Goods and Services Tax
An Overview

Issued by
The Honourable Michael H. Wilson
Minister of Finance

August 1989

Canada

ERRATUM

GOODS AND SERVICES TAX
AN OVERVIEW

Chart 2, page 17 -- The vertical axis of the chart has been mislabelled. "Percentage change" should read "Per cent".

GOODS AND SERVICES TAX
TECHNICAL PAPER

Chart 1, page 7 -- Same correction as above.

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Ministère des Finances Canada

Table of Contents

I. The Reasons for Sales Tax Reform

A. The Government's Economic Strategy

The Goods and Services Tax (GST) is an integral part of the government's agenda for securing Canada's economic future. Sales tax reform will achieve three important goals.

- The GST will contribute to the deficit reduction effort and ensure we can continue to pay for programs and services Canadians value.
- The GST is an essential element of the government's plan to make the changes necessary to ensure that Canada can compete effectively in the world economy.
- The GST will improve the overall fairness of the tax system. Lower and modest income Canadians will be better off once the GST is in place.

The government is committed to controlling expenditures while maintaining the programs Canadians value: programs that enhance Canadians' standards of living, improve their quality of life, and ensure that all Canadians share in the benefits of a strong economy. Canadians know these programs are costly. Protecting the environment, providing high levels of skills training, and supporting high quality health care will continue to require significant levels of federal spending into the future. We must be assured that the funds will be there to meet the priorities of Canadians.

Sound economic management dictates that we do more than focus on the day-to-day demands of a complex, international economy. Good fiscal management includes planning for tomorrow's fiscal requirements, today. The large yearly deficits that have led to the accumulation of our enormous debt have put pressure on the government's ability to meet other priorities. They mean that we are borrowing from future generations, instead of paying our own way. They cannot continue indefinitely.

The present federal sales tax (FST) is an unreliable source of revenue for the federal government. It is charged on a relatively narrow base and is, more and more, subject to avoidance. It must be replaced. The 1989 budget, containing the broad outlines of the GST, is an expression of the government's continuing commitment to make fiscal management a priority, so that Canadians can continue to enjoy the programs we all value well into the future. Canadians know the risks of not acting to bring the debt under control. The size of the debt has left us exposed to increases in interest rates and vulnerable to international economic shocks. The reliability and stability of our sources of revenue are all the more important in such an environment. The year-by-year reductions in the deficit outlined in the 1989 budget – reductions secured by the GST – will ensure that we can continue to provide Canadians with a standard of services that is among the best in the world.

Making the Changes Necessary to Compete

Canada's prospects for economic growth in the future are rooted in the steps we take today. In a world in which change occurs quickly, our ability to respond to that change, to take advantage of the opportunities it presents, determines our ability to safeguard the economic security of all Canadians into the 1990s and beyond. This government is committed to making the changes necessary to ensure Canada can compete effectively in the world economy.

In today's international marketplace, an important factor in determining a country's ability to compete successfully is the efficiency with which it uses its resources. Recognizing that people are one of our most valuable resources, the government has acted to make literacy, training and skills development a priority. However, the efficient use of labour, as well as our other major productive resource, capital, has been hampered by our reliance on an outdated, discriminatory and unreliable federal sales tax.

All taxes distort the use of productive resources to some extent. One of the goals in designing a tax system, however, is to keep these distortions to a minimum, while raising the revenue the government needs to provide public services. Canada is now the only industrialized country in the world that continues to impose a tax on sales by manufacturers. The present manufacturers' sales tax is antiquated and harmful to the Canadian economy. It makes Canada's annual economic output about $9 billion lower than it would be with the Goods and Services Tax in place. Because of the way the present tax is structured, Canada's exports are subject to a hidden tax and are more costly to produce than comparable products from other countries. Similarly, the present tax makes imports into Canada more competitive than Canadian-made products. In addition, because of its archaic structure, the tax has spawned a significant amount of avoidance activity on the part of firms and has led the government to introduce a complex set of special arrangements in an effort to achieve equity in the system while preserving revenues. The resulting federal sales tax system is a complicated patchwork of administrative provisions that is burdensome to operate and upon which the government cannot continue to rely.

The introduction of the GST is a key element of the federal government's economic strategy. Replacement of the federal sales tax will reinforce other government initiatives to improve economic efficiency, raise productivity, and increase Canadian living standards. Among these initiatives are:

- the Canada-U.S. Free Trade Agreement which, by securing access to the large U.S. market, will permit Canadian firms to operate more efficiently on a world scale;
- the personal and corporate income tax reforms of 1988, that have made the tax system fairer and made economic rather than tax considerations the basis for resource allocation;
- deregulation in the energy and transportation sectors, thereby removing regulatory barriers to competition and the efficient use of resources; and
- the new labour market development strategy that will upgrade the skills of the work force.

These reforms increase Canada's potential output – its ability to supply goods and services – and make our economy more competitive. In particular, the Free Trade Agreement and sales tax reform will yield large economic benefits for Canada. It is estimated that together they will raise output by as much as 5 per cent, or more than $30 billion in today's dollars. Almost one-third of this gain, or some $9 billion, will be the result of sales tax reform.

A Fairer System

This government shares with Canadians a commitment to ensuring fairness in our tax system. Sales taxes have been viewed historically as inherently regressive. That is why this government introduced a refundable sales tax credit into the income tax system in February 1986. In the April 1989 budget, as a first step toward the new Goods and Services Tax Credit, the government enriched the existing credit. By 1990, it will be $140 for adults and $70 for children. In addition, the income threshold – i.e., the income level up to which the full credit is provided – will have been raised to $18,000. For recipients of the full credit, these changes more than offset the increases in the federal sales tax announced in the April budget. Canada's system of refundable income tax credits is one of the most effective in the world.

Once the Goods and Services Tax is implemented, the progressivity of the federal tax system will be enhanced. A fairer system will be achieved through a number of integrated tax changes that will target income tax assistance to lower and modest income Canadians. As a result, families earning less than $30,000 per year will be better off after the Goods and Services Tax is in place.

B. The Existing System Must Be Replaced

Structurally Flawed

The existing federal sales tax was put in place in 1924. At that time, the economy was characterized by relatively simple patterns of production and distribution. By and large, manufacturers engaged solely in production and wholesalers in distribution. Neither engaged in retailing. But today, in Canada and throughout the industrialized world, there is a high degree of vertical integration between manufacturers, wholesalers and retailers. Yet Canada is alone among industrial nations in its continued reliance on a manufacturers' sales tax. The tax is antiquated and hurts our ability to compete with the world.

The key structural failings of the tax are widely acknowledged.

1. A Tax That Damages Competitiveness

The present tax is buried in the price of all goods and services made in Canada, even those that are nominally exempt from the tax, such as food and clothing. Because the tax is levied on a broad range of business inputs, including such items as motive fuels, vehicles, computers, office furniture and equipment, and telecommunications services, a part of the tax is imbedded in the prices of all the goods and services produced using any of these inputs.

Further, the FST results in a form of double taxation, or tax cascading. Tax is applied to inputs used in the production process which becomes imbedded in the selling price of the goods they are used to produce – goods which, in turn, are subject to tax. For example, a firm making computers also uses taxable telecommunications services. Eventually, part of that tax is passed on in the price the firm charges other businesses for its computers. Since computers are taxable under the FST, the purchasing firm ends up paying tax on the full purchase price, including that part of the telecommunications tax imbedded in the computer's price.

While exports are not taxed directly, taxes paid at the manufacturing level become an indirect charge on Canada's exports. In international markets, this places Canadian-made products at a competitive disadvantage.

2. Favours Imports Over Canadian-Made Goods

The present tax is the only consumption tax in the industrialized world that favours imports over domestically produced goods. Two features of the present tax system cause this result. First, a significantly higher degree of tax cascading is reflected in the price of goods made in Canada. Second, when the FST is applied to imported products, it is levied on a price that does not generally include the costs of marketing and distribution – costs that are usually included in domestic manufacturers' selling prices. The importer therefore pays less tax and can thus price more competitively than the Canadian producer. In fact, on average, the tax as a percentage of the retail price is one-third higher on domestic goods than on competing imports.

3. Discourages the Efficient Allocation of Resources

Under the current system, manufacturers can reduce their tax liability by shifting activities such as marketing and distribution beyond the point of taxation. As a result, firms structure their activities for tax reasons, rather than for sound business efficiency reasons. Business decisions are distorted and inequities are created between firms that are able to restructure and those that cannot. These activities also serve to erode the tax base further and to reduce the reliability of sales tax revenues.

4. Discriminatory, Narrow Tax Base

About one-third of the goods and services Canadians buy are directly subject to federal sales tax. Of these, four (tobacco, alcohol, automobiles and auto parts, and motive fuels), representing 16 per cent of consumer expenditures, generate one-third of all federal sales tax revenue. This represents one of the narrowest consumption tax bases in the industrialized world.

5. Excessively Complex

The present tax is very complex both for business to comply with and for the government to administer. Unlike the Goods and Services Tax, the present tax applies at four different rates. There is a host of exemptions. In defining those exemptions, it has been necessary to draw ever finer distinctions between products so that today, for a system that includes 75,000 firms, there are no fewer than 22,000 special arrangements and administrative interpretations required to keep the tax in operation.

6. Distorts Consumers' Choices

At present, the tax is applied at the manufacturing stage of production – prior to the retail stage when most consumers make their purchases. Consumers have no way of knowing the true magnitude of post-manufacturing mark-ups at the wholesale and retail levels. These mark-ups vary widely, both across different industries and across competing products within industry sectors. The effect on retail prices is therefore highly variable and unpredictable. Indeed, it is virtually impossible for consumers to know how much federal tax they are paying when buying a product. Consumers' perceptions of the underlying value of products is distorted and their purchasing choices are biased.

In summary, the inadequacies of the present federal sales tax are clear. It is outdated and damaging our ability to compete with the rest of the industrialized world. It is hindering our ability to use our resources efficiently and lowering our productivity. It is complex and inequitable. The tax is constraining our economic output by about $9 billion per year.

The system has been pushed beyond its limits and can no longer sustain the demands placed upon it by Canada's sophisticated and internationally-oriented economy. The structural weaknesses of the system have afforded some corporations the opportunity and the incentive to explore and use all means available to reduce their tax liabilities. As such, the federal sales tax is an increasingly unpredictable and unreliable source of important revenues for government services. It is essential that it be replaced.

A Major Change

Securing Canada's economic future is among this government's highest priorities. Abolishing the present federal sales tax and replacing it with a comprehensive, modern consumption tax system is an essential element of the government's plan to achieve that goal. The government recognizes that the replacement tax – the new Goods and Services Tax – represents a major change in the manner in which the federal government collects its sales tax revenues. For this reason, the government has had extensive consultations with Canadians since proposing sales tax reform in June 1987.

The design of the GST is guided by two basic objectives:

- to manage reform in a way that protects lower and modest income Canadians; and
- to make the new GST system straightforward for Canadians to comply with.

1. Protecting Lower and Modest Income Canadians

Canada is in a unique position: our extensive experience with refundable tax credits delivered through the income tax system ensures that we will be able to offset the regressivity that is inherent in taxing consumption. The package of integrated measures that will accompany the GST will ensure the tax system is fairer after sales tax reform than before.

A broad tax base, a low rate, and an effective mechanism for targeting assistance are the best means of guaranteeing fairness to Canadians. The most common alternative, removing items from the consumption tax base, provides the greatest benefit to the wealthy. It also significantly increases the complexity of the tax for both consumers and businesses, and requires a higher rate on other items that will be purchased by lower income households.

Increased assistance provided through the refundable GST Credit, in tandem with the lowering of the middle personal income tax rate, will protect lower and modest income Canadians from the otherwise potentially regressive impact of sales tax reform. Families earning less than $30,000 will be better off once the GST has been implemented than they are under the existing system.

This government recognized the value of credits when it first introduced the refundable sales tax credit in 1986. Refundable credits can be targeted to those who need them and adjusted to meet the requirements of households of varying circumstances and sizes. Benefits can be delivered on a regular basis and in advance of paying the GST.

Since Canada already operates a sophisticated refundable credit system, the vast majority of lower income Canadians currently file income tax returns. This ensures they receive the credit even when no income tax is paid. The 1989 income tax forms will contain a GST Credit application. The information requested will be essentially identical to that now required for the existing refundable sales tax credit. The new GST Credit will be delivered automatically, four times a year and by separate cheques. Over 9 million Canadians will receive GST Credit cheques.

2. Straightforward Operation

The government is committed to making the Goods and Services Tax straightforward. The single 9-per-cent rate and broad base already make the GST simpler in operation than either the present tax or indeed most of the consumption tax systems of other countries. Additional steps will be taken to ensure that the tax will be straightforward in operation for small businesses.

a) Consumers

For consumers, the GST will be similar to a retail sales tax. The GST replaces an existing tax that is charged, directly and indirectly, at varying rates on a range of goods and services. The GST will apply at the retail level, at a single rate of 9 per cent, to a very broad range of goods and services. This does not mean, however, that the prices of those goods and services subject to the GST will rise by 9 per cent. Price changes will reflect the combined effect of removing the old tax and then applying the GST. For example, under the new system, a new car will be taxed at a rate of 9 per cent of the selling price, rather than 13.5 per cent of the price at the wholesale level.

Under the new system, the amount of tax in the retail price of all taxable goods and services will be the same – 9 per cent. There will therefore be virtually no tax distortion in the marketplace between imported and domestically produced goods;

between goods sold by independents and goods sold by large department and chain stores; and between the sales of goods and services.

b) Business

With a single rate and a broad base, the tax will be straightforward. Most businesses will simply subtract the tax paid on their purchases from the tax charged on their sales. If the tax collected on their sales is greater than the tax paid on their purchases, the difference will be remitted to the government. If it is less, the difference will be refunded to the business.

In recognition of the more limited administrative resources available to smaller businesses and in order to reduce further their compliance burden, the government has designed a number of measures for their use. These measures include:

- a small traders' exemption whereby small businesses with annual sales less than $30,000 may, if they wish, remain outside the GST system;
- streamlined accounting systems;
- less frequent filing requirements than large firms; and
- a small business administration fee of up to $600 per year.

In addition, the government will provide assistance to firms wishing to modernize their cash registers. Together with the single rate and broad base, these measures make the GST straightforward for businesses to operate and simple for consumers to understand.

II. Overview of the System

A. How the GST Works

The GST is a tax on final consumption. It will apply at a rate of 9 per cent to the vast majority of goods and services sold in Canada. Unlike a retail sales tax, the GST will operate throughout the production and distribution chain.

This multi-stage collection process is a common tax structure that is currently in use in 48 countries around the world. Indeed, it is now the predominant system used for the general taxation of consumption in industrialized countries. Today, 19 of 24 of the most highly industrialized economies in the world – the members of the Organization for Economic Cooperation and Development – rely on sales tax systems of this kind. One reason for the common use of this type of consumption tax is its superiority to a retail sales tax system.

- Unlike a retail sales tax, the GST successfully removes tax from productive inputs. This increases incentives for investment and, in turn, results in greater domestic output and higher real incomes.
- The multi-stage nature of the GST means it is less prone to avoidance and is, therefore, a more reliable and secure source of revenue than a retail tax.

The sound structure and operation of the GST make it the best option for replacing the present tax. The chart on page 10 illustrates the GST in operation.

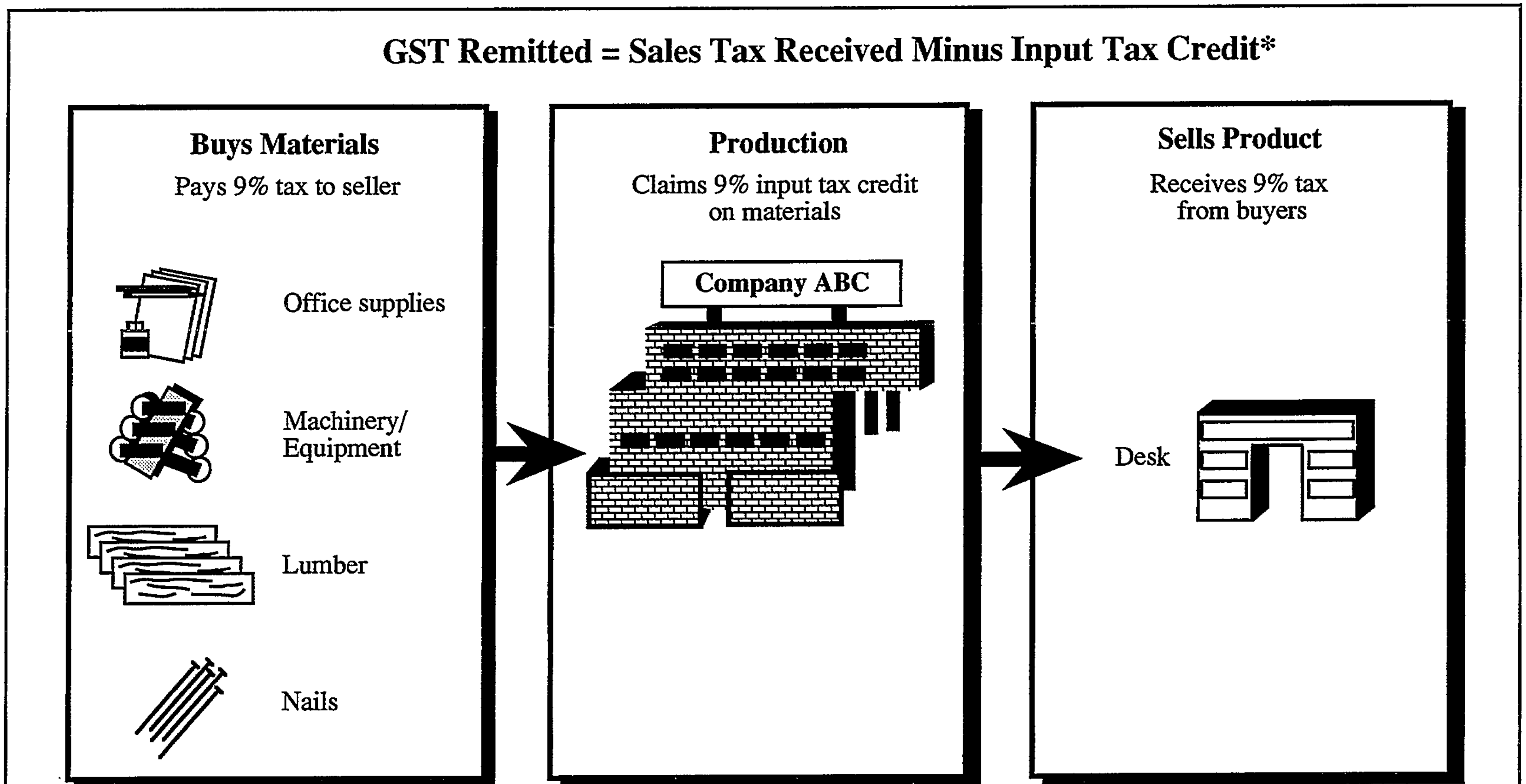
Under the GST system, purchasers will be required to pay the 9-per-cent tax to the supplier of the taxable good or service. The supplier, in turn, will be required to remit the tax to the government. Every person engaged in a commercial activity (unless specifically exempted by the $30,000 small business threshold) will collect the GST on all the taxable goods and services they provide in the course of carrying on that activity.

Once a taxable good or service has been sold, the seller will remit the difference between the tax collected on sales and the tax paid on purchases. Sellers will get the tax on their inputs back through an input tax credit. This system of input tax credits will ensure that only the final consumption of goods and services is taxed.

The GST will apply to goods and services produced, imported, and consumed in Canada. As a result, Canadian-made goods and services will compete in the domestic market on an equal footing with those produced outside the country. Canadian-made products destined for export will also have all the GST removed.

Chart 1

Goods and Services Tax: Basic Operation



* *Note*: If the input tax credit exceeds the sales tax received, then Company ABC will get a tax refund for the difference.

Since other countries with a similar tax system also remove the consumption tax from their exports, this will help our products compete more effectively in the international marketplace.

B. What Is Taxed

The goods and services that will be taxable under the GST constitute the tax base. The GST base will be very broad, covering the vast majority of goods and services consumed in Canada. The broad nature of the base is both desirable and necessary in meeting the objectives of fairness and simplicity. A broad base, in conjunction with a generous refundable sales tax credit, will ensure that lower and modest income Canadians are better off under the GST. Further, a broad base means there is much less interference by the tax system with consumers' choices in the marketplace.

Canadians will not be charged GST on a limited number of goods and services. Items on which the GST will not be charged fall into two categories: tax free and tax exempt.

For tax-free – i.e. "zero-rated" – sales, vendors will not charge GST. However, they will still be able to claim input tax credits for any tax paid on purchases used in making the tax-free good or service. This will effectively remove all tax from these goods and services.

For tax-exempt sales, vendors will not charge tax on their sales. By the same token, however, they will not be able to claim input tax credits for the GST paid on inputs bought for the purposes of making the exempt good or service.

Tax-Free Items

1. Basic Groceries

In December 1987, the government decided to exclude basic groceries from the GST base. In keeping with this commitment, basic groceries – covering the overwhelming majority of sales of food for preparation and consumption at home – will not be subject to the GST.

However, consistent with their treatment under the existing federal sales tax, soft drinks, candies and confections, and snack foods will continue to be taxable.

Restaurant meals and prepared take-out foods will also be taxable. This is consistent with their treatment under most provincial retail sales taxes. As well, it recognizes the distinction between foods prepared and consumed at home, and those prepared in eating establishments.

Notwithstanding this general treatment, the following categories of prepared foods will be exempt from the GST:

- food service programs provided in nursing homes;
- university meal plans;
- primary and secondary school prepared meals;
- Meals on Wheels and similar programs offered by charities and non-profit organizations; and
- food and beverages provided by charities and non-profit organizations for the purposes of relieving suffering or distress.

Because there are some food products that are not easily placed in one or the other broad categories of basic groceries and prepared foods, the government will be consulting with consumers and with the foodservices industry to determine the most practical way of drawing the necessary boundary lines.

Basic groceries will be tax free throughout the production and distribution chain. Therefore, there will be no tax on sales of basic foodstuffs to food processors, to wholesalers, or to retailers. In keeping with the treatment of basic groceries, sales by farmers and fishermen of agricultural and fish products will be tax free.

2. Prescription Drugs

All drugs prescribed by authorized medical practitioners will be tax free.

3. Medical Devices

The broad range of medical devices currently exempted from federal sales tax will be tax free under the new system. In addition, replacement parts and repairs to such devices will be tax free. These medical devices include such items as: prescription eyeglasses and contact lenses, hearing aids, artificial limbs, canes, crutches and wheelchairs, diabetic equipment, and hospital beds.

Tax-Exempt Items

1. Health and Dental Care

Virtually all health and dental care services will be exempt from the GST. The exemption includes: health care services provided by a public or private hospital, or nursing home; and services provided by health care practitioners if they are insured under the health care plans of two or more provinces. This will include, among other things, physiotherapy, optometry, and chiropractic services.

2. Educational Services

The exemption for educational services is very broad and falls under the following categories.

(a) Elementary and Secondary Schools

Schools that follow the approved curriculum of their province will not charge tax on their instructional services. The exemption will also apply to school-organized activities provided for the benefit of students, such as cultural or language exchanges. In addition, extra-curricular courses providing instruction in either of the official languages of Canada will be exempt.

(b) Publicly Funded Colleges and Universities

Credit courses offered by publicly funded colleges and universities will be exempt from the GST. Courses of instruction in either of the official languages of Canada, whether part of a degree or diploma program or not, will also be exempt.

(c) Courses for Entry into Regulated Professions

Many professions are regulated under statute by non-profit organizations. Courses or examinations provided by these organizations to acquire or upgrade a professional accreditation, for example, bar admissions courses, will be exempt.

(d) Occupational Training in Private Vocational Schools

Instruction in courses that are part of a program designed to develop or enhance students' occupational skills, when the instruction is provided by an institution organized and operated mainly to provide such training, will not be taxed. To be exempt, courses must be part of a program that leads to a diploma or certificate similar to that provided by a community college or similar institution. Courses that will qualify for an exemption would include, for example, those offered by private secretarial schools. Such things as sailing, skating and wine-tasting courses would not generally qualify.

3. Day-Care Services

Day-care services provided on a non-profit, commercial, or public basis will be exempt. This includes day care provided in private homes and services provided in provincially licensed centres. The exemption also covers nursery school services, after-school programs provided by schools and community centres, and day camps.

4. Legal Aid Services

Legal services provided under a provincially authorized legal aid program will be exempt. This exemption will apply to payments to the lawyer by both the client and the legal aid society.

5. Residential Rents

As indicated in the June 1987 White Paper, rents for long-term accommodation will be exempt.

6. Financial Services

The June 1987 White Paper proposed a unique tax structure for the financial sector that attempted to identify the charges for financial services that are included in the margin of financial institutions. While some progress was made in translating this proposal into an operational tax structure, substantial technical problems remained. Given this, and the fact that no other country in the world has successfully applied sales tax to financial services, the government announced in the 1989 budget that GST would not apply to financial intermediation services.

Accordingly, the GST will affect the financial sector in three ways. First, financial institutions will pay tax on their purchases. Second, financial services, such as loans and deposits, mortgages, and life, property and casualty insurance, will not be taxable. And third, most of the remaining services provided by financial institutions (such as safety deposit boxes, for example), will be taxable in the normal manner.

Identifying taxable and exempt services in this area is a technically difficult undertaking. In order to ensure the approach is clear and practical, the government will be consulting further with tax professionals and the industry.

7. Municipal Transit and Passenger Ferries

As indicated in the June 1987 White Paper, passenger transportation provided by municipal transit services on a non-profit basis will be exempt. Passenger ferry services will also be exempt.

C. The GST in Operation

Ensuring Fairness

1. Income Tax Changes

(a) Refundable Goods and Services Tax Credit

Once the GST is in place, the federal tax system will be more progressive and lower and modest income Canadians will be better off. This will be achieved through the implementation of a new refundable GST Credit. The Credit will be paid quarterly and in advance of expenditures on taxable goods and services by households. As such, the first payment of the Credit will be delivered to recipients in December 1990, i.e., prior to the GST start-up date of January 1, 1991.

(i) Credit Design

The GST Credit will be similar to the present refundable federal sales tax credit in that it will be calculated on the basis of income tax returns. This allows the assistance to be well-targeted and ensures an exceptionally high take-up rate by Canadians eligible to receive it. The government will be working closely with the social services community to ensure that those Canadians who are most severely disadvantaged, and sometimes without a permanent home, receive the GST Credit with a minimum of effort. The amount of the GST Credit received will be based on the recipient's prior year income and family status in order to ensure assistance is delivered before expenditures by households.

The Credit will be provided in four equal payments (July, October, January and April). To ensure that the first quarterly payment occurs prior to implementation of the GST, it will be made in December 1990.

(ii) Amount of Credit

At $275, the adult credit will be almost tripled from its present level, and will be double the level of the 1990 federal sales tax credit.

The $100 child credit will represent a doubling of the current child credit and will be one and one-half times its level in 1990.

Single parents will also claim an adult credit of $275 for one of their children.

Eligible single adults will be provided with an additional credit of up to $140. Single parents will also be eligible for this additional credit. A single adult eligible for both the full adult and the additional credits will receive $415 in total. A single parent of one child, eligible for full credits, will receive $690 in total.

The income threshold at which the GST Credit begins to be phased out will be raised from the 1990 level of $18,000 per year, to the level of the child tax credit, or about $25,000. Over 9 million Canadians will receive Credit cheques.

The GST Credit and its threshold will be indexed to increases in the consumer price index (CPI) in excess of 3 percentage points. This is consistent with the current indexation in the personal income tax system.

The following table illustrates the level of GST credit associated with annual incomes and family size.

Annual Sales Tax Credit

	Credit					
	Single			Family of four (2 adults, 2 children)		
Income	1988	1990	1991	1988	1990	1991
	(in dollars)					
10,000	70	140	352	210	420	750
15,000	70	140	415	210	420	750
20,000	0	40	415	10	320	750
25,000	0	0	405	0	70	740
30,000	0	0	155	0	0	490
35,000	0	0	0	0	0	240

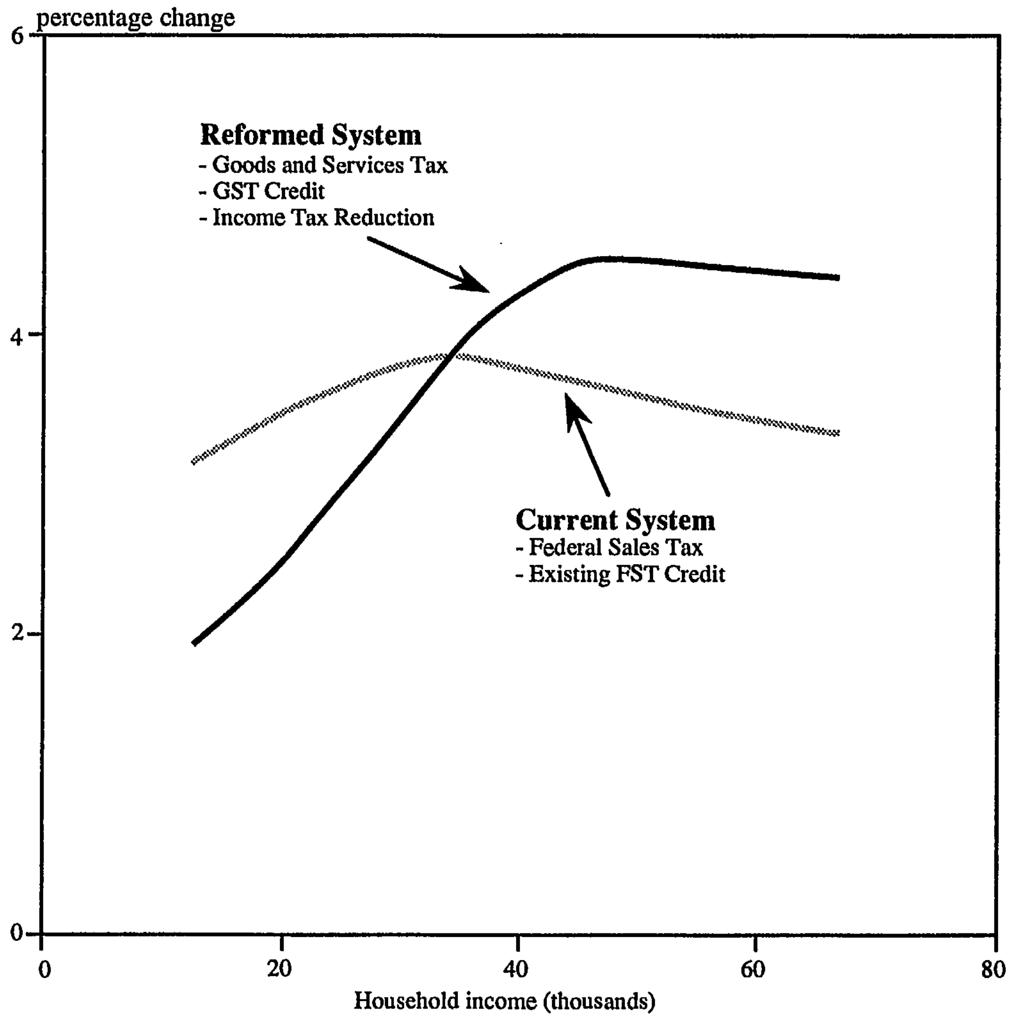
(b) Middle-Income Tax Rate Reduction

In 1991, the middle personal income tax rate will be reduced from 26 per cent to 25 per cent. This measure will provide a tax reduction to middle-income earners in the income range where the credit is being phased out. Lowering the middle personal income tax rate will also provide a more progressive income tax rate schedule of 17 per cent, 25 per cent, and 29 per cent.

Chart 2

Fairer System

Families with Children



Together, the refundable GST Credit and the lowering of the middle personal income tax rate meet the government's commitment to improve the overall fairness of the tax system. As a result of these measures, families earning up to $30,000 per year will be made better off under the GST system.

2. Housing

Although the existing federal sales tax does not apply directly to sales of new homes, a substantial amount of sales tax is hidden in house prices. Most of this tax burden comes from the 9 per cent FST applied to building materials such as lumber, bricks, doors and windows, and the 13.5 per cent tax applied to other items such as paint and wallpaper.

For the nation as a whole, the current effective FST rate on a newly constructed house, including the sales tax increases announced in the 1989 budget, averages somewhat more than 4 per cent. This means that the cost of a typical house of $150,000 is really $144,000 with about $6,000 worth of tax. This effective tax rate varies across Canada primarily because of differences in the relative importance of the currently untaxed land costs in the price of new houses.

Unlike the existing system, under the GST no net tax will be collected on the inputs used to produce a house. Instead, sales tax will be applied directly to the sale of newly constructed houses. Residential rents will be tax exempt since GST will be collected when the developer/builder sells the rental dwelling to the landlord. The resale of existing houses will also be exempt from the new tax. It would be unfair to tax the sales of these houses under the GST since they already contain a substantial amount of tax under the existing system.

Given that the current effective tax rate on a new house is a little more than 4 per cent on average, the increase in price due to the introduction of the 9 per cent GST would be somewhat less than 5 per cent. In light of this, the 1989 budget indicated that the GST would not be allowed to prejudice the reasonable opportunity for home ownership that Canadians would otherwise have enjoyed.

In order to fulfill this commitment, a special housing rebate will be introduced which will substantially offset the impact of the GST on the price of newly constructed and substantially renovated houses purchased as principal residences. The GST housing rebate will direct about $900 million to buyers of new houses. Consistent with its approach to the refundable GST Credit, the government believes that any special tax provisions for housing should be well-targeted. As a result, there will be a restriction on the price of houses eligible for assistance. This will prevent very wealthy households from benefiting from the rebate.

a) How the Rebate Operates

The rebate will be operated by the home builder at the time of sale. This will ensure that purchasers benefit from the rebate immediately and do not have to go through a lengthy administrative process. For houses priced at $310,000 or less, the rebate will be 4.5 per cent. In effect, the seller of the house will simply charge GST at a rate of 4.5 per cent, approximately equivalent to the existing FST in the price of a new house. For houses priced between $310,000 and $350,000, the rebate will be $13,950, i.e., the value of the 4.5 per cent rebate on a $310,000 home. For houses between $350,000 and $400,000, the rebate will be calculated on a downward sliding scale. No rebate will be provided for houses costing $400,000 or more.

Perhaps the best measure of the impact of the GST on the affordability of a newly constructed home is the anticipated impact of the GST net of rebate on monthly mortgage payments. This is illustrated in the following table.

Effect of the GST on Typical House Purchase

City	Current typical house price	Additional tax with 9% GST	Additional tax after rebate	Net effect on monthly mortgage payments*
		(in dollars)		
Halifax	95,000	4,400	300	2
Charlottetown	80,000	2,750	(650)	(5)
Trois-Rivières	70,000	2,600	(400)	(3)
Montreal	100,000	5,100	750	6
Toronto	270,000	16,250	4,450	35
North Bay	120,000	5,050	(100)	(1)
Regina	100,000	4,900	550	4
Edmonton	120,000	5,550	350	3
Vancouver	190,000	9,900	1,650	13

* Estimates assume a 12 per cent mortgage amortized over 25 years, and a downpayment equal to 25 per cent of the purchase price. Brackets indicate a reduction.

As a result of the GST housing rebate, the tax will not pose a barrier to affordability. In virtually every city in Canada, the increase in typical house prices due to the GST will be one per cent or less. Indeed, in many parts of the country, the net increase will be less than one-half of one per cent. In many other centres, the amount of federal tax on a house will fall. The principal exception will be Toronto where, at present, land prices are extraordinarily high. Notwithstanding this, the GST rebate will limit typical house price increases in that city to about 1.6 per cent.

Because the price of houses people purchase is tied closely to their household income, the vast majority of program funds will be targeted to middle-income Canadians. The following table shows the distribution of rebates according to household income range.

Distribution of Rebates by Household Income Range

Household income	Distribution
(thousands of dollars)	(per cent)
0 - 40	14.0
40 - 60	36.5
60 - 80	35.4
80 - 100	13.9
100 +	0.2

The GST housing measure will ensure the government meets its commitment by providing assistance directly to those home buyers who otherwise might be faced with an affordability problem as a result of the tax change. Over 90 per cent of purchasers of newly constructed homes will receive the maximum rebate, and 85 per cent of program funds will go to Canadians with household incomes under $80,000.

Operational Issues

1. The GST and Consumers

The federal government is committed to ensuring that Canadians are informed in a clear and visible manner that the GST is being applied. In this regard, the GST will be very different from the existing federal sales tax.

The vast majority of Canadians are currently not even aware that they are paying FST, and those who are aware cannot calculate the actual amount of tax that is paid on any given purchase. This disservice to consumers stems from the structure of the tax itself.

First, because the tax is applied on sales by manufacturers to wholesalers and retailers, consumers pay the tax in the form of higher prices. The fact that tax is included in these prices is not apparent to the consumer. Moreover, because there are four different tax rates and because wholesale and retail mark-ups vary widely, it is impossible for even the informed consumer to know how much federal tax is being paid when buying a commodity.

Second, because the federal sales tax applies to a broad range of inputs into the Canadian production process, a hidden tax burden is imposed on virtually every domestic good or service purchased in the country.

The GST will be a visible tax. The essence of visibility involves the application of tax at the retail level on a very broad base with a uniform rate. This ensures that Canadians will know when and at what rate they are paying federal sales tax.

The government believes that a model presentation of the GST by retailers has two key components.

- Identifying separately the amount of tax on cash register receipts. This ensures that consumers will have a tangible record of the amount of federal tax paid on purchases.

- Prominently displayed prices within the store (e.g., shelf prices) should incorporate the GST, thereby informing consumers of the total of the cost of the good and the federal tax. This will assist them in making budgeting decisions as they shop, before they go to the check out counter. Where vendors choose to incorporate the GST in their shelf prices, this fact should be clearly indicated.

Vendors will be encouraged to adopt this model approach for the presentation of the GST. However, not all firms will be able to do so, at least in the short term, because of the technological constraints imposed by the cash register systems that are already in place in stores. These constraints will make it difficult for many retailers to identify two separate sales taxes – the provincial retail taxes and the GST – at the cash register simultaneously. Over time, as retailers upgrade their cash registers or introduce bar code scanning systems, it will become easier for them to identify the GST on register receipts in most stores. The federal government believes it is important to assist vendors to overcome these technological constraints on the model presentation of the tax. As a result, assistance will be provided for firms purchasing more sophisticated cash register equipment.

Cash register constraints may be particularly severe in those stores selling a mixture of taxable and tax-free items under both the GST and the provincial retail sales taxes (e.g., grocery stores). Small businesses in this situation will be able to adopt streamlined accounting procedures which will remove the need to keep track at the cash register of both categories of sales. As a consequence, these vendors will not be able to identify the amount of GST separately on cash register slips. This overall approach for small business reflects the government's commitment to ensuring that sales tax reform is practical. In this instance, it avoids forcing small businesses to make immediate and often costly changes in their cash register and accounting systems.

In all stores where the GST is included in the price, the government will provide retailers with the appropriate signs required to indicate this fact to consumers.

The government will also be working with business associations and individual retailers to promote the model presentation of the tax. Moreover, the government will be consulting with business associations and advertising councils to promote consistent pricing and advertising practices.

Although the GST will apply to goods and services at a 9-per-cent rate, this does not mean that prices will increase by that amount. This is because the 9-per-cent GST will be replacing the existing tax which is levied, both directly and indirectly, at four different rates on a range of goods and services.

So the impact of the GST on prices will be the result of the combined effect of removing the old tax and replacing it with the GST. The price of things that are not taxed under the existing system will increase, while the price of many goods now taxed at the standard 13.5 per cent rate will fall.

There will be a number of forces operating to ensure that the savings from the removal of the existing federal tax will be passed on to consumers. The first, and most important of these, will be the competitive pressures of the marketplace itself. Each individual firm will have an incentive to reduce prices to gain an edge over its competitors. They, in turn, will respond by matching price reductions in order to remain competitive, setting in motion a chain reaction that should effectively flow tax savings through to consumers.

To strengthen these competitive pressures, the government will be working with wholesalers and retailers to ensure they are fully aware that the 13.5 per cent federal sales tax on manufacturers' selling prices will no longer be in effect as of January 1, 1991.

These market forces will be reinforced if consumers are in a position to make their own judgements about the price consequences of implementing the GST. To assist consumers in this regard, the government will establish a special office to provide information, prior to implementation, about what consumers might expect in terms of price increases and decreases for key goods and services. After implementation, the office will receive consumer complaints about pricing practices related to the introduction of the GST and investigate allegations of unfairness.

2. Small Business

In order to keep the tax straightforward for small firms to administer, the following measures have been designed.

- Businesses with annual sales of less than $30,000 will choose whether or not they wish to be in the GST system. As a result, more than three-quarters of a million small businesses will be relieved of the need to operate the tax.
- Streamlined accounting procedures will permit businesses that sell a mixture of taxable and tax-free products and have annual sales of less than $2 million to calculate the tax owing on their sales on the basis of the taxable status of their purchases. As a transitional measure until 1993, firms with sales between $2 million and $6 million will also have access to streamlined accounting systems.

- To minimize paperburden, small businesses with annual sales of less than $500,000 will be able to calculate their tax once a year and remit quarterly instalments. Those with between $500,000 and $6 million in annual sales will be able to calculate and remit their tax quarterly. Large businesses with sales over $6 million will remit the tax monthly.
- Small businesses will be paid an administration fee of up to $600 per year to help offset compliance costs. This measure will direct about $600 million to small businesses.

3. Charities

In recognition of the important contribution of charitable organizations to Canadian society, they will be provided with a rebate of 50 per cent of the GST they pay on their purchases.

Sales by charities will, for the most part, be exempt from GST. In the interest of fairness, where charities compete with businesses in making commercial sales, such sales will be taxable.

There will be a comprehensive exemption for activities undertaken exclusively by volunteers.

4. Non-Profit Organizations

Non-profit organizations (NPOs) that receive at least 50 per cent of their funding from governments will also receive a rebate of 50 per cent of any GST they pay on their purchases.

Commercial activities undertaken by NPOs in competition with private businesses will be taxable. However, a large number of their activities will be exempt, including, for example: health and education services and services provided to the aged and the disabled.

5. Farmers and Fishermen

In keeping with the decision to make basic groceries tax free, all sales of agricultural products, farm livestock and fresh caught fish will be tax free. As such, farmers and fishermen will be able to claim input tax credits and will be refunded the GST they pay on their purchases.

6. Government Sector

In designing the operation of the tax in the government sector, the goal is to ensure that competitive equity is preserved between the public and private sectors with respect to the provision of goods and services, while recognizing the unique role that public sector bodies play in Canadian society.

Competitive equity will be preserved by treating goods and services in the same manner whether they are provided by the public or private sector. In other words, it will be the nature of the product rather than the nature of the provider that will determine the product's tax status.

Many government activities will not be considered taxable goods and services for the purposes of the GST, even though Canadians may pay a transaction fee for the service. For example, transactions arising out of the regulatory functions of government will generally not be taxable. This will include the provision of driver's licences, radio broadcasting licences, passports, construction permits, and fines and penalties.

7. Municipalities, Schools, Colleges, Universities and Hospitals

Because these institutions will, for the most part, be providing tax-exempt services, they will be unable to claim input tax credits for GST paid on their purchases. This would result in a substantial increase in federal taxation, which the government believes would not be appropriate. Therefore, these institutions will receive partial rebates of the GST paid on their purchases to ensure that the reform of the federal sales tax imposes no greater tax burden than before reform.

D. Economic Effects

The Benefits of Sales Tax Reform

The benefits to the Canadian economy from sales tax reform will extend across all regions and sectors of the economy. They will be realized through a higher level of potential output, resulting from increases in productivity and competitiveness and expansion of the capital stock (plant, machinery, and equipment).

The positive influence of the GST is expected to be large.

- 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.

1. More Efficient Use of Resources

The present federal sales tax leads to an inefficient use of resources in the economy because it distorts relative prices of both productive inputs and final products. The distortions arise because of the four different FST rates, widespread exemptions, and the early stage in production at which the FST is levied. The burden of taxation is highly uneven as a result. In the manufacturing sector, for example, machinery and equipment used in production is exempt, while a much greater proportion of machinery and equipment purchases in other sectors is taxed. These distortions can become magnified as goods and services move in stages toward the consumer. Distorted prices lead to distorted choices: the economy is not using its resources in the most efficient way possible. This depresses potential output.

The GST will significantly reduce the influence of the tax system on the decisions of both producers and consumers. Canadian producers will compete against imports on a level playing field. Domestic producers will face the same effective tax rate as foreign producers, instead of the higher rate they now pay with the FST. For example, the current effective tax rate for domestic household furniture producers is 70 per cent higher than for foreign producers. For office machines and equipment, the margin is over 65 per cent. The removal of the tax on inputs will strengthen the international competitiveness of Canadian products in both domestic and international markets. As a result of these changes, domestic production activity will increase, along with jobs for Canadians.

2. Lower Cost of Capital Goods

For many sectors of the Canadian economy, the current sales tax system penalizes investment in capital goods by taxing capital purchases. Under the GST, purchasers of capital goods will be able to claim an input tax credit for taxes paid on such purchases. This will be equivalent to a 4-per-cent reduction, on average, in the price of capital goods. The reduction will vary from industry to industry, depending on the degree to which their purchases are now taxed. In the services sector, for example, most capital purchases such as computers and office fixtures are subject to the existing federal sales tax. Therefore, a relatively large decline in their capital costs can be expected. Lower capital costs will increase incentives to invest and lead to a significant increase in the capital stock over time.

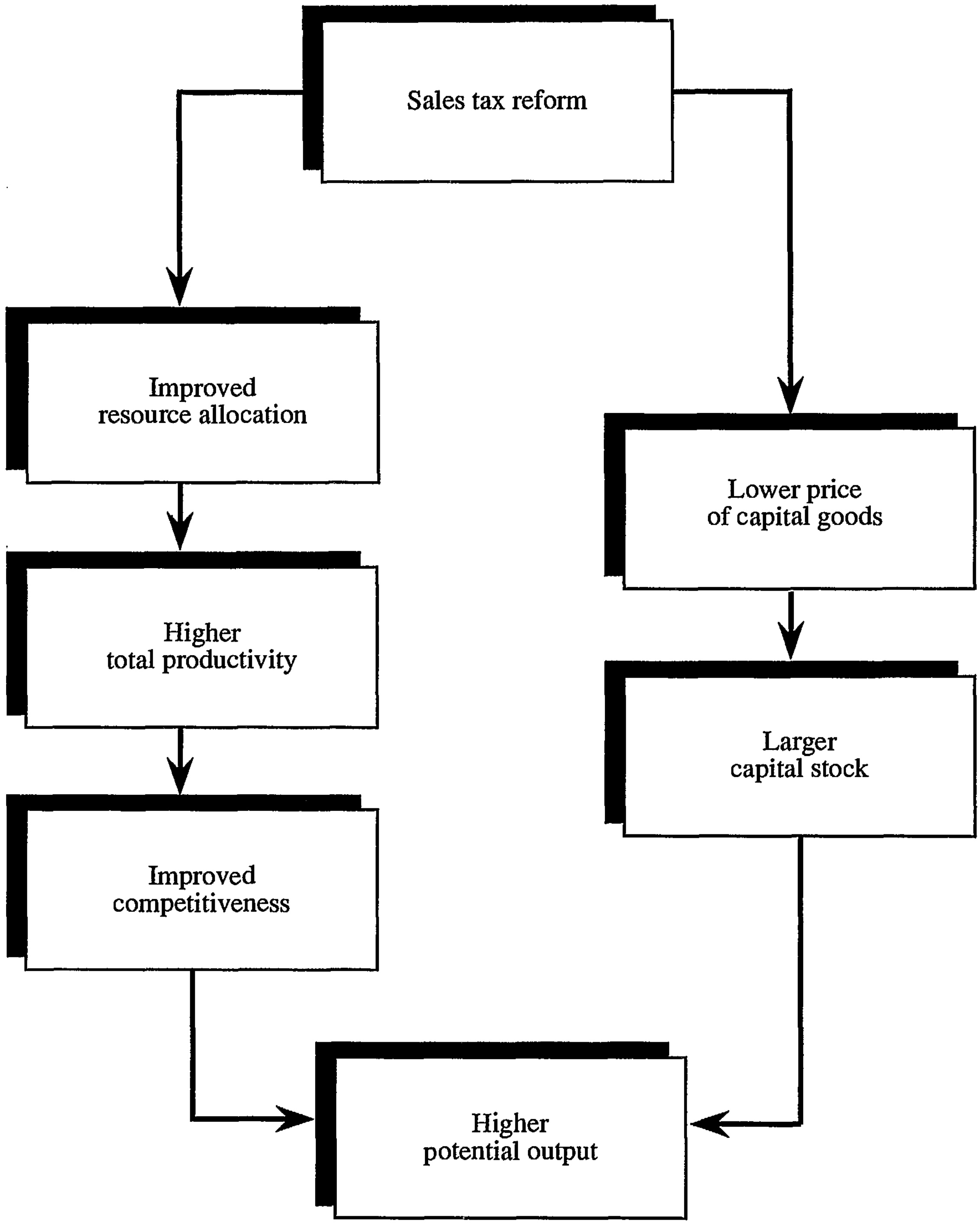
Sectoral and Regional Benefits

The improvements in Canada's economy resulting from replacing the present tax with the GST will be widely spread across Canada's economic sectors and regions.

Sectoral and regional effects will reflect the impact of FST replacement with the GST on both product prices and business input costs.

Chart 3

Impact of GST on Potential Output



Since the GST will lower the effective tax rate on manufactured goods, the prices of these products will tend to be lowered relative to other goods and services. Conversely, the GST will increase the effective tax rate on some other goods and most services; their relative prices will therefore tend to increase.

There will be opposite effects from the elimination of the FST on business inputs. For non-manufacturing sectors, such as the services and resource sectors, the removal of taxes on inputs will lower production costs, making them more competitive at home and abroad. Since a fairly large proportion of purchases in the manufacturing sector is already exempt from the FST, the removal of input taxes will benefit this sector relatively less.

The economic gains of sales tax reform will be shared across all sectors of the economy. Chart 4 illustrates the effects of sales tax reform on output by sector.

The breadth of the sectoral gains will ensure that regional benefits are also widespread. While Atlantic Canada and the Prairies will enjoy relatively higher gains from sales tax reform, there will also be gains in Central Canada.

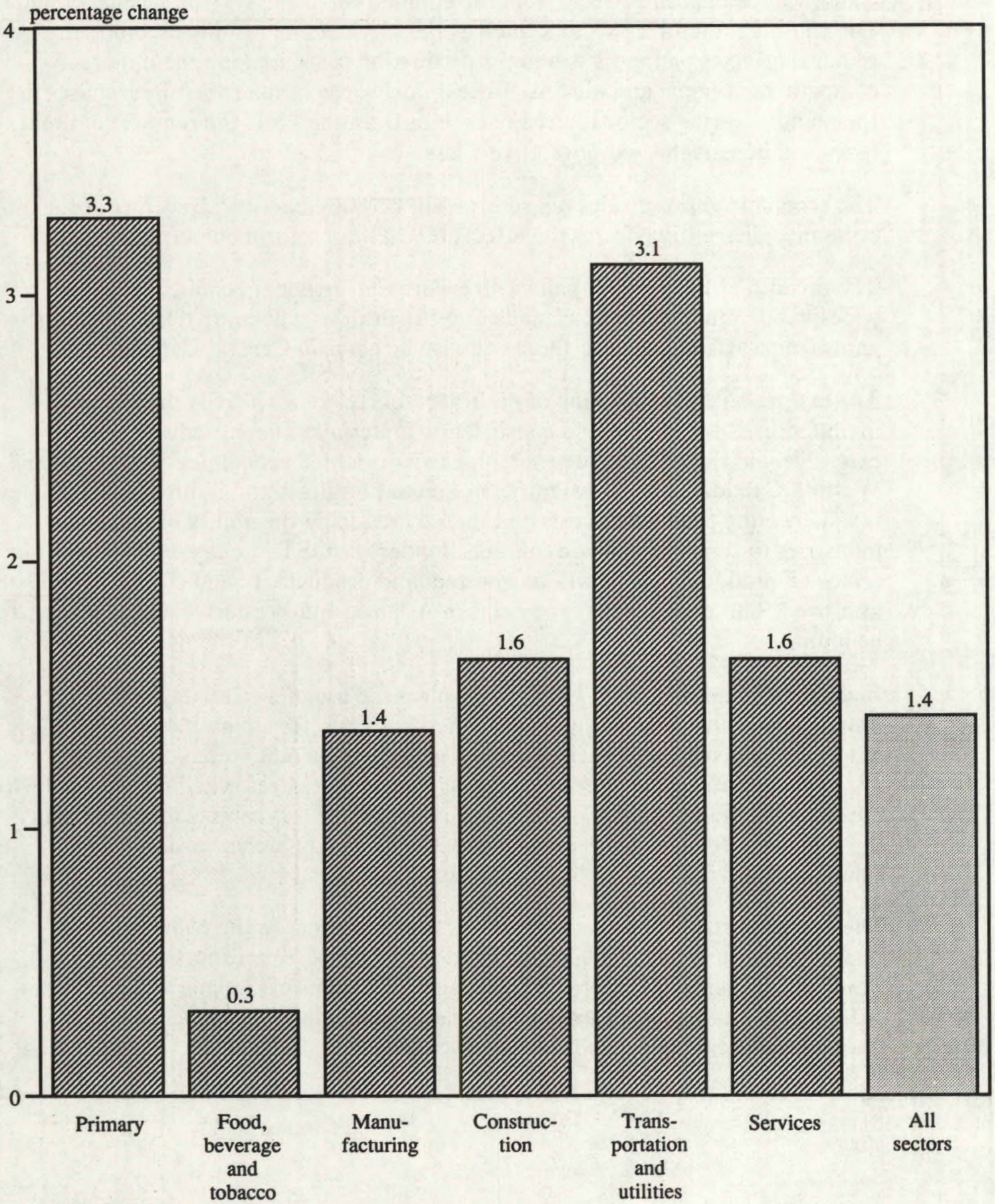
The extraction and processing of natural resources relies heavily on the use of manufactured equipment and construction materials. These products, used extensively in the resource-dependent, export-oriented economies of Atlantic and Western Canada, contain a significant amount of direct and indirect federal sales tax, increasing production costs and thereby reducing the ability of these industries to compete in world markets. Under the GST, the tax on inputs will be removed, production costs will be lowered, and productivity and competitiveness improved. This explains why the gains in Atlantic and Western Canada will be high.

In contrast, manufacturing typically involves the use of a relatively smaller proportion of previously taxed inputs. In effect, therefore, manufacturing itself is more lightly taxed than other industries under the current federal sales tax, implying a relatively smaller output gain from sales tax reform. This, coupled with the fact that industries in Central Canada tend to be less capital-intensive than those in other regions, helps explain why Ontario and Quebec have somewhat smaller gains from reform than the national average.

The complete removal of tax from the production process, the elimination of import biases, and the lifting of the burden of the tax from exports, including exports of resource-based products, suggest all regions of Canada will gain from federal sales tax reform, and in a reasonably well balanced manner. Chart 5 illustrates anticipated gains in output by region.

Chart 4

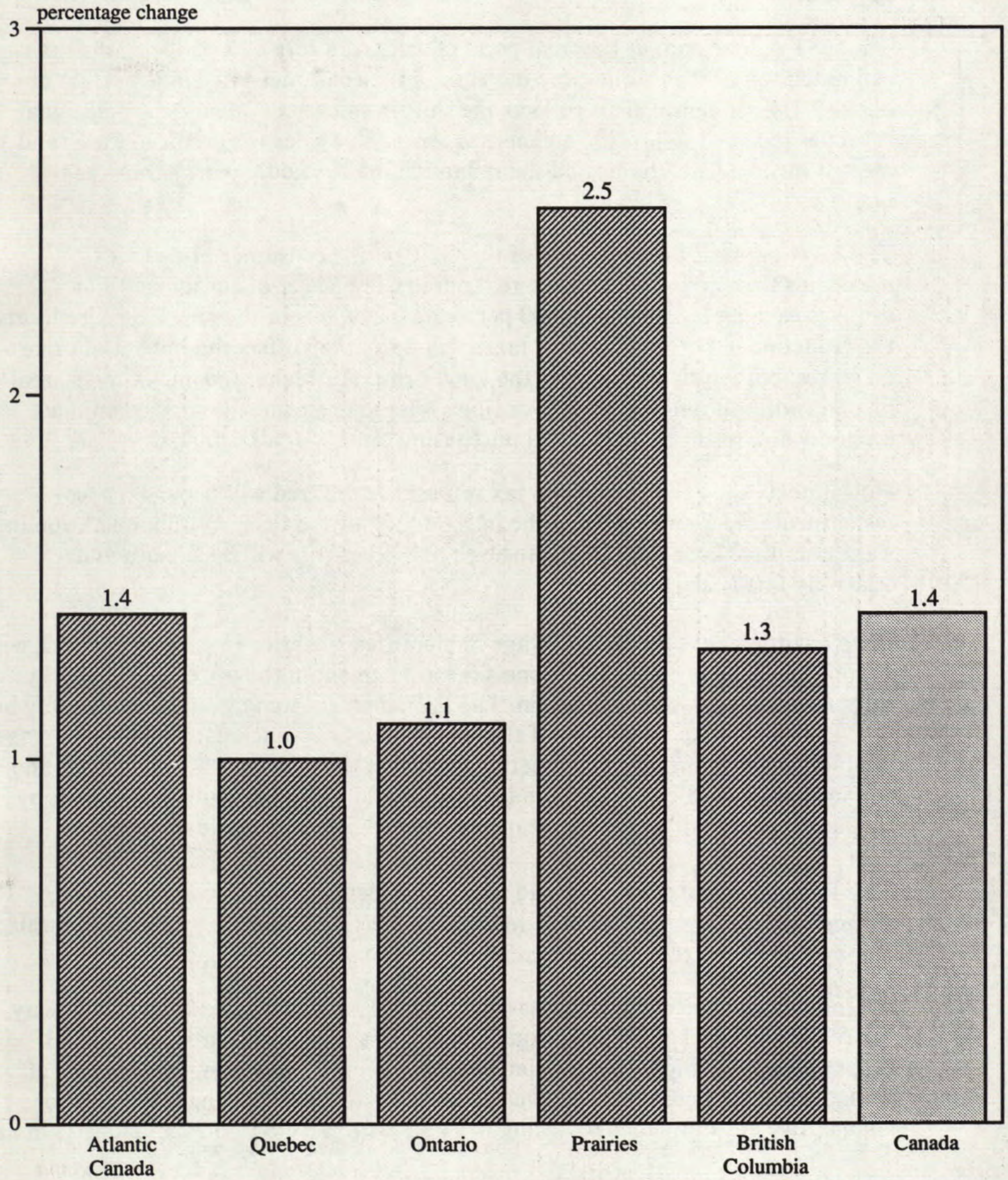
Long-Run Sectoral Output Gains From Sales Tax Reform



Source: Department of Finance, *The Goods and Services Tax*, April 1989 budget, p. 16.

Chart 5

Long-Run Regional Output Gains From Sales Tax Reform



Source: Department of Finance, *The Goods and Services Tax*, April 1989 budget, p. 18.

Managing the Transition

From its first year of implementation, sales tax reform can put the economy on a path of increased output and employment as it adjusts toward the higher level of potential output.

The GST will be paid at the final point of sale. At a rate of 9 per cent, the tax is estimated to result in a one-time increase in the consumer price index (CPI) of about 2 1/4 per cent[1]. This reflects the shift in sales tax systems, the additional revenues required to provide a generous refundable sales tax credit to lower and modest income Canadians, and the reduction in the middle personal income tax rate.

The 2 1/4 per cent direct impact of the GST on the consumer price index overstates the initial effect on the real purchasing power of consumers. For families earning less than $30,000 per year, the effects of the new GST Credit and the reduction in personal income taxes will more than offset the impact of price increases, both initially and over the longer run. For higher income families, real incomes will fall initially. But, over time, sales tax reform will strengthen the economy and result in higher real purchasing power for all Canadians.

How quickly the benefits of sales tax reform are realized will depend on the response of prices and wages to the introduction of the GST. With moderation in wage and price behaviour, the transition to the benefits will be smooth and relatively fast (Chart 6).

In an environment of price and wage moderation, the price impact of the GST will be minimized and confined to a one-time adjustment in the price level. Interest rates need not rise in this situation. The Canadian economy would immediately be in a position to take advantage of the lower input costs, increased total productivity, and improved competitiveness that the GST will bring. Output and employment would begin rising in the first year of GST implementation and, by the fourth year, half of the long-run gains, or $4.5 billion, could be realized.

This increase in output would lead to a higher demand for labour, leading to higher employment, and a lower unemployment rate. Sales tax reform could raise employment from the start and create more than 60,000 new jobs by 1992.

An inflationary price-wage response to the GST, on the other hand, would delay the realization of these benefits and result in less favourable employment and output effects during the transition. In such circumstances, unit labour costs of Canadian firms would rise relative to our competitors, offsetting the direct competitive advantages of replacing the FST with the GST. Instead of a rise in net

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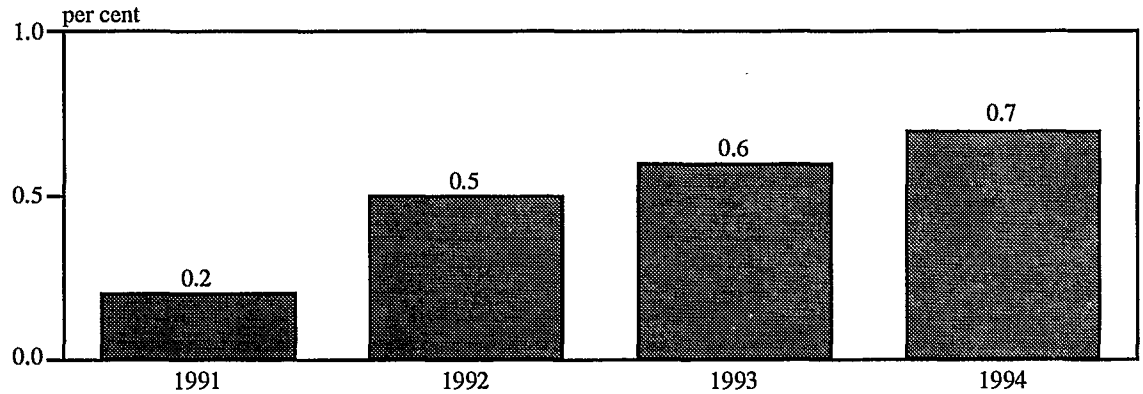
[1] In the April budget document *The Goods and Services Tax*, the consumer price impact was estimated to be between 2 1/2 and 3 per cent. The revised estimate of 2 1/4 per cent takes account of refinements to the estimates of the applicable GST tax base.

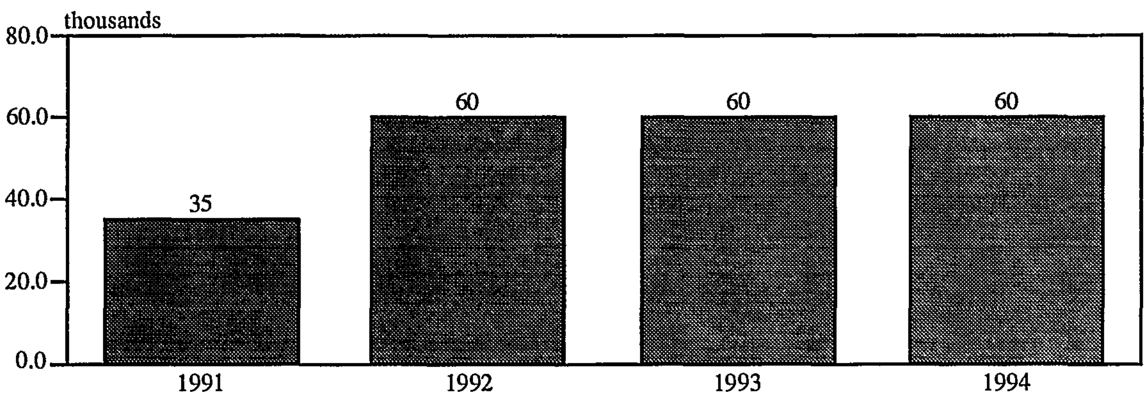
Chart 6

Economic Impact of Sales Tax Reform

Impact on the Level of Real GDP



Impact on the Level of Employment



exports, losses could occur in the transition. An inflationary response could also lead to higher interest rates.

Clearly, avoiding an inflationary response over the transition period serves the interests of all Canadians by ensuring that the benefits of sales tax reform are realized smoothly and quickly.

The Fiscal Implications of Sales Tax Reform

Sales tax reform will encourage investment, enhance productivity and raise the economy's potential output. Achieving these benefits will assist the government in reducing the deficit, controlling the debt, and ensuring a more stable and reliable source of tax revenues. Sales tax reform will establish a more solid basis for the government's fiscal planning.

Sales tax reform is critical to ensuring the deficit track projected in the 1989 budget is realized. Replacing the present federal sales tax with the GST will secure the $2 billion increase in sales tax revenues announced in the budget as a critical component of deficit reduction. The GST will raise about $24 billion in federal revenues in 1991. This figure is net of the housing rebate, the small business compensation fee as well as the rebates in respect of public sector purchases. The net revenues raised by the GST will, in 1991, exceed the $18 1/2 billion that would have been raised by the FST by about $5 1/2 billion.

These additional revenues will be used to provide the enhanced refundable GST Credit for lower and modest income Canadians, to reduce the middle personal income tax rate, to offset increased costs of indexed programs such as elderly benefits, veterans pensions, and family allowances, and to meet administration costs of the new system.

The measures to improve the overall fairness of the tax system and the impact of sales tax reform on budgetary expenditures roughly offset the increase in tax revenues. As a result, the overall fiscal situation is essentially unaffected by the direct impact of sales tax reform.

Sales Tax Reform: Fiscal Offsets

	Full year impact
	(billions of 1991 dollars)
Enhanced GST Credit	2.4
Middle income rate reduction	0.7
Price impact	
Indexation of personal income tax system	0.8
Transfers to persons (OAS, family allowances, etc.)	0.9
Transfers to provinces	0.3
Administration costs	0.2
Total fiscal offsets	**5.4**

Details may not add due to rounding.

III. Legislative Timetable

It is important in undertaking a major tax change of this kind that the new system reflect the considered views of Canadians. It is also essential that businesses, which will be required to collect the GST on behalf of the federal government, are well-informed about the operation of the new system and have the time necessary to put the appropriate administrative systems in place. As an initial step, the accompanying technical paper sets out in some detail the key features of the GST. It will provide the basis for further discussion and technical refinement of the tax. In particular, the government will invite the House of Commons Standing Committee on Finance to examine that paper and to hold public hearings on the proposal.

The government also plans to release draft GST legislation in early fall. This draft legislation will form the basis for technical consultations with businesses, the tax professional community and other interested parties on the detailed design and operation of the new tax. It will also be a good starting point for businesses in planning and developing the systems required to collect the GST on behalf of the federal government.

On the basis of these consultations on the draft bill and following receipt of the report of the Standing Committee, the government will prepare final legislation for consideration by Parliament. It is expected that a bill will be introduced in the House of Commons in the fall session.

Well in advance of the start-up of the tax on January 1, 1991, Revenue Canada will be working closely with businesses to assist them in preparing for the new system. And most important, the government will act to ensure that the Canadian public is well-informed in advance about the GST.

IV. Conclusion

The benefits of sales tax reform to the Canadian economy will be substantial. The removal of tax-induced distortions will result in an improved and more efficient use of resources in the economy. Investment spending will be encouraged and the capital stock will expand. Canada's potential output will increase by 1.4 per cent. When the gains in potential output are realized, Canada's economy will be more investment-oriented and more competitive internationally. This will translate into higher incomes and a higher standard of living for all Canadians.

The goals of sales tax reform are straightforward and realistic. The GST will contribute to the deficit reduction effort and ensure we can continue to pay for programs Canadians value. It will result in a more competitive economy at home and internationally. And it will improve the fairness of the tax system so that those who need protection, receive it, while those best able to pay taxes cannot avoid paying their share.