E-COMMERCE IMPORTS INTO CANADA: SALES TAX AND CUSTOMS TREATMENT

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With e-commerce imports into Canada on the rise, sales tax and import duty payments on these imports are likely to yield considerable revenues for the public sector. This, however, depends on the degree of customs compliance when these shipments are processed upon import by delivery operators and customs authorities.

This experimental study tested the extent to which e-commerce shipments to Canada are correctly processed upon import. We find that these shipments are treated differently at customs clearance, where sales tax (HST/PST) and import duty should be applied, depending on the type of delivery operator. We conclude that sales tax and import duty are significantly less likely to be collected when shipments are sent via postal versus express operators.

We conclude that the missed collection of sales tax and import duty on e-commerce inbound postal shipments results in a significant loss of public revenue to Canada. Moreover it distorts competition between Canadian retailers and foreign competitors. Finally, it distorts the competition between postal and express operators.

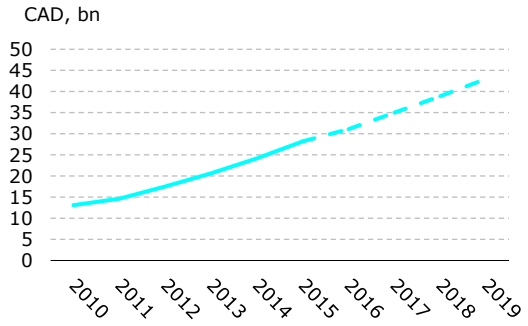
Summary of results

- The incomplete collection of sales tax and import duty on postal shipments inbound into Canada is estimated to cause a **loss of Canadian public sector revenue of up to C$ 1.3 billion per year**
- There is a **significant difference in customs compliance** depending on whether a shipment is imported via postal operators or express carriers
- **Sales tax** is collected on only **25 per cent of postal shipments imported into Canada,** whereas express operators collected on 100 per cent of shipments
- **Import duty** is collected on only **6 per cent of postal shipments imported into Canada,** whereas express operators collected on 98 per cent of shipments

BACKGROUND

Until recently, the appetite for online retail in Canada has been surprisingly low. Compared to countries with similar level of technical infrastructure, the Canadian online retail sector has not secured the same share of the total "retail pie".[1] However, more recently, the market for online retail is growing at a higher pace than ever. According to a report on e-commerce in Canada, the compound annual growth rate of sales in online retail is expected to be 5 times that of traditional brick and mortar sales over the next 3 years.[2] The size of the online retail market is projected to grow to approximately C$ 30 billion in 2016.[3] The rapid growth is believed to be driven by a number of factors including a more developed assortment of sellers operating online for the Canadian market as well as a higher demand for online shopping as consumers become more acquainted with e-commerce.

Figure 1 Size of Online Retail market in Canada



Source: Marketline, 2015. Marketline Industry Profile - Online Retail in Canada, page 8

This study focuses on e-commerce goods coming into Canada – this is of particular importance in Canada because of the high amount of e-commerce goods that are purchased from outside the country. In fact, 70% of online purchases made in Canada are made from foreign merchants.[4] This means that a large share of the e-commerce market in Canada involves cross-border shipping.

E-commerce imports into Canada are by law subject to customs duty and Harmonised Sales Tax / Provincial Sales Tax (HST/PST).[5] More specifically, shipments are subject to sales tax, if the total intrinsic value of the shipment content surpasses a de minimis threshold of C$ 20. Likewise, shipments with goods of a total intrinsic value of equal to or more than C$ 20 are also subject to import duty.

With e-commerce imports into Canada on the rise, collection of sales tax and import duty are likely to yield considerable revenues for the public sector. This however depends on the degree of compliance with which these shipments are processed at import.

Furthermore, imports pose a potential regulatory control issue as hazardous objects may enter Canada if shipments are not screened effectively.

Against this background, this study of customs clearance of cross-border e-commerce shipments aims to understand in greater detail the reality of customs clearance processes that apply when e-commerce shipments are imported into Canada. We designed a purchase and shipment experiment which investigates customs clearance applied to goods imported into Canada, via express carriers on the one hand and national postal operators on the other hand.

RESEARCH DESIGN AND METHODOLOGY

Three principal research questions guide our research design.

First: Is there a difference in compliance with customs related processes (sales tax and import duty) for international shipments inbound to Canada, depending on the type of operator used: postal or express carrier?

Second: What is the impact of any differences in customs compliance on public sector revenue?

[1] Centre for Retail Research (2016) Online Retailing: Britain, Europe, US and Canada 2015-2016. Page 3

[2] Forrester (2014), *Canadian Online Retail Forecast, 2014 To 2016*

[3] Centre for Retail Research (2016) Online Retailing: Britain, Europe, US and Canada 2015-2016.

[4] Borderfree (2015), Canada Country Report

[5] Our experiment involved delivery to Ontario, where the HST unified sales tax regime applies. In what follows, we will refer to HST/PST as sales tax.

Third: Is there a difference in the formal customs clearance for controlled goods, depending on the type of operator used: postal or express carrier?

To answer all of these questions, Copenhagen Economics conducted a shipment experiment from August to October in 2016. The experiment involved a fully completed e-commerce transaction for 200 online purchases. As a result, these packages were shipped by e-sellers from five key trading partners of Canada (China, France, Japan, UK and US). The shipments for the experiment to test diligence of sales tax and duty contained general consumer goods,[6] all of which are subject to sales tax and import duty under Canadian laws. They were bought from independent e-retailers offering goods on e-commerce platforms, sending these items as per their standard e-commerce processes.

All shipments contained items that are subject to duty and sales tax, i.e. their value exceeded the C$20 import de minimis threshold. Part of our sample were of a "low value" (between C$30 – C$60) and part of them were of "high value" (C$185 – C$235).

Approximately half of the items were shipped using postal operators (i.e. sent via the national postal operator in the country of origin to the national postal operator in Canada, Canada Post) and half using express carriers (FedEx, UPS).

Table 1 Total shipments, by value of items

Number of shipments	Express Carriers	Postal	Total
High value (app. C$ 200)	45	35	80
Low value (app. C$ 30)	55	65	120
Total	**100**	**100**	**200**

Source: Copenhagen Economics

Table 2 Total shipments, by country of origin

Country	Express Carriers	Postal	Total
China	15	27	42
France	17	17	34
Japan	20	20	40
UK	28	16	44
U.S.A.	20	20	40
Total	**100**	**100**	**200**

Source: Copenhagen Economics

For each of these shipments, we observed whether sales tax or import duty were collected in the customs clearance process.[7]

Moreover, we ran a separate experiment regarding controlled goods and customs compliance of such imports. Under customs legislation, some merchandise categories are defined as controlled goods, for which there should be a formal customs clearance. This typically requires the receiver of the parcel to sign a power of attorney in favour of the customs broker. For this reason we specifically ordered 40 items (20 express and 20 postal) that are within the definition of controlled goods.[8]

FINDINGS ON CUSTOMS COMPLIANCE

We find a statistically significant difference in customs compliance depending on whether a shipment is carried by a national postal operator or an express carrier. This applies to both the collection of sales tax and the collection of import duty.

Table 3 Sales tax and import duty levy frequency

Value	Express Carriers	Postal
Sales tax levy frequency	100%	25%
Import duty levy frequency	98%	6%

Source: Copenhagen Economics

[6] Such as clothing, basic sports or camping equipment and electronics.

[7] We have observed some shipments where e-sellers underreported the value of contents in the shipment documentation, stating values below the de minimis threshold. We have dropped from our main statistical analysis those observations where underreporting occurred. Underreporting occurred more often for postal than express carriers shipments.

[8] Specifically, we imported vitamin supplements as defined by Memorandum D-19-9-1.

We find that sales tax is collected on only 25 per cent of items that are imported into Canada by postal operators, whereas express carriers collected on 100 per cent of the shipments. This means that express carriers collected sales tax for all shipments in our experiment. In contrast, postal operators only collected sales tax for one quarter of their shipments.

Moreover, we observe that import duty is collected on only 6 per cent of items imported via postal operators, whereas express operators collected duty for 98 per cent of dutiable shipments. In other words, only a very small share of postal shipments were correctly cleared at customs by applying import duty.

While all goods are well over the de minimis threshold, high value goods are on average C$200. By doing the sample split by item value, we find that, even for high value items, the collection frequency for postal items is far from the theoretical 100 per cent. However, postal sales tax collection is higher for high value items, as shown below. The value of items has no impact on express shipments.

Table 4 Sales tax levy frequency by item value

Value	Express Carriers	Postal
High Value	100%	52%
Low Value	100%	3%

Source: Copenhagen Economics

Table 5 Import duty levy frequency by item value

Value	Express Carriers	Postal
High Value	96%	14%
Low Value	100%	0%

Source: Copenhagen Economics

The current lack of compliance with customs processes for postal shipments generates concerns about equal treatment for different types of operators for the purpose of procedures of sales tax and import duty collection. Lack of compliance on postal shipments results in unfair competition between postal and express operators.

Moreover, lack of compliance could have an impact on the competitive position of Canadian e-retailers. The lack of application of sales tax makes goods coming from outside Canada cheaper than comparable items purchased by Canadian consumers from Canadian sellers (both online and offline). This gives an advantage to manufacturers and sellers located outside Canada, relative to their Canadian competitors, when a postal operator is used to deliver the goods. The lack of application of import duty fails to implement the applicable legislation, in a way that ends up favouring non-Canadian manufacturers and sellers.

COMPLIANCE ON IMPORTS OF CONTROLLED GOODS

We have monitored whether imports of controlled types of merchandise results in verification of the controlled nature of the goods. The results show that for controlled goods sent via postal operators, none of the shipments went through formal customs clearance, while 85 per cent of parcels sent via express operators did. Given the result from the customs compliance experiment we can indicate what this may imply for border security in Canada.

Table 6 Compliance of formal customs clearance on controlled goods

Value	Express Carriers	Postal
Compliance rate	85%	0%

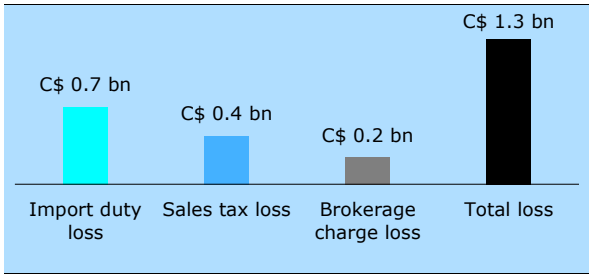
Source: Copenhagen Economics

LOSS OF PUBLIC SECTOR REVENUE

The failure to collect sales tax and import duty on postal shipments for more than two-thirds of items purchased online has a substantial negative impact on public revenue. The result is a sizable missed revenue opportunity for the Canadian government.

We estimate the total loss of public sector revenue from incomplete collection of sales tax and import duty at **C$ 1.3 billion**.

Figure 2 Public sector revenue loss



Source: Copenhagen Economics

The incomplete duty collection on postal packages imported into Canada yields lower import duty revenue for Canada than what is expected given current e-commerce in-flows via postal operators. This incomplete collection of import duty directly translates into a loss of public sector revenue for Canada of approximately **C$ 0.7 billion**.

The present sales tax bill for Canada from postal packages imported into Canada is significantly below actual revenue potential. The incomplete collection of sales tax directly translates into a loss of public sector revenue for Canada of approximately **C$ 0.4 billion**.

Furthermore, when a parcel goes through customs via Canada Post without the correct sales tax and/or import clearance, the Canada Post per item brokerage charge (currently C$ 9.95) is also foregone on each of these shipments. This translates into a loss of public sector revenue for Canada of approximately **C$ 0.2 billion**.

ESTIMATION METHOD

To estimate the total loss in public sector revenue, we take the findings of our shipment experiment – which show the extent of the lack of collection of sales tax and import duty on postal packages inbound to Canada – as a starting point. In order to assess the impact on public sector revenue, we rely on a number of parameters on international e-commerce shipments from publicly available reports and sources.[9]

We start by estimating the value of sales tax liable and import dutiable e-commerce goods that are imported into Canada every year. We use publicly available data and estimates from specialised e-commerce researchers in order to get a best estimate. The Centre for Retail Research has examined the value of e-commerce merchandise (online retail) purchased by Canadian consumers and expect it to be C$ 30 billion in 2016.[10] Combined with information on the share of purchases by Canadian consumers that are made from merchants outside the country and imported to Canada,[11] we estimate the total value of the cross-border online retail that comes into Canada to be C$ 21 billion.

The next step in our analysis is to estimate the value share that should be sales tax liable or import dutiable. We consider the shipments that are above the C$ 20 de-mini threshold to be sales tax liable or dutiable. We assume a similar distribution of item values as for the study conducted by CBRA (2014) on shipments into the European Union. This gives us an estimated value of 96 per cent of shipments that are sales tax liable and dutiable.[12]

The third step is to apply the average sales tax and import duty applicable to liable items. In this way, we estimate the amount of sales tax and duty that could theoretically be collected each year on sales tax liable or dutiable items imported into Canada. For sales tax, we apply a retail trade weighted average of the rates used in various provinces in Canada, which results in 11.96 per cent.[13] For imports, we refer to an average import duty of 8.56 per cent applicable to dutiable items, as stated by Pitney Bowes (2016).[14]

The estimation relies on the share of sales tax liable or import dutiable shipments that come into Canada via national postal operators. Since there is no publicly available information for Canada on this share, we rely upon and interpolate from two different sources, thus we apply an estimate of a postal share of imports at 47%.[15] The lack of Canada-specific data in the public domain on this share implies that our chosen proxy is exposed to bias in a way that may either over- or under-

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[9] See Appendix for a more detailed explanation of sources and calculations step by step.

[10] Centre for Retail Research (2016) Online Retailing: Britain, Europe, US and Canada 2015-2016. This estimate is corroborated by both the estimates of Forrester, 2014 (Canadian Online Retail Forecast, 2014 To 2019) and Marketline, 2015 (Industry Profile - Online Retail in Canada).

[11] Borderfree (2015), Canada E-commerce Report 2015.

[12] Cross-border Research Association (2014), *The import VAT and duty de-Minimis in the European Union – Where should they be and what will be the impact?*, Fig. at pp. 27-28.

[13] Lapitov et.al. (2016), *Modeling the Economic Effects of Raising the De Minimis Threshold in* Canada, Technical Paper, page 12.

[14] Pitney Bowes (2016), Duty Calculator Country guides.

[15] The first source is evidence from research on imports into Europe (CBRA, 2014), based on which the share delivered by postal operators is 70% of all imports; however this estimate is not Canada-specific. The second source (an estimate of 23%) is specific to Canada yet is based older information (year 2011-12) and also likely affected by same bias identified in our present experimental study. Thus we use an average of these two sources, applying thus a value of 46.5% for the postal share of all imports shipments.

estimate the actual share of dutiable shipments to Canada that are postal shipments.[16] We have conducted a sensitivity test which measures how the loss of public sector revenue varies as a function of this share (as shown in appendix).

As a final step, we apply the collection rates found in our experiment. As shown in Tables 4 and 5, the collection rate appears to vary as a function of the value of the shipment (even if all shipments are above the legal de minim threshold). For the purpose of our estimation of loss of public sector income we take as representative package an import of our "higher value" range of C$185-235.[17] Thus, when calculating the foregone public income on postal shipments, we apply the higher of the two collection rates found empirically in our experiment (within Table 4 and then within Table 5) – namely a collection rate of 52% for sales tax and of 14% for import duty. Based on this evidence from the shipment experiment, we determine the overall loss of public sector revenue (sales tax, import duty and brokerage charges foregone) related to postal shipments.

PUBLIC POLICY IMPLICATIONS

The findings of this study lead us to ask the following questions, which may contribute to more fulsome debate surrounding Canadian public policy and revenue collection, as well as border security. The overarching question for policy makers is how to address the failure to collect sales tax and import duty, as identified in the study. In order to resolve this issue, several areas are probably deserving of additional research.

First, a key area of focus is revenue collection and security inspection policies and practices. It is relevant to research what measures are the most effective and efficient, so as to empower customs agencies, with the appropriate resources, modernised processes and technologies to address the missing duty issue identified in this study.

Second, it is relevant to investigate what steps – both at a national, North American and global level – are the most appropriate to ensure that customs agencies have access to higher quality, electronic and timely data on shipments, irrespective of the type of operator handling the shipment. At present, while express shipments provide, according to the law, advance data for imports' screening, this is not the case for postal imports.

Third, it is relevant to research how to ensure efficient regulatory control management with regards to imports of potentially hazardous goods.

Fourth, we acknowledge that limitations in the availability of data in the public domain make the estimates of loss of public income imperfect. We welcome further research; for this reason, the methodology of the public income loss estimation applied in the study has been detailed transparently. Thus, any future new or updated data points can be directly applied, so to refine further these estimates.

Last, online retail growth exacerbates the policy challenge identified in this study. If online retail were to continue growing at e.g. 10% each year, the public income loss due to postal imports would also grow 10% yearly. This will be the case unless appropriate reorganisation, process improvements and related resources are applied to solving the challenge of incomplete collection of sales tax and import duty on postal imports.

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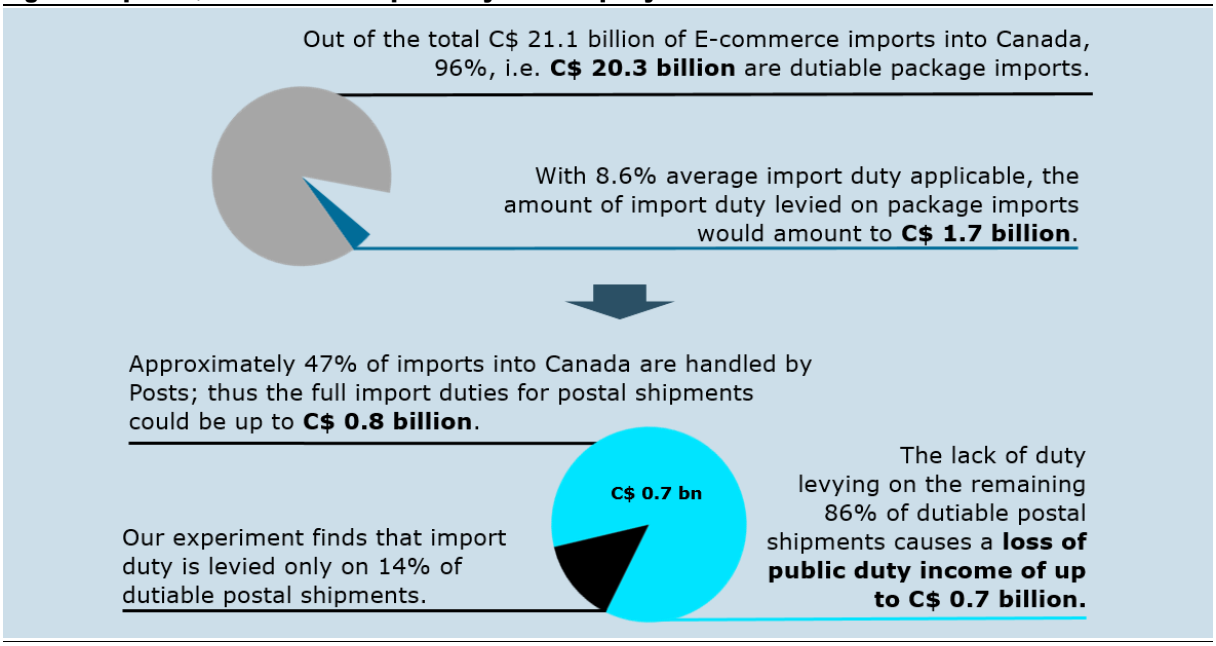
[16] CBRA surveyed European customs agencies, obtaining the share by carrier type, out of the total number of import declarations below shipment value of 1000 EUR: it is thus a volume-based share. Reasons why using the CBRA European data may overestimate the actual share of postal shipments for imports to Canada are: (a) The postal share out of total value of contents imported may be lower than a volume-based share, since express carriers are traditionally more active on higher-value shipments; (b) Express carriers may be historically less established in Europe than in Canada. Reasons why CBRA European data may underestimate the actual share in Canada are: (c) In Canada, express carriers' shipments may have a lower average value of contents than in Europe; and (d) The de minimis threshold for sales tax and import duty is higher in Europe than Canada, thus average value of dutiable items may be higher in Europe and, since express carriers are traditionally more active on higher-value shipments, CBRA European data may capture a lower postal share of imports than is the case in Canada.

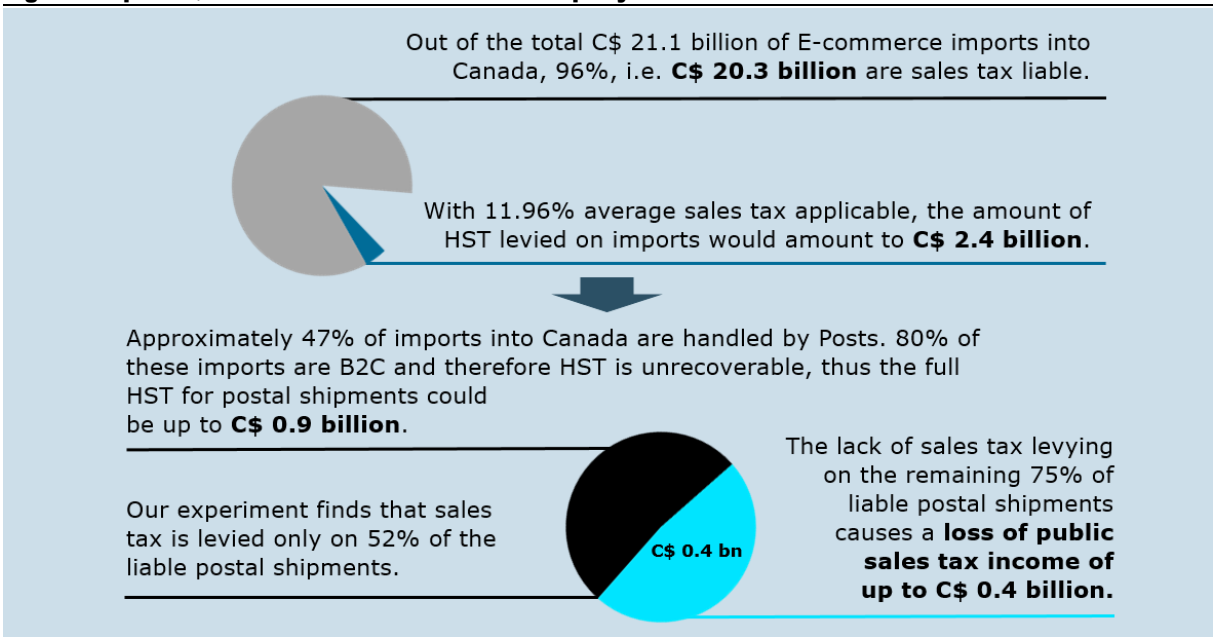
[17] According to RFi Group Payments Diary 2015 data, the average online payment in Canada was $219. http://www.globalretailbanker.com/product-news/canada-online-sales-gaining-traction-amongst-canadians

Figure 3 Up to C$ 0.7 billion in import duty are lost per year



Source: Copenhagen Economics

Figure 4 Up to C$ 0.4 billion in sales tax are lost per year



Source: Copenhagen Economics

APPENDIX

A. Chi-squared test

The Chi-squared test tests the independence of two binary variables. The test evaluates the null hypothesis that the data are independent, i.e. that the sales tax collection frequency is the same for express carrier shipments and postal shipments.

If the null hypothesis is rejected, then it establishes that there is a statistically significant pattern. This is the case when the test yields a high Chi squared value (and hence a low p-value).

In our experiment, we apply the Chi-squared test to the shipment type (express carrier shipment or postal shipment) and the successful levying of sales tax. The Chi-squared test shows that shipment type and sales tax collection are not independent variables. Instead, having postal as the delivery mode for a shipment is associated with a decrease in sales tax collection.

We repeated the same statistical check, for import duty collection. The Chi-squared test shows that shipment type and import duty collection are not independent variables. Instead, having postal as the delivery mode for a shipment is associated with a decrease in the collection of import duty.

Table A1 Chi square significance test

Variables	Coefficient	P-value	Statistical significance
Sales tax levying			
Shipment mode	92.48	0.000	HIGH
Import duty levying			
Shipment mode	80.76	0.000	HIGH

Source: Copenhagen Economics

B. Logit regression

A logistic (or logit) regression is a regression model where the dependent variable being explained is a categorical variable, for example a binary variable as in this case.

The following tables show the results of the two logit regressions we have performed to explain the drivers of the dependent variable: whether sales tax is levied (alternatively, import duty).

Table B1 Regression: estimating sales tax collection

Variables	Coefficient	Standard error	z value	P>|z|
Postal shipment	-6.537***	1.221	-5.35	0.000
Constant	2.836***	0.727	3.90	0.000
High Value	3.584***	1.066	3.36	0.001

Note: ** denotes statistical significance. *** p<0.01, ** p<0.05, * p<0.1. Pseudo R squared = 0.641*
Source: *Copenhagen Economics*

Table B2 Regression: estimating import duty collection

Variables	Coefficient	Standard error	z value	P>|z|
Postal shipment	-6.442***	1.113	-5.79	0.000
Constant	2.496***	0.619	4.03	0.000
High Value	1.708	1.116	1.53	0.126

Note: ** denotes statistical significance. *** p<0.01, ** p<0.05, * p<0.1. Pseudo R squared = 0.729*
Source: *Copenhagen Economics*

The coefficients in the above table are logit regression coefficients, thus their interpretation is non-linear. Where coefficients are positive and significant, the corresponding variable has an impact in increasing the odds (probability function) that the sales tax (or import duty) is levied.

Thus, the regression analyses for both sales tax and import duty confirm that there is a statistically significant difference in customs compliance between postal shipments and express carrier shipments.

Moreover, for sales tax, a further driver of collection is the value of the shipment, i.e. collection is more likely for items in our higher category.

Finally, we have tested the country of shipment origin as control variables, though with no significance found: the collection of sales tax or import duty is not affected by the origin of the shipment coming into Canada.

C. Detailed calculation of impact on public sector revenue

The following table tests how the loss of public sector revenue specific to postal shipments varies, if the share of imports handled by postal operators varies.

Table C1 Sensitivity test

Share of imports handled by postal operators	Import duty	Sales tax	Brokerage charge	Total loss of public revenue
70%	1.044	651	243	1.938
60%	895	558	243	1.696
50%	746	465	243	1.454
40%	597	372	243	1.212
30%	447	279	243	970

In the above sensitivity test, the value of income associated with brokerage charge does not vary because it has been estimated on the basis of Canada Post's own published data on the number of inbound pieces.

At the next page, table C2 provides the detailed step-by-step calculations of the estimated loss of public sector revenue associated with postal shipments.

Table C2 Step-by-step calculation of yearly loss in public sector revenue

I. INBOUND ONLINE RETAIL ANALYSIS	FORMULA	FIGURE	LABEL	SOURCE
Value of online retail (C$ m)		30,147	A	Average of CRR (2015): C$30bn; Forrester (2015): C$29.3bn; Marketline (2015): C$31.1bn
Share of online retail that is from foreign merchants		70%	B	Borderfree (2015), Canada Country Report 2015
Value of inbound online retail (C$ m)	A*B	21,103	C	CE calculation
Share of value of imports packages that are above the de minimis, i.e. which is dutiable and sales tax liable		96%	D	CE, based on CBRA (2014) study for the EEA (Figures at pp. 27-28)
Value of dutiable / sales tax liable package imports (C$ m)	C*D	20,259	E	CE calculation
II. IMPORT DUTY ANALYSIS	**FORMULA**	**FIGURE**	**LABEL**	**SOURCE**
Average import duty applicable on dutiable items		8.6%	F	Pitney Bowes (2016), Duty Calculator Country guides
Amount of import duty liable (C$ m)	E*F	1,734	G	CE calculation
Share of imports handled by Posts (up to)		46.5%	H	CBRA (2014) study for the EEA p. 21
Amount of import duty liable on postal package imports (C$ m), up to	G*H	806	I	CE calculation
Import duty collection ratio found in experiment (postal shipments)		14%	J	CE experiment result
Missing import duty, i.e. Loss of public revenue (C$ m), up to	I*(100%-J)	**693**	K	CE calculation
III. SALES TAX ANALYSIS	**FORMULA**	**FIGURE**	**LABEL**	**SOURCE**
Average sales tax rate		11.96%	L	Sidley Austin (2016), technical report, p. 12
Amount of sales tax liable (C$ m)	E*L	2,423	M	CE calculation
Share of imports handled by Posts (up to)		46.5%	N	CBRA (2014) study for the EEA p. 21
Amount of sales tax liable on postal package imports (C$ m), up to	M*N	1,127	O	CE calculation
Share of shipments which are B2C imports (sales tax unrecoverable)		80%	P	Sidley Austin (2016), technical report, p. 13
Amount of unrecoverable sales tax liable on postal package imports (C$ m), up to	O*P	901	Q	CE calculation
Sales tax collection ratio found in experiment (postal shipments)		52%	R	CE experiment result
Missing sales tax, i.e. Loss of public revenue (C$ m)	Q*(100%-R)	**433**	S	CE calculation
IV. BROKERAGE CHARGES ANALYSIS	**FORMULA**	**FIGURE**	**LABEL**	**SOURCE**
Number of inbound items into Canada handled by postal (m pieces)		53	T	Sidley Austin (2016), technical report, p. 13
Brokerage charge per parcel declared (C$)		9.95	U	Canada Post (2016), Customs Requirements
Amount of brokerage charges liable on postal package imports (C$ m)	D*T*U	506	V	CE calculation
Handling fee collection ratio found in experiment (postal shipments)		52%	X	CE experiment result
Missing brokerage charges, i.e. Loss of public revenue (C$ m)	V*(100%-X)	**243**	Y	CE calculation
Total loss of public revenue: (C$ m), up to	**K+S+Y**	**1,369**	Z	CE calculation

Note: All indicators refer to yearly figures Canada-wide.

Source: Copenhagen Economics; additional sources listed in the table

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