely heroes in the persons of Brian Mulroney and Finance Minister Michael Wilson. Mulroney’s second term as prime minister dawned in the midst of an economic recession. The government was faced with a mounting national debt and an FST that had simply ceased to function effectively. Although the rate of the largely

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13 Ibid., at 58.
14 Canada, Department of Finance, A New Direction for Canada: An Agenda for Economic Renewal (Ottawa: Department of Finance, November 1984).
hidden tax had steadily increased to 13.5 percent, continuing erosion of the tax base made it less reliable as a revenue source. With little other choice, Mulroney began what was to be a three-year consultative process to study possible replacements.

In a 1987 white paper, the government declared its clear preference for a single national VAT to replace the existing system of federal and provincial sales taxes.\footnote{Canada, Department of Finance, \textit{Tax Reform 1987: Sales Tax Reform} (Ottawa: Department of Finance, June 18, 1987).} However, exploratory forays in this direction indicated that there was little support for such a tax. Eventually, after the 1988 election, the government announced that it would introduce its own invoice-credit VAT as a replacement for the FST.

The chosen course thus revealed, the government started down the road that would lead to implementation of the new tax system. It soon became clear that Canada was about to adopt an entirely unique model for its version of a VAT.

**The Canadian Goods and Services Tax**

From the outset, most believed that every effort should be made to move away from the multiple rates and exemptions that characterized most European VAT systems. To the contrary, many of Canada’s policy makers at the time advocated a system like the one introduced in New Zealand in 1986. New Zealand’s GST had seemingly been implemented with nary a whimper. Advertised by a series of folksy commercials, and accompanied by income tax reductions at the time of implementation, the tax had a single rate and very few exemptions. However, as the Canadian model began to take shape, it became apparent that Canada’s GST would be more complicated.

The first area of debate targeted the proposed application of the tax to food. While Department of Finance officials and most of the business community believed that the GST should apply to groceries, there was a public outcry over the notion that the new tax would apply to the basic necessities of life. Faced with evident public outrage on the issue, the government yielded to the extent of promising that “basic groceries” would not be subject to the tax. This compromise, of course, resulted in anomalies in the classification of taxable items, such as the infamous “pig rule” (referring to the fact that five donuts were taxable while six were not).

Medical services and equipment and residential rents soon joined the list of excluded supplies. Charities and non-profit organizations, initially misunderstanding the negative consequences of being “taxable” under a VAT, lobbied to be exempt, and unfortunately for them, got their way. Finance Minister Wilson then announced that municipalities, universities, schools, and hospitals (“the MUSH sector”) would bear no greater tax under the new GST than they had borne under the previous FST system. This set the stage for the negotiation of rebate rates with each group, which would be used by members of those groups to reclaim a portion of their otherwise unrecoverable input tax.
In 1989, the government released a technical paper that provided the roadmap for the reform that was to come.\textsuperscript{18} The paper clearly set out the case for reform:

- First, the GST will reduce the FST-induced biases that affect consumption and production. It will eliminate the bias in favour of imports and eliminate the hidden tax on exports, thus improving the international competitiveness of Canadian producers. Improved competitiveness will lead Canadian business to expand operations and jobs. The GST will also ensure that the relative prices of competing goods and services better reflect underlying economic costs. This will result in decisions that use resources more efficiently, leading to significant increases in total productivity and potential output.
- Second, the GST, by fully refunding the tax on business inputs, will lower the cost of capital goods, thereby generating higher levels of investment, a larger capital stock, and greater potential output.\textsuperscript{19}

Still occasionally relied on by practitioners today who are trying to argue the intended tax policy in a particular situation, the technical paper also set out the framework for the new tax. Despite the concessions that had been made, public support for the tax continued to decline and the government referred its technical paper to the House of Commons economic and finance committee. The committee recommended a number of additional changes to the tax, including reduction of the proposed rate from 9 percent to 7 percent.\textsuperscript{20}

In January 1990, Finance Minister Michael Wilson tabled Bill C-62, the legislation that was to give birth to the new tax. Rather than introduce a new statute (for reasons that were never entirely clear, even at the time), the government chose to enact the GST legislation as part IX of the Excise Tax Act\textsuperscript{21}—the same statute that had imposed the FST. Rules to provide for the transition from one tax to the other were included in part VIII of the Act.

The legislative passage of the new tax was to take the government over more bumpy terrain. The bill was approved in the House of Commons, where the Conservatives held the majority, but there appeared to be little support among the public at large. Meanwhile, in the upper chamber, Liberal senators vowed to kill the bill. However, they were not prepared for the constitutional manoeuvre that was to follow. With the approval of the governor general and the queen, Prime Minister Mulroney invoked section 26 of the Constitution Act, 1867 (the so-called deadlock clause) to make eight temporary additional appointments to the Senate, thus creating an instant Conservative majority in the upper chamber.

\textsuperscript{18} Canada, Department of Finance, \textit{Goods and Services Tax: Technical Paper} (Ottawa: Department of Finance, August 1989).
\textsuperscript{19} Ibid., at 31.
\textsuperscript{21} RSC 1985, c. E-15, as amended.
The ploy worked. Attempts by the Opposition and by some provinces to challenge the tax in the courts were not successful, nor was a long and noisy filibuster by Liberal senators on the eve of the bill’s passage.

And so, battles having been fought and blood having been spilled, the legislation to implement the GST received royal assent on December 17, 1990 and took effect on January 1, 1991.

This did not, however, end the controversy. Several provinces (led by Alberta) challenged the constitutionality of the GST. On June 25, 1992, the Supreme Court of Canada ruled in favour of the federal government.22 The court held that the GST does not violate provincial jurisdiction because its purpose is essentially to raise revenue for the federal government, and its effects on matters within provincial jurisdiction are therefore incidental to this purpose. The court also rejected the claim that businesses should be compensated for the cost of collecting and remitting the tax.

In the end, the Mulroney government paid a high price for what some might call its act of fiscal courage (and for its earlier implementation of the Canada-US free trade agreement). In the 1993 election, the first to be held after the introduction of the GST, the former Conservative majority in the House of Commons was reduced to a mere two seats.

The new Liberal government had promised in its pre-election Red Book that it would replace the hated GST with “a system that generates equivalent revenues, is fairer to consumers and to small businesses, minimizes disruption to small business, and promotes federal-provincial fiscal cooperation and harmonization.”23 Once in office, it reconsidered the business transfer tax that had been rejected by the previous government. However, citing constitutional reasons, the House of Commons finance committee, which had been tasked with considering possible options, decided that the federal GST should instead be replaced with a harmonized federal-provincial sales tax.

THE HARMONIZED SALES TAX

The first progress toward tax harmonization came via Quebec, but probably not in a manner that would have been foreseen, or indeed desired, by most.

In 1991, the federal government and the government of Quebec entered into an agreement that made the provincial government responsible for the administration and collection of the GST in Quebec. Then, in 1992, Quebec introduced its own VAT, the Quebec sales tax (QST). Since that time, the Quebec government has essentially harmonized the QST with many elements of the GST. In 2011, this process was advanced with the announcement that the Quebec and federal finance ministers had signed a further memorandum of agreement regarding sales tax harmonization.

That agreement provided for the implementation of additional changes to the QST effective January 1, 2013.

The Quebec-Canada GST marriage has not been without its challenges; the sometimes subtle, sometimes significant, differences in the province’s legislation and administrative practices have posed challenges for Quebec-based businesses. Nevertheless, most would concede that the collaboration was a step in the right direction.

Meanwhile, the federal government continued its efforts to achieve harmonization between the GST and the retail sales taxes in the other provinces. A milestone was reached in 1996, when the federal government announced that it had signed memorandums of understanding with the governments of Nova Scotia, New Brunswick, and Newfoundland. These were followed by the negotiation of comprehensive integrated tax coordination agreements with the respective provinces. The agreements provided for administration and collection of a new federally imposed harmonized sales tax (HST)—again, a VAT—with both federal and provincial components. Under complex formulas, each province receives its proportional share of HST revenues, and the federal government makes one-time “compensation” payments to each province in return for the harmonization. The agreements also include conditions that provide for provincial flexibility in rebates, including point-of-sale, public service body, and housing rebates.

The legislation implementing the HST received royal assent on March 20, 1997 and took effect on April 1, 1997. The original HST framework agreements arguably provided insufficient incentives for additional provinces to agree to harmonization. However, over time, the federal government loosened the reins and agreed to greater flexibility in the ability of provinces to tailor their tax bases, as well as enhanced financial inducements to adopt the HST. As a consequence of that decision, the harmonization train has continued to roll, with only one significant impediment along the way:

- Ontario and British Columbia harmonized their retail sales taxes with the GST effective July 1, 2010.
- Almost unbelievably, however, the BC government, giving effect to the results of a province-wide referendum on the HST, exited the HST system and restored its previous provincial sales tax effective April 1, 2013.24
- More recently, in Prince Edward Island, the provincial government adopted the HST effective April 1, 2013.25

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24 British Columbia, Ministry of Finance, “Action Plan in Place To Return B.C. to 12% PST/GST,” News Release, August 26, 2011 (www2.news.gov.bc.ca/news_releases_2009-2013/2011FIN0067-001048.htm). It will be interesting to see how the BC government will find the revenues to reimburse the $1.599 billion in transitional assistance received from the federal government when it opted into the HST.

Thus, by the end of 2012, all provinces except Manitoba, Saskatchewan, and Alberta (which currently has no provincial sales tax) have either implemented or announced some harmonization with the federal GST—although, as noted, British Columbia has decided to return to the old system.

**DEVELOPMENTS IN OTHER JURISDICTIONS**

In Europe, since 2008, a clear trend has emerged toward increased indirect tax rates, involving both VAT and excise duties. This will undoubtedly increase the share of indirect taxes as part of total revenue for many countries in the coming years. The average standard VAT rate across the 27 member countries of the European Union oscillated for many years around 19.5 percent before it started to rise steadily after 2008. By the start of 2012, the average EU VAT rate had passed 21 percent. The trend continued throughout that year, with further increases imposed in Italy (from 21 percent to 23 percent), Ireland (from 21 percent to 23 percent), Cyprus (from 15 percent to 17 percent), and Hungary (from 25 percent to 27 percent).

It is notable that countries are now raising their standard rates above the threshold that applied in the past. When Hungary set its new standard VAT rate at 27 percent, it broke the magic barrier for the top EU rate, which for a long time was believed to be 25 percent. Considering that many, mainly northern, EU countries already charge 25 percent, it is quite possible that other European countries may follow Hungary’s lead in the coming years unless economic conditions improve.

It is not just the standard VAT rate that is on the rise. One recent development is that EU countries are also starting to raise their reduced VAT rates. France, Greece, Italy, Norway, Poland, Portugal, and the Czech Republic have all recently increased their reduced rates or removed goods and services from the scope of the lower rate. Interestingly, this trend could eventually lead to more countries charging a single tax rate. Traditionally, European countries have applied a range of VAT rates and used reduced rates for basic needs such as foodstuffs or to favour local industries, such as tourism. In other parts of the world, reduced rates are less common, and many countries, such as Chile, Israel, and Japan, have a single VAT rate. The Czech Republic could be the first EU country to enter this group with its plan to merge its two existing rates into a single-rate VAT of 17.5 percent by 2013.

Even in the United States, the only OECD country currently without a VAT/GST, some newspaper commentators have called for the introduction of a federal general consumption tax to help cover the budget deficit, discourage consumer spending, and stimulate personal saving. While a federal VAT may not be in the cards, individual US states are now seriously considering the introduction of general consumption taxes to cover their budget deficits.

While it is clear that the Obama administration will not initiate a discussion at this time on the possible implementation of a VAT, since such a move would almost certainly amount to political suicide, it will be interesting to see what will be done to address the country’s fiscal imbalance. The United States relies more on income taxes, as compared with consumption-type taxes, to raise revenue than any other
major developed nation, even taking into account state sales taxes. One factor that may trigger increased interest in a US VAT is the difficulty of raising additional revenue under the current income tax system. Higher tax rates may be problematic because they have been found to be damaging to the economy. The 2007 OECD policy brief suggests that, compared to other types of taxes, income taxes are among the least conducive to economic growth. This observation is borne out by the increased use of consumption-type taxes in many OECD member countries.

There is no way to predict if or when a US VAT will be enacted, but given the present and forecast budget deficit outlook, strong consideration of a national VAT may be inevitable. Over the past 40 years, many articles have been written on the tax increases/spending cuts needed to reduce the US deficit to below 4 percent of gross domestic product (GDP) in 2015 (from the almost 9 percent of GDP in 2010), including implementation of a US VAT.

The options can be summarized as follows:

- raise individual income taxes;
- raise all taxes;
- cut all Medicare, Medicaid, and social security spending;
- cut discretionary spending;
- cut all spending;
- cut all spending and raise all taxes; or
- impose a VAT.

These options appear to make a US VAT an attractive choice, since many would say that taxes can no longer be increased and to cut spending would not be economically viable under current conditions. However, some members of the US Congress are strongly opposed to such a tax because they believe that the substantial revenues that it would raise would ultimately lead to bigger government.

Three US states—Texas, Ohio, and Michigan—already impose a receipts-based tax that is very close in form and substance to a VAT. Others are now considering this option. On September 29, 2009, a tax reform package was put to the California State Legislature, which includes a proposal to replace the corporate income tax and the state general fund sales tax with a business receipts sales tax similar to a VAT. If this consumption tax legislation is passed in California, other states may follow.

What is clear is that it will be very difficult for the US government to rely on increases in personal or corporate income taxes to eliminate the deficit, and it remains to be seen whether the deficit can be fixed with spending cuts. Higher income

26 Supra note 1, at 4-5.
tax rates may be problematic because they have been found to be damaging to the economy. The US statutory corporate income tax rate, at 39.2 percent (including both federal and state corporate tax rates), is the second highest among the 50 largest economies. In an effort to lower corporate income tax rates, a VAT could be a revenue-offsetting enabler, as well as help to pay down the federal deficit.

The United States has a relatively low tax burden as a percentage of GDP, but its income tax burden is relatively high, at 46.8 percent (in 2008) as a share of total tax revenue, compared to consumption taxes at 17 percent. In other OECD countries, corporate and personal income taxes as a share of total revenue were 36.4 percent in 2008 while consumption taxes were 30.9 percent.28

What are the options?

The United States is the only country among the developed economies with no broad-based consumption tax at the national level. Yet economic analysis suggests that consumption taxation is superior to income taxation because it does not penalize savings and investments. Whether this argument will ultimately prove persuasive, only time will tell.

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