

Speech to a Joint Meeting of the Canadian and Empire Clubs
in Toronto on Monday, March 18, 1968

by

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TAX REFORM

Since the Report of the Royal Commission on Taxation emerged a little over a year ago I have followed the comments and criticisms with great interest. While some of the comments have shown a fair knowledge of the tax systems of Canada and other Western countries, and have I think contributed to a general understanding of the subject, others appear to me to strongly oppose any tax reform along the lines that the Commission recommended, or any other lines. I remain proud to be associated with this Report and firmly committed to all it contains. I recognize the immense importance of tax reform if we are to have a fiscal system in keeping with the needs of our country.

It has been suggested that there are two general approaches to tax reform: one of these is to devise a total plan which takes into consideration the customs and habits of Canadians as well as the state of the economic development of the country; the other would be to assume that the present system is basically what Canadians require and to direct recommendations to correcting its apparent inequities and anomalies.

Most of you will recall that the second of these routes is that generally followed in the United Kingdom, where they have been richly endowed with excellent royal commissions on taxation, each addressed to specific problems.

I do not consider that this has produced a good tax system. In fact, I consider the British tax system has been so bad as to have added significantly to the economic ills of that country. It has a relatively narrow tax base with confiscatory rates, which have unquestionably contributed to the export of talent and the depression of the efforts of workers. I am firmly convinced that had the first route been pursued in Britain many years ago they would have ended up with a broader tax base and lower rates.

I, for one, would not have wished to be associated with a commission which had a restricted approach to tax reform. It must be evident that any recommendations regarding parts of a tax system can only be useful if they have regard to the whole. If one considers that the whole system is itself faulty, it would be a very unsatisfactory task to be patching up parts.

The terms of reference given to us were: "... to enquire into and report upon the incidence and effects of taxation imposed by Parliament, including any changes made during the currency of the enquiry, upon the operation of the national economy, the conduct of business, the organization of industry and the positions of individuals; and to make recommendations for improvements in the tax laws and their administration that may be consistent with the maintenance of a sufficient flow of revenue...."

These instructions went on to spell out a number of specific matters without restricting the generality of the foregoing. One of these is "... the means whereby the tax laws can best be formulated to encourage Canadian ownership of Canadian industry without discouraging the flow of investment funds into Canada."

Our first undertaking was to address ourselves to a number of Canadian organizations and enquire as to just how they would interpret our terms of reference. These organizations were the Canadian Tax Foundation, the Canadian Chamber of Commerce, Queen's University Tax Study Group, Canadian Manufacturers' Association, Canadian Labour Congress, Canadian Institute of Chartered Accountants, the Canadian Bar Association. Their comments on the direction of our enquiry were most helpful and carefully considered by us.

After listening to some 220 submissions rendered to us right across Canada, it seemed clear that there was a strong case for general tax reform. What we heard and what we found caused us to indite the existing tax system in accordance with the 7 points set forth at the beginning of our Report, namely that:

1. The present system is unfair: We found that, based upon the criteria in the Report, 3,125,000 persons are overtaxed 15 per cent or more and 631,000 are undertaxed 15 per cent or more.
2. Canadians are less well off than they could be because the present system distorts the distribution of productive goods and services and does not assist in the efficient allocation of such goods and services.
3. The fiscal system is not being used as effectively as could be for economic benefit.

4. In some fields, compliance and collection costs have been needlessly raised because of duplicate federal and provincial administrations.
5. Federal tax administration is not sufficiently shielded from political influence and is too centralized.
6. Federal procedures used to obtain and analyze new ideas prior to the introduction of legislation are inadequate.
7. Federal administrative and judicial appeal procedures are deficient.

We stated in our Report that when we commenced our undertaking our bias was that the present system was basically sound and compared favourably with the systems of other countries. Our enquiry did not change this view, but simply that we felt the system fell far short of the attainable objectives. I might add that we also found that the morality of Canadian taxpayers is relatively high. I believe that it is about on a par with that of the United States, and I consider that they are both higher than in European countries. This morality is a delicate flower and could shrivel very fast if taxpayers concluded that the burdens of government were unfairly apportioned.

What are the major reforms that are required? It is difficult to state these briefly, seeing that we have written over 600,000 words and we believe we have wasted none whatsoever. However, I will pick a few that I consider to be urgent.

I agree with the statement of the Canadian Chamber of Commerce in their submission to us that the tax base should be broader. The choice in devising a tax system is whether to pick out a few items for one's base and bring those into assessment, or to use a great many items and produce the same amount of money with lower rates. Broadening the base has the disadvantage of bringing into assessment many transactions which have so far been unfamiliar to Canadians as matters for tax. However, the amounts I speak of are so huge that by contemplating a broader base, together with wiping out some concessions, we were able to recommend the elimination of the double tax on corporate income of Canadian residents and at the same time to reduce the Canadian income tax rates to where they are comparable with those of the United States. This meant average reductions of 15 to 20 per cent and a top rate of 50 per cent. However, the roar that has gone up concerning the broadening from those affected has been immense. Almost everyone is adversely affected by a broader base and favourably affected by lower rates. The net result is different for every taxpayer. For the most part, complaints look at one side only and thus either mis-state the results or greatly exaggerate the injury. Perhaps this is good fighting tactics, but hardly gives a fair appraisal of the Report.

We would bring capital gains into tax, because we see no difference in the benefits whether capital or income. We report that the ability to pay taxes depends upon economic gains without regard to the source from which they come. The usual reply disregards fairness and states that such taxation would produce very small revenue and would be difficult to administer. The answer, of course, lies to some extent in the results of the U.S. system, which even with a faulty tax produces about 6 per cent of its income tax from capital gains. It has been said that every other country in

the world distinguishes between the taxation of capital and income by a special preferred rate to capital. This, of course, is just not so. The distinction given to long-term holdings is not a distinction between capital and income. The United States' courts dismissed such a distinction about 1916. The reason for a difference in tax rate is simply because under a graduated rate schedule it would be unfair to bring into the income of one year accruals that have occurred over a long period. This unfairness can be met by either the lower rate, which has been adopted in the United States, the United Kingdom, and many other countries, or by a more liberal system of averaging. We preferred the latter, particularly when taken along with some of our other recommendations: - namely, to reduce the top rate of tax to no more than 50 per cent and to eliminate corporation tax as it pertains to residents.

I cannot leave the matter of capital gains tax without drawing attention to the fact that our proposed system does not duplicate the taxation of undistributed income of corporations, whereas the capital gains taxes of the United States and every other country I am aware of does exactly that. Increases in the value of shares come about because of the accumulation of earnings and also because of the improvement in the prospects of future earnings - let us call the latter "goodwill" gain. Studies over a period of time have shown that on average the accumulation factor is about equal to the goodwill factor. In the United States earnings, whether distributed or not, are taxed at the corporate level, a little over 50 per cent, then when the shares are sold the undistributed portion is again taxed as part of the gain on the shares but at the reduced rate applicable to long-term gains where that applies. Thus undistributed earnings would, therefore, always be taxed more than 50 per cent.

Under our proposal, earnings would be taxed at the personal rate of individuals and that is generally less than 50 per cent, which is the top rate proposed. The undistributed portion of earnings would not be taxed again upon the sale of the shares. The goodwill factor under the United States' system will be taxed at the reduced rate for long-term holding, and in Canada it would be taxed at the full rate. If you put these two together you will see that the total taxation of share gains in Canada would average less than in the United States. What is more, under our proposal there would be an averaging procedure, which is not available in the United States.

It is now freely predicted that we are likely to have a U.S. style capital gains tax. Indeed, I think that from the public reaction to our Report, the Government is quite apt to choose this course. Of all the weak parts of the U.S. tax system, most U.S. commentators would state that their capital gains tax is the weakest. The only thing to be said in its favour is that it is more equitable than the complete absence of a capital gains tax.

Now after broadening the base and lowering tax rates, perhaps the next most significant reform we recommend is the elimination of the discriminatory tax against the income from corporate shares. We refer to it as integration of personal and corporate taxes. Such discrimination does not apply on the income of co-operatives, on the income from indebtedness, such as bonds and debentures, on the income of partnerships, sole traders or trusts. During the hearings the significance of this discrimination was pointed out to us by such associations as the Canadian Manufacturers'. Many others referred to the unfair advantage of co-operatives over corporations, or the underwriting bias favouring bonds over stocks. Perhaps some hoped for

double taxation of co-operatives, but in my view that would be a ridiculous solution, unless one believed in double taxation, which I don't think has ever been supported broadly by Canadians.

The elimination of the double tax on corporate income is, of course, an old story in Canada. Up until 1926 the evils of double tax were recognized and dividends were not taxed. This did not continue and the question of double tax was raised by the Rowell-Sirois Report in the middle thirties. It became the subject of lively discussion in the late forties, when many revisions were made to the income tax law. So far as I know, nobody was at that time able to figure out an acceptable mechanical method of achieving this. When the Commission staff came forward with something very like our recommendation, I felt that they deserved medals for persistence and ingenuity. The integration principle has been greeted by the thought that it is radical, but I am sure that it is only radical to Canadians, or possibly citizens of the United States. When the Canadian dividend credit was introduced in 1953 the Minister of Finance stated that he considered this to be a first step towards the ultimate elimination of double tax. The 1953 increase in the dividend credit to 20 per cent went some distance towards integration but with little regard to equity.

Up until 5 or 6 years ago the United Kingdom allowed full credit to shareholders for underlying corporation taxes. They did this by a method of gross-up. However, circumstances destroyed the purity of the tax by imposing on corporations a separate profits tax for which credit was not allowed. It is noteworthy that the United Kingdom abandoned their integration procedures in order to discourage the distribution of earnings by domestic corporations as well as achieving some other objects, and at the same time - or close to the same time - the French adopted an integration system to encourage retention

of earnings by corporations. They each proceeded in opposite directions to achieve the same ends. It was assumed by the French that a lower tax on dividends would reduce the pressure from shareholders for increased dividends. We came to the same conclusion. Germany has avoided double tax on corporate income by differentiating between the rate of tax on distributed and undistributed earnings. I observe that proposed reforms in Belgium include the elimination of double tax on corporate income.

Only about 3-1/2 per cent of the total portfolios of Canadian life insurance companies are invested in Canadian equities, and we expect that the integration plan would unlock much more of the wealth of financial institutions for investment in corporate ownership. At present they do not obtain the benefit of the dividend tax credit whereas we would extend to them full credit for underlying corporate taxes.

Our integration proposal was not conceived to discourage foreign ownership. However, by eliminating the tax law's discrimination against dividends of Canadian residents, it satisfies the instruction we received in our terms of reference, and which is quoted above, as to the encouragement of Canadian ownership. I have stated in the United States that only by their adoption of an equally sensible law could we, by reciprocity, place their residents holding Canadian shares in a position equally favourable to Canadians. At the same time, as our shares become more attractive to residents, Canadian bonds should become slightly more attractive to non-residents.

It has been suggested that this is not a suitable time for making drastic changes in the Canadian tax laws; rather we should wait until the laws of the different nations come closer together so that we are moving in the right direction. This, of course, would make very good sense if there is any indication that time would bring tax laws closer together. Indeed, I think that the reverse is true without some

conscious effort on the part of nations to achieve this, such as is happening in the European Economic Community to promote the flow of trade. You might think that the tax laws of Canada and the United States would in some ways resemble each other. Let me remind you that they could scarcely be further apart. The United States taxes the family by the device of splitting income - Canada does not. The United States depends mostly on income tax - Canada depends very largely on sales and excise taxes. The United States does not distinguish in its taxation between capital and income - we do; Canada provides some degree of integration of corporation and personal tax by the 20 per cent dividend credit.

Another significant reform that we recommend is the taxation of the family rather than the individual. This, of course, is the practice adopted in most Western countries and yet I believe there are many Canadians who consider it a radical departure. Before we commenced this task it was very commonly stated at tax conferences and in conversation that it is grossly unfair that two families with similar income and responsibilities should pay different amounts of taxes because in one case the income was attributed to one consort and in the other was divided between the two. Naturally, the present administrative difficulty of keeping the two streams of income clearly identified against the interest of the taxpayer is immense. Consistent with the family principle, we would not bring into tax transfers between spouses - inter-vivos or at death.

Now I would like to add a few words on the taxation of estates. It must seem fair to you as it did to us that taxes of all kinds be borne in accordance with our ability to share the costs of government. I readily admit that there are various ways of measuring this ability

but the Report suggests that perhaps the most satisfactory measure is the receipt of wealth: that is, the total economic gain over a lifetime. Following from this I think it is important that wealth received by gift or inheritance be included in the tax base. Then we must consider who pays that tax and look at his ability to do so. It seems to me that gift or inheritance tax may be paid by, but can never be borne by, the donor or the testator - in the latter case he is dead. The tax is borne unquestionably by the person receiving the gift or the inheritance and I believe the amount of tax should have regard to the circumstances of that person. Then, of course, it would be grossly unfair under a system of progressive taxation to include such a receipt in the tax base of one year without some means of averaging. We have provided a maximum of ten years and it has been suggested that this is too short and the result tends to be punitive. There may well be merit in such an observation and perhaps the period should be extended to twenty years or even longer seeing that the amounts given or transferred on death have been accumulated over a long time.

I have noticed many statements to the effect that amounts received from this source should not be included with ordinary income but should be taxed at a special rate. About a year ago I was seated at a table between two men for whom I have a very high regard - one is from the United Kingdom and is, perhaps, the senior tax lecturer and writer in that country, the other is a senior professor at one of the large universities in the United States and amongst his subjects is included taxation. He has served his government in a

senior capacity in taxation. At that time I addressed a question to these two gentlemen. Simultaneously, I asked whether in their opinion the receipt of inherited wealth should attract a greater or a lesser tax than the receipt of one's ordinary salary or wages. The American replied that, in his opinion, it should attract a greater amount of tax seeing that it was in the nature of a windfall and taxation thereon would be less painful than taxation of one's salary. The Englishman, on the other hand, said that inheritance should attract less tax, and then he admitted readily that he could not support this by reason but he was moved by the traditional approach to the distinction between capital and income in the United Kingdom. In all events, this left me reasonably satisfied that what was set out in the Report was right down the middle of the fairway.

Many people advocate that inheritance taxes be completely done away with. I think I must remind you that the annual take is about 4 to 5 per cent of personal income tax. Well, I for one am not prepared to have my income taxes hoisted 5 per cent or more in order that a relatively few members of society can receive their inheritance tax free. Inheritance taxes may seem harsh on those families who have fostered and developed private companies, and whose estates do not provide protection against taxation on such assets, however it is hardly reasonable that tax laws exact a lesser toll from an estate consisting of bricks and mortar than from an estate which is composed of liquid assets. This does not mean to say that the state should not be compassionate in its collection and accept reasonable terms of payment providing the debt is properly secured and it bears interest.

It must always be remembered that taxation never rests on property or things. It is borne by people. Sometimes we talk about it as though it is borne by corporations, but this of course is not so. It is borne by shareholders of corporations, or by customers of corporations, or employees of corporations. The interesting part of this task has been its total involvement with people. It is important that the incentives of people to work in Canada are maintained to the same extent as incentives for Canadians to invest in Canadian enterprise. We found no merit in arguments that the product of investment should be taxed more or less than the product of labour.

In our Report we stated that we gave primacy of place to the equity objective. Some of our critics have claimed that we gave inadequate attention to the uses of the tax system to encourage economic growth. Four points should be borne in mind:

1. Social instability is inimical to growth; and an unfair tax system is one of the major causes of social instability.
2. The present tax system is so inefficient that it is possible to make it more equitable without reducing the rate of growth.
3. The Report suggested a variety of policies that could be implemented if Canadians wanted a more rapid rate of growth - such as accelerated depreciation and a system of investment credits. These growth policies would be both more efficient and more equitable than most of the concessions contained in the present tax structure.

4. The Report recommended many changes in the tax structure that would offset the negative economic effects of changes that were justified on the grounds of equity. Lower marginal rates, full loss offsets, generous and full credit for corporate tax are notable examples.

We believe that we can have more equity and more growth. To argue that we stressed equity at the expense of growth is to suggest that the present system is an efficient taxing instrument. This we deny. Indeed, when one considers how and why the present system evolved it would be strange indeed if it were efficient.

We have endeavoured to make clear that an appraisal of the effect of each recommendation taken by itself is quite unfair. For instance, capital gains taxation alone would quite obviously depress the stock market and would probably impede investment in risky projects. By allowing the full writeoff of capital losses and by removing the restrictions on the deductibility of business expenses and losses, and simultaneously adopting the integration proposal, our studies show that this will not be harmful. One can go on to say that capital gains tax taken together with a reduction in personal tax rates, which can be achieved as a result of the taxation of capital gains, will produce a good economic result.

In emphasizing equity ahead of growth we recognized that taxation is primarily a means of transferring purchasing power from the citizens to the government. Taxpayers must be satisfied that it is done fairly. Taxation has, of course, significant economic effects. We describe it as one of two blades of scissors in the fiscal system. The other is expenditure, and finance ministers are concerned with both as well as with such other economic tools as monetary policy and debt management. Taxation has an important role in achieving economic stability.

There may well be some economic ends in business growth that taxation can serve best. However, it is my view that taxation has been over-used for such purposes in the past. I can see no difference to a taxpayer in exacting from him the full amount of taxes on parity with other taxpayers and then bonusing him with government funds for economic or social purposes, or on the other hand reducing his taxes by the amount of the bonus. But, I can see vast differences to government. Tax abatements slip by in government accounts with very little public concern, the amounts of such abatements as we have seen, can become huge. I submit that if these amounts, or if similar amounts, were paid out in subsidies they would be apparent and subject to annual review. What is more, it is possible that they would be withdrawn, whereas a tax abatement once adopted seems to be established for all time. Tax abatements can only benefit profitable taxpayers, whereas to assist or direct economic growth it is frequently desirable to provide help before profits result. Whether we abate taxes or pay subsidies, there should be public and frequent review of the benefits received against the taxes conceded or payments made. Conditions change and government funds can readily be used inefficiently.

During the time of our enquiry I travelled to Italy to ask about the tax concessions and subsidies they had given to establish industry in the South. This was a very extensive programme and covered tariff concessions, government interest-free loans, property concessions, and many others. It also included income tax exemption for 10 years. My Italian informants all told me that they considered the least important of the concessions to be income taxes. In all events, I think it is clear that one must have regard to all the circumstances and needs of each region to prescribe the right mixture for its development.

Taxes are only one of the tools. Our Report recommends a full-scale research programme to learn more about the process of regional growth.

I suggest that if we believe in the efficacy of free capital markets, we generally leave it to them to provide the most efficient allocation of the capital resources of the country. To the extent one varies the tax rate between industries in Canada, one deliberately interferes in this free allocation, and expresses a preference for one kind of production over another. If any such interference seems justified, it should be done with extreme caution, for it may well reduce the total productivity of the nation.

Returning to tax reform, I believe firmly that there can be little if any reform without a complete plan for the revision of the entire system, even though this be implemented gradually. Presumably this is the purpose of the long promised White Paper. If the plan contained in our Report is not the best plan for Canada, there must be developed an alternative plan or we will never reach a good system. This is because the political costs of amending some taxes are high and taken by themselves may be unalterable. The taxes that can be imposed with the lowest political costs are obviously those that are the least painful and I suggest that in our system they are the sales tax at the manufacturers' level and corporation taxes. The incidence of both these taxes are well diffused throughout the economy and to a large extent emerge in higher prices for goods.

The French, who have always been probably the world's experts in plucking geese with the minimum of squawks, have a hidden sales tax which is now as high as 25 per cent. This is by the route of "value added" taxation and certainly I would not like to see any such plan adopted for

Canada. In my way of thinking, bad taxes are those where the effects are concealed from the taxpayer and which generally emerge only in the higher prices of goods where one cannot discern how much of such higher prices is due to taxation. We are all very fond of saying that governments must reduce expenditure. I can think of no more effective means of discouraging politicians from increasing expenditures than by making taxation as painful as possible.

Conversely, if I were a politician, I would like to find the least painful method of taxation and obviously I would look to indirect sales taxes and corporation taxes. Now, in our Report we have said that both of these should go and without a national tax plan and some help from interested citizens I think it is asking quite a lot of politicians to deliberately throw out their tax friends. At the time of our hearings, manufacturers' sales tax did not appear to have a friend in Canada, largely for the reasons I have just given. In fact, it was almost universally recommended that it be transferred to a tax at the retail level, irrespective of what the total rate of retail tax might then become. We would then all know what was our sales tax burden. Nobody knows the extent to which corporation taxes are reflected in the higher prices of goods, but I suspect that it is substantial. It is not possible to tell with any accuracy what would be the effect of our integration proposal on the price of goods. I believe that over a period of time price reductions or lesser price increases would be quite significant.

I think that there is little doubt that if we wish our productivity to be competitive with that of our great neighbour we must try, as far as possible, to eliminate concealed taxes from the price of our goods. If we do not, we will, I believe, force up labour costs and damage our competitive position.

It is encouraging to learn from the newspapers that my fellow commissioners and I do not stand alone in believing that considerable tax reform is necessary to Canada and that now is the right time for it. If any of you share our opinion in this regard I hope that, even though your views may not coincide with the recommendations of the Report, you will do everything within your power to encourage reform in order that Canadians may have confidence that they bear no more than their fair share of the cost of government and that taxes may not impede economic growth.

I have little patience with fears that tax reform may upset the economic balance of the country. Canada is a large country in area and in population. We are a relatively affluent people, industrious, well-educated and healthy. We are endowed with good land, fresh water and minerals - indeed, we are a strong country whose problems appear to be mostly of our own making and avoidable. We are quite capable of withstanding economic jolts from tax reform.

In reading some material sent out by a life insurance company I noticed these words, "I find portions of the Report to be highly consumption-oriented, and with a definite bias against personal savings." This sentence appears to mean that the recommendations of the Report encourage people to spend and discourage them from saving. The only support, I know, for such a statement is that we would remove concessions to one form of savings so as it be taxed the same as others, and I have no

apology for that. It must be evident to all that lower taxes imposed on the vast majority of taxpayers, and particularly on those of low income, will improve their opportunity to save. I think a tax system should not exempt all savings from tax, if we had concluded otherwise it would have been logical to recommend scrapping income tax in favour of an expenditure tax.

The frustration of this exercise to-day is the limitation of time. Many of my statements are inadequate and I have omitted several important matters. However, I cannot close without stating that fair taxation and cheap, easy administration do not generally go together. The two worst taxes we have - namely, manufacturers' sales tax and corporation tax - are collected relatively cheaply and efficiently.

I urge those of you who have not done so to read the Report. It is no longer than other royal commission reports. The reading time is about 20 hours for a fast reader and about 50 hours for most of us. You will then find that discussing it becomes more rewarding and only by reading the Report itself can you examine the reasons for its conclusions. You may then understand that the word "radical" is badly chosen as a description of our work. There is scarcely a significant recommendation which has not been applied in some other country or has been the subject of tax literature for years. To those of you who have read it, I express appreciation and the hope that you can support what I have just said.