

## VAT Lessons From Canada

By Martin A. Sullivan

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Newsflash: It is possible in the real world to enact a value added tax that will modernize an aging tax system, promote competitiveness, and reduce a spiraling budget deficit — without unduly burdening low-income families or creating a stealthy “money machine” that finances big government. Make no mistake: A VAT would be immensely unpopular with almost every segment of the public. But responsible liberals and conservatives (that is, those running the government) can support a VAT once they finally realize the alternatives are worse.

Canada’s experience might be a preview of VAT possibilities in the United States. Our neighbor to the north has a European-style VAT, officially known as a goods and services tax. Unofficially, it is called the “go south tax” or the “gouge-and-screw tax.” The federal tax rate is 5 percent. Provinces with more than four-fifths of Canada’s population have — or will soon have — their own VATs that piggyback on the federal GST. Provincial rates are currently between 7 and 8 percent. To reduce the burden on low-income families, there are refundable tax credits as well as exemptions for necessities.

The Canadian story has four parts:

(1) *Conservatives introduced the VAT.* In September 1984 Brian Mulroney united Canada’s fractious conservatives and gave them their first general election victory in 13 years. It was the largest parliamentary majority in Canadian history. A priority for the new prime minister was to repair Canada’s relationship with the United States. Six months after the election, he was singing “When Irish Eyes Are Smiling” with Ronald Reagan on a Quebec City stage. Mulroney shared the Gipper’s views on national security and free trade, and the two became fast friends. Running on his record of support for the North American Free Trade Agreement, in 1988 Mulroney led conservatives to their first national reelection victory in a century.

Concerned about industry's competitiveness and an unyielding budget deficit, Mulroney proposed a 9 percent VAT on goods and services in 1989. The tax would replace the clunky old 13.5 percent tax imposed on sales by manufacturers. The Mulroney proposal sparked instant controversy and met a tidal wave of public opposition. But with party discipline unlike that in the United States, Mulroney got approval in the House of Commons. (The one dissenting conservative was thrown out of the party.) Passage in the liberal-dominated Senate was secured only after Mulroney used an obscure constitutional provision that allowed him to appoint eight senators on a temporary basis. The 7 percent VAT finally passed after a two-month filibuster by Liberals. It went into effect on January 1, 1991.

Contributing to the Canadian VAT's unpopularity was its visibility: Tax and before-tax prices are separately stated on receipts and invoices. Because of the VAT as well as a number of scandals, Mulroney's popularity plummeted. He resigned in June 1993. The election in September 1993 was a bloodbath for conservatives. Mulroney's Progressive Conservative Party, which had won 211 seats in 1984 and 169 seats in 1988, was obliterated in 1993, winning a mere two seats in the House of Commons. It would be 12 years before the conservatives returned to power in the form of the new Conservative Party under the leadership of current Prime Minister Stephen Harper.

(2) *Liberals broke their promise to replace the VAT.* Before the 1993 election, the Liberal Party detailed its policy proposals in a 100-plus-page "Red Book" (considered by some to be a precursor of sorts to Newt Gingrich's 1994 Contract With America). In it the party vowed to replace Canada's hated VAT: "A Liberal government will replace the GST with a system that generates equivalent revenues, is fairer to consumers and to small business, minimizes disruption to small business, and promotes federal-provincial fiscal co-operation and harmonization." Liberal Jean Chrétien became the new prime minister in November 1993. He made numerous unambiguous announcements of his intentions. For example, on May 2, 1994, he said about the GST: "We hate it and we will kill it."

The Chrétien promise turned out to have all the staying power of George H.W. Bush's 1988 "read my lips" pledge. After much

study, the Liberal government decided to keep the tax. On April 23, 1996, Finance Minister Paul Martin (who would be prime minister from 2003 through 2005) made it explicit: “We made a mistake. It was an honest mistake. It was a mistake in thinking we could bring in a completely different tax without undue economic distortion and within a reasonable time period.”

(3) *Provinces harmonized with the federal VAT.* Canada’s national VAT has a variety of implications for provincial consumption taxes.

- *Quebec.* Because of its strong separatist movement, Quebec often has unique arrangements with the federal government. When the GST was introduced, Quebec negotiated a deal in which its provincial government would administer and collect the federal VAT along with its own VAT (known as the QST, the Quebec sales tax). The QST rate, currently 7.5 percent, is scheduled to increase to 8.5 percent in January 2011 and to 9.5 percent in January 2012.
- *Atlantic provinces, Ontario, and British Columbia.* In 1997, at the urging of the Liberal government, three of Canada’s Atlantic provinces — Nova Scotia, New Brunswick, and Newfoundland — dropped their own sales taxes and replaced them with a single federal-provincial harmonized sales tax collected by the federal government. The current HST rate in these provinces is 12 percent (5 percent federal and 7 percent provincial). Nova Scotia has announced its intention to raise the rate to 14 percent in 2010. Both Ontario and British Columbia replaced their provincial sales tax with an HST effective July 1, 2010. The rate in Ontario, Canada’s most populous province, is 13 percent (a 5 percent federal portion and an 8 percent provincial portion), and British Columbia’s is 12 percent (5 percent federal and 7 percent provincial).
- *Other provinces.* Traditional retail sales taxes remain in Prince Edward Island, Manitoba, and Saskatchewan. Neither Alberta nor any of Canada’s three territories have their own retail sales taxes or VATs.

As a result of changes in Ontario and British Columbia, approximately 85 percent of Canada’s population will have provincial VATs in 2010.

(4) *Conservatives reduced the VAT rate.* As federal budget deficits changed to surpluses, Harper became prime minister in January of 2006. During his election campaign, Harper vowed to reduce the VAT rate. He followed through on his promise and reduced the rate from 7 percent to 6 percent in July 2006 and to 5 percent in January 2008. In the October 2008 national elections, Conservatives increased their seats in Parliament from 124 to 143 (out of 308).

### Lessons

*Burden on the poor.* A major objection to a VAT is its potentially disproportionate burden on low-income households. The VAT is a tax on consumption, and consumption as a percentage of income is generally larger for the poor than the rich. Around the world, this problem is usually addressed by exempting (more technically, by zero rating) necessities. For reasons of simplicity and efficiency, experts strongly prefer the use of refundable income tax credits to offset the burden of a consumption tax. Canada uses both zero rating and income tax credits. There are lots of technical issues about exactly how to measure the degree of regressivity of any VAT plan. The central point here is that the Canadian experience shows that the tools are available to relieve as much burden on the poor as necessary.

*Conflict with the states.* The Canadian provinces have harmonized their sales tax with the federal VAT at their own pace and on their own terms. The obvious advantages of harmonization are simplification for taxpayers, reduced administrative costs, and the economic efficiency and competitive benefits of a broader tax base. In general, business strongly supports harmonization. But provinces have exercised their option to diverge from federal law where the inherent advantages of harmonization were outweighed by political considerations and cultural differences. Canadian provinces may have a different tax base than the federal tax, different rates from each other, or different administration, or they may not impose any provincial VAT at all. If the U.S. government adopted a VAT, the states would have an economically attractive option not currently available to them.

*Stealth tax/money machine.* Most conservatives argue that a VAT would be a powerful and hidden revenue generator that would

result in higher overall taxes and allow a large increase in the size of government. Here is some typical commentary:

Handing Washington a whole new source of revenue would be akin to giving keys to a liquor store to a bunch of alcoholics. It would permanently slow economic growth and lower the standard of living for generations of Americans to come. It would also be a bottomless well for Congress to go back to each time it wants more of our money to pay for new spending programs. Once a VAT is in place, turning back the growth of government will be next to impossible, and the efforts of President Obama and his congressional allies to recast the nation into a full state of dependency on Washington will be complete. [Daniel J. Mitchell, "VAT Attack," *New York Post*, Apr. 8, 2010.]

Most of its burden is borne by consumers. They file no VAT returns, so its stealthiness delights the political class, which can increase it in small, barely noticed increments, with every percentage point yielding another \$100 billion. [George Will, "The Perils of the Value-Added Tax," *The Washington Post*, Apr. 17, 2010.]

A VAT is likened to a "national sales tax," so once in place, most Americans would barely notice it — just as they barely notice state and local sales taxes. [Robert Samuelson, *The Washington Post*, Apr. 21, 2010.]

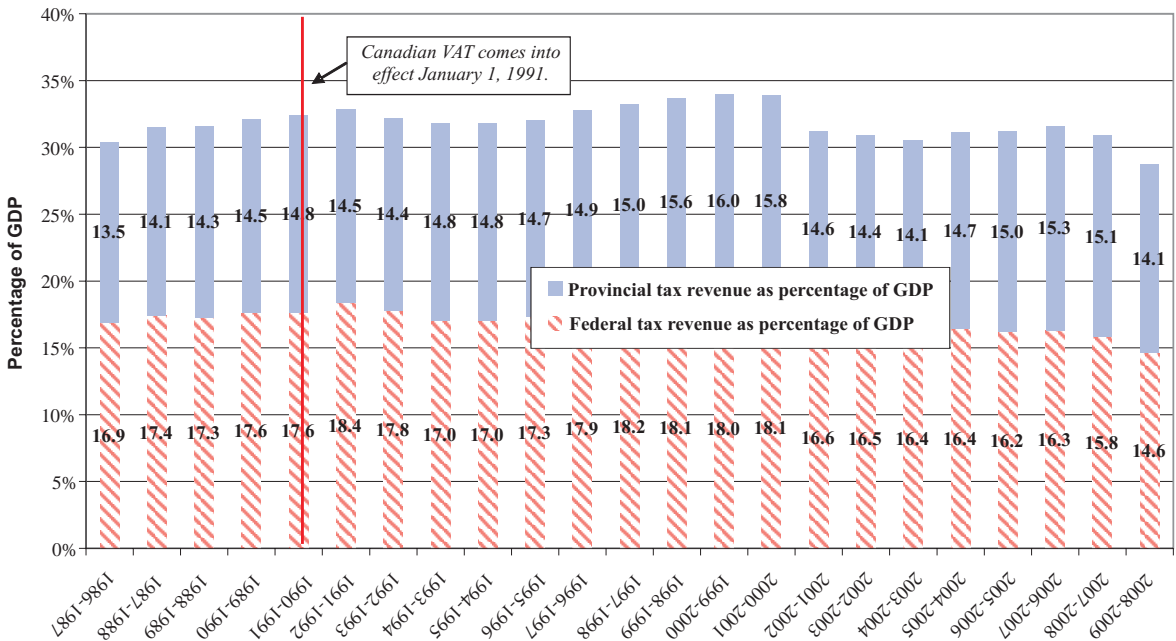
And then there is the amendment offered by Republican Sen. John McCain of Arizona, approved by the Senate on April 15. The text in its entirety reads:

It is the sense of the Senate that the Value Added Tax is a massive tax increase that will cripple families on fixed income and only further push back America's economic recovery and the Senate opposes a Value Added Tax.

Canada's experience is exactly the opposite of what these quotations forecast for the United States.

In Canada the VAT is highly visible. As already noted, Canadians pay VAT with each purchase, and the amount they pay is shown at each visit to the checkout counter. In fact, by replacing the truly hidden manufacturing sales tax, the Canadian VAT

### VAT Has Not Been a 'Money Machine' for Canada



Source: Canada Department of Finance, Fiscal Reference Tables October 2009, tables 4 and 31, available at <http://www.fin.gc.ca/frt-trf/2009/frt09-eng.asp>.

made taxation more transparent. Canadians are reminded of the VAT not only when they are shopping, but also when they get their news, as the tax is frequently the subject of high-profile political debates at both the federal and provincial level. The VAT's visibility is probably the main reason Harper proposed reducing the VAT rate (and not income tax rates) during the 2004 election.

As you can see from the figure, the introduction of a VAT in Canada has not led to any burst in overall taxation. The figure shows that federal revenues as a share of GDP and total (federal and provincial) revenue as a share of GDP have remained fairly steady since the introduction of a VAT in 1991. In the four years before introduction of the VAT, federal revenues averaged 17.3 percent of GDP. In the four years after, they averaged 17.6 percent of GDP. From 2000 through 2008, federal revenues averaged 16.3 percent of GDP.

### Challenges

The Canadian experience confirms every politician's instinct that supporting a VAT is career suicide. For a VAT to become law in the United States, we need a more enlightened public or more courage from our politicians. It is hard to be optimistic on either of those counts.

But, as much as they would like to, politicians cannot always give the people what they want — especially when resources are scarce. Economics and arithmetic do frame debates, and if you do the economics and the arithmetic, the case for a VAT is compelling. The alternatives are drastic cuts in government spending, higher taxes on corporate and personal income, or spiraling government debt. The first is unrealistic. The second is a poor fit for an increasingly global economy. The third is a journey into an abyss of unknown depths.

It is easy to oppose the VAT with slogans and sound bites. The message is political candy: We want to prevent tax hikes. But this is a long-term debate. Ultimately for the message in the rhetoric to survive, it must be retrofitted into rational analysis. And that means a detailed budget plan that tames the deficit without a VAT. That's the unenviable task conservative economists now face. In the meantime, don't believe the doomsday rhetoric. Look

at the VAT with an open mind, and use Canada's experience as a starting point for what an American VAT might look like. ■