VAT Treatment of Public Sector Bodies: The Canadian Model

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The goods and services supplied by the sector that consists of government entities, public sector bodies, non-profit organizations, charitable organizations (hereafter collectively referred to as the *PNC* sector) continue to elude the best practice under the value-added tax (VAT): the full taxation of goods and services supplied by the PNC sector, with credit for tax paid on purchases made in order to render the supplies. Although there are very few genuine conceptual problems preventing the full taxation of such supplies under the VAT, some roadblocks remain in the way. Often, they come in the form of policy concerns revolving around social objectives and income distribution. Those explain to a large extent the exceptional (and exceptionally complex) treatment of PNC supplies under the VAT in many countries. Complexity often arises because exemptions may be restricted to particular items (goods and services), or apply to supplies rendered by certain types of entities, or a combination of both. Other times, obstacles come in the form of political inertia and barriers.

While the consequences of the VAT-exempt treatment of the supplies made by the PNC sector are well understood at the theoretical level, there has been little quantification of its economic effects. They are believed to be quite important when taken together.[2] Such effects includes distortions, compliance costs, administrative costs, and the cost savings from using tax or expenditure policy instruments that are better suited than the VAT to achieve distributional and other social objectives. In aggregate, the distortions from the exempt treatment of the PNC sector are likely to be significant, especially in developed countries where the PNC sector can account for an important proportion of the gross domestic product.

This paper examines in some detail one alternative to the pure exemption model for the PNC sector. Under Canada's VATs, most supplies made by PNC bodies are exempt but such bodies are usually eligible for a rebate of VAT paid or owed on expenses incurred to make such exempt supplies. This systematic rebate system is termed the *Canadian Model*. It is argued that the Canadian Model would be a highly desirable alternative to the current EU VAT treatment of public service bodies, a situation that is widely perceived as being deeply unsatisfactory.[3] As an alternative, the Canadian model

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[2] See Pierre-Pascal Gendron, "How Should the U.S. Treat Government Entities, Nonprofit Organizations, and other Tax-Exempt Bodies under a VAT?" 63 *Tax L. Rev.* (forthcoming 2010).

[3] Rita de la Feria, "The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction." 37 *Intertax* 148 (2009).

would seem to be far more feasible than the full taxation of the PNC sector or its variant as practiced in New Zealand or, to a less extreme extent, in Australia.

The paper is organized as follows. The first section provides a synthetic overview of VATs in Canada – the GST/HST and QST system – and the basic VAT treatment of the PNC sector. The second section describes the treatment of government transactions under Canadian VATs. The third section describes the Canadian rebate model in some detail and its application, considering practical issues such as federal-provincial variations and the treatment of grants and subsidies. The fourth section reviews the tax expenditures associated with the general rebate approach as used in Canada. The last section benchmarks the Canadian system against others and suggests that it constitutes a viable and realistic option for reform of the EU VAT treatment of the PNC sector.

OVERVIEW OF VATs IN CANADA

This section provides a brief overview of VATs in Canada and then describes the VAT treatment of the public sector bodies.[4] This paper will refer to the sector that incorporates the public sector and governments, the non-profit sector, and the charitable sector as the PNC sector. The term Public Service Bodies is used in Canada in a more restrictive sense so the convention to use PNC is followed to avoid confusion and be inclusive as many of the issues concerning the VAT treatment are similar across the three component sectors.

GST/HST System in General

Three VAT systems are currently in operation in Canada: the federal goods and services tax (GST), the harmonized sales tax (HST) – operated jointly with the GST in the provinces of New Brunswick (NB), Newfoundland and Labrador (NL), and Nova Scotia (NS), collectively referred to as the three *participating provinces* – and the Québec sales tax (QST) in operation in the Province of Quebec. The GST applies in all 10 provinces and three territories at a rate of 5 %. The HST (normally referred to as *GST/HST* in government literature) is a joint federal-provincial VAT that applies at a combined rate of 13 percent (5% federal GST plus 8% provincial component) in the three participating provinces. The QST is a dual VAT that applies in Québec at a rate of 7.5% on the GST-inclusive price. The intended base of all three taxes consists of domestic consumption, whether produced locally or imported.

The scope of VAT in Canada will expand shortly and in a significant way as the Province of Ontario and the Province of British Columbia have each signed a Memorandum of Agreement with the Government of Canada that provides the framework for the introduction of an HST in Ontario and British Columbia. Subject to legislative approval, the proposed HST would come into effect on July 1, 2010 at a rate of 13% for Ontario and 12% for British Columbia.[5] Canada is the only federal OECD country – other than the U.S. – in which subnational governments have the choice of whether or not to impose their own VATs. There will be six of them shortly, assuming the newly proposed Ontario and British Columbia taxes come into effect on July 1, 2010. Table 1 provides a snapshot of the sales tax systems Canadian, including the type of tax and rate in each province, as well as its yield as a percentage of total tax revenues.

[4] This section draws on Richard M. Bird and Pierre-Pascal Gendron, "Sales Taxes in Canada: The GST-HST-QST-RST 'System'," 63 *Tax L. Rev.* (forthcoming 2010).
[5] Canada Revenue Agency, *Excise and GST/HST News* No. 74, fall (Ottawa: Government of Canada, 2009), <http://www.cra-arc.gc.ca/E/pub/gr/news74/news74-e.pdf>, (accessed 16 March 2010).

Table 1
Sales Taxes in Canada, June 2010

Jurisdiction	*Name of Tax*	*Type of Tax*	*Rate (%)*	*Yield as a share of total taxes (%)*	*Administration*	*Comments*
Canada	GST/HST	VAT	5 / 13	17.3	Federal except in Québec, where it is provincial	GST rate (federal) is 5% and applied throughout the country; the federal government also administers a provincial sales tax rate of 8% in the three HST provinces (sum is 13%)
Newfoundland and Labrador	HST	VAT	8	25.1	Federal	HST revenues collected in the three HST provinces are distributed to provinces based on estimated taxable consumption
Nova Scotia	HST	VAT	8	44.2	Federal	Same as for Newfoundland
New Brunswick	HST	VAT	8	15.3	Federal	Same as for Newfoundland
Prince Edward Island	PST	RST	10	27.4	Provincial	Applied to retail sales price including GST
Québec	QST (TVQ)	VAT	7.5	16.2	Provincial	Applied to GST base plus GST
Ontario	PST	RST	8	22.3	Provincial	Applied to retail sales price, (excluding GST)
Manitoba	PST	RST	7	23.1	Provincial	Same as Ontario
Saskatchewan	PST	RST	5	18.4	Provincial	Same as Ontario
British Columbia	PST	RST	7	16.8	Provincial	Same as Ontario

Source: Bird and Gendron, note 4 *supra*, at 2.
Note: Yield figures are from 2008. The base of the Québec Sales Tax (QST or TVQ, *Taxe de vente du Québec*) differs slightly from that of the GST. Moreover, although the base of the provincial HSTs is the same as that of the GST, as we discuss later, each province can alter the effective base by rebating its tax. Each Retail Sales Tax (RST) province has its own tax base, generally with considerable taxation of business inputs and with limited coverage of services. These taxes are not coordinated in any way with each other or with the federal GST.

In sum, the four principal components of the Canadian sales tax system consist today of:

- The federal VAT introduced in 1991 – the Goods and Services Tax (GST);
- The extension of the GST in 1997 to three small Eastern provinces – the Harmonized Sales Tax (HST);[6]

[6] Strictly speaking, the terminology sometimes used in Canada, especially at the federal level, is not GST (for federal) and HST (for provincial) as we use those terms here but rather CVAT (for Canada-VAT, not the Compensating VAT) for the federal portion of the tax that applies in all provinces) and PVAT (Provincial-VAT) for the portion of the tax that applies on property or services supplied in or brought into a participating province. The official name of the (combined) federal-provincial tax is the GST/HST, as used in the text below. It is also common in Canada to refer to all three varieties of subnational sales taxes simply as Provincial Sales Taxes (PSTs): for example, see the discussion in Karin Treff and David B.

- The unique provincial VAT introduced in 1991 in the province of Québec – the Québec Sales Tax (QST), a dual VAT; and, finally,
- The provincial sales tax that continues to exist in most other provinces – the retail sales tax (RST).[7]

Exemptions in PNC Sector

The majority of the goods and services sold and consumed in Canada are subject and within the scope of the GST/HST. There are about 10 major statutory exemptions under the GST/HST,[8] many which depend on the satisfaction of numerous detailed conditions and criteria. Like in many VAT regimes around the world, the GST/HST features statutory exemptions in the areas of: real property; health services; education services; daycare and personal care services; legal aid services; supplies made by charitable organizations; public sector bodies; financial services; and ferries, toll roads, and toll bridges.

Under the GST/HST, taxable supplies are goods and services that are supplied in the course of a commercial activity and are subject to GST/HST, including zero-rated supplies. The latter are supplies that are taxable at a rate de 0%. Exempt supplies are supplies of goods and services that are not subject to GST/HST. A registrant cannot claim input tax credits for the GST/HST paid on expenses incurred to make such supplies. Public Service Bodies (PSB) may be eligible to claim a full or partial GST/HST rebate for the tax paid or payable to make exempt supplies. PSB means a non-profit organization, a charity, a municipality, a school authority, a hospital authority, a public college, or a university.[9] Commercial activity means any business or adventure or concern in the nature of trade carried on by certain persons, but does not include the making of exempt supplies or any business or adventure or concern in the nature of trade carried on without a reasonable expectation of profit by an individual, a personal trust, or a partnership where all of the members are individuals.

Perry, *2007 Finances of the Nation* (Toronto: Canadian Tax Foundation, 2008), Ch. 5. This treatment is essentially correct: it makes almost no difference to the country as a whole whether any particular province chooses to impose its sales tax in the form of VAT or an RST. It may, however, make a considerable difference to the province in question. Along the same lines, provincial governments usually refer to their sales tax (regardless of how it is characterized in this paper) simply as a PST (provincial sales tax) rather than an RST (retail sales tax) or a VAT (HST or QST, as the case may be): the RST terminology is used here to clarify.

[7] The province of Alberta and the three northern territories (Yukon, Northwest Territories, Nunavut) have no sales tax, although the GST applies in those jurisdictions.

[8] See *Excise Tax Act* (hereinafter "The Act"), RSC 1985, Ch. E-15, Schedule V.

[9] Canada Revenue Agency, *GST/HST Public Service Bodies' Rebate* (Ottawa: Government of Canada, 2009), <http://www.cra-arc.gc.ca/E/pub/gp/rc4034/rc4034-09e.pdf>, (accessed 16 March 2010).

Persons are required to register for GST/HST if they provide taxable supplies in Canada and are not small suppliers. A PSB is considered a small supplier if its total revenues from taxable supplies from all its activities are C$50,000 or less per year. A gross revenue threshold of C$250,000 also applies to charities and public institutions. A non-profit organization (NPO) that is a small supplier may elect to register voluntarily provided that it is engaged in commercial activity in Canada. An NPO that made only exempt supplies would be deemed not to be engaged in commercial activity and would therefore not be allowed to register. While a charity that makes taxable supplies may register as a small supplier, most supplies made by charities are exempt. For that reason, a charity that makes exclusively exempt supplies is not allowed to register and is therefore exempt by default. Even though such a charity cannot claim input tax credits for tax paid or owed on purchases, it is eligible to claim a PSB rebate of GST/HST paid on eligible expenses. In other words, a non-registrant PSB can never claim input tax credits but may be eligible for a rebate. Similar rules apply to municipalities and the single entity model is used for registration purposes. Municipal boards, commissions and departments that are legally part of a municipality cannot register separately.

From an overall system perspective, the vast majority of the goods and services supplied by the PNC sector in Canada are exempt, although some are taxable and some are zero-rated. Taxes incurred by PNC entities on any purchases made to deliver taxable or zero-rated supplies (commercial activity) are fully creditable. There are specific exemptions for hospital and clinical care, medical and dental services, public and private nursing home services, educational and social welfare agencies, recreational public-sector programs for youth, municipal services, and most supplies made by charitable organizations. In dealing with exempt supplies, the GST/HST and QST systems depart from the pure exemption model by granting rebates of some or all of the tax paid on the inputs purchased to make exempt supplies. These rebates are granted ex post and at variable factors, where factors are a fraction of the tax paid or owed that is rebated. Interestingly, medical devices and prescriptions drugs – which may also be supplied by exempt organizations – are actually zero-rated. In situations where PNC entities supply those, zero-rating clashes with the sector's exempt treatment and results in increased complexity.

TREATMENT OF GOVERNMENTS IN THE CANADIAN SYSTEM

This section is concerned with the important portion of the activities of the PNC sector which consists of government-to-government (G2G) transactions.[10] Such transactions are also special in Canada since the design of the GST in respect of their treatment has been influenced by federal-provincial relations.

Under Canada's constitution, federal and provincial governments cannot tax each other so the federal GST could not be applied to sales to provincial governments. However, the governments of the HST provinces, like the federal government, have agreed to pay GST/HST on their taxable purchases in order to simplify the administration of the tax by vendors. Sales to other provinces are not taxable if properly certified; since suppliers are entitled to claim input tax credits (ITCs) on all supplies made to provincial or territorial governments, whether or not GST/HST is collected. Thus, such sales are in effect zero-rated.[11] These rules do not apply to provincial public sector enterprises (Crown corporations) such as the large electricity suppliers, so these companies are both responsible for collecting the tax on their supplies and can claim refunds of taxes paid on their inputs. In other words, they are treated like any other businesses. In principle, the important public sector institutions included in the so-called MASH[12] sector were, as agents of the provinces, exempt from charging federal GST on sales (unless they sold taxable goods). On the other hand, unlike the provincial governments these institutions were subject to tax on business inputs. However, the federal government decided to provide a partial refund of taxes on inputs purchased by the MASH sector in order to keep these bodies in more or less same relative position as they had previously been under the manufacturers' sales tax (which was embodied in the prices of their inputs) the predecessor tax to the GST. Although the refunds varied by type of provincial body, on average they amounted to roughly two-thirds of input taxes paid by the sector.[13]

The federal government of Canada is considered a single entity for GST/HST purposes, and includes all departments, branches, corporations, and agencies. The federal government pays GST/HST on its purchases, and charges GST/HST on its taxable supplies. Municipalities are subject to the same treatment with the key difference that many supplies of goods and services by municipalities and para-municipal organizations are exempt.

[10] Section draws on Gendron, note 2 *supra*, and Bird and Gendron, note 4 *supra*.

[11] Although all governments are subject to GST/HST on taxable supplies, all departments and agencies are registered as one entity and hence supplies within any government (broadly defined) are not taxable. In addition, certain supplies are specifically exempted e.g. most registration, information provision, and licensing activity as well as homemaker services provided in residences, garbage collection, and law enforcement and fire protection.

[12] Municipal, academic, schools, and hospitals.

[13] Given the huge and varied collection of VAT registrants in Canada lumped together as 'non-profits' their 50% rebate seems more likely to be a compromise between 0% and 100% than an estimate based on any careful study. Interestingly, as will be shown in Tables 2 and 3 *infra*, the same (arbitrary) rate is currently applied in all other Canadian VATs, although most apply different rebates in other sectors.

Special arrangements exist with respect to the treatment of sales or supplies to provincial and territorial governments under the GST/HST. The governments of the three participating HST provinces have agreed to pay GST/HST on their taxable purchases. The tax collection agreement between the federal government of Canada and the Government of the Province of British Columbia specifies that both parties agree to pay the harmonized sales taxes in respect of supplies acquired by their respective governments.[14] The same will apply under the similar agreement with Ontario. Also, all government departments and agencies in the Province of Prince Edward Island (interestingly, an RST province) and the territory of Nunavut (which has no territorial sales tax) pay GST/HST on their taxable purchases. The remaining provincial and territorial governments (see Table 1), however, do not pay GST/HST on their taxable purchases subject to the provision of certification that purchases are made with Crown (government) funds. Government authorities eligible under this arrangement include all departments or ministries, and some of their Crown corporations, boards, commissions and agencies. Businesses that make supplies to the remaining governments do not charge GST/HST but they are entitled to input tax credits for any GST/HST paid on expenses incurred to make those supplies. The supplies are effectively zero-rated in that case.

Under a reciprocal federal-Québec tax agreement, the federal government, its corporations and agencies are generally not required to pay QST on their purchases which are effectively zero-rated. Agencies not covered by the agreement must pay QST. Québec government corporations and agencies listed in the agreement are not required to pay GST (or the QST) on their purchases. The Québec government, its corporations, agencies, and agents are required to collect GST and QST on their taxable sales, unless those are specifically zero-rated. Similar to the federal system, the Québec government authority must deliver a certification that purchases have been made with public funds.

The incorporation of the largest fraction possible of government activity in the scope of the GST/HST is important in four important respects: simplicity, accountability, transparency, and VAT mechanics.[15] Bringing governments in the tax simplifies administration considerably and avoids the management of multiple exemptions. Accountability and transparency are also enhanced because governments appear to stakeholders as being part of the system as opposed to lying at its margins. Finally, VAT mechanics are preserved as the VAT chain is kept intact all the way to the end. Multiple exemptions at this level have impacts that are so complex that it is almost impossible to assess with certainty who benefits from them.

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[14] Government of Canada and Government of British Columbia, *Comprehensive Integrated Tax Coordination Agreement between the Government of Canada and the Government of British Columbia*, 2009, at 12.

[15] The first three were also noted by Robert F. van Brederode, *Systems of General Sales Taxation: Theory, Policy and Practice* (Alphen aan den Rijn, The Netherlands: Wolters Kluwer, 2009), at 202.

THE CANADIAN REBATE MODEL IN PRACTICE

From both foregoing sections, the GST/HST clearly emerges as an integrated federal-provincial sales tax in the sense that both the federal and provincial components are applied on the same base by the same administration at the same time. There are some deviations from this apparent ideal though. The most important instance of deviation is discussed next.

Rebates in General

As part of the gradual harmonization process between the federal GST and provincial sales taxes over time, a variety of VAT rebates have come to be granted in sectors such as PNC and real property, and for specific goods such as books. Thus, even if the statutory rates of the federal and provincial taxes were identical, the effective rates of the provincial components of this integrated sales tax imposed on different activities would not necessarily be the same as those of the federal component, nor entirely identical in all the HST provinces. The reason is simply because, as Table 2 shows, the rebates that characterize the Canadian VAT system do not always apply in the same way in different provinces. The table also shows the wide applicability of the rebate approach. The GST/HST and QST systems have featured rebates from their inception to achieve certain socio-economic objectives while recognizing the problems and burdens a pure exemption causes.

Moreover, although not all details are yet finalized, the Ontario version of the HST, to be introduced on 1 July 2010, will include different rebates factors (or rates) for all categories than those shown in Table 2: 78% for municipalities, 78% for universities and colleges, 93% for hospitals, and 82% for charities and non-profits.[16] Except for the GST rebate to municipalities, these are considerably more generous than the existing rebates under the GST or the HST. The housing rebate will also be more generous, apparently reflecting the higher house prices, particularly in the Toronto area: 75% of the provincial tax on houses under C$400,000 will be rebated, with the rebate being reduced for houses between C$400,000 and C$500,000. Ontario will also have more 'point-of-sale' zero-rating – not just for books, but also for children's clothing and footwear, children's care seats and car booster seats, and feminine hygiene products. On the other hand, unlike the other HST provinces, but like the QST, its new tax will restrict ITCs for businesses with taxable sales of over C$10 million, financial institutions, energy (not used by farms or to produce goods for sale), telecommunications services (other hand internet access or toll-free numbers), food, beverages and entertainment, and road vehicles less than 3,000 kilograms as well as fuel, parts and certain services for such vehicles. All these deviations from the 'GST norm' will, it seems, will be administered free of charge by the federal government.

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[16] This paragraph is based on Ontario Ministry of Finance, *2009 Ontario Budget* (Toronto: Government of Ontario, 2009), <http://www.fin.gov.on.ca/english/budget/ontariobudgets/2009/chpt3.html#c3_salestax>, (accessed 22 May 2009).

Table 2
All Credits and Rebates in the HST Provinces, Canada, June 2010

	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%	50%	50%
New Housing Rebate	36% with a maximum of C$6,300[b]	No rebate	18.75% with a maximum of C$1,500[c]	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 energy[d]; - Fire departments; - Motor vehicle rebate; - Computer rebate; - Heritage properties; - Segregated funds.	- Rebate program for building materials for Labrador homes; - Home heating rebate program[e].
Low-Income Credit	Yes	No credit	No credit	Yes

Notes: (a) When the GST was introduced, the federal rebate for municipalities was 57.14% of the otherwise unrecoverable GST paid by municipalities. The rebate rate was increased to 100% effective February 1, 2004; (b) The rebate is gradually reduced for homes valued between C$350,000 and C$450,000 and fully phased out for homes valued at C$450,000 or more; (c) Rebate is limited to first-time new home buyers. Compared to the GST new housing rebate, no thresholds apply; (d) The *Your Energy Rebate Program* started on December 1, 2006, rebates 8 percent of total home energy costs to the homeowner. For most homeowners, the rebate is automatically taken off the bill by the power company. Budget (Federal) 2008 modified the rebate slightly to remove non-heating uses of electricity from the rebate; (e) The *Home Heating Rebate Program*, introduced in 2001, was increased from C$200 to C$300 for 2008, and will increase to C$400 for households in coastal Labrador. Electricity and wood users will receive a maximum of C$200.
Source: Bird and Gendron, note 4 *supra*, at 27.

The story on the British Columbia version of the HST, to be introduced on July 1, 2010 as well, is sensibly the same.[17] The tax will include its own provincial point of sale rebates on books, children's clothing and footwear, children's diapers, children's car

[17] Government of Canada and Government of British Columbia, note 14 *supra*, at Annex B.

seats, children's booster seats, feminine hygiene products, and motor fuels. Rebate rates for the provincial component of HST will amount to: 75% for municipalities, 57% for charities and qualifying non-profit organizations. There will also be different rebates for certain transactions in the real property sector.

Rebates on PNC Bodies

Under the rebate system, PNC bodies are within the scope of the GST/HST and QST (if applicable) but supplies are treated as exempt, with a fraction of the GST/HST or QST paid on purchases rebated following the filing and processing of a rebate application. It is worth noting that the initial rebate rates – which have, on average, increased since 1991 – were initially set then to ensure that the average sectoral tax burden would not increase when the GST replaced the manufacturer's sales tax (MST).

Table 3 expands on the first row of Table 2 and shows rebate factors (or rates) for the GST, HST and the QST for PNC bodies by category of supplier. Rebates are available if an organization is either one of the following:[18]

- Public institution;
- Public service body (PSB);
- Qualifying non-profit organization (qualifying NPO);
- Selected public service body; or
- First Nation or Inuit Government (self-government refund).

Here, public institution means a registered charity for income tax purposes that is also a school authority, a hospital authority, a public college, or a university. A qualifying NPO means an NPO that receives at least 40% of its total revenue in government funding. A PSB means a non-profit organization, a charity, a municipality, a school authority, a hospital authority, a public college, or a university. A *selected* public service body is a school authority, university, or public college that is operated other than for profit, or a hospital authority, a municipality, a facility operator, or an external supplier.

The rebate program in the first three cases is called the *GST/HST Public Service Bodies' Rebate*, and the last is called *GST Self-Government Refund*. A First Nation or Inuit Government is also eligible provided that it has entered in an agreement with the Government of Canada that provides for a 100% refund of GST for goods and services acquired for self-government activities. Certain special supplies by PNC bodies are also eligible for rebates as follows: books (100% of GST/HST, federal component only); goods and services exported by a registered charity or public institution (100% of GST/HST, both federal and provincial components); and eligible facility operators or external suppliers (83% of GST/HST, federal component only).

[18] Canada Revenue Agency, note 9 *supra*.

Rebates are funded out of general government revenues. Interestingly, even though the GST/HST is a joint system, HST provinces do exert some control over their tax base – on the side of base expansion – by deviating from GST rebate rates for some components. GST rebates have been enhanced over time, most notably in the case of municipalities. The rebate rate rose from 57.14% of the tax paid on purchases to 100% in 2004. The rebate applies to the GST and the federal portion of the HST but it is interesting to note that the rebate rate for the provincial portion of the HST has remained at the old rate, and it is actually zero in Newfoundland and Labrador (NL). One year later, the federal government extended the 83% GST rebate rate for hospitals to eligible charities, non-profit organizations, and public institutions that render services similar to those usually rendered by hospitals. Again, the rebate is most generous for the federal portion of the HST, but much less so for the provincial portion outside the Province of Nova Scotia (NS). Overall, NS has harmonized its rebate rates to the GST the most. QST rebates, which apply to the Province of Québec (QC) are less generous than GST rebates but more so than those in New Brunswick (NB) and NL.

Table 3
GST/HST and QST Rebate Rates (%) in PNC Sector, Canada, June 2010

Type of Organization	**GST**	**HST NB**	**HST NL**	**HST NS**	**QST QC**
Municipality	100	57.14	0	57.14	0
University[a]	67	0	0	67	47
School authority	68	0[c]	0	68	47
Public college	67	0	0	67	47
Hospital authority	83[b]	0[c]	0	83	51.5
Charity or public institution	50	50	50	50	50
Q. non-profit organization	50	50[d]	50[d]	50[d]	50

Notes:
(a): Includes affiliated colleges or research institutes under the GST.
(b): Health care rebate applies to charities, non-profit organization and public institutions that render services similar to those usually rendered by hospitals.
(c): In New Brunswick, hospital and school authorities that are part of the provincial government pay HST on their purchases, but the full amount of HST (100% of the provincial component) is rebated to them.
(d): NPO qualifies for 50% rebate of provincial part of HST if it is not a selected Public Service Body.
Source: Gendron, note 2 *supra*, at 18.

A few notes about Table 3 are in order. First, goods and services exported by a registered charity or public institution give rise to a 100% rebate of both federal and provincial components of the GST/HST. Second, self-government refunds amount to 100% of tax paid. Finally, hospital facility operators and external suppliers to hospitals are eligible for the 83% rebate.

The rebate system only mimics zero-rating in two cases: first, regarding the GST municipalities pay on purchases, or the federal portion of the HST municipalities pay in the participating provinces, and second, with respect to the provincial component of HST

paid on purchases by government-run hospitals and schools in New Brunswick. All eligible bodies must file the same tax return form to receive their *GST/HST Public Service Bodies' Rebate*, whether they are municipalities subject to the 100% GST rebate or any other type of eligible to the rebate. Thus, no eligible PNC body handles GST/HST like an ordinary commercial business would. In an effort to alleviate compliance costs, however, the authorities allow charities to used special simplified tax calculation methods. Nevertheless, the tradition of having different rebate rates for federal and provincial components will continue when British Columbia and Ontario enter the system: charities resident Ontario will be able to claim an 82% rebate of the provincial portion of HST while those residents in British Columbia will be able to claim a 57% rebate of that portion.[19]

A system with fixed rebate rates appears, at first glance, quite simple and predictable for registrants. It may be the latter, but certainly not the former due to the heterogeneous treatment of entity and supplier types and actual supplies. Rebate rates do indeed vary by type of supplier, by the place where supplies are made, and by type of goods or service supplies. As a result, there is non-neutral treatment of similar supplies made by different types of suppliers in different provinces. The varying rates also create incentives to choose certain organizational forms over others to deliver certain goods and services over others. Another source of non-neutrality is the fact that the treatment of some supplies approximates zero-rating (when rebate rates are close to 100%) for some suppliers but not for others. Finally, businesses that operate in several provinces (e.g., New Brunswick and Québec) must fill two rebate claim forms that feature three sets of calculations. Ironically, despite the rigid harmonization model underlying the HST, rebate rates vary across those provinces and vary from rebate rates that relate to the federal (GST) component. It is striking to see such departures from a harmonized base under what is supposed to be one *harmonized* system (GST/HST).

In spite of the fact that the GST and QST are relatively well harmonized, the Québec rebate system is far less generous on average. Different rates for the same supplier-activity combinations introduce additional compliance costs. Under the Québec system, the apparently equal – featuring 50% rebate rates in both cases – treatment of charitable and non-profit organizations effectively penalizes charitable organizations, since most of the supplies they make are exempt while most supplies made by non-profit organizations are taxable. As a consequence, non-profit organizations recover a larger fraction of the total QST paid on inputs than charities do. Beyond non-neutralities, the problem of the Canadian system is its failure to make a choice between full taxation and zero-rating of the PNC sector, even though it has already moved part of the way towards either goal in some cases. The Canadian system is stuck, in some way, since full zero-rating is unrealistic from a revenue perspective and inappropriate as an overall policy standpoint as it would fail to tax the consumption of the outputs of the PNC sector and therefore create its own non-neutralities. David and Poddar, writing in the business press in Canada, concluded that the GST in Australia and New Zealand applies to organizations

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[19] Canada Revenue Agency, *Basic GST/HST Guidelines for Charities*, GST/HST Info Sheet GI-067 (Ottawa: Government of Canada, March 2010), <http://www.cra-arc.gc.ca/E/pub/gp/rc4034/rc4034-09e.pdf>, (accessed 16 march 2010).

in the PNC sector in the same manner as to private sector organizations and have called for the same treatment to be implemented in Canada.[20] Their plea remains unanswered to this day and there is no evidence that Finance Canada – the federal government department responsible for tax policy – is considering this issue at this time.

In closing, it should be noted that the GST/HST and QST systems operate independently of provincial RSTs, without any coordination. Services are usually not an issue since the vast majority of them is non taxable under RSTs, but certainly many goods purchased and sold by PNC entities would be subject to RST unless specifically exempt by law.

Treatment of Grants, Subsidies, and Government Funding

As initially argued over a decade ago,[21] the correct treatment of grant or subsidies is to add them to the price of the good or service to arrive at the consideration for VAT purposes they can be linked directly to supply. Table 4 presents a summary of the correct treatment under various situations, including those where grants or subsidies are awarded. The shaded cell represents the situation of interest here, where an adjustment should be made for grants or subsidies directly linked to supply.

Table 4
Requirements for Equal Treatment under Full Taxation

Criterion	Taxation of private goods	Taxation of public goods
Economic neutrality	Same treatment of supplies made by private businesses and PNC bodies	Apply to any consideration charged for supplies
Consideration	Apply VAT on amounts charged as consideration (price *plus* grants directly linked to supply)	Supplies made for nil consideration call for zero tax (effectively zero-rating)
Input tax credit	Full (once supplies become taxable)	Full
Revenue loss	None	None if government collecting VAT is the one making the supply
Distortion of competition	None	None since public goods are supplied by private sector businesses

Source: Gendron, note 2 *supra*, at 8.

Private goods supplied by PNC entities without any grants are treated the same way as private goods supplied by the private sector: VAT applies to the full amount of consideration. In the case where grants are linked directly to the supply of private goods by PNC entities, the grant amounts must be added to the consideration charged prior to calculating VAT due. The VAT base per unit supplied thus consists of the sum of the

[20] Irene David and Satya Poddar, "Now Fix Rest of GST", *National Post* [Toronto], February 6, 2004, at FP15.
[21] Michel Aujean, Peter Jenkins, and Satya Poddar, “A New Approach to Public Sector Bodies”, 10 *Intl. VAT Monitor* 144 (1999).

price per unit and grant per unit. This treatment of grants avoids a distortion of competition between the private and public sectors since as PNC grants linked to supply are used to equalize the full consideration for VAT purposes. With that adjustment, private and public sector bodies rest on an equal footing for VAT purposes. Left unchecked, such a distortion would favour the public sector when grants would allow public sector bodies to charge a lower gross output price than private sector suppliers. This would amplify the advantage of public sector bodies from not having to charge VAT while similar private sector suppliers would have to. This advantage is clearly proportional to VAT rates and hence perceived to be serious in the EU due to high rates relative to countries such as Australia, Canada, Japan, New Zealand, Singapore, and South Africa.

EU discussions have tended to focus on a narrow definition of distortion of competition: the advantage that may accrue to public sector bodies from not having to charge VAT to users or consumers, while private sector bodies making similar supplies have to. Again, the improper treatment of grants and subsidies – being left out of the calculation of consideration when they are directly linked to supply – has the potential to impede competition much more. This can be especially damaging if the entire system penalizes the development of outsourcing, which appears to be the case in the EU. Those layers of implicit support for public sector body also appear to impose significant compliance costs on the private sector. Overall, this negates many of the cost advantages of outsourcing services, in favour of expenditures on tax planning to achieve a certain tax status or treatment of transactions.

The general rule for the treatment of grants and subsidies under the GST/HST is that "[I]f it is established that a supply takes place in return for a transfer payment, the payment may be regarded by the Department[22] as 'consideration' for a supply. The amount of the transfer payment must then be used to calculate any Goods and Services Tax (GST) payable."[23] For example, if a person receives a C$100,000 transfer payment from a grantor to set up a training program and arranges to train employees of the grantor's company, the payment will be regarded as consideration for the supply of training services to the grantor. The recipient of the payment must therefore collect the tax from the grantor. There are two tests for the tax to be payable. To determine whether a transfer payment is consideration for supply, it must first be established whether the recipient has or will make a supply as a result of having received the payment. If that is the case, then one must then determine whether there is a direct link between the transfer payment and the supply.

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[22] Canada Revenue Agency.

[23] Canada Revenue Agency, *Goods and Services Tax Treatment of Grants and Subsidies*, GST/HST Technical Information Bulletin B-067 (Ottawa: Government of Canada, 1992), <http://www.cra-arc.gc.ca/E/pub/gm/b-067/b-067-e.html>, (accessed 16 March 2010).

There are several exclusions from this general rule. For instance, the following transfers are not considered to be consideration for supply: transfers that constitute charitable donations made in exchange for an income tax receipt; transfer payments by governments and public service bodies made in the public interest rather than for the direct benefit of the body itself; and transfers that form part of ongoing program of financial support.

The rules for the PNC sector may be summarized as follows. In the case of municipalities, transfer payments made or received in the public interest or for charitable purposes do not give rise to GST/HST either way (as above). If, however, there is a direct link between a transfer payment made by the grantor and a taxable supply made by the recipient of the payment, the transfer payment may be taxable and thus GST/HST may need to be collected on the amount. The tax treatment of transfer payments is determined by the Canada Revenue Agency on a case-by-case basis.[24] Rules for charities and non-profit organizations in respect of donations, grants, and subsidies are similar to those that apply to municipalities. Transfer payments are not taxable unless there is a link between the payment and a supply. Sponsorships are usually not taxable but sponsorship payments used mainly (over 50%) to fund advertising expenses, for example, would be deemed to constitute such expenses and hence be taxable.[25] Again, this is assessed on a case-by-case basis by the tax authority.

There is also a government funding test for non-profit organizations. This refers to an amount of money (including a forgivable loan that is easily identifiable) that that is either used to support the non-profit organization's objectives but not to pay for goods or services supplied by the organization or the grantor, or for an exempt sale of goods and services made by the organization but not for the use or consumption of the granter. A non-profit organization is said to be qualifying when its percentage of government funding for a given fiscal year is at least 40% of revenue.[26] For example, following Table 3, a qualifying non-profit organization can claim 50% of the GST or the federal portion of HST. It can also claim 50% of the provincial part of the HST if it is not also a selected public service body.[27]

In closing, it should be noted that very recent case law has eschewed the policy guidelines of the GST/HST Technical Information Bulletin B-067 in favour of the use fundamental contractual and statutory principles. A very recent case[28] involved the City of Calgary and the Province of Alberta which entered in a series of agreements under which the province funded most of the capital costs of various public transit facilities and rolling stock that the city purchased or built. The Tax Court of Canada (TCC) ruled that

[24] Canada Revenue Agency, *GST/HST Information for Municipalities* (Ottawa: Government of Canada, 2009), <http://www.cra-arc.gc.ca/E/pub/gp/rc4049/rc4049-09e.pdf>, (accessed 16 March 2010), at 24.
[25] Canada Revenue Agency, *GST/HST Information for Charities* (Ottawa: Government of Canada, 2008), <http://www.cra-arc.gc.ca/E/pub/gp/rc4082/rc4082-08e.pdf>, (accessed 16 March 2010), at 9, and Canada Revenue Agency, *GST/HST Information for Non-Profit Organizations* (Ottawa: Government of Canada, 2009), <http://www.cra-arc.gc.ca/E/pub/gp/rc4081/rc4081-09e.pdf>, (accessed 16 March 2010), at 10.
[26] Canada Revenue Agency, note 9 *supra*, at 17.
[27] See subsection "Rebates on PNC Bodies", *supra*.
[28] *City of Calgary* (2009, TCC 272).

the payments by the province were consideration for a taxable supply of a service made by the city to the province even though the city used the equipment to render exempt supplies. The decision meant that the city was entitled to claim input tax credits for the full recovery of the GST paid on the assets' input costs. The decision disregarded the various tests provided in The Act.[29] If this trend continues, there should be a serious revisiting of the proper treatment of grants and subsidies in Canada. In the interim, this case could complicate the characterizations of transactions.

[29] Peter Mitchell, "GST Policy on Grants and Subsidies," 17 *Canadian Tax Highlights* 9 (2009).

TAX EXPENDITURES ON CANADIAN VAT RELIEF

This section presents estimates and discussion of the tax expenditures on the Canadian rebate model within and outside the PNC sector. Other VAT relief measures such as exemptions and non-export zero-rating are also shown for comparative purposes. Such estimates are very illuminating, not so much in terms of large amounts of revenue foregone – which is fully expected – but rather for what they suggest about the importance of the economic distortions due to the exemption in the PNC sector. From the point of view of the overall efficiency of the VAT – including traditional measures of economic efficiency as well as compliance and administrative costs – operating a VAT where the PNC sector is fully taxable[30] is not equivalent to operating a VAT where the PNC sector is fully exempt but the VAT on purchases is returned in varying amounts to different organizations for different supplies, even with generous recoveries (say over 2/3 of VAT paid). Obviously, the overall efficiency cost per dollar of revenue is higher under the latter scenario since the VAT fails to reach the intended VAT base: final consumption and purchases by non-registered persons. This means that most of the last component of value added is missed, where it is assumed that some VAT on inputs may end up being shifted forward in higher output prices. Given that many of the supplies of the PNC sector are income elastic, this last component is not trivial.

Table 5 shows estimated GST tax expenditures as a percentage of GST revenues for various rebates, exemptions, and zero-ratings.[31] Data are presented for two years (2005 and 2008) since the GST rate fell from 7% in 2005 to ultimately 5% for part of the fiscal year ending in 2008. There was a transitional rate of 6% in between. This fact explains the drop in tax expenditures from 2005 to 2008. All monetary figures are expressed in current Canadian dollars, and the base used to calculate the percentage figures is the net GST collected during the year. The figures are only estimates, and as such, cannot be added up meaningfully.

It is striking that tax expenditures on the zero-rating of basic groceries exceeds any one of the other line items. The definition of basic groceries is evidently broad. Tax expenditures on rebates and exemptions for items outside the PNC sector are shown for comparative purposes only. The top three rebate items, in decreasing order, were municipalities, education, and hospitals, with tax expenditures on municipalities' rebates more than twice as large as the second largest component. Tax expenditures on exemptions are not so directly interpreted. Their estimates reflect the revenues that would be collected if the supplies were taxed but input tax credits were allowed for taxable purchases by suppliers. The top three exemption items, in decreasing order, were health care, education, and municipalities.

[30] See discussion of New Zealand in the next section.

[31] The data are drawn from Richard M. Bird, "The GST in Canada: Plus ça change, plus c'est la même chose?" 63 *Bull. Intl. Tax.* 414 (2009). The article should be consulted for additional details such as data notes, caveats, and original primary data sources.

Three remarks about these numbers are in order: first, there is less dispersion in exemptions than rebates and the top three items are of the same order of magnitude and fairly close. Second, health care exemptions rank higher than hospital rebates because the former reflects the delivery of heath care by non-hospital institutions and centres, and non-profit and charitable organizations. Finally, tax expenditures on rebates are more important than the (loosely) corresponding expenditures on exemptions. Again, rebates have a direct impact on revenues since effectively transform the exemption of PNC bodies into a partial zero-rating system. A genuine zero-rating system for PNC bodies has been touted before; it is clear from the top half of the table that such a system would sacrifice significantly more revenue than is shown in the table. In terms of Table 3, that would make rebate rates in the leftmost equal to 100% throughout. The additional revenue loss would also affect provinces with VATs if those were to increase rebate rates on the provincial portion of the HST or on the QST.

Table 5
Estimated GST Tax Expenditures, CAD millions (% of GST Revenues), 2008

Item	2005	2008
Rebates		
Charities	295 (0.09)	255 (0.08)
Non-profit organizations	75 (0.02)	60 (0.02)
Education	805 (2.43)	675 (2.02)
Hospitals	515 (1.56)	435 (1.30)
Municipalities	1,730 (5.23)	1,520 (4.55)
Housing	960 (2.90)	815 (2.44)
Tourists	80 (0.02)	10 (0.00)
Exemptions		
Child care	155 (0.47)	130 (0.39)
Education	555 (1.68)	460 (1.38)
Health care	585 (1.77)	490 (1.47)
Municipalities	430 (1.30)	365 (1.09)
Legal aid	25 (0.01)	25 (0.01)
Housing	1,375 (4.16)	1,150 (3.44)
Road tolls, bridges, ferries	25 (0.01)	25 (0.01)
Zero-rating		
Basic groceries	3,920 (11.86)	3,200 (9.58)
Drugs and medical devices	920 (2.78)	785 (2.35)

Source: Bird, note 31 *supra*, at 418.

To conclude, the GST system relies on extensive tax relief using rebates, exemptions, and zero-rating. This adds up to very substantial relief indeed and in very significant foregone revenues. Based on 2007-08 fiscal statistics, total GST foregone as a result of broadly defined GST reliefs (including some minor items not included in Table 5) added up to at least C$16 billion while the GST's net revenue yield was about C$29.9 billion. This means that reliefs amounted to over half (53.5%) of actual GST collections. On the bright side, the system provides a very clear path to increase revenues: reduce rebate rates on PNC bodies (the indirect and less visible approach); convert exempt goods and services into taxable good and services (the direct and visible approach); or convert zero-rated items into taxable items (the reckless and dangerous approach). In relation to the last possibility, it should be noted that the federal income tax return features a refundable GST tax credit that is meant to compensate low-income households for some of the GST paid. The credit is proportional to the number of dependents and is clawed back with rising household income. Claiming it requires filing a federal tax return, something not all low-income individuals or households necessarily do or wish to.

BENCHMARKING AND IMPLICATIONS FOR EU VAT REFORM

This section presents a brief overview of the alternative treatments of public sector bodies that have been used in practice. It does not review those models in detail as they have been discussed extensively as well as recently in the literature.[32] Only the key features are described below. It then evaluates the Canadian model against these alternatives and comments on its applicability elsewhere.

Overview of the Australian System

All activities of public bodies and non-profit organizations (the "PN" of PNC) are within the scope of the GST. Two important features of the system as it applies to the PN sector are worth noting. First, there is no exemption system applying specifically to supplies by PN bodies. Second, expenditure budgets approved by Parliament for such bodies are not, unlike the case of New Zealand, viewed as consideration for the supply of public administration or other functions of the body.

Examples of supplies made by a non-profit organization that will be taxable under GST include: entry to an event such as a show, concert, or exhibition; hiring out rooms or equipment for a fee; providing membership to an organization; or selling items such as books, clothing and most food items. Most education, child care, and health services are zero-rated (*GST-free*). Some transactions remain exempt (*input taxed*) however. An example would include the supply of food and beverages provided at school tuck shops run by non-profit organizations.

A few special rules apply to charities (the "C" of PNC), gift-deductible entities and government schools. The following goods and services are zero-rated when supplied by charities, gift-deductible entities or government schools: sales of donated second-hand goods; raffles and bingos; and non-commercial sales of goods and services (including accommodation). Sales by such entities will be zero-rated when deemed non-commercial. This determination requires that the amount charged by the organization for the good or service be either less than 50% (75% for accommodation) of the market value, or less than 75% of the amount the organization paid to acquire the good or service. A charity, gift-deductible entity or government school may also elect to make its sales at a fund-raising event exempt if the event does not recur regularly. This would effectively relieve the organization from the obligation to collect GST on the supplies, calculating GST on supplies and purchases, filing GST returns and making payments.[33] Activities eligible for

[32] See, for example, Gendron, note 2 *supra*, at 14, on which the overviews that follow draw; van Brederode, note 14 *supra*, at 194; Michel Aujean, "Application of VAT to Public Bodies: The EU VAT System, Current Issues and Proposals," in Richard Krever (ed.), *VAT in Africa* (Pretoria: Pretoria University Law Press, 2008), at 71; and Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (New York: Cambridge University Press, 2007), at 285.

[33] As an additional measure to relieve the compliance burden, non-profit organizations that are members of the same non-profit association can elect to form a GST group if they make many sales and purchases

the exemption election would include shows, dinners, and performances, events where all goods except alcohol and tobacco are sold for A$20 or less, and approved fundraising events. Supplies made at regularly occurring events (15 times per year or more) will be automatically taxable.

Overview of the New Zealand System

The base of New Zealand's VAT (GST) is probably the broadest in operation today. The treatment of the PNC sector contributes to this state of affairs. As in the case of Australia, New Zealand's GST distinguishes itself from other VATs around the world by treating entities in the PNC sector as suppliers to both the private and the public sector.[34] This treatment means that goods and services provided by the PNC sector are taxable. Fees and charges are used to measure the value of supplies to the private sector. Following a unique model, and unlike Australia, supplies to the government are measured by the corresponding parliamentary budget appropriations. Generally speaking, PNC bodies add VAT to their invoices and obtain credit for the VAT paid on purchases from private *or* PNC sector suppliers. This simple and neutral treatment effectively solves the numerous non-neutralities encountered when PNC supplies are exempt while similar private sector supplies are taxable.

There are further differences with Australia, however. The New Zealand system allows for even fewer zero-ratings and optional exemptions. Going further that Australia and Canada, the New Zealand GST taxes the "untouchables" such as food, children's clothing, and books and medicine.[35] There remain some concessions under the New Zealand system, however. For examples, nonprofits funded by donations effectively receive zero-rated treatment. More importantly, administrative concessions are granted to non-profit organizations to facilitate compliance rather than as a matter of tax policy. Those concessions relate to accounting methods, registration thresholds, and group taxation. A desirable feature of such concessions is that they do not fundamentally undermine the functioning of the VAT, unlike exemptions, unwarranted domestic zero-rating, multiple rates, or thresholds that are set too low.

Comparative Evaluation

The Australian-New Zealand system comes closest to the theoretical ideal of full taxation of the PNC sector. It does so in a relatively clean way and with some administrative accommodations for entities that would otherwise incur disproportionate compliance

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among themselves. With group treatment, the members do not have to pay GST on group transactions and, of course, no credits can be claimed.

[34] Schenk and Oldman, *supra* note 32, at 289.

[35] "Untouchables" are, in the mind of the public, what should just not be taxed. See David White, "The Serious Research Gap on VAT/GST: A New Zealand Perspective after 20 Years of GST", 18 *Intl VAT Monitor* 343 (2007). There are obviously other differences between the Australian and New Zealand regimes but they are not essential to this exposition and are therefore omitted here.

costs. It is by far the simplest of all alternatives considered here. The Canadian system occupies an interesting middle ground with a broad exemption that is partly offset by rebates than can be quite generous in some cases. While GST/HST rebate rates have been relatively stable over time, they have slowly tended to become more generous with the passage of time. The Canadian system is not simple, however, and therefore imposes compliance and administrative costs which would exceed those under full taxation. That is because PNC bodies get special VAT treatment which differs from that received by most other persons.

At the other extreme lies the EU system. It seems to have become a prisoner of its history and the Sixth Directive. There does not appear to be a clear path to address the problems from exemption (real or effective) in a comprehensive and cost-effective way or with a reasonable amount of certainty. Pressure to change is resisted as well.[36]

In practice, things are of course not that clear-cut. Table 6 presents a subjective evaluation of the main four alternative models to the exemption of the PNC sector: Australia, New Zealand, Canada, and EU. The criteria reviewed are: administrability, simplicity, efficiency, predictability, and base autonomy. *High* stands for very good while *Low* stands for poor. For simplicity, models used in other VAT countries are disregarded here as they incorporate features of the four models reviewed.

Table 6
Evaluation of VAT Models for the PNC Sector

Criterion	**Australia**	**New Zealand**	**Canada**	**EU**
Administrability	High	High	High	Medium
Simplicity	Medium	High	Medium	Low
Efficiency	Medium	High	Medium	Low
Predictability	High	High	High	Low
Base autonomy	Not applicable	Not applicable	Medium	Low

The New Zealand model comes close to the ideal of full taxation and thus ranks highest against all criteria, with Australia a close second. The latter model is more complicated. Base autonomy is irrelevant in both countries: New Zealand is a unitary country, while GST revenues in Australia are distributed to states and territories based on a formulary approach. In both cases, compliance and administrative costs are unlikely to be trivial, but would be the lower than under the other two models.

The Australia-New Zealand models are widely acknowledged to represent best practices in this area. The EU model lies at the other extreme with its well-documented economic non-neutralities, arbitrariness, proneness to litigation, and host of other problems. One problem less frequently mentioned has been noted by Sijbren Cnossen in

[36] For a detailed and critical assessment of where the EU system stands, see de la Feria, note 3 *supra*.

the past. The EU VAT system is a true gold mine for tax advisors and consultants in the VAT planning and recovery businesses. The compliance and administrative costs of the system – on top of efficiency losses due to distortions – would by far rank as the highest of all models reviewed here.

The Canadian Model Reconsidered

As noted earlier, the Canadian model lies somewhere between the two extremes of the New Zealand and EU models. The Canadian model embodies a genuine advantage over the EU model in that it allows for base autonomy given the allowed variation in rebate rates. This widens its applicability to federal countries. Using rebate rates as policy variables, the Canadian provinces that operate sub-national VATs can control the rebates they grant for the VAT to PNC bodies for the purchases they make to render exempt services, and hence revenues.[37] Provinces have exercised this autonomy by granting rebates that are usually less generous than the federal component. This has been tempered by the desire of the federal and provincial governments to harmonize VAT. Overall, the effective treatments do not vary too wildly once one takes into consideration that the federal component is smaller in dollar terms since the federal GST rate is 5% versus the usual 8% provincial component. This explains the "medium" score.

The compliance and administrative burdens of the Canadian model are not trivial. Returns still have to be filled, books have to be kept, and in some cases input VAT may have to be apportioned if a PNC body delivers mixed supplies – a combination of exempt and taxable supplies. In practice, however, the scope of public service body exemptions under The Act is so wide that the vast majority of supplies and bodies are exempt and hence subject to the rebate system only. The system is also predictable in the sense that rebate rates are known to all stakeholders and applied consistently. This predictability is important in keeping compliance and administrative costs reasonable and to avoid unnecessary litigation.

The Canadian system relies on a very significant amount of relief and hence sacrifices significant revenue. Ultimately, the rebate model has been too gradualist and has tended to converge towards the wrong system because its partial or full zero-rating is too generous a treatment for the PNC sector, conceptually speaking. It certainly appears to achieve a number of socio-economic objectives but does so at quite a cost. In its logical conclusion, that system would end up creating new non-neutralities by favouring outputs of the PNC sector activities as opposed to others. Moreover, given that the income elasticity of much of the outputs of the sector (e.g., education, health, municipal infrastructure), the rebate model ends up sacrificing significant and growing amounts of revenue over time and undermines the revenue-raising potential of the GST/HST system. Again, the correct VAT treatment of the outputs of the PNC sector is full taxation, full stop.

[37] See Tables 2 and 3 *supra*.

Given the existing expenditure framework in Canada (transfers, equalization, etc.), the Canadian model could of course be improved by making all the outputs of the PNC sector taxable (see Table 4) and using expenditure policies to replicate some of the targeted reliefs (only if politically or practically – in the case of some charities, for example – necessary) as well as the income tax system to provide GST relief to low-income households. There does not seem to be any appetite for such reforms in Canada at the moment although one should note that the increasing harmonization of the sales tax field would seem to be setting the stage for such reforms to take place in the next five years, especially if the provinces that will still operate retail sales taxes after 1 July 2010 consider joining in. In conclusion, the Canadian system leaves room for improvement towards the ideal of a modern VAT.

Can the Canadian Model Be Exported?

Whether the Canadian model should be used elsewhere depends on the particular context. As noted elsewhere, a country considering the adoption of a VAT would do well by getting the design right and applying full taxation to the PNC sector from inception.[38] This is an easy case compared to situations where an existing system is flawed but hard to reform for a number of reasons; the EU VAT is a good example. At this point, it is useful to consider the suggestion by de la Feria and Krever to apply the cost-benefit criterion when addressing concessional exemptions.[39] From the perspective of both EU and Canadian models, it is not known whether concessional exemptions achieve objectives at a reasonable cost. The earlier discussion of tax expenditures under the Canadian system provides a rough indication of the magnitude of concessions, though, but is not informative as to their effectiveness. The legal and collateral costs of both systems are also hard to measure, although one may presume that they are higher in the EU case due to the lack of structure of rebates (when compared to the Canadian system with fixed rebate rates), and its considerable complexity and attendant litigation.

The ideal solution for the EU would be simple: bring the entire PNC sector under VAT along the lines of the Australian-New Zealand model. Although it lies way beyond the scope of this paper, a full cost-benefit analysis that incorporated all compliance and administrative costs (in addition to the considerations noted by de la Feria and Krever[40]) would probably support that notion. Given the history of policy-making and rules that govern decision-making in the EU, the New Zealand (and even Australian) model seems way too radical a surgery to contemplate as a fix for the exemptions of the PNC sector in the EU. The other extreme – leaving the EU system as it is – is undesirable and has given rise to plentiful criticism and calls for change.

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[38] This point was made in the case of the U.S. by Gendron, note 2 *supra*.
[39] Rita de la Feria and Richard Krever, "Ending VAT Exemption: Learning from Experience towards a *Post-Modern* VAT", presented at the conference on VAT Exemptions: Consequences and Design Alternatives, Oxford, 15-16 April 2010.
[40] Id.

As a practical compromise, a variant of the Canadian rebate model suitably adapted to EU conditions may be worthy of deeper consideration for EU Member States.[41] Based on available evidence and the foregoing discussion, it appears reasonable to suppose that the Canadian rebate model outperforms the EU model on the basis of the cost-benefit criterion. Maybe the Canadian model could constitute the first step in breaking the EU VAT impasse in the PNC sector.

[41] The adaptation of the Canadian rebate model to the EU situation would require consideration of important questions such as: Who pays the rebates (Members States or the European Commission)? Should rebates be paid to PNC bodies of other Member States? Should government bodies tax another? The answer to those and many other questions would of course be tied with community funding arrangements.

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