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November 27, 2009

**To: NEB Members, CAW Locals, Retired Workers Chapters,
National Representatives - Ontario Only**

From: Jim Stanford, CAW Director of Economic, Social & Sectoral Policy

Re: Analysis of the Harmonized Sales Tax (HST)

Dear Brothers and Sisters;

In recent weeks I have received many questions and inquiries from local union officials and activists regarding the provincial government's plan to restructure its provincial sales tax - moving from the current PST structure, to a new system that will be harmonized with the federal government's GST. To address these questions, I have prepared this information package, which contains some basic facts and figures on the HST, the impact it will have on Ontario's economy and society, and my recommendations as the CAW's Economist and Policy Director regarding how our union should approach this issue.

Let me summarize my main points here:

- The harmonization plan will replace one provincial sales tax (the PST) with another (the HST) that will collect roughly the same amount of total tax revenue.
- The system for collecting the HST is more efficient and less harmful than the PST. It spreads the sales tax burden more fairly across all sectors (unlike the current PST, which imposes a much higher tax burden on manufactured goods).
- The HST will deliver a benefit to Ontario's hard-hit manufacturing sector, in several ways: reducing the multiple taxation (called "cascading") which the current PST imposes on manufactured goods; reducing the cost of new capital investments in Ontario by manufacturers; and leveling the playing field between domestic producers (who currently pay a cascaded sales tax) and importers (most of whom do not).



- The HST will have no noticeable impact on the total amount of sales tax that is collected from Ontario consumers. It will increase sales taxes on some products, but reduce it on others. This is a restructuring of an existing tax, not a “tax grab” (as opposition politicians have described it).
- The HST will not have any noticeable impact on the fairness of our sales tax system. Shifting from one sales tax to another (collecting the same amount of revenue) will not make our current tax system any more or less fair.
- If we’re concerned with fighting for a more fair tax system, we should focus our efforts on opposing cuts (both provincial and federal) in corporate income tax rates, and opposing cuts in personal income taxes (which are collected in a more progressive manner than sales taxes like the PST or HST).
- Political opposition to the HST does not reflect a well considered call for a fairer tax system. It’s more about electoral gamesmanship by opposition parties eager to damage the current government. When the anti-HST coalition tries to tap into knee-jerk anti-tax sentiments to win more votes, it also encourages a regressive, potentially dangerous attitude to government and the public services those taxes support. We’ll pay dearly for that kind of attitude in coming years. Progressive forces will face an intense and challenging battle to preserve public services against budget cuts, fighting back against right-wing forces that want to downsize public services and programs in the face of current budget deficits.
- The anti-HST campaign, by fanning the flames of “tax rage” among Ontarians, will likely undermine the coming fight to preserve public programs and services - services most of us use routinely such as health care, child care and education, as well as other programs that unemployed coworkers and family members are accessing for the first time.
- Given these factors, I do not recommend that CAW locals, retired worker chapters, or activists participate in the various anti-HST activities which will be organized by the opposition parties in coming months. In preparing this letter, I have consulted with the members of the CAW’s National Executive Board, with public sector union leaders, with progressive tax and social policy experts, and with my colleagues in the CAW Research department. Most share my concern that the anti-HST campaign, by tapping into a conservative anti-tax sentiment, risks doing significant damage to our social programs (and the tax base for those programs).

I understand that collecting sales taxes on certain industries that did not pay the tax before (in Ontario, this is mostly financial services and some personal services) raises strong emotions. What many people do not understand, however, is that the current PST imposes a tax burden on many goods and services that is much higher than the “official” 8 percent rate. This is an extra “invisible” burden that the HST will remove. I hope that learning more about how the HST is designed, will allow our members and activists to make a more informed decision on this issue.

The CAW has neither endorsed nor condemned the provincial government's 2009 budget, which contains some very positive features (including aid for manufacturing and some important anti-poverty measures), and some very negative features (such as major cuts in corporate income taxes). In my judgment the HST is not the issue on which we should focus our energies; there are many more important battles to fight.

I should note that the attached material addresses the impact of the PST and HST in Ontario. The issues are somewhat different (and the financial effects are certainly different) in B.C., which is also implementing the HST, and thus the B.C. situation requires a separate analysis.

I hope that this letter answers your questions, but feel free to contact me (by phone 416-718-8497 or e-mail stanford@caw.ca) if you have further inquiries.

In Solidarity,

A handwritten signature in black ink, appearing to read "Jim Stanford". The signature is written in a cursive, flowing style.

Jim Stanford
Economist and Director of Economic, Social, & Sectoral Policy

c.c. Front Office

JS/kvcope343

Sales Tax Harmonization in Ontario: Issues and Controversies

Tax Policy and Progressive Values

Before considering the specific issues related to the HST transition, it is important to think about the key factors and criteria we keep in mind as progressive trade unionists as we evaluate tax policy decisions.

A society goes through three different sets of decisions, as it determines how much taxes will be collected, and how they will be collected. These issues are listed here, in order of descending importance:

Level 1: How Much Taxes Should be Collected?: This is the most important decision affecting how equal and inclusive a society is. Across the world, countries which collect a higher share of GDP in taxes (and then spend those revenues on public services which enhance the well-being, security, and equality of their citizens) demonstrate greater equality, social security, health, and democratic participation. We have had many debates in recent years about the fairness of our tax system: arguing that various groups should pay a fair share (depending on their ability to pay) of the total costs of funding government and public services. But the overall size of the tax burden (and the overall state of our public services) is even more important to progressive values than precise debates about tax fairness. Countries with the most extensive and generous public services (Scandinavia, France, Austria, Belgium) have very high total tax burdens (accounting for over 50% of GDP in some cases), including a wide range of different taxes. These countries, despite their commitment to social equality, have sales taxes much higher than our own (exceeding 20% in most European countries, and an average of 25% in the Scandinavian countries).

Fighting to support the idea that Canadians should pay more taxes (not less), in order to support more public services (not less), is probably the most critical priority facing those concerned with building a more fair and humane society. Needless to say, it's politically very tough to call for higher taxes, which is why even progressive politicians usually steer clear. (Some progressive politicians, shamefully, even call for tax cuts as a way of getting votes.) At a minimum, however, we must oppose tax cuts. The CAW has consistently opposed tax cuts. Like most progressive forces, we opposed the federal government's recent cuts to the GST - even though the GST is a "regressive" sales tax (it's more important that the government keep collecting taxes to support public services). In Nova Scotia, the new NDP government there is considering a recommendation to increase their HST by two percentage points (to a combined federal-provincial rate of 15%) to address the deficit that has resulted from the downturn.

We must always be sure that our statements and actions are supportive of the core notion that Canadians *should* pay taxes. It's the "price" of living in a more civilized, inclusive society.

Level 2: What *Kinds* of Tax Should be Used to Collect Those Revenues?: Once a society decides how much public services it is willing to pay for, there are many different types of taxes that can be utilized to meet those revenue needs: income taxes, corporate taxes, sales taxes, tariffs on imports, user fees, property taxes, wealth taxes, and many other forms of tax. Some taxes tend to be more "fair" (imposing the greater burden on those who can best afford to shoulder it) than others. The most progressive taxes are progressive income taxes (where the rate rises with the level of household income), corporate taxes (since high-income households own most business wealth), and wealth taxes. The least progressive taxes are flat-rate income taxes, sales taxes, and user fees. With regressive taxes, lower-income households pay a higher share of their total income, than higher-income households.

These tax fairness considerations explain why the CAW has traditionally opposed cuts in income taxes and corporate taxes. However, these tax fairness considerations should not be confused with the issues raised in "Level 1" above - namely, while we want a tax system that is fair, it's even more important to have a tax system that is well-funded enough to pay for the public services we need. It would be easy, but unreasonable, for us to argue (allegedly in the name of "tax fairness") that there's always "somebody else" who should pay taxes to fund the public services we need. In any society with decent public services, the masses of the population (including workers) need to pay a significant share of their income in taxes of various forms. We can't hope to enjoy good public services if we always want "someone else" to pay the taxes.

Level 3: How Should Taxes be Specifically Designed?: For each of the broad types of taxes described above, governments make many specific and technical decisions regarding precisely how the taxes should be designed, administered, and implemented. Some of those specific choices relate to fairness; some relate to economic efficiency. With income taxes, for example, we have argued (on grounds of both fairness and efficiency) for the equal inclusion of all types of income (including capital gains, dividends, and other types of financial income) in the tax calculation; in contrast, conservative governments have created great loopholes for financial income (so high-income earners pay less tax). In the area of corporate taxes, it is much better to tax profits than capital investment; capital taxes act as a disincentive to new investment (which is something workers want more of), but corporate income taxes do not (at least not directly). Finally, in the area of sales taxes, it makes economic sense to design a sales tax in a manner which is fair to different parts of the economy, and which does not unduly penalize our own products (compared to imports).

Please note that the transition from the PST to the HST falls clearly within the “Level 3” category of issues. It is not an issue of how much taxes to collect (since about the same amount of revenue will be collected from the HST, as the PST). And it is not an issue of how much to collect from sales taxes, as opposed to other kinds of taxes (since both the PST and the HST are sales taxes). It is an issue of redesigning an existing sales tax, so that it collects the same amount of revenue but in a fairer and more efficient manner.

What is the HST?

The harmonized sales tax would take Ontario’s existing provincial retail sales tax (PST), restructure it (applying it to a broader range of goods and services, while providing rebates for taxes paid at each stage of production), and then collect it jointly with the federal GST. This would come into effect next July 1.

B.C. is also planning to implement an HST. Four other provinces (Quebec, Nova Scotia, New Brunswick, and Newfoundland) also collect their sales taxes through the HST system. In those provinces there has been no measurable negative impact on consumers or the fairness of the tax system, resulting from the replacement of the previous PST with the new HST.

Value-Added Tax versus a Cascading Tax

The main design virtue of the HST is that it avoids a problem with the existing PST called tax “cascading.” Right now businesses pay PST on their taxable inputs (parts, materials, many services, etc.). Then they charge PST on the total value of their output (including the built-in cost of the PST they already paid on inputs). The result is that tax is paid several times on the same good during the production cycle. This “cascading” effect can add up quite substantially by the time a product reaches the final consumer. For manufactured goods in particular (since parts are purchased many times over, as a product moves from one stage of production to the next), the final effective PST rate is much higher than the “official” rate. For manufactured goods, the true final effective PST rate is well over 10% - but that “extra” tax is hidden from consumers, built into the higher pre-tax prices of manufactured products.

Why Does Cascading Matter?

Cascading is important for two reasons.

1. It increases the effective tax rate well above the official rate - and, moreover, it does this in an uneven manner (much more for manufactured goods than for services).

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2. It makes Canada's products less competitive. PST is not charged directly on exports, but it is indirectly built into the prices exporters pay for all their inputs. So our exports are more expensive. Most other countries, however, have sales taxes that avoid this cascading problem, so their products are relatively cheaper. We put our own products at a disadvantage.

The more input-and-output stages in the production of a product, the larger becomes the impact of cascading. Manufacturing involves a longer and more "chopped up" supply chain (with dozens of purchases from suppliers and sub-assemblers until the final product is produced), and so the impact is worst on manufacturing. For example, the auto industry has the most developed and complex supply chain of all - and hence cascading has an especially large and negative impact in this sector. The implicit ("cascaded") sales tax built into a complex manufactured product like an automobile can be twice as high as the "official" 8% PST rate. Consumers may not know that they are paying tax at twice the official rate - but they are paying it all the same.

The Value-Added Methodology

Because of these problems associated with cascading retail sales taxes, most countries in the world have moved to a value-added system for collecting sales tax revenues. The federal government did this when it introduced the GST in 1991. Several other provinces (including Quebec, Newfoundland, New Brunswick, and Nova Scotia) have since converted their own provincial sales taxes to the value-added model.

The value-added approach eliminates the cascading problem in the following manner. Companies pay HST on all their own purchases. They collect HST on all their sales. Then they remit to government only the *difference* between what they collected, and what they paid. In other words, they pay HST only on the *extra value* which they added to the products in their particular stage of production. (That's why it's called a "value-added tax.")

At the end of the whole production chain, when the final consumer buys the product, they are now paying the sales tax only *once*, on the entire value of the product (rather than more than once, under the cascading system). And they have paid tax at the official rate - not the hidden rate.

Impact on Exports and Imports

Exporters don't have to collect the HST on their export sales (since exports aren't taxable). But they still get the rebate of the HST they paid on their own inputs. The result is that exports are more competitive.

Imports, on the other hand, are charged the full HST on their final sale within Canada. (Imports are also taxed under the existing cascading PST, too.) But most other countries in the world use a value-added methodology for their sales taxes (exempting exports). Therefore, the fact that Ontario's exporters currently pay a cascading tax, while most of our competitors don't, constitutes a disadvantage for our products in international trade (in both Canadian markets and international markets). Converting to the HST would correct this imbalance.

Other Benefits

There are two other economic benefits of the harmonized sales tax system worth mentioning:

1. It reduces administration costs of collecting the tax (since companies and governments now do it once, instead of separately for the GST and the PST). This will save about \$500 million per year in compliance costs in Ontario.
2. It will reduce the cost of business investments in new capital equipment (which will now be fully free from provincial sales tax - instead of the partial exemptions which are provided under the current PST system). Economic studies (from groups like the Centre for the Study of Living Standards and the Centre for Spatial Economics) have suggested this could be one of the most effective ways to stimulate new business investment through the tax system. It generates far more "bang for the buck" in boosting investment than cutting corporate income taxes (which the CAW has opposed anyway).

Impact on Manufacturing

It is generally recognized that manufacturing is the big "winner" from converting the existing PST system to the HST value-added model, for several reasons:

1. Manufactured goods are most vulnerable to the cascading effect of the existing PST, because they are the ones that go through the most "stages" in production (with a product moving several times, from one supplier to another, before it reaches the final consumer).
2. Manufacturing is heavily dependent on exports, which get a boost from the value-added approach.
3. Manufacturing relies heavily on capital investment in new equipment, which would now be fully exempt from sales tax.

Impact on Other Industries

While business in general approves of the shift to the HST, some particular sectors have opposed the tax. This is almost always due to the fact that these sectors enjoyed an exemption from the previous PST, but would now fall under the same umbrella as the GST (which applies to almost all goods and services purchased in Canada). In Ontario about one-fifth of total consumer spending is currently exempt from the PST. This segment of consumer spending would now face the provincial sales tax - and hence companies in these industries are opposed.

The main examples of these sectors that lose “exemption” under the HST model include:

- ***New home construction.*** In Ontario, new homes are not charged PST, but they will be charged HST. The provincial government has addressed this problem by providing an HST credit to all home buyers, which would offset the HST paid on the first \$400,000 of a new home. (Previously built, re-sale homes are not affected by the HST.) Most home-buyers, therefore, will not be affected by the HST, nor will the construction industry.
- ***Financial services.*** The banking and mutual fund industries have been very vocal opponents of the tax.
- ***Other personal services.*** A whole range of other smaller service industries (from haircuts to movie admissions to massages) will also now be subject to HST.

Not counting new housing (which gets the special credit), around 10% of consumer spending in Ontario will face the new tax. The rest of consumer purchases (especially Canadian-made manufactured goods) will benefit from the elimination of the multiple-taxation caused by the current PST.

Impact on Consumers

Consumers will now pay sales tax on some goods and services (representing about one-fifth of their total spending) that they didn't pay before. This is the most visible “negative” impact of the tax - and the one that has sparked the most “tax rage.”

But there is also a less visible benefit to consumers: The multiple sales tax payments (“cascading”) which were built into the other 80% of their purchases will be removed, and that will be reflected (after prices adjust) in lower pre-tax prices for those products. Business conditions are excessively competitive right now (consumer prices have even been falling in recent months, as hard-hit companies try to attract

customers), so it will not take long for this adjustment to occur. Business's deductibility of their own HST payments will be phased in over the first years of the new system to parallel this process of price reductions.

The net impact almost balances out. The new HST will collect about the same total tax as the former PST. Economic studies estimate the average net impact of the HST on all consumer prices in Ontario will be less than 1 percent. The claim made by some HST opponents that average consumers will pay an additional \$2000 per year each because of the HST is false. The net impact of the HST will not be noticeable (although consumers will certainly notice that they now pay tax on a wider range of services - and that's the fact that the tax-rage campaigns are aiming to take advantage of). The government is offering temporary tax rebates to Ontario families to help offset the adjustment to the new HST system.

The provincial budget indicates that the revenue from the existing PST will be \$17.5 billion this year. Under the new HST, the core sales tax revenue (adjusting for the phase-in of business deductibility discussed below) grows to \$18.2 billion in 2010-11, and \$19.3 billion in 2011-12. This reflects the normal growth of the government's tax base (due to increased consumer sales and ongoing inflation). As a share of the total economy, total personal income, or total consumer spending, provincial sales tax payments will not measurably change as a result of the transition from the PST to the HST.

The Tricky Politics of the Anti-HST Crusade

A strange coalition of right-wing and left-wing forces has come together to fight the HST. In Ontario, both the Conservatives and the NDP hope the HST will spark a populist backlash against the Liberal government. So far this campaign hasn't had much traction - perhaps because headlines have been dominated by the government's huge deficit. NDP materials denounce the government's "tax grab" - a theme which clearly implies that taxes are bad. Most anti-HST web sites are dominated by anti-government, anti-tax ravings.

In my judgment, the anti-HST movement can only have a negative impact on our effort to build and shore up support for people to pay taxes to fund public services. Most of the people who support the campaign against the HST, are very clearly calling for less taxes and smaller government.

Fair Taxes and Unfair Taxes

All sales taxes (unlike income taxes) depend on your spending, not your income, and hence they impose a higher proportional burden on low-income individuals. But this

is true of *all* sales taxes (including the existing PST and the new HST). Shifting from one sales tax (cascading) to another (value-added) has no significant distributional effect.

If we are really concerned with making the tax system more fair, we should:

1. Campaign for higher income taxes on high-income earners.
2. Campaign for higher corporate tax rates (rather than lower, as most provinces and the federal government have implemented).

Both of these measures would make our tax system more fair. Stopping the HST and preserving the PST will have no change on the fairness of our tax system. The most progressive strategy of all would be to scrap the PST and replace the revenues with substantially higher corporate and personal income tax rates. No party has proposed this, however, given the political challenges of proposing to raise personal income taxes.

The Coming Fight for Public Services

It is now clear that progressive forces will need to fight an epic battle in the next several years to defend public services (including medicare, education, and income security programs) against an all-out attack from conservatives who will use the deficit as an excuse for attacking the public sector. This fight will exactly mirror the fight we had in the mid-1990s (and for the same reasons: it's the delayed reaction to the recession, and resulting large deficits).

Canada still hasn't recovered from that round of budget cuts. Our society is meaner, less secure, and more unequal as a result of those cutbacks. Nothing will damage social equity more than another round of big cuts in public programs. This will need to be a key priority of progressive forces. Right-wing politicians are already lining up at all levels of government (federal, provincial, and municipal) to pledge to "cut government waste" by taking the axe to public programs.

Fighting the HST, when we should be fighting to preserve public services, is a diversion that will undermine our efforts to defend the public sector (and public sector workers) against these coming attacks.