

**Open for Business?**

**An Analysis of the Social Services Tax on  
Legal Fees in British Columbia**

Presented to:  
Canadian Bar Association  
British Columbia

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## **EXECUTIVE SUMMARY**

- Social Services tax (SST) on legal services was introduced in British Columbia in 1992.
- The tax is inequitable as British Columbia is the sole province in Canada which imposes a provincial sales tax only on legal services among the professional services.
- SST on legal services is inefficient as it is not only a sales tax on consumption, but also a sales tax on capital investment.
- SST on legal services increases the cost of doing business in British Columbia, thus compromising the competitiveness of industry.
- Literature reviewed indicates that removing sales tax brings about positive economic impacts, with the removal of tax on capital goods more substantial than the removal of the same tax on consumption.

The material presented in this report and the studies that we cite from other jurisdictions clearly indicate that the BC economy would experience positive gains from the elimination of the social services tax on legal services.

## **INTRODUCTION**

In 1992, a seven percent Social Services tax on legal services was introduced in British Columbia. It was initially intended to fund legal aid, but has consistently been allocated to general revenue. The tax was increased to 7.5 percent in 2002, realizing over \$100 million (\$104,616,000 in 2002-2003 fiscal year) annually in tax revenue.<sup>1</sup> The rate was reduced to seven percent again effective October 21, 2004. British Columbia is the sole province in Canada which imposes a provincial sales tax only on legal services among the professional services.<sup>2</sup>

In this report, Roslyn Kunin & Associates (RKA) will undertake an initial examination of the impact of the social services tax on legal services in British Columbia. Specifically we will examine relevant literature and describe what data is available. We will also make recommendations as to the methodology in quantifying the economic impact of the SST on legal service industry in British Columbia.

In the next section, we will start the analysis by laying down the theoretic framework in which taxes are analyzed. In the section that follows, we provide findings from literature review.

## **PRINCIPLES OF TAXATION IN PUBLIC FINANCE**

The Social Services Tax, also called the Provincial Sales Tax (PST), is a consumption tax levied on most goods and some services. While the tax allows the provincial government to collect more revenue, it raises the cost of legal services for consumers, be they individuals purchasing a new home, businesses setting up a production facility, or any other users of legal services.

From an economic point of view, any tax system creates a distortion to the economy. Such a distortion can be large or small depending on a specific tax

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<sup>1</sup> Ministry of Provincial Revenue.

<sup>2</sup> Amongst the five provinces in Canada that impose a stand-alone provincial sales tax, British Columbia, Saskatchewan, Manitoba and PEI treat legal services as taxable services. These five provinces are British Columbia, Saskatchewan, Manitoba, Ontario, and Prince Edward Island. No professional services are taxable under PST in Ontario. However, Saskatchewan, Manitoba, and Prince Edward Island impose the provincial sales tax on all professional services, including legal, accounting, architectural, consulting, and engineering services. The other three maritime provinces have fully harmonized HST system and Quebec has a partially harmonized HST system, which is a value-added tax system. Services that are taxable under GST are also taxable under HST. So legal services will be taxable in these provinces as well.

system's design. Still, there are two basic principles that should be followed when a tax policy is designed. They are equity and efficiency.

In this section, we will point out areas where the SST on legal services violates both these principles.

## **Equity**

The sales tax is intended to be a general tax on consumption. In theory, an ideal general sales tax taxes all retail sales once, but only once. In practice, many non-retail transactions are taxed, while many retail transactions are exempt from taxation. The reason that the general sales tax should be as comprehensive as possible is that it should make the system fairer. The Social Services Tax on legal services is not equitable and it violates the principle of "horizontal equity". To tax a person who obtains tax advice from a lawyer and not one who obtains tax advice from an accountant is not equitable.

Moreover, sales taxes are regressive as they are charged as a percentage of the taxable transaction. In other words, they absorb a larger proportion of the income of lower-income taxpayers than of higher-income taxpayers. This is because higher-income persons consume a smaller proportion of their incomes and the portion of their incomes that they save is not subject to sales or other consumption taxes. In fact, the regressivity inherent in the provincial sales tax imposed upon legal services is being challenged as it deters the poorest in the society from purchasing all the legal services they may require.<sup>3</sup>

For example, based on data from the 1996 Family Expenditure Survey by Statistics Canada, for the two-person household in Canada with an income before tax below \$30,000, expenditure on legal services non-related to dwellings accounted for 0.23% of the household's income before tax. For a similar household in the income bracket between \$70,000 and 89,999, expenditure on legal fees not related to dwellings accounted for only 0.17% of its income before tax.

The regressivity inherent in the provincial sales tax also means that the cost of doing business for small businesses is higher than for businesses of larger size. Based on a recent survey by the Canadian Bar Association, British Columbia, on the cost of legal fees for a simple incorporation, 72 participating firms indicate an average cost of \$588. This will account for a larger budget share of a small business than a medium or large sized business.

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<sup>3</sup> In this regard, we note that the regressivity of the PST imposed on legal services tax is somewhat mitigated by the fact that there is legal aid provided to those meeting certain financial criteria. However, legal aid is not available to all aspects of legal matter. We also note that the PST on legal services is exempt for low income earners as a result of the case of *Christie v. AG of B.C. et al.* See <http://www.courts.gov.bc.ca/jdb-txt/sc/05/01/2005bcsc0122err1.htm>

## **Efficiency**

By efficiency we mean the efficient allocation of economic resources. Even when a government is contemplating imposing a sales tax on a category of goods or services, it should carefully analyse what should, and what should not, be taxable. In general, a good or service can fall into one of the following three categories.

- Goods and services primarily purchased by businesses, such as heavy construction materials, accounting, and television advertising;
- Goods and services primarily purchased by households, such as clothing, day-care service, and cable TV; and
- Goods and services frequently purchased by both households and businesses, such as restaurant meals, landscaping, and pest control.

Economic theory generally recommends not taxing the first category of goods and services, so-called “business-to-business” sales. The reason is that taxing the goods and services businesses buy to use as inputs into the production of other goods and services often leads to “tax pyramiding” or “tax cascading”. Tax pyramiding or tax cascading refers to the situation in which an input is taxed when purchased and then effectively taxed again when its cost is passed through into the price of a taxable good or service into which it has been incorporated. Tax pyramiding results in the actual sales tax imposed on a particular good or service bought by a household being higher than what is added at the cash register. Because the sales taxes imposed on inputs are hidden in the selling price of the item, they are even more burdensome for low-income families than the visible sales tax that is imposed on the final sale. This is because necessities like food and utilities that often are tax-exempt nevertheless can have substantial sales taxes hidden in their prices.

An example of the cascading effect of the tax on legal services is in the housing industry where taxes on legal fees re land assembly, strata structures, etc. accumulate to increase the final cost of housing in British Columbia.

Taxation of business inputs also tends to complicate sales tax administration. For example, rules need to be developed for taxing services like accounting that are purchased by businesses for company-wide use in multiple provinces.

The greatest concern of economists regarding sales taxation of goods and services purchased by businesses is that it can distort the allocation of economic resources. In the case of legal services, for example, since those provided to an employer by an employee are not subject to sales tax, it can encourage businesses to provide services using their own internal legal counsel even if the services could be produced more efficiently by an independent law firm. This would reduce the development and availability of independent legal services.

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Such a lack of services would deter start up companies and other firms too small to afford or require in-house counsel from locating in or moving to the jurisdiction with the tax on legal services if a non-taxed service is available elsewhere. Such is the case in Canada.

In addition, if purchases of services subject to sales tax are major cost items for a business a more efficient business that tries to pass those taxes into its prices could lose business to a less efficient competitor located in another province that exempts those inputs from sales taxation. Examples of major cost items for a business could be electricity and telecommunications services for an Internet service provider. While some legal service requirement, particularly those purchased by individuals, are tied to a location; many businesses and those choosing to start a business have more freedom to select a location based on the availability and cost of the goods and services they will need.

Also, a business that makes substantial purchases of taxable services might choose to expand in a province that is sub-optimal on other criteria but that exempts those services from sales tax. This is equivalent to saying that the sales tax embedded in services favours imports over exports when the same services are not taxable in another jurisdiction. The net result is loss of (potential) businesses, jobs, income and government revenue.

Applying these theories to the application of SST on legal services in British Columbia, we can argue that the tax adversely impacts the overall economy, as well as the industry itself, in the following manner. It fails in

- Attracting and retaining head offices.
- Keeping BC industry as productive as it could be
- Attracting and retaining businesses in sectors that make extensive use of legal services including:
  - Biotechnology
  - Information technology
  - Entertainment
  - Construction
  - Resource extraction
  - Development by and with First Nations

(All of these industries make above average use of legal services with respect to both real estate and intellectual properties.)

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- Attracting and retaining the legal industry itself in BC as a source of jobs and revenue.
- Undertaking research and development activities.
- Keeping legal services in BC competitive compared to other professional services such as accounting and consulting.
- Keeping BC legal services competitive with other jurisdictions especially Alberta and Ontario where no provincial sales taxes are imposed on legal services.

## ECONOMIC GROWTH AND COMPETITIVENESS

Because the provincial sales tax applies to both individual consumption and purchases of business inputs, it represents two types of taxes. Where it is levied on personal consumption, it is a consumption tax. Where it is levied on business inputs, it acts as a tax on capital investment since it is applied to a business input. Sales taxes on capital investment – such as steel, machinery, computers and services to business which become inputs into other goods and services – generate a significant proportion of PST revenue. As shown in Table 1 that follows, PST revenue from taxing business inputs is almost as large as PST revenue from taxing final consumption.

Table 1 The Tax Mix in Canada (Fiscal Year Ending March 31, 2004)

	% of Tax Revenues			% of GDP
	Federal	Provincial / Territorial / Local	Total	
Personal income taxes	26.4	14.4	40.9	12.1
On wage income	25.3	13.8	39.1	11.6
On investment income	1.2	0.6	1.8	0.5
Payroll taxes	6.1	5.7	11.7	3.5
General payroll taxes	0.0	2.4	2.4	0.7
Contributions to social security plans	6.1	2.4	8.5	2.5
Health and drug insurance premiums	0.0	0.8	0.8	0.2
Property taxes	0.0	11.2	11.2	3.3
Residential	0.0	6.5	6.5	1.9
Business	0.0	4.7	4.7	1.4
Corporate income taxes	7.5	3.2	10.7	3.2

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Corporate capital taxes	0.4	0.9	1.4	0.4
Sales taxes	8.6	8.5	17.0	5.1
Value-added taxes	8.6	2.8	11.4	3.4
Retail sales taxes	0.0	5.6	5.6	1.7
On consumer spending	0.0	2.9	2.9	0.8
On business inputs	0.0	2.8	2.8	0.8
Excise taxes and customs duties	3.4	3.6	7.1	2.1
Total tax revenues (%)	52.4	47.6	100.0	29.7
Total tax revenues (\$ billions)	189.6	171.9	361.5	

*Source: Department of Finance. "Taxation and Economic Efficiency: Results from a General Equilibrium Analysis" in Tax Expenditures and Evaluations 2004. Ottawa, 2004.*

It just makes sense that economic growth will be compromised if a large portion of a company's earnings must be used to pay taxes. The more money that is taken as taxes, the less there will be available for further investment and the less productive and competitive BC's industries will be.

There has been extensive research over the years both in Canada and different provinces in quantifying the magnitude of the potential detriment of sales taxes.

Using a regional general equilibrium model,<sup>4</sup> Hamilton and Kuo (1991) of the Department of Finance analyzed the impact of the 1991 sales tax reform. Specifically, they analyzed the economic impacts from replacement of the Manufacturers Sales Tax (MST) with the Goods and Services Tax (GST). The study concluded that sales tax reform could increase real output in Canada in the long run by 1.4% and welfare by 0.9%. The principal objectives of tax reform were to remove the hidden taxes from the cost of capital and from exports, thus improving Canada's international competitiveness. Consequently, the biggest gainers in terms of GDP improvements were expected in the capital-intensive, export-oriented sectors.

Hamilton and Kuo's work also took provincial sales taxes into consideration. They concluded that extending the 1991 sales tax reform to include provincial sales taxes could add another 0.8% to real output. All regions across Canada were shown to benefit from their specification of harmonization because of the reduced cost of capital goods with elimination of taxes on business inputs. The effective PST rate on capital goods was estimated to be 3.7%.<sup>5</sup>

<sup>4</sup> A general equilibrium model is a model constructed to simulate economic activities as a result of policy changes. It captures the basic structure of the Canadian economy, taking into account the differences in the structure of economic activity across regions. This approach also identifies the interaction between key sectors of the economy and the influences of the Canadian tax system.

<sup>5</sup> The notion of "effective tax rate" arises when the actual burden of the tax is lower or higher than the stated "nominal tax rate". It recognizes the fact that firms can be taxed (or subsidized) not only directly, but also indirectly by other taxes (or subsidies) that affect its costs.

Table 2 summarizes the sectoral results of the Hamilton and Kuo study.

Table 2 Effects of Sales Tax Reform on Sectoral Real Output

Sector (% change in GDP)	Federal Only Reform (GST)	National Reform (HST)
Primary	3.3	3.8
Food, beverage and tobacco	0.3	0.8
Manufacturing	1.4	1.8
Construction	1.6	3.5
Transportation and Utilities	3.1	3.6
Services	1.6	2.7
<b>Total</b>	<b>1.4</b>	<b>2.2</b>

*Source: Hamilton, Bob and Chun-Yan Kuo, "Reforming the Canadian Sales Tax System: A Regional General Equilibrium Analysis", Canadian Tax Journal, v.39(1), 1991, p. 126.*

An earlier study by Dungan and Wilson (1989) also shows positive, although much delayed, results. The study shows that, in the long run, the overall gains from a more efficient tax system would be realized within five to six years after implementation. After ten years, output would improve by 0.4% to 0.6%. However, in the short run, loss out-weighted gain. They estimate that the general price level rises by 2.5% by the third year of implementation if monetary policy is used to defend the exchange rate. Real GDP is reduced by 0.3% for the first four years, and the unemployment rate is 0.6 percentage points higher by the fourth year.

Most general equilibrium tax model literature indicates that, amongst various tax policies, taxes on capital (that is on business inputs like the SST on legal services) are the most distorting, followed by taxes on labour and then by taxes on consumption. In addition, models that examined the impact of investment incentives found them to be among the most effective measures.

Baylor and Beausejour (2004) examine seven tax policy initiatives and find that the two most effective are increases in capital cost allowances and the lowering of personal capital income taxes.<sup>6</sup> Like the increase in capital cost allowances, a reduction in sales taxes on capital goods or business inputs such as the SST on legal services has the advantage of lowering the after-tax price of commodities used as capital goods, which translates into a reduction in the replacement cost of capital. As with the increase in capital cost allowance, this lowers the effective acquisition cost of new capital below its market value and stimulates investment. Table 3 below summarizes welfare gain per dollar of lost present value of

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<sup>6</sup> Personal capital income taxes are taxes on capital gains, dividends, and interest income.

government revenue for these tax policy initiatives.<sup>7</sup> Note that the legal services tax is in effect a sales tax on capital<sup>8</sup> and thus cutting it would have a large positive welfare impact.

Table 3 Impact of Revenue Equivalent Tax Initiatives on Welfare

Tax Measure	Welfare gain (in dollars) per dollar of lost present value government revenue <sup>9</sup>
Increase in capital cost allowances on new capital	1.35
A cut in personal capital income taxes	1.30
<b>A cut in sales taxes on capital goods</b>	<b>1.29</b>
A cut in corporate income taxes	0.37
A cut in personal income taxes	0.32
A cut in payroll taxes	0.15
<b>A cut in consumption taxes</b>	<b>0.13</b>

Source: Baylor, Maximilian and Louis Beauséjour. *Taxation and Economic Efficiency: Results from a Canadian CGE Model*. Canada, Department of Finance Working Paper 2004-10.

As an illustrative example, in 2003/2004 fiscal year, a total of \$110,115,000 of PST on legal services was collected in British Columbia, of which \$109,940,000 was PST collected from services provided by lawyers.<sup>10</sup> This represents a value of \$1,465,866,667 worth of legal services provided. Based on data available from the *Survey of Household Spending* in 2003,<sup>11</sup> an estimated 98,200 households in British Columbia spent on average \$777 per household for a total \$76,312,600 on legal fees related to own dwellings. (Note that this represented only 6.3 per cent of all households in BC reported spending on legal services related to own dwellings. Also the expenditure reported includes taxes.) An additional 104,810 households spent on average \$1,694 per household for a total \$177,543,600 on

<sup>7</sup> The welfare gain is a measure of the economic well-being gained from the change of the tax system. This measure captures the increased potential for consumption or leisure from replacing a specific tax with other taxes. As the tax system becomes more efficient, Canadians have more disposable income so they can consume more goods and services or increase their leisure time – by working fewer hours – while maintaining their consumption levels.

In this analysis, the revenue lost from a specific tax reduction is replaced by a general tax spread evenly across all Canadians.

<sup>8</sup> The portion of legal services that is purchased by businesses for the purposes of production.

<sup>9</sup> Replaced by a general tax spread evenly across all Canadians. Example of a general tax is a lump-sum tax.

<sup>10</sup> The remaining amount of PST is from legal services fees paid to notaries public.

<sup>11</sup> Source: Statistics Canada, CANSIM Tables 203-0003 and 203-0015.

legal fees unrelated to their own dwellings. This means that a total of (\$1,465,866,667-76,312,600-177,543,600) = \$1.212 billion worth of legal fees was paid by businesses for the purposes of investment and production. This represents 82.7 per cent of the total value of legal services provided.

The welfare gain resulting from removing the PST on legal fees paid by businesses would be  $\$109,940,000 \times 82.7\% \times 1.29 = \$117.3$  million, and the gain from removing the PST on legal fees paid by households would be  $\$109,940,000 \times 17.3\% \times 0.13 = \$2.5$  million.

Note that this example only shows the order of magnitude of the welfare gain from removing the PST on capital goods (i.e., legal fees paid by businesses for the purposes of investment and production) and from removing the PST on final consumption (i.e., legal fees paid by households). The underlying assumptions for the values shown in Table 3 refer to removal of sales taxes across all industries in the economy. In our example where only PST on the legal services industry is removed, the welfare impact values that would have shown in Table 3 are much smaller.

At the provincial level, in Ontario, the Centre for Spatial Economics (2004) develops a general equilibrium model to evaluate the economic impact of various tax reforms that “drive towards smarter taxation”.<sup>12</sup> Of the eight options the Centre modeled,<sup>13</sup> eliminating the provincial sales tax on capital investments has the most positive impact on competitiveness at a relatively low cost to the provincial treasury. It has the highest impact on GDP per capita in the province, increasing it by 0.4 percent over the status quo. The fiscal multiplier for eliminating sales tax on capital goods is \$3.50.<sup>14</sup> That is, for every dollar of tax revenue lost by eliminating the provincial sales tax on capital goods, GDP increases by \$3.50. This multiplier is the third highest of the eight options studied. It also has the second highest impact on employment growth. Table 4 below summarizes the economic impacts of these eight tax policy options.

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<sup>12</sup> Institute for Competitiveness & Prosperity. “Taxing smarter for prosperity” Working Paper 7, March 2005

<sup>13</sup> The eight options that were modeled in the study were:

- removing the PST from capital goods;
- harmonizing the PST with the GST at a rate of 7 percent;
- harmonizing the PST with the GST at a rate of 8 percent;
- eliminating Ontario’s corporate capital tax;
- instituting a uniform provincial corporate income tax of 7 percent for all corporations (large and small);
- instituting a uniform corporate income tax of 8 percent for large corporations only;
- increasing Ontario’s capital consumption allowances for new machinery and equipment (M&E) by 25 percent; and
- reducing personal income taxes by 10 percent across the board.

<sup>14</sup> Fiscal multiplier is a measure to assess the trade-off in prosperity increase versus lost tax revenue. It calculates the increased GDP benefit per dollar lost in tax revenue. The multiplier measures the cumulative impact on real GDP divided by the overall reduction in provincial government revenue.

Table 4 Effects of Tax Policy on GDP per Capita, Employment Growth, Labour Productivity, and Government Revenue, Ontario

Impact After 10 Years	GDP per Capita (% change)	Employment (% change)	Labour Productivity (% change)	Fiscal Multiplier
Corporate Capital Tax	0.2	0.3	0.1	1.8
Corporate Income Tax: 7%	0.2	0.3	0.1	1.2
Corporate Income Tax: 8%	0.2	0.3	0.1	1.2
Capital Cost Allowance (new capital only)	0.1	0.2	0.1	4.0
Sales Tax Harmonization: 7%	0.4	1.0	0.1	3.1
Sales Tax Harmonization: 8%	0.4	0.5	0.3	48.0 <sup>15</sup>
Remove Sales Tax on Capital	0.4	0.7	0.3	3.5
Personal Income Tax	0.3	0.3	0.0	0.9

*Source: Centre for Spatial Economics. "Tax Policy, Competitiveness and Prosperity in Ontario" Report prepared for the Institute for Competitiveness & Prosperity. 2004*

Results from this study reiterate the positive long-term economic impact from removing the sales tax from capital goods. Such is the case with the PST on legal services.

In British Columbia we could find no studies of this kind examining the economic impacts of various tax policies, or the effects of the provincial sales tax on legal services in particular.

The material presented above and the studies from other jurisdictions clearly indicate that the BC economy would experience positive gains from the elimination of the social services tax on legal services.

<sup>15</sup> This is the value reported in the study cited.

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