

Harmonizing the RSTs and GST: Lessons for Canada from the Canadian Experience

Charles E. McLure, Jr.
Hoover Institution
Stanford University

I. Introduction

I am pleased to have the chance to talk to you today about harmonizing the provincial retail sales taxes (RSTs) with the federal goods and services tax (GST).¹ I am, however, a bit discombobulated. Ordinarily I might be asked to draw lessons for Canada from the US experience. Since there is no federal value added tax (VAT) in the US, I cannot very well describe and appraise our experience in harmonizing the federal VAT and state sales taxes. Ordinarily when I speak or write about the federal GST and its Quebec counterpart, the Quebec Sales Tax (QST), it is to draw lessons for the United States (or elsewhere) from the Canadian experience.² Of course, that is not the purpose of today's workshop; the purpose is to draw lessons for Canada. Thus I will speak about lessons for Canada from the Canadian experience. This is, of course, risky, since my audience knows the Canadian system far better than I.

I will restrict my comments to the context of revenue-neutral shifts in the method of imposing provincial sales taxes and will not discuss questions of fiscal balance raised by Michael Smart and Richard Bird.³

I think it unwise for the provinces to continue to levy the existing highly defective and uncoordinated provincial RSTs, for reasons I describe below. I assume that the "Alberta option" of having no provincial sales tax at all, is not a realistic option for other provinces. Three options thus seem worthy of consideration by the provinces:

First, join the three small eastern provinces in the Harmonized Sales Tax (HST) system;

Second, reform the provincial RSTs and harmonize them with the federal GST; or

Third, adopt a Quebec-style VAT.⁴

¹In preparing these comments for posting on the Internet I have taken the opportunity to address several comments and questions from the floor. I do this in footnotes marked with an ampersand (&) at the beginning.

²See McLure (2005). Much of what is presented here is taken from that article.

³See Smart and Bird (2006) and Michael Smart's presentation today.

⁴&During the discussion session I was asked about a scheme that would resemble the HST, but distinguish between sales made to various provinces and allow individual provinces the choice of the tax rate to be applied to sales made within their territory. This seems to involve essentially federal administration of provincial surcharges on the part of the federal GST base with destination in particular

I will consider each of these options, assuming for argument's sake that the federal GST retains essentially its present form. Before doing so, I will set the stage by describing the characteristics of an ideal sales tax, how a VAT helps achieve these characteristics, how a well-structured RST could achieve the same results, and defects of existing provincial sales taxes. I do not discuss provincial adoption of defective forms of provincial VAT, the base of which might differ widely from that of the federal GST. That option should not be considered seriously, if only because differences in federal and provincial tax bases would make coordination with the federal GST quite difficult, for reasons explained in the appendix.

II. Characteristics of an Ideal Sales Tax

A well-designed sales tax would exhibit five characteristics.⁵ Three are important for economic reasons, one for administrative reasons, and one for political reasons.

- 1) Essentially all sales to consumers in a given jurisdiction would be taxed at a single rate;⁶
- 2) Essentially all sales to business would be exempt or otherwise freed from tax;⁷

provinces. It appears to differ from surcharges in one important legal respect, however. Provincial surcharges would presumably run into the constitutional limitation on provincial taxes to "Direct Taxation within the Province". By comparison, experience with the HST suggests that structuring what is essentially a surcharge as part of the GST would allow the tax to be collected on interprovincial sales and sales to GST-registered businesses. This may thus be the best way forward. Of course, one would not necessarily expect Quebec to participate in such a scheme, unless it could administer the part that affects it.

⁵For similar principles, see Mintz, Wilson, and Gendron (1994).

⁶&The theory of optimal taxation tells us that tax rates should *not* be uniform – that they should vary inversely with the elasticity of demand for particular products and that products should be taxed more heavily than others if they are complementary with leisure, which cannot be taxed directly. This is a counsel of perfection that ignores political and administrative realities, not to mention econometric issues. Once we cast loose from the lodestar of uniform taxation, it is necessary to defend against special pleadings for preferential treatment, based on econometric estimates of the relevant elasticities. Even the estimates of honest econometricians – not to mention those of less scrupulous ones – can differ, leaving politicians the task of choosing which to believe and opening the door for lobbyists. Finally, rate differentiation requires drawing distinctions between similar products that entails needless costs of administration and compliance and invites evasion based on misclassification. See Deaton (1987) and Slemrod (1990).

When, as Deputy Assistant Secretary of the US Treasury for Tax Analysis, I was engaged in preparing the proposals to President Ronald Reagan that became the basis of the Tax Reform of 1986, we insisted that we should "tax all income uniformly, without regard to its source and use". We resisted the inclination to favor particular sources and uses of income for reasons analogous to those described above. We knew, of course, that the political inability to tax income from owner-occupied housing would likely mean that all other income should not be "taxed uniformly and consistently". See McLure and Zodrow (1987).

⁷There would, of course, be the potential for abuse by those who claim that "dual use" products intended for personal consumption are bought for business use. On the other hand, one of the problems that has stymied efforts to tax services, the need to apportion sales of services to a business operating in multiple provinces, vanishes if all sales to business are not taxed.

- 3) Sales would be taxed under the destination principle, which means that exports from the taxing jurisdiction would occur tax-free and imports into the jurisdiction would bear the same tax as domestic (or local) products;⁸
- 4) The first three objectives would be met without undue costs of compliance and administration; and
- 5) Each government would have the power (and the responsibility) to set its own tax rate.⁹

In the context of multilevel finance the fourth characteristic, reasonable costs of compliance and administration, implies two additional characteristics:

- 6) There would be substantial conformity between the sales tax bases of the federal and provincial governments; and
- 7) There would be substantial cooperation between federal and provincial tax administrations.

I will employ these seven characteristics of an ideal sales tax system to appraise existing provincial RSTs and schemes to reform and coordinate them, the HST, and the Quebec approach.

Before proceeding it will be useful to note that if the first two principles were satisfied, all provinces and the federal government would have the same tax base, and to explain why I emphasize provincial control over tax rates, but not the tax base. Provincial control of tax rates is essential to the determination of revenues and thus the size of the provincial public sector that can be financed – how much will be spent on goods and services provided by provincial governments. It is, of course, true that deviating from the ideal tax base would also affect the revenues that could be derived from a given tax rate. But it does so by incurring the economic and administrative/compliance costs described below.

⁸A well-known theorem states that, under certain ideal conditions, the choice between origin- and destination-based sales taxes would not matter, because the difference would wash out in differences in exchange rates or (of more relevance in the domestic context) differences in price levels. For an evaluation of this proposition in the real world, see Feldstein and Krugman (1990). Leaving aside the fact that the ideal conditions are not likely to be realized, there are at least three reasons to prefer the destination principle. First, in order to implement the origin principle, it would be necessary to value exports and imports. Unless tax rates were essentially uniform, which would eliminate provincial sovereignty in this area, the need to monitor transfer prices between related entities would be insuperable at the provincial level. By comparison, under the destination principle only direct imports by households need to be valued. Second, the destination principle probably reflects better where public services provided by provincial governments are consumed. Finally, the origin principle would be politically unpopular (imagine trying to explain the equivalence of origin and destination taxes to a vendor who is trying to compete with untaxed imports or to an exporter who cannot make exports tax-free), it would be under constant attack, and it might be unsustainable for political reasons. The result might be either a “race to the bottom” in rates or a shift to the destination principle.

⁹I leave open the possibility of exempting some sales to consumers (e.g., of prescription drugs) and taxing some sales to business (e.g., of luxury automobiles ostensibly used in business).

A. How VAT Achieves the Economic Characteristics of an Ideal Sales Tax

Under a prototypical VAT, tax is levied on all sales, whether to consumers or to businesses,¹⁰ but businesses that are registered for VAT are allowed a credit (“input credit”) for VAT paid on their purchases (“input VAT”).¹¹ Thus the first two economic characteristics of an ideal sales tax are achieved.¹² Destination-principle treatment of international trade in goods is achieved by taxing all imports and zero-rating (applying a zero rate to) all exports; since exporters are allowed a credit for tax on purchased inputs (and a refund, if appropriate), exports occur tax-free.¹³ The VAT is not nearly as simple in practice as this description suggests, but its costs of administration and compliance are reasonable, given that it does achieve the first three objectives.

¹⁰I focus on the tax treatment of sales to households and businesses, including commercial operations of governments and non-profit organizations, setting aside the tax treatment of purchases of non-commercial arms of governments and non-profit organizations, which can be either taxed or exempt (or zero-rated, under a VAT). Of course, the MUSH (municipal, university, schools, and hospital) sector is exempt from federal GST in Canada.

¹¹Either exemption or zero-rating of domestic sales (or exempting exports, rather than zero-rating them) complicates the story.

Zero-rating eliminates tax if applied to sales to consumers, as vendors are allowed credit for taxes paid on inputs to zero-rated sales. Otherwise it has no effect, as reduced taxation of business inputs simply reduces credits for input VAT. It is generally not necessary to distinguish between inputs to taxable sales and inputs to zero-rated sales, as credits for input VAT are allowed for tax paid on both.

Exemptions reduce tax (by the amount of tax not collected on value added at the last stage), if applied to sales to consumers. Otherwise they increase tax, by breaking the chain of input credits. If a given trader makes both taxable (or zero-rated) sales and exempt sales, it is generally necessary to distinguish between inputs to taxable (or zero-rated) sales and inputs to exempt sales, as input credits are allowed only for tax paid on the former.

Both exemptions and zero-rating at the retail level violate the first characteristic of an ideal sales tax. Exemptions before the retail stage violate the second and third characteristics, by breaking the chain of input credits. Both zero-rating and exemptions create complexity. For convenience of exposition in what follows I generally suppress references to non-registered traders, which pay tax on their purchases, make sales that are de facto exempt, and are not allowed credits for input VAT, lumping this group together with consumers.

¹²No country fully follows this prototypical model, in part because it is administratively difficult to apply to some sectors (financial services and real estate), in part because of the desire to remove the compliance burden on small business (via exemption), in part for distributional and other political reasons (via exemption or zero-rating of “necessities”), and in part for revenue reasons (via limitations on input credits). New Zealand perhaps comes closest among developed countries.

¹³This statement (and the analogous one for the RST) ignores the collection of tax at the border (or at the post office) on direct imports of goods by individuals, the difficulty of collecting tax on direct imports of services and intangible products by individuals, and the collection of tax at the border on products brought in by tourists. Electronic sales of digital content directly to consumers from outside the nation are not easily taxed. Imports for business use should be exempt under an RST. Under a VAT purchases by registered traders can be handled through reverse charging.

B. Achieving the Economic Characteristics of an Ideal Sales Tax under an RST

In order to achieve the first two economic characteristics of an ideal sales tax under an RST, it is necessary for vendors to distinguish between sales to households, which should be taxed, and those to businesses, which should be exempt.¹⁴ If that can be done effectively, the result is the same as under the prototypical VAT, except that tax is collected entirely at the retail stage, and it is not necessary to rebate tax on exports.

C. Potential Trouble Spots

Aside from important mechanical issues of administration and compliance that I do not propose to discuss, such as “one-stop shopping” for registration, filing of tax returns, payment of taxes, and audit, several potential “trouble spots” arise in attempting to create a sales tax system that exhibits the characteristics of an ideal sales tax system described earlier. Among the most important are the monitoring of exemptions (RST) or credits for input taxes (VAT) for purchases by business and the tax treatment of interprovincial sales. In both these areas the existence of a federal VAT can assist in the implementation of a provincial RSTs or VATs.

III. Defects of Existing RSTs

Existing provincial RSTs – but not the Quebec value added tax – violate all but one of the principles set forth earlier:¹⁵

- 1) Many sales to consumers, especially of services and intangible products, are exempt;
- 2) Many sales to business are taxed;
- 3) The destination principle is seriously violated;
- 4) The “system”, comprised of provincial RSTs, the QST, and the GST (along with the HST), is incredibly complicated, in part because:
- 6) The bases of the provincial RSTs differ from that of the federal GST, and
- 7) There is virtually no cooperation between federal and provincial tax administrations.

Exemptions, including those for only selected business purchases, create complexity. Violation of the destination principle is inherent in the taxation of business purchases. Even if exports

¹⁴Under an RST the distinction between zero-rating and exemption of business purchases vanishes.

¹⁵As I note below, except that individual provinces lack control over tax rates, the HST is consistent with all the principles. Bird and Gendron (1998) provide a general description of the provincial sales taxes, including the QST and HST.

from a province are exempt, the hidden taxes paid before the export stage are not rebated. Similarly, even if imports into the province are subject to the RST, they are not burdened with the hidden taxes imbedded in the prices of similar local products. In addition, because of the constitutional limitation that provinces can levy only “Direct Taxation within the Province”, interprovincial sales cannot be taxed. This means that destination provinces must collect taxes on such transactions directly from the purchasers, an especially tall order in the case of sales to households. In short, the RSTs levied by the provinces are highly defective.

The failure to comply with the principles of good sales tax design has several adverse consequences.

First, the failure to tax all goods and services sold to households has implications for both economic neutrality and equity. Consumption decisions are distorted; those whose preferences tend toward taxed products pay higher taxes than those with the same income but a preference for exempt products; and the progressivity of the tax system is likely to be reduced, because exempt services figure more heavily in household budgets, the higher is household income.

Second, the failure to exempt all sales to business distorts choices of methods of production and distribution, particularly decisions on whether to purchase inputs or produce them, in order to save tax. Differences in taxation also affect consumption choices of households and the equity of the system.

Third, and this is perhaps the most important of all these adverse consequences, the taxation of capital goods discourages saving and investment and retards growth of productivity.¹⁶

Fourth, for a given constellation of exchange rates and price levels, violation of the destination principle places local producers at a competitive disadvantage, relative to foreign producers and producers in other provinces.¹⁷

Finally, the complexity of the tax levied by any one province is costly. Moreover, because of differences in the tax bases of the various provinces (and that of the federal government) and the

¹⁶Chen and Mintz (2003) estimated that, on average, provincial sales taxes on capital goods add about five percentage points to the marginal effective tax rate on income from capital in Canada. This additional burden is, of course, greatest in the provinces that levy RSTs.

During the discussion period I referred listeners to the following example taken from McLure (1998), p. 1177, note 57: “Perhaps the most celebrated example of tax-induced migration of industry is that of Intel, which built a new factory in New Mexico, rather than pay California sales tax on its construction costs. Although Intel is one of the quintessential corporations of the digital age, this episode could have occurred in any industry that was relatively footloose.” I added that the American penchant to use tax incentives for industrial location and to shift to using only sales in apportioning corporate income among the states amounts to “Looking for Love in All the Wrong Places” or at least in the wrong order, meaning that it would make more sense to begin by rationalizing the tax treatment of business purchases, including those for investment, before pursuing such “beggar-thy-neighbor” policies. See also McLure (2002).

¹⁷It should be noted that, for the viewpoint of any one province it makes no difference that other provinces or other nations (e.g., the states in the US) have similarly defective sales taxes. That province could improve its competitive advantage by implementing the destination principle, no matter what occurs elsewhere.

lack of cooperation between provincial and federal tax administrations, the Canadian sales tax “system” is needlessly complex and costly.

Violation of the first two principles of good sales tax design is primarily a matter of poor provincial tax policy, not administrative necessity. There is little administrative reason that provincial tax bases could not include essentially all sales to consumers and exempt essentially all sales to business.¹⁸ If those reforms were made, most differences in provincial (and federal) tax bases, most of the complexity resulting from those differences, and the most important departures from the destination principle would also be eliminated, without the need for coordinated multilateral action by the provinces.¹⁹ By comparison, adoption of uniform administrative procedures and provincial cooperation with the federal tax administration would require multilateral action.

IV. Options for Consideration

A. The HST: Not the Way Forward

The easiest way to achieve all but one of the characteristics of an ideal sales tax would be for the remaining provinces to join the HST system. Under the HST, the federal government collects GST at a higher rate on sales to the three participating provinces than on sales to other provinces. Together with the federal government, the participating provinces determine the HST rate.²⁰ The revenue resulting from the rate differential is then divided among the participating provinces in proportion to estimates of consumption expenditures in those provinces. Because the HST is seen as a federal tax, rather than a provincial tax, it can be collected on interprovincial sales, contrary to the situation under the provincial RSTs or even the Quebec VAT. Besides satisfying the destination principle, the HST is a preeminently simple system to administer.²¹

The HST is not, however, the way forward.²² Although the HST system produces revenues for the participating provinces in a simple manner, it violates the fifth principle stated earlier, that “each government would have the power (and the responsibility) to set its own tax rate”. (I would even go so far as to say that the provincial part of the HST is not really a provincial tax at

¹⁸My guess is that the taxation of business inputs largely reflects flawed thinking about policy (“If families pay sales tax, why shouldn’t business?”), the desire to hide the true cost of government, and of course, fear of the political consequences of replacing the existing flawed systems with a better system that would require higher statutory tax rates to achieve a given effective tax rates, rather than careful consideration of administrative realities.

¹⁹With the posited degree of uniformity, it would be far easier to apply the destination principle to direct sales to consumers made by vendors located in other provinces.

²⁰All three HST provinces must agree in order to reduce the rate differential; agreement of two is enough to raise it.

²¹Of course, it shares whatever faults plague the federal GST.

²²See, however, note 4 above.

all; it is a form of tax sharing. This characterization would be even more accurate if all the remaining sales-tax provinces shifted to the HST.) The HST implies an enormous sacrifice of provincial fiscal sovereignty, and with it accountability to provincial electorates, that is neither desirable nor necessary. I would guess that it is likely to remain politically unacceptable, at least in the economically powerful provinces. I suspect that in saying this, I am preaching to the choir, albeit perhaps not the choir in Ottawa.

B. Provincial VATs: One Way Forward

Quebec has shown, beyond a shadow of a doubt, that it is possible to levy a provincial value added tax, something that many long thought difficult, if not impossible.²³ Of course, Quebec has an advantage that was not usually assumed by those who reached that conclusion: the existence of the federal GST. It is much easier to monitor cross-border transactions, including credits for input tax, in this context than under a system of “stand-alone” provincial VATs.

While some differences in the provincial and federal tax bases remain, the bases of the two taxes exhibit considerable harmonization. And, of course, there is considerable administrative coordination, as the province administers the GST for the federal government.

The constitutional restriction of provincial taxes to “Direct Taxation within the Province” has an implication that goes beyond complicating collection of tax on interprovincial sales to households. Businesses cannot be required to pay tax on purchased inputs and claim credits for input tax, as in the textbook VAT. Rather, businesses registered for QST are allowed the option of making purchases on a tax-exempt basis. To the extent this occurs, the QST functions as an RST, rather than a VAT. Despite this anomaly, the Quebec tax scores high marks when judged by the criteria described earlier.

C. Reformed RSTs: Another Way Forward

It would be somewhat more difficult to coordinate the administration of the federal VAT with provincial RSTs, even if the two were levied on a consistent base, because of the way the two taxes operate. A VAT is ideally levied on all sales. By comparison, an RST should ideally exempt all sales to business. But it would be possible to allow RST exemptions for all sales that give rise to input credits under the GST. This would require that vendors determine whether a sale is to a business, and thus eligible for GST input credit and, by extension, for RST exemption.²⁴ For provincial sales tax purposes proof of registration for federal VAT would serve this purpose.

²³Bird and Gendron (2000) describe the Canadian solution, and Keen and Smith (2000), Varsano (2000), and McLure (2000) describe possible ways of dealing with trade between subnational jurisdictions in other contexts.

²⁴On the difficulty of such distinctions, see Cnossen (2002).

D. Both Provincial VATs and RSTs: Two Ways Forward?

Quebec seems unlikely to switch from the QST to a provincial RST, and some other provinces might also adopt VATs. What if some provinces wanted to retain their RSTs, but reform them? Would attempting to coordinate both types of provincial tax with the federal GST be “a bridge too far, even if both forms of provincial sales taxes were consistent with the federal tax”? This question deserves further study.²⁵

It seems that the views of business should weigh heavily in this decision.²⁶ Would business strongly prefer to be required to comply only with provincial VATs, along with the federal GST/HST, or would they be indifferent to the form of provincial sales tax? It seems that evidence from Quebec regarding the choice between making business purchases on a QST-exempt basis, on the one hand, and paying tax and claiming input credits, on the other, should be quite informative.

²⁵In the United States local governments in many states impose RSTs, making state use of the value added tax problematical. The vast majority of these local taxes are levied on the state base and collected by the state. Although some local taxes exhibit a uniform rate throughout the state, some rates are set locally.

State shift to a VAT would leave these local governments high and dry, as it is hard to imagine implementing a destination-based local VAT. It would be possible to shift to a local version of the HST, but that would have implications for the accountability of local governments similar to those mentioned earlier. This leads me to conclude that reform of the RST may be the best way for the American states to go. Of course, none of this is relevant for Canada, since there are no local sales taxes.

²⁶In the abstract one might expect business to prefer the provincial VAT model for reasons other than ease of compliance, which is of interest here, since it should offer greater assurance that provinces will eliminate tax on business purchases. Quebec’s failure to follow the textbook model in this regard makes this expectation suspect.

Appendix: Defective Provincial VATs: Another Road to Nowhere?

Quebec's initial experience, in which the federal and provincial tax bases differed more than now and the province did not allow input credits for all tax on business purchases, may seem to suggest that neither absolute uniformity of national and subnational tax bases nor credits for all input taxes is required for a dual VAT to function. But such a conclusion should be accepted only with great caution. Certainly, anything resembling the lack of uniformity currently found in provincial RSTs would make federal-provincial coordination extremely difficult, and could swamp the system.

Provincial deviations from the federal tax treatment of sales could take the form of either exemptions or zero-rating (or even multiple rates) and could differ from province-to-province. Both exemption and zero-rating would imply different tax treatment of a given sale for federal and provincial VAT purposes, as provincial tax would not be collected on zero-rated and exempt sales. Though not desirable, zero-rating (or other rate differentials) would probably be relatively innocuous, if considered by itself. Businesses making zero-rated sales would be allowed input credit for all taxes paid on purchases, and businesses making zero-rated purchases would have no input credits for such purchases. By comparison, exemptions would especially complicate compliance and administration in a dual VAT, as input credits should not be allowed for tax paid on inputs to exempt sales. Thus on a given business purchase input credits might be allowed for federal VAT, but not for all provincial VATs.

Logically, one would expect subnational VATs to deviate from an ideal national VAT mostly in their treatment of products sold primarily to households, since any failure to allow complete input credits would harm the competitive position of the taxing provinces. But for revenue reasons Quebec initially did not allow complete input credits and still does not allow them for large companies. Moreover, the RST provinces' steadfast refusal to eliminate the RST on business inputs, despite the obvious negative effects on competitiveness, makes one wonder whether they would allow credits for all input taxes.²⁷ The risk that they might not allow full input credits is especially worrisome, given the inclusion of most services in the comprehensive federal VAT tax base. Increased provincial taxation of business services, without compensating input credits, besides complicating compliance and administration, would be a real step backwards on policy grounds.

²⁷I assume, by comparison, that provinces would zero-rate exports to other provinces, rather than only exempting them. Exemption of exports might also constitute grounds for refusing federal cooperation.

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