

HOSSEED! AGAIN!

The REAL Story behind tax cuts.



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The issue

Now that the annual deficits faced by most governments in Canada are either eliminated or drastically reduced, we are witnessing a concerted attempt to create political pressure for across-the-board tax cuts.

The theory being advanced is that we, the people, should be able to share the “fiscal dividend” through cuts in income taxes.

Is the argument really that simple, or one-sided?

The (TINA) strategy— There Is No Alternative

From 1988 until the 1997 budget season, federal and provincial governments alike suffered from “deficit hysteria”. Governments, we were told, were confronted with tough choices, thrust upon them by the need to respond to soaring deficits, crushing debt loads, ruthless bond rating agencies and global competition. They told us that they had no alternative but to respond to this situation by cutting public programs and services, and eliminating public sector jobs.

We should remember that this deficit hysteria was originally fomented by the corporate community and those with an extreme bias towards the private sector and against the public sector. Who can forget the travelling road show, where the Business Council on National Issues (BCNI) met with each government to convince them of the need for immediate, drastic action on government deficits?

The important point to remember is that the deficits of governments were used to justify a single strategy: namely, cutting public spending and the public services Canadians rely on. As such, revenue measures—like a fairer tax system to bring in additional revenues from corporations and high income individuals; or taxing speculative currency transactions—were held to be out of the question, except in some minor way (e.g., through a small temporary surtax on banks).

So were reductions in the bank rate, held at high levels by the Bank of Canada to keep inflation low. Who can forget that higher-than-necessary interest rates dramatically increased the interest payments made to banks and other financial institutions? They reaped billions of extra dollars from the public treasury, from investing in high interest, risk-free government securities.

Government intervention to create jobs was also rejected. Fewer unemployed workers would have translated into additional tax revenues and reduced social assistance costs for governments. In fact, the deficit hysteria strategy required *additional* unemployment, which occurred as governments cut their own workforces.

This deficit hysteria wasn't even consistent. When the government of

Ontario announced across-the-board tax cuts in the face of huge deficits, the business community argued that the deficit wasn't the biggest issue.

The point is that the strategy *wasn't* about cutting government deficits. That could have been done much more effectively through other means. The strategy was one of using the deficits of government to justify cuts in important government services to reduce important social programs like public education, public health care, and social services. People *wouldn't* have tolerated those cuts without the deficit hysteria to convince them that there was no alternative.

Tax cuts replace deficit hysteria

Now that the deficits of governments are gone or going (more slowly than if more progressive policies had been used to fight them, by the way), the people who favour smaller, less effective governments and fewer social programs need a new set of arguments.

That's where the new thrust for across-the-board tax cuts comes from. The business press, the business community, the financial markets, the right of centre political parties, all insist that the public is clamouring for tax cuts; and that the economy would be healthier with lower taxes. Conrad Black's paper, the *National Post*, is almost hysterical on the issue, with page after page devoted to inflamed rhetoric about the crying need for tax cuts. The Treasurer of Alberta, Stockwell Day, has even talked about the money that governments steal from the citizens through taxes.

These tax cutters have figured out one simple fact: if you reduce taxes too much, you can't rebuild public services. Health care will stay underfunded, education will be a privilege only the rich can afford, and people in need will have no place to turn except to charities.

And the wealthy will keep more money to spend on themselves.

It's important to note, in this context, that the tax cut debate *isn't* about what the public wants. Poll after poll shows that the public wants decent public services, health care that works, education that teaches their children, social services that protect their communities, and environmental protection.

Tax cuts go against those objectives. They are a way to permanently

underfund public services, and permanently weaken governments. Their objective? To ensure that the valuable public services we've lost in years of deficit hysteria can't be rebuilt.

A quick look at government revenue

To help us judge whether tax cuts are an appropriate policy response, it helps to understand some basic facts about government revenues.

Issue #1: Personal versus corporate taxes

The trend is unmistakable: the corporate share of the overall tax burden keeps getting smaller. A lot smaller. On the other side, the relative burden on individual taxpayers has increased quite substantially. This can be seen quite clearly in the table that appears below.

As we will show later on, there is a particularly serious problem in relation to huge multinational corporations.

*Share of government revenues (all levels) accounted for by personal and corporate income taxes
(Source: Statistics Canada)*

<u>Year</u>	<u>Personal income taxes</u>	<u>Corporate income taxes</u>
<i>1950</i>	20.6%	22.4%
<i>1966</i>	31.2%	12.7%
<i>1984</i>	39.9%	8.8%
<i>1995</i>	46.7%	6.1%

Issue #2: The preferential treatment given to certain types of income

A few years ago, an article appeared in the *Globe and Mail* strongly disputing the widely held view that Canada's personal income tax system is unfair. The National Union was so astounded by this allegation that we decided to analyze taxation data in detail, to determine how true it was.

We found that while the tax system *is* mildly progressive, that isn't the whole story. The real issue was the high cost, in terms of lost government revenues, resulting from the preferential treatment given under our tax laws to certain types of income mainly received by wealthier Canadians—like dividends and capital gains. We calculated that if dividends, capital gains, and other types of income mainly received by wealthier individuals were taxed at the same rate as wages and salaries (which make up the bulk of the income received by middle- and lower-income Canadians), annual tax revenues would be \$4.0 billion higher.

We hate to generalize, but isn't it mainly those wealthy people—who are the main beneficiaries of those tax preferences right now—who are putting all that money into the stock market and mutual funds? If we reduce their taxes, won't this just give them more cash to invest in the stock market and mutual funds?

How does that help unemployed workers and poor children?

Issue #3: Other sources of government revenues

It would be a mistake to think that personal and corporate income taxes are the only sources of government revenues. For example, in 1997, user fees provided Canadian governments with \$24 billion in revenues, or just under 7% of their total revenues. This was more than governments raised from corporate taxes.

In the same year, the GST provided the federal government with over \$18 billion in revenues, representing 13% of its total net revenues. This was also more than the amount the federal government raised from corporate taxes.

Gambling revenues, whose impact falls overwhelmingly on lower-income Canadians, are also a growing source of government revenues, now accounting for 4% of all revenues.

Can this system be improved?

Taking all of this together, it's our view that if our governments really wanted to improve their financial situations, while making the tax system a

lot fairer than it currently is, they would:

- Find a way of increasing the share of the tax burden paid by corporations (particularly, as we will show later on, by huge multinationals, who are often able to shift income and costs between countries to avoid taxes).
- Find a way of ensuring that different types of income are treated equally by the tax system (by the way, this was the central recommendation of Canada's only Royal Commission on Taxation, which reported in 1967).
- Reduce the GST, user fees, and their reliance on gambling all of whose burden falls disproportionately on low- and middle-income earners.

Cutting taxes doesn't lead to fairer taxes

The current debate about tax cuts and the debate being created and driven by the same gang that used government deficits to weaken and shrink public services is focused on two options. Both would result in drastically lower taxes across the board.

1. Existing tax rates would be reduced for everyone, so that those making the most money would get the most benefit; and the overall amount paid in taxes would be greatly reduced.

2. A "flat" tax system that eliminates "multiple" taxation would be introduced. Under it, certain types of income—interest, dividends, and capital gains, which are today taxed at preferential rates—wouldn't be taxed at all, because they originate in corporations that have "already paid" taxes on their profits.

Think about who earns the vast majority of the interest, dividend and capital gain income that would no longer be taxed under a flat tax system. Now you know who has been most vocal in promoting a "flat tax" system, and why.

There is of course another option, but not one that's so far getting much attention in this manufactured debate. We could improve the tax system so that taxes are fairer, while ensuring that governments have the necessary money to provide important public services.

Fairer taxes yes. General tax cuts no.

When governments cut taxes across the board, in a general tax cut, two things happen. First, they reduce the money they have with which to deliver public services. Secondly, the people who can easily afford to pay their taxes get the biggest reward.

The argument that across-the-board tax cuts treat everyone equally is based on the premise that 30% for one person and 30 % for another is equal. Thirty seconds worth of reflection will show that when it comes to paying taxes, this is nonsense. If you make a million dollars, a 30% tax cut save you thousands of dollars. If you make \$30,000, a 30% tax cut means a few hundred dollars less in taxes. That's an interesting form of equality.

But because of the internal rules of the tax system, the effect is even worse than that. Across-the-board tax cuts mean a *higher* percentage of saving to the higher income earners. So not only do they get more dollars – by far – in an across-the-board tax cut, they actually get a higher *percentage* benefit. This effect was demonstrated by OPSEU's Jim Onyschuk, in an article published in the *CCPA Monitor*. In that article, Onyschuk strongly disputes the claims of Ontario Premier Mike Harris and his finance minister, Ernie Eves, who have claimed that their general tax cut benefits every taxpayer on an equal basis, since all are getting the same 30% reduction. The implication is that someone making \$100,000 a year will get back ten times the rebate going to someone with an income of \$10,000, and someone making \$1,000,000 will get back 100 times more.

According to Onyschuk, the Ontario tax cut system doesn't work that way at all. In fact, it rewards the rich much more, proportionately, than it does the poor.

In fact:

- An employee with a taxable income of only \$10,000 will get back a grand total of \$466 over the four-year span of the tax cuts, or \$2.24 a week.

- An employee with a taxable income of \$50,000 will get back \$3,926 over the same four years, or \$18.88 per week. In other words, with five times the income of our \$10,000 earner, the \$50,000 earner gets back 8.4 times the tax break.

- This effect continues right up to the very highest income levels. As Onyschuk's article shows, someone reaping \$1,000,000 will get back a total of \$77,465, or \$372.43 per week. This means that instead of being just

100 times better off than somebody earning \$10,000 per year, the million-dollar earner is **166.6 times better off!**¹

Onyschuk has also shown that the benefit from the Harris tax cut is even greater, if our million-dollar earner's income results from stock market speculation (which reaps the benefits from lower taxes on capital gains). If that is the case, the four-year tax break will result in a tax reduction of some \$98,635, or \$474.21 a week.

Therefore, instead of being just 100 times better off than the \$10,000 taxpayer, the million-dollar market speculator in fact ends up **211.7 times better off** from the Harris tax cuts.

The 1999 Alberta budget: a single-rate tax system

In his government's March 1999 budget, Provincial Treasurer Stockwell Day announced that Alberta would be implementing a single-rate tax, to begin in 2002.

Under the new system, which will reduce the taxes paid by the average Alberta family by up to \$1,200 per year, personal income will be taxed at a flat rate of 11% (instead of levying provincial taxes as a percentage of federal taxes payable). The biggest change in the system will be in the basic personal and spousal deductions, which will be boosted dramatically to \$11,620 from \$7,131 and \$6,055 respectively on January 1, 2002. When the system is fully implemented in 2002, Alberta's tax revenues will be reduced by some \$600 million per year.

Although everyone's taxes are reduced under Mr. Day's proposed reform, rich people's taxes are cut more than anyone else's. However, since low and middle-income people will also pay fewer taxes (with many being removed from the tax rolls altogether), the government obviously hopes that criticisms about the benefit to wealthier Albertans will be muted.

General tax cuts are only part of the story

As we have shown, even lower income earners seem to benefit from general, across-the-board tax cuts. But is that everything we need to know about them?

The supporters of tax cuts claim that taxes are far too high, and those lower taxes will turn the government's financial situation around, and spear-head economic growth. Because nobody really likes high taxes, this message is often quite effective, even among low- and middle-income earners, including some union members.

It's important to recognize, however, that the impact of tax cuts on low- and middle-income earners is relatively quite small, providing them with only very modest amounts of extra cash.

Just as important is this: any benefits from tax cuts are more than eliminated by additional charges and fees, to finance public programs (and in many instances, to help finance the programs that *used* to be public).

For one thing, when a senior level of government cuts taxes, it also passes on the cost of public services to lower levels. In other words, a provincial tax cut typically means more municipal taxes and more local user fees.

Secondly, since these public programs are still needed, the money has to come from somewhere. Statistics Canada recently released a study that showed that while the tax burden on Canadian families decreased by a marginal amount (\$120 for the average family) between 1996 and 1997, spending in areas where governments have cut back is surging. According to the study, out-of-pocket expenditures by individual families on education rose by 19% between 1996 and 1997 (mostly due to a rise in post-secondary tuition fees); and individual spending on health care rose by 15%.

In reality, it's corporations and high-income earners who benefit most from tax cuts. Remember: the benefits of the 1981 Reagan tax cuts went almost entirely to the wealthiest 20 % of the population.

As such, tax cuts won't necessarily stimulate the economy, and they certainly won't make our economic system—which already favours corporations and high-income earners—any fairer.

Ontario's tax cuts: more than meets the eye

The 1999 Ontario Alternative Budget has calculated that an average Ontario family (three people at the median income) will save \$738 from the \$6 billion Harris tax cut. But the same family will be out-of-pocket by \$766 as a result of increased health care costs, higher property taxes, user fees, and interest charges on the debt incurred to pay for the tax cut.

Behind such averages, says the Alternative Budget, is the stark reality that many families are getting clobbered by the Harris government's policies. An average income, two-person family with one child going to university has already lost more than a lifetime of Harris tax cut benefits because of tuition fee increases. A typical seniors couple with an income of \$44,000 would find their entire Harris tax cut eaten up by increased seniors drug plan user charges.

As for public services, continues the Alternative Budget, the Harris claims about increased investment in health and education are definitely debunked. After inflation and population growth are taken into account, Ontario's health budget has been cut by \$2 billion since the government was elected in 1995.

Furthermore, the new funding formula for elementary and secondary education takes \$1.2 billion out of the school system, or in other words, \$570 for every child in school.

Does lower public spending really equal "savings"?

There is a false premise in a lot of the arguments about cutting government spending: namely, that somehow this money, if not spent by the government, is *saved*.

Of course it is only *saved* if the activity it was spent on wasn't essential. Otherwise the money will still be spent, just by different people or in different ways. And those that have the *most* to spend will suffer the *least* from the fact that the public service has disappeared.

Can we, as a society save money on health care? We could control drug prices, we could spend less on expensive equipment, and we could even control doctors' fees. But health care is a necessity. So if we don't deal with reductions like these, we aren't really reducing costs if *government* doesn't spend tax money on health care. As we have already shown, we're only relocating the cost to the individual.

In the US, there is no universal health care system. As a result, individuals, companies (through the cost of benefit plans), and charities all fund the cost of most health care services. The system is way more expensive, huge numbers of people aren't able to afford care, and health insurance cuts people off for getting sick, so individuals go bankrupt if they get a chronic illness. So how does the lack of government spending mean that the society saves money?

If we don't spend money on police, some people end up living in walled communities, with security they pay for individually. Those that can't afford this protection are left out in the cold.

If we don't spend money on the amenities of life, companies won't move their operations to our communities. Or if they are already here, they will move away partly because they can't retain workers. How does this save us money as a society?

If we don't pay for our roads, the roads will wreck our vehicles, at our cost, or we'll face toll roads where we pay more to drive.

If we don't pay for decent social services through taxes, our communities will become dangerous and unpleasant places to live, with human misery that would shame us all crime and homelessness and poverty and de-

spair. What price do we put on this short term saving of public money?

When our environment is left to the mercies of polluters because we can't afford to protect it, and when we can't safely breathe the air or drink the water or eat the food, how much will we have saved? How will this saving compare to the cost of health care for people injured by environmental disease, or the cost of environmental cleanups?

The big myth about tax cuts

It's important to recognize that beyond the rhetoric, the tax cut argument is based on a single premise: the tax system (which provides revenues to the public sector) is taking too much money away from the "productive" private sector; and transferring it to the "unproductive" public sector. As a direct by-product, these taxes (and the actions of the governments they help fund) are held to impose a high cost of doing business in the private sector, which is forced to operate far less efficiently than it otherwise would.

Another way of putting this is as follows. Taxes are said to take funds away from corporations and individuals (particularly those with high incomes), who would otherwise use them for productive purposes in free markets. This money is transferred down the black hole of the public sector, where it is wasted on ineffective programs and undeserving people. Supporters of tax cuts want to rectify this alleged problem by liberating much of this cash. Additional spending cuts, which they also support, would liberate another large portion.

According to this logic, with lower taxes:

- businesses will hire many (if not all) of the workers who are now unemployed;
- investors will save more of their hard-earned income; and
- the prices of goods and services will reflect their true value, instead of being "distorted" by high levels of taxation.

Those who favour tax cuts rely on corporations and high-income earners to turn things around. Why hasn't this occurred within the existing system? As we have discussed, they get preferential treatment within it as well. Would cutting their taxes spur them to act? We don't think so.

Let's address the question of whether corporations, flush with all that

extra cash, will run out and create jobs. In an article published in the October 1997 issue of the *Monitor*, the Canadian Centre for Policy Alternatives showed how most of the large corporations that promised to create “more and better jobs” after the Canada-US free trade agreement (FTA) was signed have instead significantly reduced their workforces since 1988.

Thirty-three of these companies, which had a combined total of 621,280 employees before the free trade era began, reduced that number to 405,276 by the end of 1996. This was an overall elimination of 216,004 jobs, a collective cutback of nearly 35%. And the “downsizing” still continues. Only 11 of the companies tracked by the CCPA increased their workforce, and then by only 28,073 employees in total.

All of the companies still being tracked by the CCPA are members of the Business Council on National Issues, comprising 150 chief executive officers from major multinational companies, whose combined assets total \$1.5 trillion.

A final note. During the same period, the 33 corporations who shed workers increased their combined annual revenues by more than \$40 billion—up from \$117.8 billion in 1988 to \$158.2 billion in 1996, a rise of more than 34 %.

Will those companies suddenly reverse course, if they get a tax cut? We don't think so.

Taxes in an age of globalization

Let's examine a related issue. In this country, the BCNI which represents the 150 largest corporations operating in Canada has been a leader in calling for reductions in corporate taxation. The real question is whether these or other multinational companies are paying their fair share at all, in Canada or elsewhere.

Multinational corporations and world trade

According to scholarly estimates, multinational corporations now manage about 40% of global trade through trading goods, services, financial capital, and other assets among their own subsidiaries and affiliates.

This is called “intrafirm” trade.

Here are two examples of how this occurs:

- A US computer company ships design components to its plant in Malaysia, where they are assembled. The assembled goods are then shipped to another subsidiary in Bermuda, where some further assembly takes place, before the finished hardware is shipped back to the United States.

- A Japanese plant located in the US “imports” most of its components from its parent corporation and allied suppliers, then “exports” products back to the parent in Japan, or sister affiliates in other countries.

All of this intrafirm traffic is counted in national trade statistics. When Canadian-based firms are involved in this process, it explains why exports may soar while domestic unemployment remains high—most of the workers may be employed in low-wage countries instead of at home.

Using the system to avoid taxes

This intrafirm model also explains how multinational corporations are able to avoid taxes. By using artificial “transfer prices” in these transactions—the prices which are charged by one affiliate to another—multinationals are often able to shift taxable income within their corporate groups to reduce their overall tax burden.

Such behaviour can greatly affect the tax revenues of individual countries. For example, in the first example in the previous section, both Malaysia and the US are deprived of tax revenues if:

- the Malaysian affiliate sells the assembled products to the Bermuda firm at an artificially low price (resulting in very low revenues for the Malaysian company, and very low tax revenues for the Malaysian government); and

- the Bermuda affiliate—which operates in a well-known tax haven—re-sells the assembled product to the US affiliate at a very high price (resulting in high costs, and lower profits, in the US; and low tax revenues for the US government).

In a similar vein, through financing their debt in high-tax jurisdictions, multinationals are able to generate interest expenses that are written off against the income earned in those high-tax countries.

Obviously, such actions can greatly affect both the level and location of investment and production, around the globe.

A real-life example

Corporate spokespeople often counter such allegations by saying they are just rhetoric. A 1993 study, conducted by four university professors and published by the National Bureau of Economic Research in the United States, demonstrates how serious this problem may be.

Two hundred US corporations were included in the study. After subjecting five years of data from those companies to complex analyses, the four professors found that “the average multinational firm with subsidiaries in more than five regions using income shifting to reduce its taxes to 51.6 % of what they would otherwise be.” American companies with subsidiaries in low-tax countries paid relatively low US taxes per sales or assets, lower than the multinationals with branches in high-tax countries, according to the study².

Thus, “tax arbitrage” provided another incentive, along with cheaper labour, to relocate operations in low-tax economies.

This study also found that multinational firms conduct “income shifting” to avoid capital controls imposed by governments.

Dealing with this problem: a unitary taxation system

Although there are tax agreements among countries, to deal with tax avoidance by multinationals, the problem remains quite serious. This is compounded by the fact that the tax burden on lower- and middle-income individuals continues to grow, while countries around the world are increasingly finding public programs and services more difficult to fund.

The leading governments could put a stop to this erosion of their tax bases, *if* they had the nerve to challenge these multinational corporations. One solution would be through acknowledging the global nature of this problem, and developing a universally applicable unitary taxation system to deal with it. This would help in our quest to make taxes fairer, both domestically and globally, through addressing the accounting games that caused a significant part of the unfairness in the first place. In this new system, taxable incomes from multinationals would be apportioned to the nations where they operated, based on where their sales or employees were located. National governments could then tax that income at any rate they

chose, but corporations could no longer move it about to escape taxation.

A global tax formula would not be difficult to devise, if ideology did not stand in the way. The scandal of multinational tax avoidance is, unfortunately, a visible sign of just who holds power in the new world order.

The real issue: the value of public services

Aside from the changes in the domestic and global tax systems suggested above, we also think another solution is needed to address our economic problems—a strong public sector that will be able to help unemployed workers and poor children in a direct way.

The “free market” may sound great in economics textbooks and corporate rhetoric. However, economic theory therefore makes an important argument for government intervention, through job creation, the provision of social assistance and other key public programs, regulation, and other means. In short, there is more than ample justification, in economic theory and in real world circumstances, for a strong and active public sector.

Indeed, government contributes to society in some very vital ways.

- Government programs ensure that high-quality, universal health care is available to protect children, the sick and the elderly; food is inspected to ensure that it is safe for our families to eat; programs and care are provided for our senior citizens; search and rescue services are carried out by our national coast guard; counseling and other forms of assistance are provided to people temporarily or permanently in need; unemployed workers are helped in their quest to find jobs; the environment is protected from polluters; and our young people are provided with the education and training they need to obtain jobs.

- Governments provide the roads, bridges, highways and other infrastructure required by the private sector. Our Medicare system is also an important asset to companies, who might otherwise have to incur the high costs of private plans, as they do in the United States.

- Government programs provide the private sector with direct income, such as when governments purchase goods and services, government

workers spend their pay cheques, and social assistance recipients use their benefits to pay their rent and purchase food.

Those who portray taxes as intrusive costs of doing business, or a “distortion” to the optimum results that would occur through free markets display a profound ignorance of how both economic theory and our mixed economy really work. Taxes help fund the public programs that contribute to economic prosperity, in economic texts and in real-world situations.

The problem we have in Canada *isn't* that *all* taxes are too high. General across-the-board tax cuts aren't a responsible proposition aimed at solving a real problem, but are just another way to cut the size and effectiveness of governments and public services. The real problem is that corporations and higher-income people are not paying their fair share, while low- and middle-income individuals are paying more than their share. The issue is tax fairness.

The debate about a fairer tax system would be a very healthy one to have in Canada; in fact, that debate is long overdue. The artificial debate about across-the-board tax cuts is just delaying the start of the real debate we do need to have about real tax fairness.

END NOTES

¹ Times better-off contrasts \$466 (the tax reduction for our \$10,000 earner) to other totals (e.g., \$77,645 is 166.6 times greater than \$466).

²An Australian study has estimated that intra-company transactions by Australian-based multinationals costs Australia well over \$1 billion a year in tax revenues.