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Goods and Services Tax Reaches a Difficult Age

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This article looks at the GST at age 15, and identifies its successes and its two key failures—namely its frequent reliance on retroactive tax amendments and its failure to harmonize comprehensively with the provinces.

The impending reduction in the rate to 6% and the stated intention to further lower the federal rate to 5% in the future may have breathed life into the possibility of a National Sales Tax system. But, would such a tax regime live up to its billing as a simple system?

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Goods and Services Tax reaches a difficult age

Mike Firth and Brian Wurts of PricewaterhouseCoopers discuss how the Goods and Services Tax has performed since it started 15 years ago and how the federal government and the provinces might overcome the obstacles to a national sales tax

At 15 years of age, the Canadian Federal Goods and Services Tax (GST) is at a crossroads. There have been some economic and fiscal successes, but two notable failures. One is the GST's dubious distinction of being the tax statute that has taken retroactivity from a desperate last resort, to an ingrained brutal habit. The second is Canada's dismal failure to evolve to one, centrally administered sales tax, the yield from which is shared between federal and provincial governments; five provinces still independently operate a sales tax. The new federal government's initiative to cut the GST rate to 6% in July 2006 and to 5% within this mandate has great potential; it could break the political ice jam and move Canada to a single national sales tax system, or it could lead Canada into more costly complexity and mess. This article reviews the GST's progress to age fifteen, and surveys the promise and angst of its imminent adolescence.

Origin of the tax

The GST was introduced as a replacement for the Federal Manufacturers Sales Tax (FST). Not intended to increase federal revenues, it was implemented to rectify many of the structural economic defects associated with the former outmoded manufacturers' tax, particularly its negative effect on competitiveness.

The 1991 birth was a difficult one for a tax perceived by small business as an accounting nightmare and by the public as a tax grab. In fact, initially the GST raised significantly less revenue than the manufacturer's sales tax it replaced. Combined with the unpopularity of the Conservative government of Brian Mulroney, the tax was an easy target which the media found irresistible to exploit. The Canadian Senate finally passed the Bill introducing the GST only two weeks before it went into effect.

Successes

Given the turmoil surrounding its birth, there was a question whether the GST would last a year. Talk of tax revolt was everywhere. The GST enjoyed an orderly implementation, however, resulting in no detectable price inflation. Over the past 15 years, the GST has, by most accounts, performed well and has become, though begrudgingly, an accepted part of the Canadian fiscal landscape. There have been some problems to be sure – highly publicized cases of tax evasion with fly-by-night companies claiming input tax credits for fictitious purchases before vanishing from sight, and fraudulent exports of vehicles by used car vendors. But, in the main, the GST has been a dependable and growing source of revenue to the federal government, raising, according to the Department of Finance 2006 Budget Plan, some C$31.9 billion ($28.7 billion) in 2005-2006.

Failures

Harmonization – an elusive prize

A real threat to the GST came in 1993, when a Liberal government was elected on a platform featuring a promise to scrap the GST. An extensive review by the House of Commons Finance Committee concluded that the GST was the best of the available alternatives however. It also highlighted one of GST's greatest failures, by recommending efforts be undertaken to integrate the federal tax with those of the provinces to maximize the fiscal and economic benefits. The best that could be achieved was inclusion of three provinces in 1997. Newfoundland and Labrador, Nova Scotia and New Brunswick now model the ideal for all of Canada, the Harmonized Sales Tax (HST) being a single integrated sales tax serving federal and provincial needs.

This shortsighted and harmful practice may spread to other statutes

Quebec has struck its own peculiar, plunky chord on harmonization. In 1997, Quebec migrated its provincial sales tax statute to a near image of the GST, and now the provincial authority administers and collects both the provincial and federal taxes. While Quebec cannot be said to be truly harmonized, it has moved itself to an idiosyncratic state of being almost there.

The dogged persistence of five Canadian provinces in independently operating retail sales taxes creates duplication of administration by governments, higher compliance costs for businesses and a drag on Canada's economic competitiveness through the taxation of business inputs and capital assets by retail sales taxes. Canada remains a resident in the most costly hotel on the highway to sales tax harmonization.

Retroactivity

The most unattractive role of the GST has been to provide the ground on which

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Brian Wurts, a senior manager in PricewaterhouseCoopers, has over 20 years' experience working in the area of indirect tax.

Wurts joined PricewaterhouseCoopers in Toronto in early 2000, as a senior manager in the indirect tax group, primarily focusing on GST issues. Since joining PwC, he has worked extensively advising on GST implications of the deregulation of the Ontario electricity market, as well as advising clients in several other industry sectors, including the insurance and tourism industries.

The majority of his career has been with the tax policy branch of the Department of Finance in Ottawa. In particular, Wurts was the chief of the policy development group for the GST from 1988 to 1995, during the development of the tax and the following four years after its implementation.

Subsequently, Wurts worked overseas in Vietnam, first as a tax adviser for the IMF from 1995 to 1997, before joining PwC where he led the VAT practice in Vietnam from 1997 to 2000.

successive governments have disgraced themselves with the introduction of retroactive tax legislation. While finance minister in 1996, Paul Martin resorted to harsh retroactivity to deal with a number of legislative missteps, striking the grandfathering from amendments he himself had introduced only 18 months earlier. These were hotly debated at the time, and presented as being a regrettable measure of last resort, but necessary to maintain the integrity and stability of the new tax. Many noted at the time that this would be a slippery slope. They were right, and further retroactivity followed, most often directed at financial institutions, the extinguished rights of which receive an unattended funeral. Fast forward to November 2005; amendments are proposed retroactive 15 years to the introduction of the GST, on two minor interpretive matters, both of which have already been before the courts. One taxpayer won its case in 2003, and the other is still awaiting a Tax Court of Canada decision now possibly rendered academic by retroactivity.

As a stand-alone measure, therefore, the economic rationale for reducing the GST rate is dubious at best

Perhaps the most enduring tax legacy of Paul Martin's time as Canada's Finance Minister will be this: Those doing business in and with Canada, particularly in the financial services sector, should make their decisions subject to the caution that Canada offers limited certainty about the legislative framework within which its taxpayers order their affairs. If a taxpayer should differ with the government's view of the law, then retroactivity is routinely considered on GST matters, and recourse to it is now a persistent feature of Canada's fiscal landscape. This shortsighted and harmful practice may spread to other statutes.

The GST at the crossroads

After years of being a source of embarrassment and discomfort for successive Liberal governments, the GST now has been pushed back into the limelight. The new Conservative government's plan to reduce the tax rate appealed to many consumers. However, the decision to reduce the GST rate rather than lower income taxes has been questioned by economists on the basis that consumption taxes, such as the GST, are widely viewed as less disruptive to the economy than income taxes. Also, the reduced GST rate undercuts the administrative efficiency of the tax.

As a stand-alone measure, therefore, the economic rationale for reducing the GST rate is dubious at best. The key issue is whether the reduction in the rate may be undertaken in such a way so as to attain the elusive goal of a national sales tax system.

Much has been made of the fiscal imbalance between the federal and provincial governments. While the federal government has been systematically realizing budget surpluses over the past decade, with the exception of Alberta, provinces are at best struggling to break even. Ontario, whose participation would be critical to

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Mike Firth has over 25 years' experience in dealing with sales taxes. In addition to leading the Canadian indirect tax practice of PwC, he has extensive experience in advising the insurance and mortgage lending sectors. He spent the first 10 years of his career with UK Customs and Excise in a variety of value added tax (VAT) enforcement, administration and audit roles before joining the London, England office of PwC to specialize in VAT as it applied to the financial sector. In 1990, he moved to Canada to assist clients of PwC with implementation of the Canadian GST and has continued to specialize in sales taxes in the financial sector. He has also worked with finance sector clients in Australia and Barbados as those jurisdictions introduced a VAT. A long standing GST adviser to the Canadian Life and Health Insurance Association, Firth has rendered GST assistance to many other industry associations including the Investment Funds Institute of Canada and the Canadian Insurance Adjusters Association.

realize a truly national sales tax system, has the largest deficit of the provinces.

The prospect of the federal government reducing its reliance on the GST has rekindled the national sales tax debate. To the extent that the rate reduction may be viewed as the federal government vacating its tax room, the provinces could choose to move into that space to address their budgetary shortfalls, and at the same time, they could harmonize their sales tax regimes into a single national sales tax.

The economic benefits of a move to such an integrated system would be substantial. In a paper released at the 2005 CICA Commodity Tax Symposium, Pierre Bocti and David Douglas Robertson argued strongly for the removal of retail sales taxes to simplify the tax system and on the basis that they tax business inputs and capital assets and negatively impact growth and prosperity. Presumably, the switch to harmonized federal-provincial national sales tax would have similar economic benefits to those which accompanied the replacement of the FST by the GST.

Just how much would a national sales tax save government and business? In a study commissioned by the Public Policy Forum in 1997, Bob Plamondon estimated business compliance costs for provincial retail sales taxes to be between C$400 million and C$700 million ($359 million and $628 million). Add to this the provincial governments' costs of administering the tax and it is clear that substantial savings would be attained if provincial sales taxes were eliminated in favour of a centrally administered national sales tax.

The announcement of a reduced rate in the 2006 Budget was not positioned as a pump primer for a harmonization initiative, or as a ceding of tax room to the provinces. It was presented simply as a tax break for consumers. By the time the new federal government took power and released its budget, the provincial budgets for 2006 had all been announced. So, timing and the stated rationale for the rate reduction precluded any linkage to a harmonization strategy.

Looking forward, the Conservative government has indicated its desire to further reduce the GST rate to 5%. If this is explained not as a tax break for consumers, but rather as an integral element of the creation of a national sales tax which will give lasting benefits to the Canadian economy, it may well be the stimulus needed to obtain the participation of Ontario and the other retail sales tax provinces.

While the prospect of a single national sales tax now is closer than it has been since 1990, this approach to achieving it could come with a cost. In this situation, the federal government's share of the tax would be only 5%, compared to either 9% or 10% for the provinces. Unlike the current HST, where the tax policy and administration is dictated by the federal government, would the provinces demand a greater say in the formulation of policy under such a national sales tax? Would complex voting rules be needed for changes to the tax policy to be enacted – where the federal government and the provinces each are assigned voting weights based on their relative shares of revenue? What type of voting rules would be workable in such an arrangement? Worse yet, could we end up with a federal GST and multiple provincial VATs, each with its own set of rules, tax rate and tax base? Hopefully, reason will prevail and Canada can finally achieve the elusive goal of an integrated national sales tax with a common rate, base and administration.

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