INCOME TAX REDUCTIONS: THE MYTH OF JOB CREATION AND ECONOMIC GROWTH[1]

Introduction

The tax base is shrinking all over the world (Goodall, December 2003), at both central government and local levels. Since the Reagan era, Washington has considerably reduced federal income tax levels, benefiting mostly the very wealthy, while eliminating or reducing social programs and transferring responsibilities to the states, which in turn transfer some of them to municipalities. Since his election, president George W. Bush has followed through with tax cuts of a size and in circumstances without precedent in U.S. history (Krugman, 2003)[2]. His Congressional leaders talk of additional income tax cuts in 2005, to extend the US$1.7 trillion already enacted.

In Canada, while politicians slash social programs and refuse to negotiate salary increases for public and para-public employees, alleging a lack of funds, they nevertheless press on with income tax cuts. Such is the case with the newly elected Quebec premier, Jean Charest, as part of his «re-engineering» of the State. At the federal level, Ralph Goodale, the minister of finance is promising 4.4 billion dollars in corporate tax cuts for 2004, while Paul Martin, the new Canadian prime minister, talks of «re-designing» government.

A Social Democratic/ Green party government in Germany is cutting income taxes by some 8 billion euros (about 9 billion US dollars) and at the same time reducing job security and unemployment insurance benefits. It previously cut taxes on capital gains. The French right-of-centre government is pursuing tax cuts planned by the previous (Socialist) government, combining these fiscal measures with decentralization of various social programs and reduction of pension benefits. The French budget for 2004 includes a deficit equal to 3.5% of GDP - and a 3% income

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[1] Notes for a joint workshop of Attac-Québec and the Tax Justice Network held at the World Social Forum IV, January 20, 2004, in Mumbai, India.

[2] A January 7th, 2004 IMF Report prepared by a team of its economists has questioned the wisdom of the Bush administration tax cuts.

tax reduction, part of Chirac's promise to lower them by 30% over five years.

The rationale varies in time and space but usually includes the Thatcherian invocation that «There is No Alternative». The argument is made that tax cuts are needed in order to be competitive and to attract investment, that cuts promote economic growth and create jobs. When there is a surplus, we are told that it must be returned to the people. As soon as it is replaced by a deficit, the argument shifts (Krugman, 2003).

For tax cuts to be effective in terms of increasing spending and creating jobs, the money has to be returned to those whose level of consumption is low. Others, who own three cars, several houses, a yatch, two videos, etc., will not increase that kind of consumption. Conversely, they are likely to modify their consumer profile by turning to imported goods, which has the opposite effect opposite of the job creation plan. Arguably it isn't tax cuts we need in order to increase consumption (assuming we believe that is a good idea), but better distribution of wealth among the social strata.

Legal and Illegal Reduction of Tax Base

The tax base has been shrinking through a mix of legal and illegal means. Government revenues have been eroded illegally in the traditional ways, i.e., tax evasion via unreported income, false reporting, unjustified deductions of expenses, transfer of income to offshore tax havens or to «internal offshore zones», treaty shopping, and tax avoidance through artificial affiliates, misrepresentation of assets, etc.

The legal (although illegitimate) ways in which corporations and individuals avoid or reduce tax liability, and the manner in which governments help them, are numerous and include - in no particular order:
income tax deferral, moving corporate head offices to tax havens, inter-company contracts and invoicing or transfer pricing, tax shelters (401Ks, registered saving plans…), derivatives in hedge funds, depreciation of assets, income splitting, tax holidays, tax credits for research and development, deduction of fines paid by corporate taxpayers for criminal acts or statutory violations, deduction from taxable income of bribes paid to obtain contracts, deduction of entertainment expenses; deduction from

retained earnings of interest paid on convertible debenture (in Canada), imaginative charitable donations, «day trader» status, family trusts, reducing the manhours spent by government tax-inspectors in auditing corporations[3], special treatment for venture capitalists, lower or nil taxation of capital gains, stock options (Sandler, Mawani, Johnson, 2003), inter-corporate dividends, payments of capital dividends, setting up of income trusts – or transformation of corporations into income trusts, reductions of income tax rates and of the number of tax brackets, etc.

And then, of course, there is the lax enforcement of fiscal legislation, particularly as regards large corporations and the very wealthy, although it isn't clear whether this should be classified as «legal» or «illegal». One could argue that for a government to fail to apply a law consistently and evenly is in itself illegal. And dare we ask whether it is accidental that business-friendly governments to a great extent abstain from prosecuting the important contributors to their election campaign funds[4]? The cuts in staff necessary for proper fiscal law enforcement is surely another of the factors.

Income Trusts

Income trusts, otherwise known as trust funds or income funds, deserve special mention for the way they reduce exposure to income tax. They are a relatively new vehicle which allows income to flow through directly to the unit holders without obligation by the income trust to pay taxes. A study by a Canadian government employee has shown that tens of millions of income tax dollars have already been lost by the federal government because of income trusts. Ottawa has done nothing to close the loophole which exempts income trusts from corporate income tax liability. These funds are proliferating. North American companies are rushing to transform themselves into income trusts, and a new stock market bubble involving these hybrid enterprises is growing. There were over 60 income fund public offerings in 2001, which raised in excess of C$4.5 billion, and over 20

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[3] This is a simple political/administrative measure which requires no change in the law or regulations, but which greatly helps circumventing fiscal legislation.

[4] As Paul Krugman has pointed out in an article entitled *The System isn't working*, published in the January 14, 2004 issue of Asian Age, Mumbai, political figures with the most direct ties to the Enron scandal, former U.S. secretary of the army Thomas White and the former senator Phil Gramm, haven't been indicted. Nor has Kenneth Lay, the Enron CEO who made substantial donations to George W. Bush's presidential election campaign.

income fund public offerings in the first quarter of 2002, which raised over C$2.0 billion.

Rather than plugging the holes in the legislation, governments are instead removing the one element which worries investors, namely, that trust units not being shares, provide no limitation of liability. In Canada the government of Ontario is amending the law to provide limited liability to holders of income trust units.

Shift of tax burden from corporations to individuals

It used to be that in North America, corporations' contributions to general revenues were more than, or about the same as, individuals'. Gradually, with the adoption of successive budgets, there has been a reversal such that individuals now bear a much larger share of the tax burden. To use the Canadian example, which is fairly typical of G7 countries, in 1950 individuals contributed 51% and corporations 49%. By 1999, it had become: individuals 77% and corporations 23%. In the Province of Quebec, under a self-proclaimed social democratic government, the gap has grown even more. In 1962, individuals paid 62% of the income taxes: in 1998 it had grown to 87%. Meanwhile the corporations' contribution fell from 38% to 13% (Lauzon et al., November 2003).

Shift from progressive income tax to VAT, consumption and sales taxes

As regards government reliance upon direct and indirect taxation as a means of raising revenues, a similar shift has taken place, that is, from income tax to value added taxes as the main source of government revenues. In Canada for instance, in the 1980s, under the guise of a «reform» touted as beneficial to exports, the Progressive Conservative government introduced the Goods and Services Tax («GST»), which extended taxation of the sale of goods to the rendering of services, greatly increasing the application of a regressive tax. The Liberal party then ran on the promise to eliminate the GST, but once in power failed to do so.

In the OEDC member States between 1960 and 2001 a major shift has taken place from progressive income tax as the more important source of revenue,

to its replacement by indirect taxes (Guex, 2003). Mexican president Vicente Fox is trying to push through the congress a new 10% sales tax, which would apply to every sale including food, medication and books. Polls show 70% of Mexicans oppose such a tax. According to the Economic Times of Chennai and Kochi, the business community is pressuring the government of India to adopt a national flat rate VAT.

Current Income Tax Reduction Rage particularly since the 90s

Since the 1980s, politicians of various hues, whether incumbents or those running for office, often describe their country (state or province) as having higher levels of taxation than the neighbouring country (state or province), and promise to create a business-friendly and competitive climate through tax reductions. They invariably use the word «taxes» without specifying whether they mean direct or indirect taxes. Nary a day goes by without the press quoting a head of state or premier reiterating his promise to cut taxes to help the «middle class», while deploring the deficit, real or concocted (McQuaig, 1995), allegedly inherited from a previous administration. These promises are frequently accompanied by a commitment to achieve zero-deficit, and nevertheless to increase expenditures in popular areas such as health or education. In the case of politicians who have already made tax cuts, the press quotes their oft-repeated assertions that the cuts are having the desired effect (economic growth, job creation…) - generally despite evidence to the contrary.

Over the years, we have witnessed two ways in which such neo-liberal tax *reforms* have been implemented. One of them has been to reduce the rates at which taxable income is assessed. The other has been a reduction in the number of tax brackets. Again, such tax-base reductions are said to be necessary to stimulate demand and investment. Yet, if we look back at World War II income tax rates, in the U.S. and England, the top bracket rates ranged in the ninety percents. Which did not prevent American manufacturers from emerging far wealthier than before the war (Galbraith, 1994).

Many G7 countries have gradually reduced the number of brackets as well as the rates, and are moving towards a single flat rate for all social classes. For instance, in Canada the federal government and most provinces are

down to four brackets, some of them to three. The province of Alberta is down to three, with the same rate of 10% for all three brackets and no surtax (Canadian Tax Journal, (2003) vol. 51, number 3, page 1163). In the province of Quebec, in 1988 the number of brackets was twelve: it is now three. Also back then the rates ranged between 12% to 28%; they now range from 18% to 26%, a shift in favour of the financially better-off. In the ODCE countries the tax burden has also shifted from the wealthy to ordinary wage earners (Guex, 2003).

The official rates do not tell the whole story. With a little help from their well remunerated tax specialists, corporations and wealthy individuals pay far less than those rates, sometimes nothing - or even manage to get tax reimbursements - by resorting to various means enumerated above, legal, dubious or outright illegal. The State of New York once had to obtain a court injunction to stop a major firm of chartered accountants from selling to owners of buildings a manual enumerating false labels to be used to misrepresent components of their properties so as to reduce municipal real estate taxes.

The rage to slash income tax paid by the corporate elite is such that governments cause State-owned entities to increase user fees, whether it be for electricity, water or public transportation, shifting the burden of raising general revenues onto ordinary citizens. Fairness, social justice and fiscal redistribution of wealth are out the window. The means of citizens to pay taxes seem no longer to be a factor as far as the establishment is concerned.

Ideological Underpinnings of Income Tax Reductions

Underlying the allegation that reducing income and capital taxes has the effect of stimulating demand and hence of promoting growth and job creation is a theory which has been put in context and described in some details by Guex (2003), known as *Public Choice*. Its proponents purport to explain the financial crisis which affects most States since the 1970s and which has coincided with the growing supremacy of financial capitalism. The crisis, we are told, is due to: budget deficits and government spending by politicians wanting to buy votes. Despite the Nobel prize in economics awarded in 1986 to James Buchanan, one of the main architects of *Public Choice* theory, and the fact that this school is pretty well dominant since the

1980s, empirical studies which have been carried out by *Public Choice* theoreticians by and large fail to validate it. However, it serves as the ideological basis for undermining the powers of elected bodies by transferring important powers to central banks, which are then no longer responsible to parliaments or to national assemblies.

Public Choice theory is also one of the ideological tools of neo-liberalism in its campaign to limit State revenues and cut funding of social programs. A cynical feeding of deficits (the Reagan *Star Wars* initiative) or the invention of deficits (in New Zealand in the early 1990s[5]) is used to justify the shrinking of the role of the State, the attacks on public servants and public services, privatizations, etc. Guex notes that in the OECD countries, the rate of growth of government revenues has gone down from 34.1% in 1980 to 0.41% in 1990.

Harribey (2003) describes how the war on progressive taxation draws its alleged justification from another neo-liberal economic theory, i.e., from the Laffer curb, a crude application of the law of diminishing returns. If you try to collect too much income tax you kill the goose which lays the golden eggs. Taxes discourage individuals from working and entrepreneurs from investing. The fact that WW II combined sky high top bracket rates with hard work and massive public and private investment is omitted from the equation. Neo-classic economists tend to eliminate time and history from their abstract schemes, and to reduce human beings to single-minded pursuers of immediate material self-interest. Harribey describes the Raffarin government's plan to stimulate the French economy by means of successive income tax reductions as a scheme to make the rich richer. And like Krugman et al., he predicts that they will fail to promote economic activity.

Tax cuts are not new. Keynes advocated them in certain circumstances and in such a way as to increase consumption. In the 1960s, the Kennedy administration decided to stimulate the economy by such means, after a sharp debate and despite the opposition of Galbraith and of then Treasury Secretary Douglas Dillon. Those income tax reductions are sometimes viewed as the precedent for the Reagan cuts of the 1980s (Galbraith, 1994).

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[5] McQuaig, 1995.

A number of observers and studies query the job-creating capacities of tax cutting stimulus packages such as those of George W. Bush. For instance, Jeffrey Rubin, chief economist at CIBC World Markets, explains the growing profits in the U.S. as a result of cost cutting, rather than of tax cuts. «Cost cutting» is a euphemism for job elimination. Which would account for the fact that in the second half of 2003, while the GDP increased, the number of new jobs did not keep pace with population growth. Rubin posits that although tax rebates gave sales a short term boost, they do nothing by way of job creation in the middle and longer term. And he concludes that the low rate of growth of disposable income "… likely means job losses, not job gains...". Others (e.g., Alan Beattie and Christopher Swan, 2003) have noted the same phenomenon, that is, that despite an economic upturn in the U.S., the job market is lagging. Of course the rise in productivity and the export of industrial and IT jobs has not helped. And enterprises often use tax cuts and rebates to finance the transfer of jobs overseas. In any event, U.S. officials eager to tout the effects of the Bush tax cuts have been disappointed.

We should not be surprised that sophisticated observers are wary of the claim that tax cuts imply job market growth. In Canada in 1995 huge income tax cuts and government spending reductions sent the economy into a near-recession. George W. Bush's three tax cuts helped turn a $230 billion surplus in 2000 into a projected $374 billion deficit. The American economy has lost almost three million jobs since he took office. Paul Krugman (2003) puts it bluntly: cutting income taxes in general doesn't create jobs or growth. And as regards the cuts specifically aimed at capital gains, he writes: *There was no widely accepted economic theory, left or right, under which the type of tax cuts proposed in early 2003 - which would gradually end taxes on capital income, but pump very little money in the first year - made any sense as a way of creating jobs in the short run*. Joseph E. Stiglitz (2003) has criticized Clinton's 1997 capital gains tax cuts, which as presidential adviser he opposed, on the grounds, inter alia, that not only did they erode Washongton's tax base in the long run, but that they fed the stock option frenzy.

Matthew Shapiro and Joel Slemrod (September 2002, updated October 2002) have carried out a study to check whether the U.S. tax rebates stimulated spending. Their findings are that the U.S.$38 billion tax rebate was spent by 21.8% of householders, had a small impact on aggregate

demand, and probably did not even succeed in providing a short-run stimulus. They add that studies of the effect of the 1975 tax reductions also generally found modest spending resulting from the rebates.

Another study by Lawrence Mishel (2003) evaluates the rate of success of what Washington calls the «Jobs and Growth Plan», to be implemented through massive tax cuts. He found, and has testified before Congress, that in order to increase jobs beyond the normal rate of growth based on population increase, the plan would have to create at least 228,000 new jobs per month. Jobs actually declined by 57,000 since July 2003. And by a strange coincidence the monthly increase in November 2003 was 57,000 - far short of the monthly increase of 306,000 which would be needed to achieve the Bush target of 5.5 million new jobs by the end of 2004 - and far short of the 228,000 monthly increase required just to achieve the natural growth figure.

Tax cuts overwhelmingly favour the very rich, providing relatively little to the middle class and next to nothing to the working class. 67% of the Canadian 1995 tax reductions went to the 5% top bracket taxpayers. George W. Bush's initial tax plan would have provided skilled workers with almost zero tax relief. Upon publication of data to that effect, a slight adjustment was made so that a one-time rebate of up to U.S.$600 rebates would go to ordinary people. The long term reductions will provide savings of over $100,000 per year for affluent Americans such as Vice-President Dick Cheney. To the extent that taxpayers do spend tax rebates, thus temporarily boosting GDP, the above cited Slemrod and Mishel studies indicate that the short-term boosts do little to generate employment. The very wealthy individuals and families tend to invest their huge tax cuts playing the stock market and in other financial activities, without contributing much to the real economy. Corporations invest their tax rebates in various financial operations, including mergers and acquisitions, which eliminate rather than create new jobs, as well as speculating on the foreign exchange market, and to finance the export of jobs to low-wage countries.

What are the establishment's real purposes in slashing income taxes? Beyond the alleged goals of stimulating economic growth, of making the local economy competitive, or of returning the money to the people, neo-liberal think tanks and right-wing politicians sometimes openly state the

objectives, which include the following. Firstly, either to eliminate progressive income tax, i.e., to reduce the number of brackets and rates to one flat rate for both billionaires and the working poor (as advocated by Steve Forbes when he ran in the GOP primaries), or to eliminate income tax as a source of revenue altogether, replacing it by a VAT or other indirect taxes and user fees as sole source. A lesser goal of the right is to eliminate taxes on capital gains. Wages will be taxed but not unearned income (Stiglitz, 2003, Krugman, 2003). Secondly, to reduce public means to pay for social programs, particularly, unemployment insurance, thus ensuring a vast "reserve army of labour", disciplining labour, reducing wages and production costs, and increasing profits. Thirdly, to eliminate or reduce public services, so as to enable neo-liberal governments to privatize and outsource them to private sector friends.

Are tax cuts reforms or weapons of class warfare? In December 2003 the moderate former leader of the Canadian New Democratic Party, Ed Broadbent, announced he would be running in the riding of Ottawa Centre. His Liberal Party opponent promptly accused him of «fomenting class warfare». *Nonsense*, the former NDP leader retorted, *It is the Liberals who have «waged a surreptitious class warfare» by cutting corporate taxes while slashing social services.*

Conclusions

Reductions in progressive tax regimes usually come as part of a package of social program cuts or elimination, deregulation of the labour market, privatizations, and contracting out services to the private sector. All of which make for deteriorated living standards for the majority - and increased profits for the few. They are part and parcel of the neo-liberal agenda.

Money laundering in offshore tax havens for tax evasion purposes, albeit important (Goodall, February 2003), is only one of the ways in which the tax base has been shrinking and by which the financial elite avoids assuming its fair share of the tax burden needed to maintain a just and democratic society. One must look at the whole fiscal picture and query government policies which implement the agenda of chambers of commerce, employer associations, and their right-wing think tanks. Apparently, there is no limit

to their demands. In December 2003, upon the appointment of the new Canadian minister of finance, known to be pro-business, not only did the representatives of the financial and industrial establishments react with glee, but the Quebec Management Council (*Conseil du patronat du Québec*) said that the government must now help the better-off segments of society by reducing their income tax! And falsely claimed that previous tax cuts had favoured the middle class. In societies where income gaps have been widening tremendously since the 1980s, one would think the wealthy classes could curb their greed for more. But whatever the agendas that drive the promoters of tax cuts, they contribute to the growing income gap documented as early as 1990 by Kevin Phillips, and which, by 2000, was examplified by the CEO : worker wage ratio of 458:1 (Krugman, 2003).

Market systems not only generate production of goods and services but also create social inequality, which must be mitigated by welfare programs and redistribution of wealth (Lindblom, 2001). This requires adequate State revenues. If the welfare state is to be maintained and reinforced, measures such as those proposed in the *Declaration and Manifesto* of the Tax Justice Network (2003) will have to be adopted and implemented. These include: the increase of fiscal data available to governments and to the public - and the exchange of such data between the various national tax authorities; curbs on capital flight; coordinated application of international and regional treaties and conventions on tax havens; transnational cooperation on common policies to end tax competition and to facilitate tax collection; the obligation of States to force fiscal disclosure by financial institutions, clearing houses, accountants, lawyers and notaries; increased government budgets for research (both by governments and by NGOs) and for enforcement of fiscal legislation; the establishment of a global forum on tax policies involving representatives of States and of civil society, in order to promote and improve cooperation, debate, and increase citizens' involvement in democratic control of taxation; taxation of transnational corporations on a unitary basis so as to end transfer pricing and tax treaty shopping; universal application of the residency principle to corporate assessment; harmonization of rates and of deductible expenses applicable to income of TNCs and wealthy individuals; and setting up regional and global tax authorities mandated to represent the interests of citizens rather than those of the business community. Finally, one might add that international conventions should provide for the elimination of artificial vehicles designed to avoid normal taxation - such as income trusts.

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