Canadian Fiscal Federalism and the Dual VAT

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to the

Visiting Delegation of Brazilian Finance Officials

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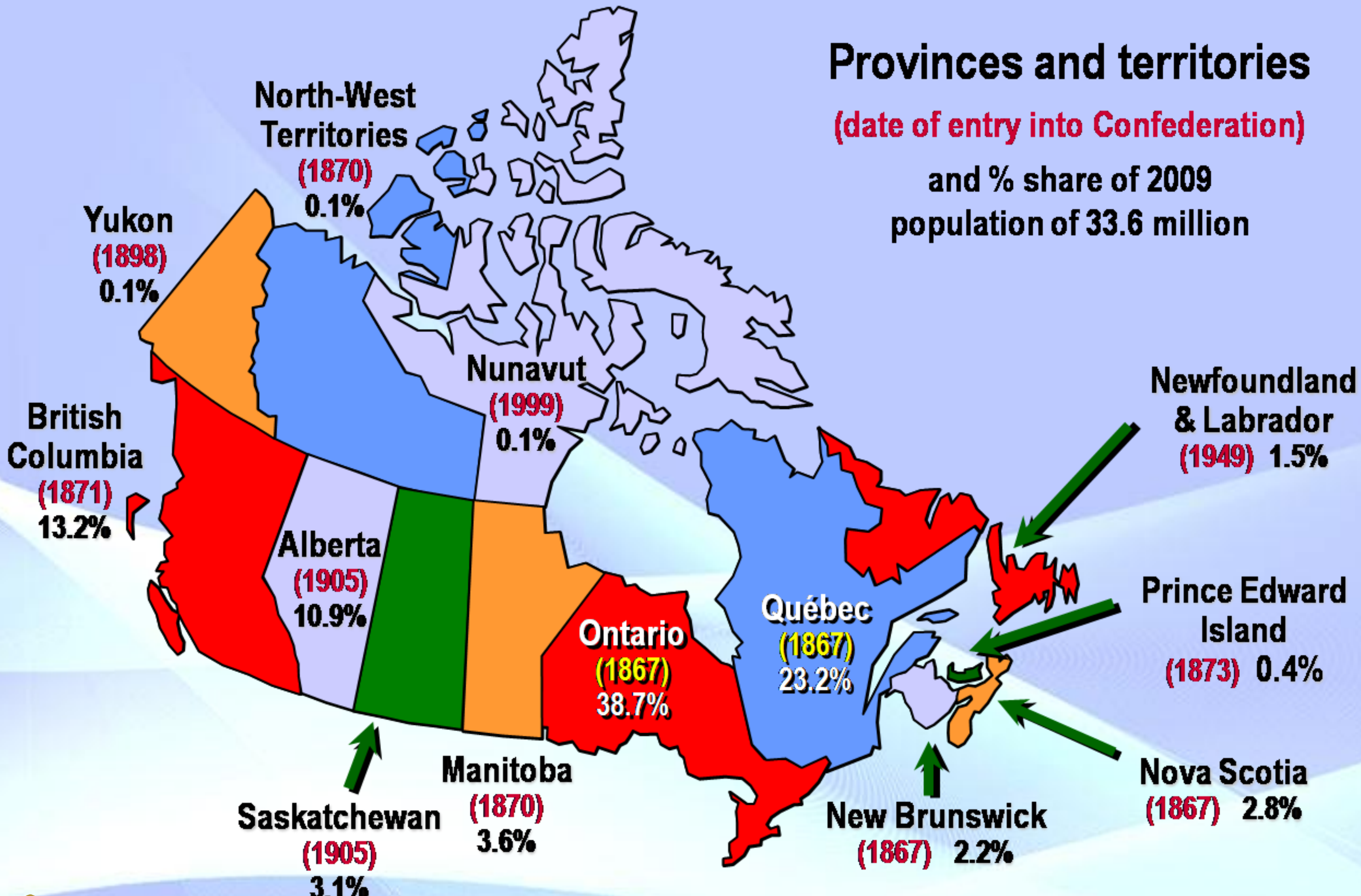
Overview of Canada's Provinces



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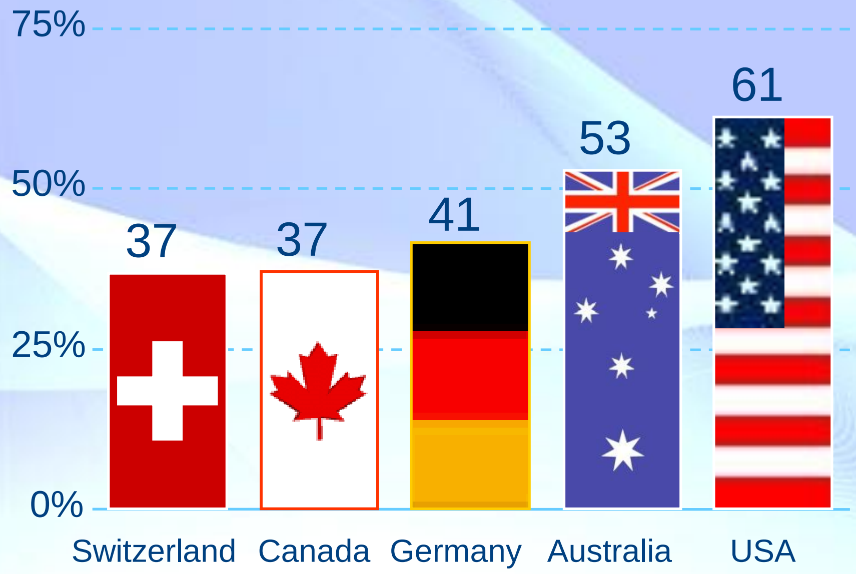
Canada in a comparative context

- Highly decentralized
- Low levels of dependence on federal transfers
- Very little conditionality
- Equalization regime entirely funded by federal government
- Equalize up not down
- Important role of resource wealth in regional disparties

Canadian provinces have a high degree of autonomy including significant fiscal resources and independence

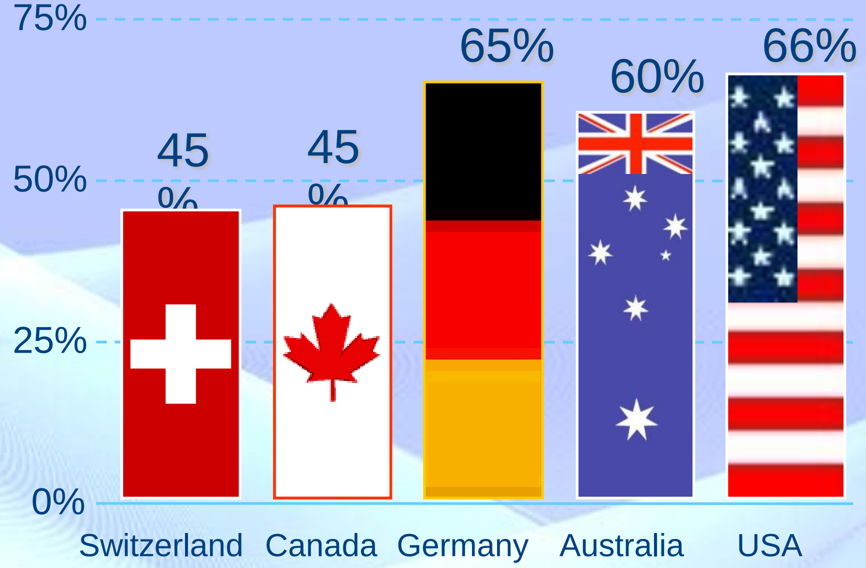
Expenditures

Federal share of direct spending



Revenues

Federal share of own-source revenues



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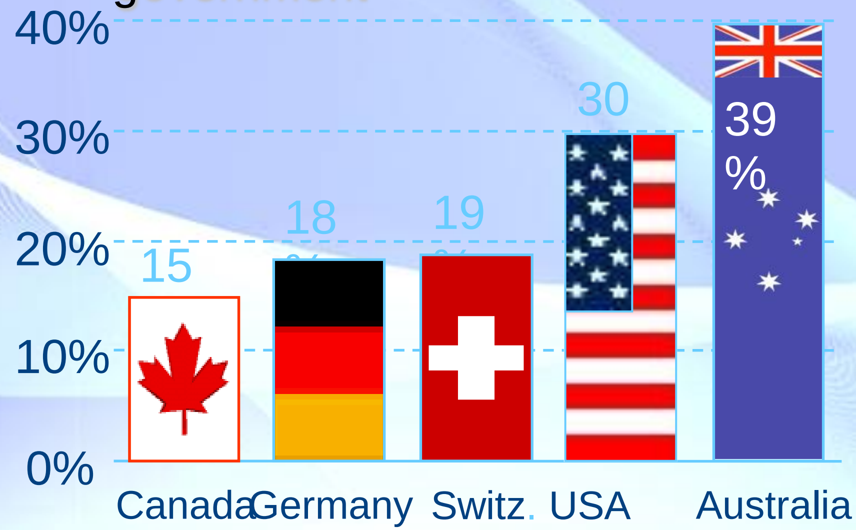
The particularly high degree of autonomy exercised by Canadian provinces reflects:

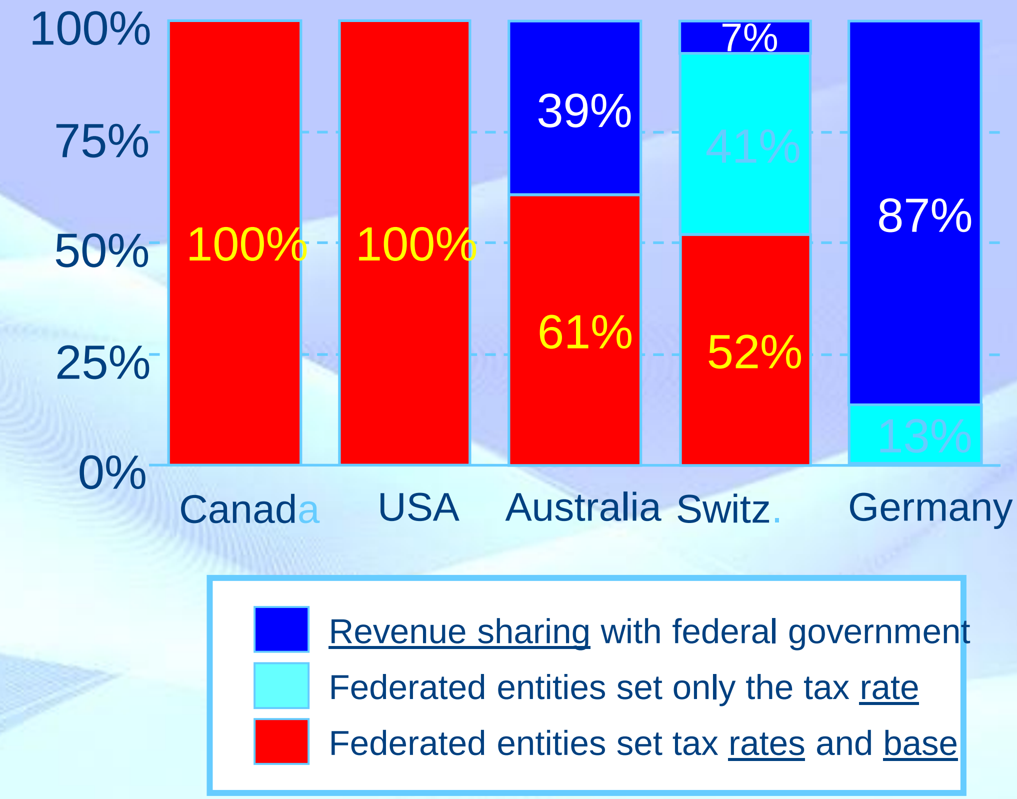
Their low dependence on federal transfers…

Federal transfers as a % of total revenues of other levels of government



…and significant control over their own-source revenues

Non-federal own-source revenues, by degree of fiscal control



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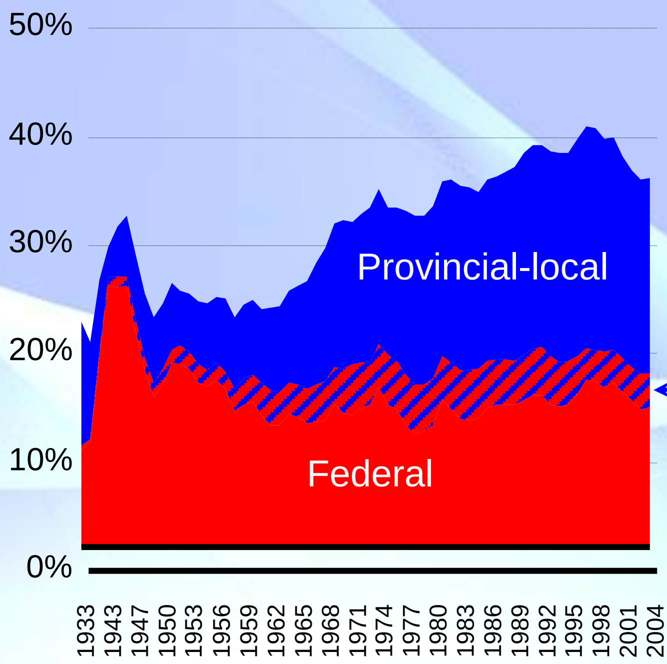
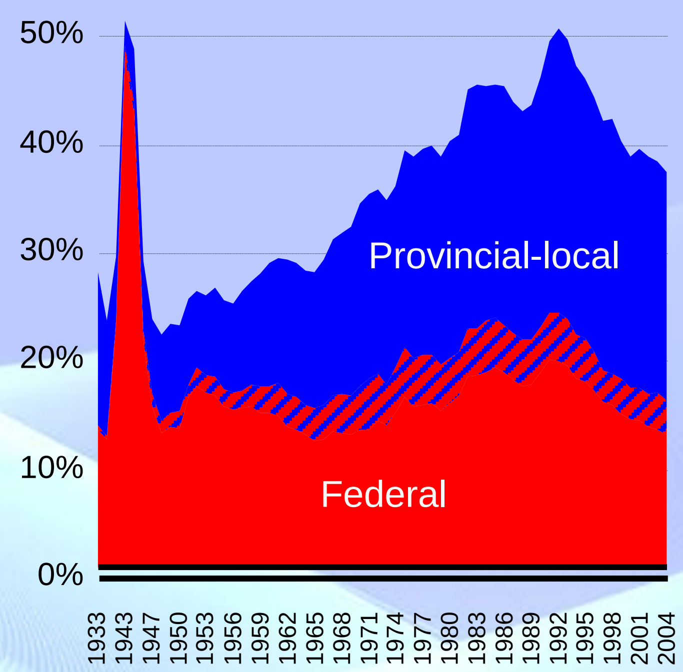
There is a long history of fiscal decentralization in Canada going back to the post-war period. It has been driven by provincial powers and responsibilities and Canada’s political dynamics

Revenues (% of GDP)



Transfers

Expenditures (% of GDP)



Source: Statistics Canada

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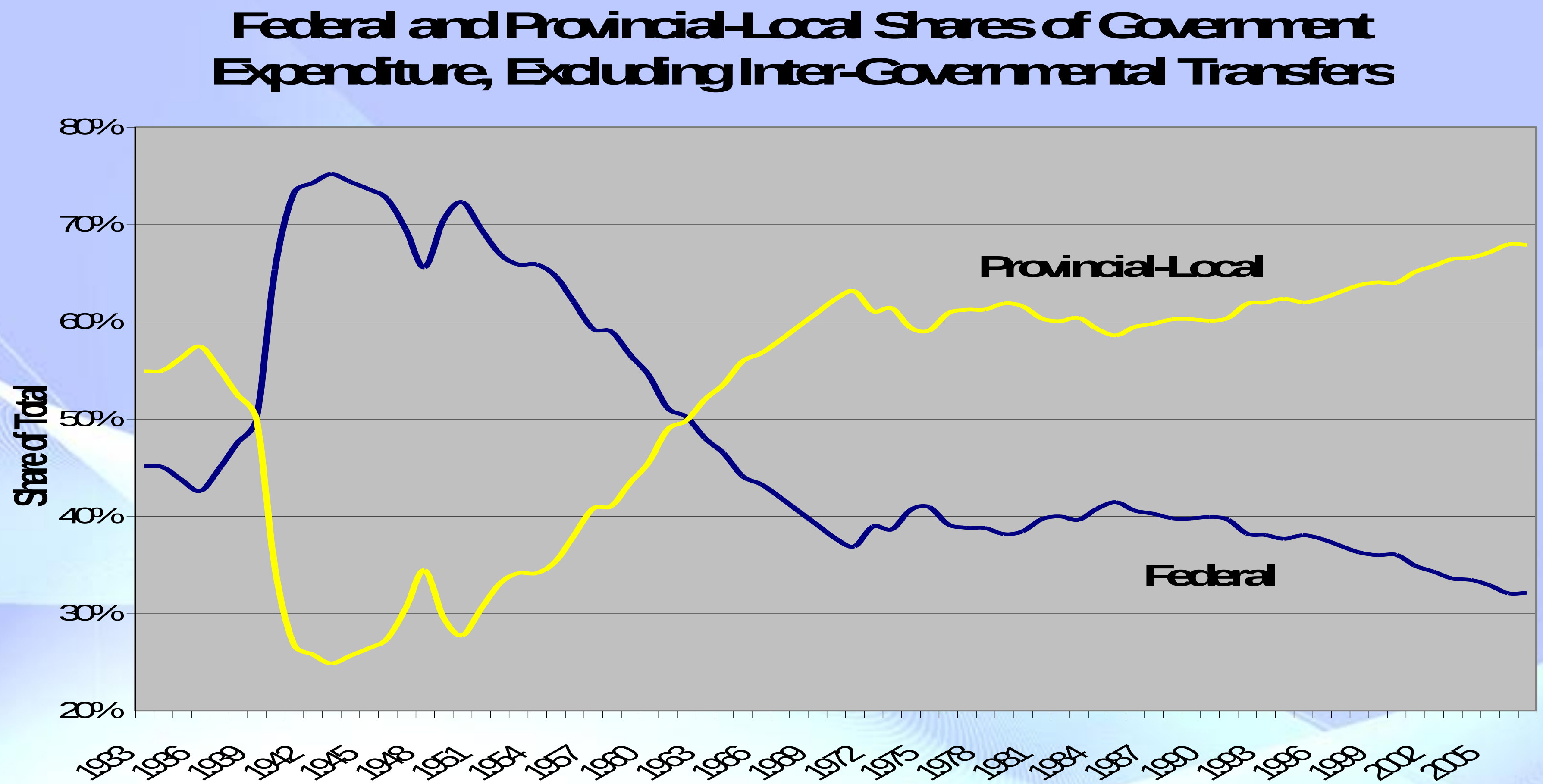
The federal share of government spending after transfers is exceptionally low



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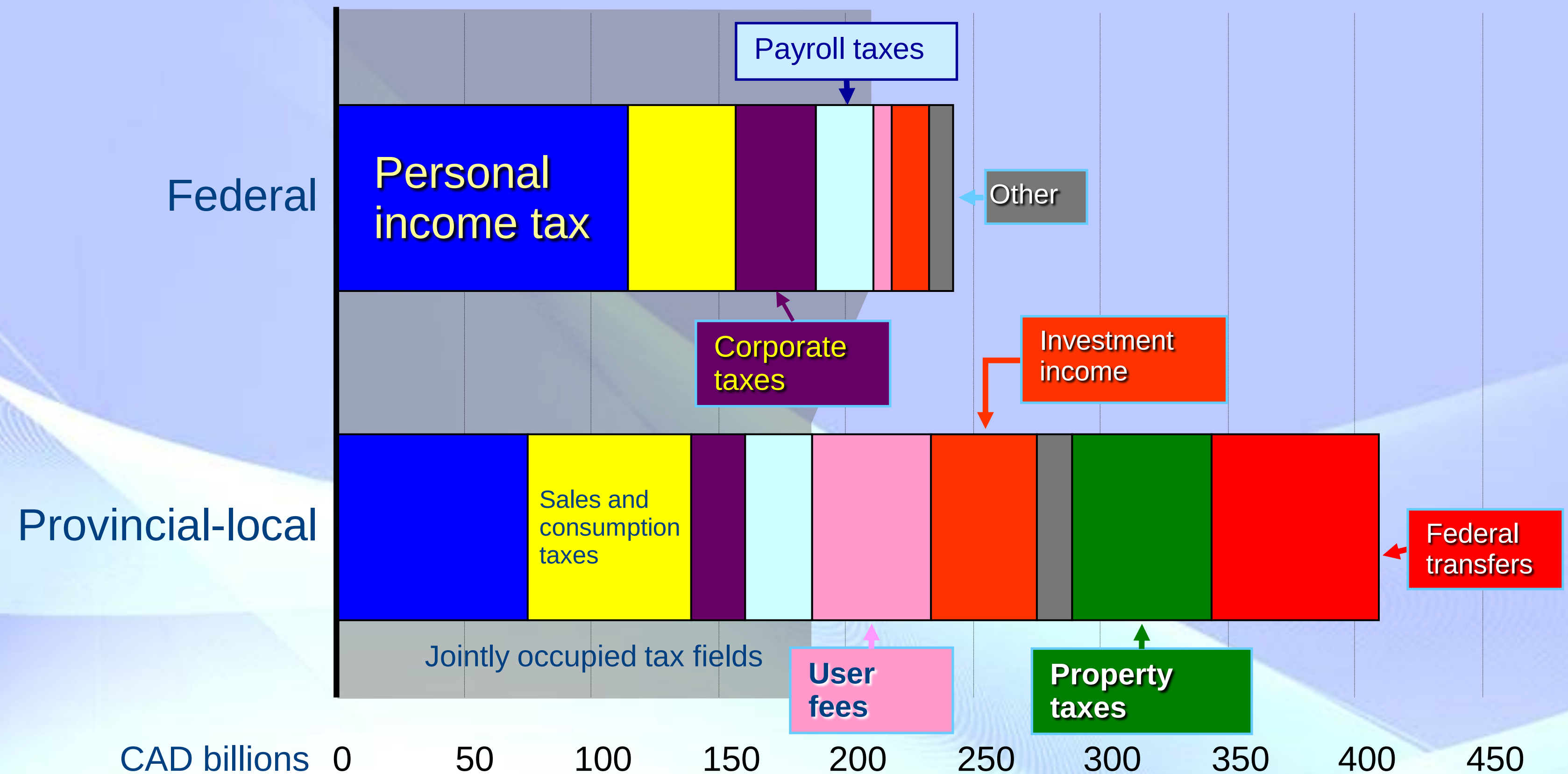
The provinces have virtually unlimited powers to tax, through joint occupancy of major tax fields.

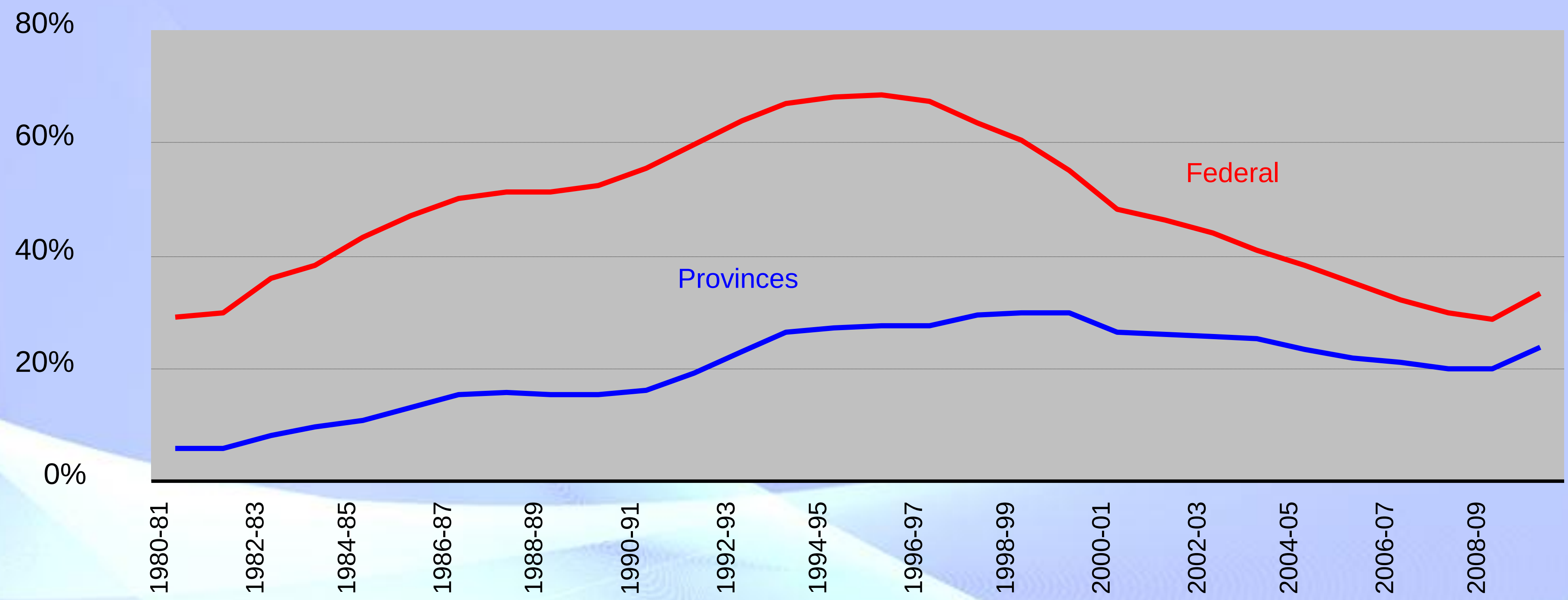


Source: Statistics Canada (2009)

The recession

- Gross government debt (82%) average in OECD, net debt (28%) very low; better forecasts than for most countries

Federal and provincial debt-GDP ratios



Source: Finance Canada

- Total projected deficits smaller than past peaks (9.1% in 92-3 vs. 5.4% in 09-10).

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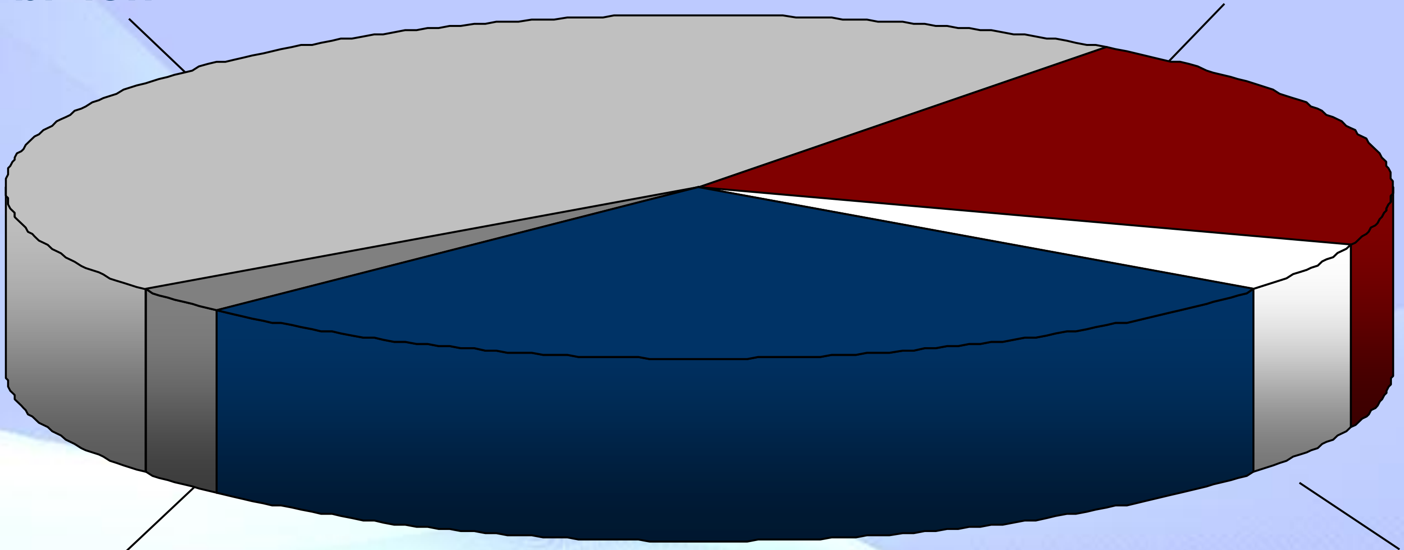
Growing differentiation in provincial situations

- This time total provincial deficits smaller (1.9% in 09-10) and heavily concentrated in Ontario (3.8% in 09-10). Alberta and Saskatchewan in surplus.
- Total provincial debt returning to levels of mid-90s (about 28%), but varies from Alberta with net savings to Quebec (minus 49% of GDP) and Ontario (minus 37%)
- Some provinces have had larger debts in past, but central and Maritimes provinces face much tougher challenge than Western provinces and NL

Debt management

- Canada has no federal controls on provincial debt.
- Many federations do.
- Provincial fiscal discipline largely because of need to raise taxes or cut programs if necessary
- Markets provide some discipline, but not fully costed, which suggests markets assign an implicit federal backstopping role.

Major transfers to provinces and territories total $53.7B in 2009-10



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Transfers per capita vary enormously by province

- Major transfers of $53B represented 19% of provincial revenues in 2009-10
- In addition,there were targetted transfers of $9.5B in 2009-10, mainly for infrastructure
- Total per capita transfers by province do not fully track differences in fiscal situations:
  - BC1,400 -Ont 1,400 -PEI 4,300
  - Alta1,100 -Que 2,400 -NL 2,500
  - Sask 1,500 -NB 2,400 -Territories 21-39,000
  - Man 3,100 -NS 3,200

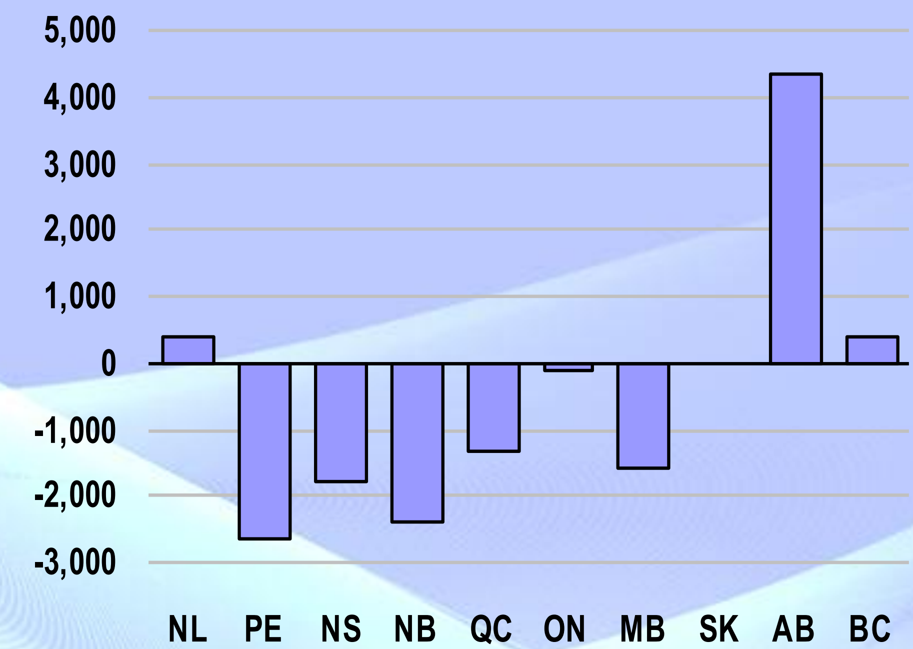
Current regime reflects series of marginal decisions, not integrated architecture

- Major transfers have different growth rates to 2014: Health transfer 6%; Social transfer 3%; Equalization "nominal growth of GDP"
- Increasing costs of provincial programs about double increases in revenues. Issue of sustainability.
- Current total transfers per capita do not reflect the relative fiscal capacities of provinces, e.g. Ontario gets considerably less than NL
- System due for major review in 2014—discussions sooner

Equalization: Economic and fiscal disparities in Canada are relatively large by OECD standards

GDP disparities (in $ per capita)

Fiscal disparities (in $ per capita)



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The Equalization Program

- Program was launched in 1957 in conjunction with a major tax decentralization for personal and corporate income taxes and inheritance taxes. Program made the devolution of tax shares to provinces acceptable to revenue-poor provinces.

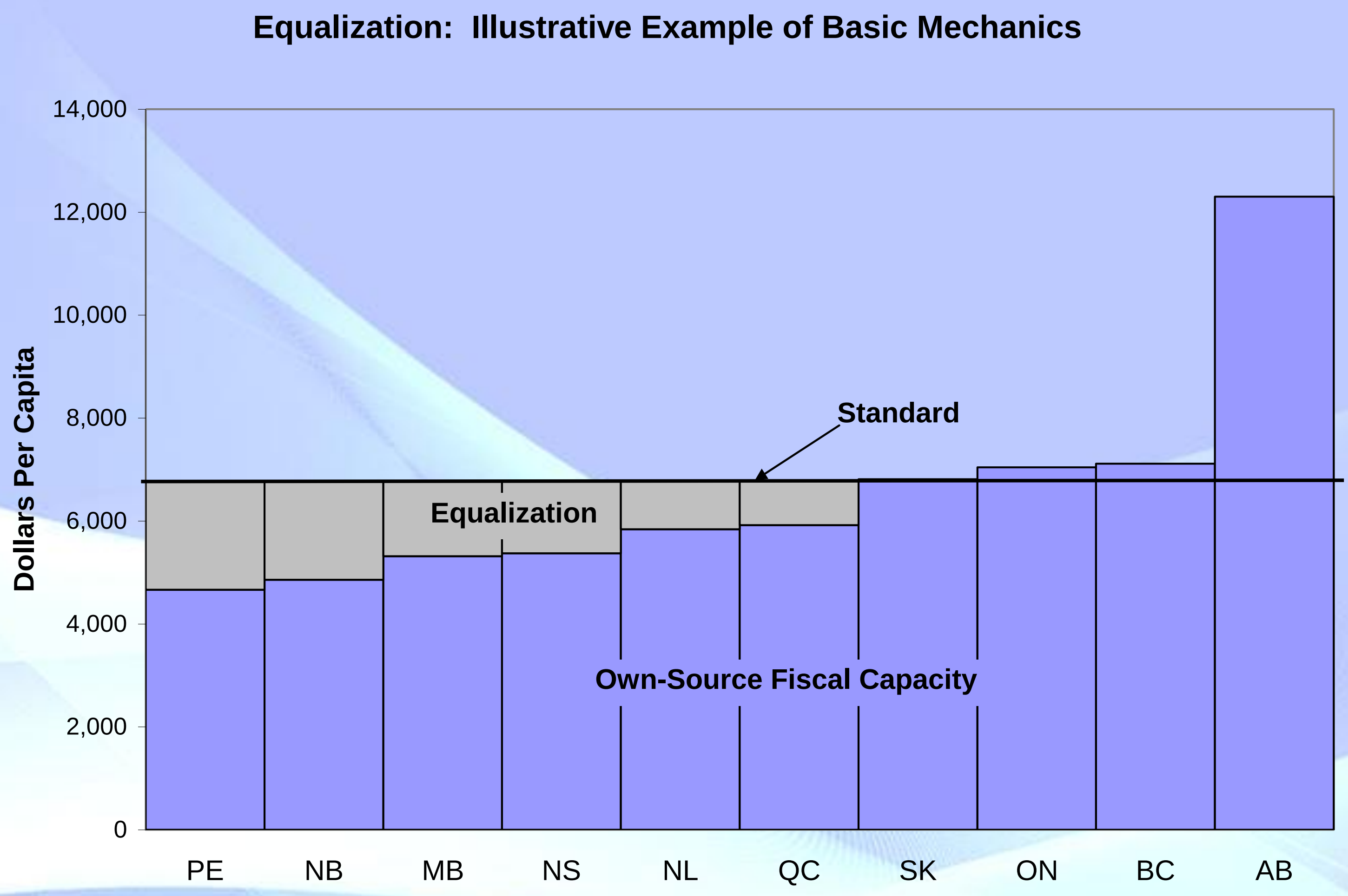
- Program “equalizes up”, not down.

- Entirely financed from federal general revenues

- Program has looked at fiscal capacity, not need.

The Equalization Program

- This graph shows the basic mechanics of the program as it has operated throughout most of its history



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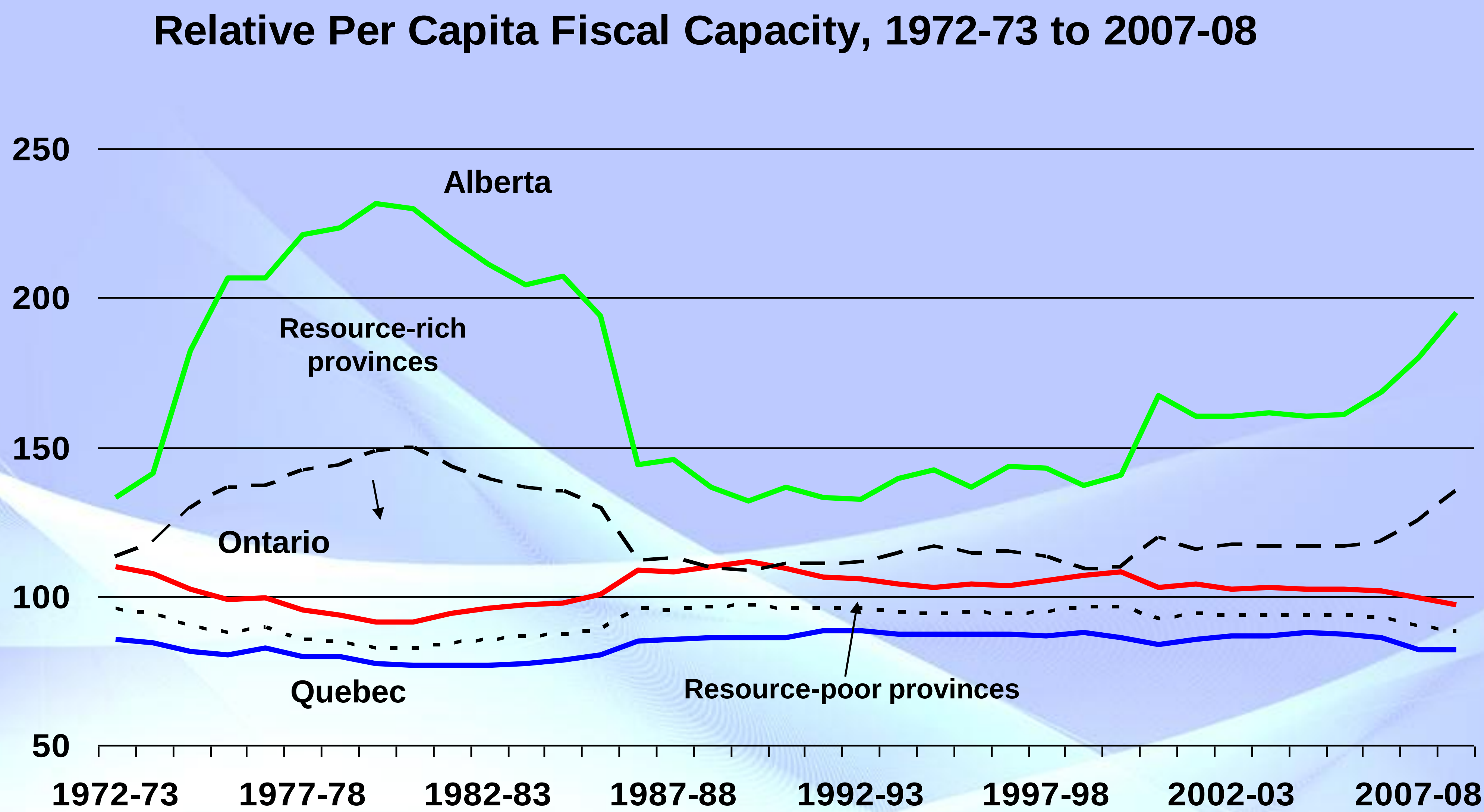
Program has shifted from an equalization standard to a fixed pool

- The Equalization standard has changed several times throughout the history of the program: top-2 province standard (1957), 10-province standard (1962), 5-province standard (1981).

- Martin government moved off fixed standard to pool. Harper government moved back to a standard but after two years went to pool approach. 2007 bargain: more for equalization in exchange for other transfers moving to a straight per capita cash basis. (Potentially over $700MM for Alberta in 2014.)

- Pool approach reduces overall volatility of program, but Ontario being in adds somewhat to volatility for other equalization receiving provinces (7 cents on the dollar).

Natural resource revenues have played a key role in the history of Equalization



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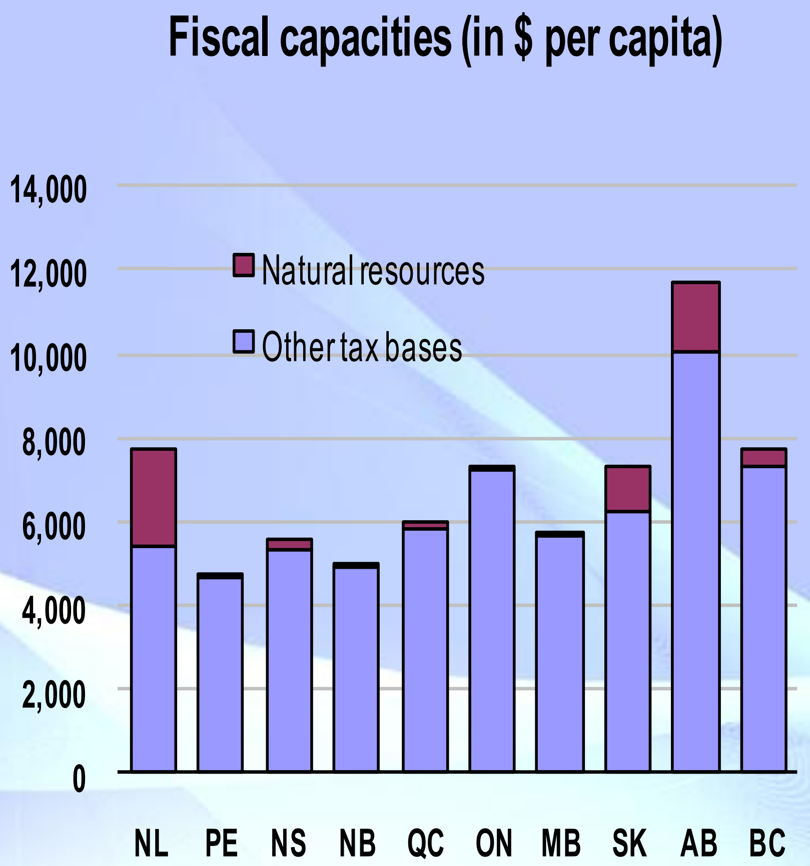
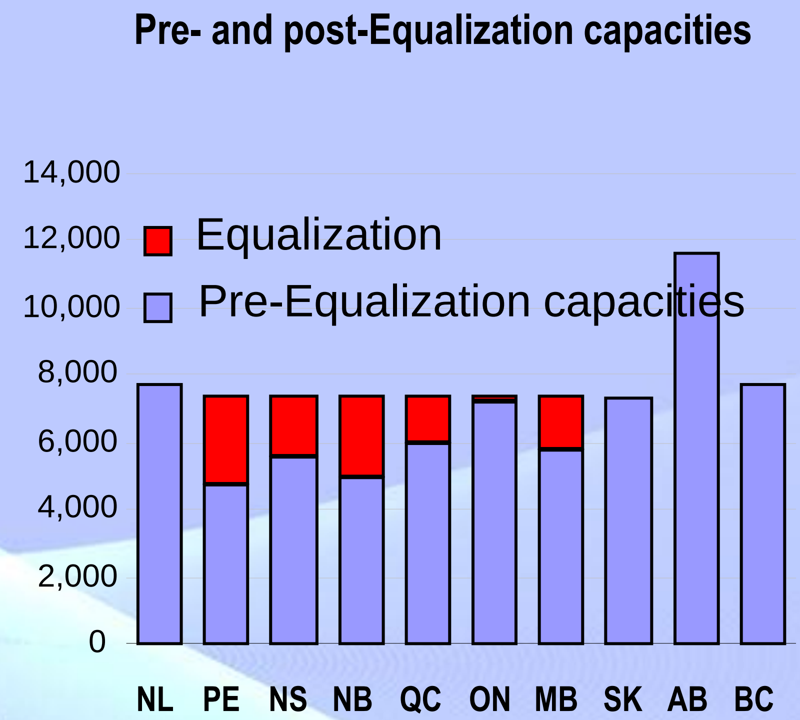
As well, provincial fiscal disparities significantly reflect the unequal distribution of <u>natural resources</u>…





-Alberta long an outlier (200% of average fiscal capacity) but NL, Saskatchewan and BC becoming increasingly resource-rich too.

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Provinces choose to impose substantially different tax rates…

Provincial-Local Fiscal Capacity, Own-Source Revenue, and Tax Effort, 2006-07

	Fiscal Capacity Per Capita	Own-Source Revenue Per Capita	Tax Effort
NL	$6,250	$6,728	107.6%
PE	$4,864	$5,162	106.1%
NS	$5,637	$5,800	102.9%
NB	$5,152	$5,282	102.5%
QC	$6,117	$7,079	115.7%
ON	$7,273	$7,310	100.5%
MB	$5,519	$5,982	108.4%
SK	$7,681	$8,863	115.4%
AB	$12,765	$9,833	77.0%
BC	$7,121	$7,073	99.3%

… and to provide significantly different levels of government services.

Total Expenditures of Provincial-Local Government Sector, 2006-07

	Provincial-Local Government Expenditure ($ Per Capita)	Percent of Average
NL	$11,051	103.7%
PE	$10,002	93.8%
NS	$10,564	99.1%
NB	$10,045	94.2%
QC	$11,931	111.9%
ON	$10,107	94.8%
MB	$10,842	101.7%
SK	$11,625	109.1%
AB	$10,751	100.9%
BC	$9,664	90.7%

Why equalization? How much?

- Federations vary from the highly equalizing to no equalization. All OECD federations except the US have equalization, but programs vary in richness and design
- Why? Economists worry about “fiscally induced migration” and the inefficient allocation of resources. Larger political issues of community and sharing.
- How much? No technical answer. Australia virtually full equalization; Germany also considerable including direct transfers from rich länder to poor. Switzerland brings all cantons up to a significant level, based on fixed schedule of transfers. US has no system and transfers reflect politics more than any principled architecture.

The sustainability of the Canadian major transfer regime

- Health and social transfers growing faster than revenues: key issue for provinces is cost control.
- Question of diminishing fiscal weight of federal government.
- Equalization had provinces with 34% of population; now 73%. Payments to other provinces, always sensitive to Ontario's fiscal capacity, now more so. Ontario will take bigger share in 2011-12 (2-year lag/3-year average).
- Affordability to federal government. As designed, yes, but if Ontario's need grew?

Issue: what to do about resource revenues?

- Major source of fiscal disparities amongst provinces and an exceptionally sensitive issue.
- Within equalization, should resource revenues have the same weight as others in calculating entitlement of equalization receiving provinces. And they should have full weight in establishing standard (comprise of 50% before pooled approach)
- Most federal governments have a significant role government in resource management and revenues. Should federal government have any access to resource revenues?
- What about big subsidies to electricity consumers in Quebec and Manitoba? Imputed lost revenues of $5B in Quebec.

Issue: What to do about other design elements of the transfer regime?

- Rebalance shares going to health and social transfers versus equalization? A totally integrated major transfer program?
- Hypothecate a major tax source (as in Australia) for transfers?
- Top up equalization with direct transfers from rich provinces to poorer ones (as in Germany)? What to do about richest provinces?
- Consider not just different fiscal capacities but also different cost drivers in equalization and other transfers, e.g. aging populations in some provinces
- Issue of municipal and infrastructure financing arrangements

A Word on Process

- Fiscally federalism is notoriously opaque, but it is fundamentally important.
- Canada faces large issues regarding the sustainability and suitability of the country's fiscal architecture. Will this highly divisive issue get the consideration it deserves if it is handled in the usual way—largely through confidential discussions amongst governments?
- Some federations (Australia, India) have arm's length bodies to prepare serious analysis and recommendations regarding fiscal arrangements. Canada did once too: the Rowell-Sirois Commission. Might it again be time for such an approach in Canada and, if so, with what mandate?
- Restructuring a fiscal regime can take many years to implement so as to avoid short-term problems

Conclusions

- Canada has had a very successful federal-provincial fiscal regime, that has led to a vibrant federalism and relatively balanced government services.
- But it faces big issues because of health and social cost pressures, Ontario's eligibility for equalization, infrastructure challenges, resource revenue disparities, differential growth, and aging populations in some provinces
- Political management that seriously engages these issues will be hugely challenging and require creativity on both the process and substance of reform.

Canada’s Transition to Value Added Tax

- Federal government had manufacturing sales tax which provided 15% of revenues
- Nine provinces had sales taxes, with different rates and designs
- 1991 Federal GST and Quebec QST
- 1997 Newfoundland, New Brunswick, and Nova Scotia join HST
- 2010 Ontario and British Columbia join HST
- Only three small provinces still have conventional sales taxes outside the HST system. Alberta and territories have no sales tax.

Why such a long transition?

- Extremely difficult politics
- Manufacturing sales tax was hidden; GST/QST/HST usually added at point of sale so highly visible
- Provinces had very different designs and usually much smaller bases (though often higher rates)
- Public not sensitive to economic benefits, but business lobbied strongly for change
- Federal government has had to bribe provinces:
  – With large transition payments
  – Offer to assume collection costs
- Federal Conservative lost 1993 election massively
- BC voters currently seeking a referendum to overturn HST

The basic architecture

- Federal goods and services tax across Canada
- Five provinces now have provincial tax which is based on federal GST and administered by federal government (Harmonized Sales Tax)
- Quebec has Quebec Sales Tax, which is closely modelled on federal GST, and it administers federal GST
- Provinces essentially must use federal base, but have some liberty to vary rate
- Revenues are distributed on a deemed destination basis

Comparison of Some Key Features of Canada's Subnational VAT Regimes

	QST	HST	HST (Ontario)
On destination basis	Yes	Yes	Yes
Autonomy in rate-setting	Yes	Yes (in principle)	Yes (in principle)
GST base	Yes (with minor exceptions)	Yes	Yes
More zero-rating than GST	Yes	Yes	Yes
Input credit restrictions	Yes	No	Yes
Good administration	Yes; provincial	Yes; federal	Yes; federal
Good cooperation between central and sub-national governments	Yes	Yes	Yes

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The Federal GST

- Was intended to be revenue neutral, with broad base including most services and housing and direct imports by consumers. Initial rate 7%; now 5%
- Difficult politics led to exclusion of “basic groceries” at last minute. Also a targetted refundable income tax credit was designed to deal with distributional issue
- Uses rebates for VAT relief: about 14 categories including MASH, charities, housing—different rates
- Huge effort during transition to explain tax to VAT registrants
- Efficient system of input credits, e.g. in 2003 $144B on sales with $130B claimed as credits for net $14B revenue.
- Non-compliance estimated at 4%
- Demonstrates that a federal VAT can exist alongside provincial sales taxes

The Harmonized Sales Tax

- Original three agreed on rate of 8%, but now BC is 7% and Ontario 8%. Atlantic provinces agreed they needed unanimity to lower rate and 2 out of 3 to raise it. Ontario and BC are free on rate, with adequate notice
- While all provinces must use federal base, the effective rates of tax vary because of different rebate schemes. Federal-provincial agreements limit extent of rebates.
- Unlike federal GST, prime criterion for *services* at provincial level is "place of performance" not location of final consumption, so provincial tax on interprovincial services is largely on origin, not destination basis. However, credits generated against such HST may be offset against GST, so in this sense it is a national scheme

Credits and Rebates in the HST Provinces

	GST		HST	
		NB	NS	NFLD
MUSH Rebates (Municipalities, Universities and public colleges, Schools and Hospitals)	M -100%a U -67% S – 68% H – 83%	M – 57.14% U – 0% S – 0% H – 0%	M – 57.14% U -67% S – 68% H – 83%	M – 0% U – 0% S – 0% H – 0%
Charity and Qualifying NPO Rebates	50%	50%		
New Housing Rebate	36% with a maximum of C$6,300b	No rebate	18.75% with a maximum of C$1,500c	No rebate
New Residential Rental Property Rebate	36% with a maximum of C$6,300	No rebate	No rebate	No rebate
Point-of-Sale Rebates under the HST	n/a	Books	Books	Books
Other HST rebates related to the 8% provincial portion of the HST (federally legislated)	n/a	-Exports from a harmonized province; -Investment plan and segregated fund rebate -Tourism industry rebate	-Exports from a harmonized province; -Investment plan and segregated fund rebate -Tourism industry rebate	-Exports from a harmonized province; -Investment plan and segregated fund rebate -Tourism industry rebate
Other HST rebates related to the 8% provincial potion of the HST (provincially legislated)	n/a	-Specially-equipped vehicles; -Segregated funds; -Research and development rebate.	-Household energyd; -Fire departments; -Motor vehicle rebate; -Computer rebate; -Heritage properties; -Segregated funds.	-Rebate program for building materials for Labrador homes; -Home heating rebate programe .
Low-Income Credit	Yes	No credit	No credit	Yes

Allocating HST Revenue

- System is not based on tracking of the revenue collected in any particular province
- Payments in any given year are based on a projection of revenues, allocated using the shares of two years previous. A province's revenue is based on a formula that applies its share of the total GST taxable base to its tax rate. Taxes paid by federal and HST provincial departments are excluded from the pool as are specified refunds and rebates.
- No allowance for unpaid GST or any revenue after closing date for adjustments. The federal government keeps such gains, but must "eat" unpaid GST ($1.3B in 2006)
- There is detailed calculation of the revenue pool, e.g. 130 categories of consumption expenditure, GST border collections, rebates to public agencies etc.

The Quebec Sales Tax

- QST destination-based, credit-invoice VAT at rate of 8.5%, applied on GST inclusive price (tax on tax)
- Base has become largely identical to GST, but large businesses are denied some input tax refunds. Export of goods and services are zero-rated (with minor exceptions). QST rebate rates are lower than GST rebate rates.
- Both GST and QST apply to foreign imports, while QST applies to domestic imports for registered QST payers on a self-assessment basis for others—but not if they would have been eligible for an input tax refund
- Quebec receives a fee for collecting GST for federal government. It has an incentive to enforce it well because the QST base grows with GST collections. Evasion estimated at 8%

Economic effects of HST reform

- Various estimates. National consumer prices permanent rise of 0.4% from Ontario and BC reforms (50% of economy). Consumer spending likely not to vary because of other tax offsets. Total tax packages are mildly redistributive in favour of low incomes (gain) relative to high incomes (loss). Expect immediate 10-15% annualized increase in business investment in machinery and equipment.

- A study in British Columbia estimated gains over ten years of $11.5B in capital investment and 113,000 jobs. The marginal effective tax rate on capital for large businesses will drop from 29.5% to 21.5%--and be more than halved for small business (to 9%)

Some Concluding Observations

- Canadian experience with a dual VAT regime has been successful and is economically superior to retail sales tax regimes. Proves an invoice-credit destination-based VAT can work at the sub-national level
- Both the HST and the QST models function well. A single national administration has compliance cost advantages, but devolved administration can work, perhaps especially with only one opt out. Intergovernmental cooperation is essential.
- The dual system preserves provincial autonomy over rates, but depends heavily on a shared base, with limited special rebates etc.
- Federal involvement is critical. For establishing the base. For border collection. And for facilitating provinces taxing their own residents effectively given extensive inter-provincial trade.

Acknowledgements

- This presentation drew substantially on the paper “Sales Taxes in Canada: The GST-HST-QST-RST ‘System’” by Richard M. Bird and Pierre-Pascal Gendron. The two tables are taken from this article which can be found at http://ssrn.com/abstract=1413333

- Slides 2-6, with the colour graphics, were prepared by David Peloquin who works within the Government of Canada’s Policy Research Initiative and has been generous in permitting me to use these and other slides on occasion.