A Recipe for Reform: Comments on the Paper by Satya Poddar and Morley D. English

Ian C.W. Russell*

Significant Investment Income Sheltered Behind Exemptions

In their paper, Poddar and English trace the evolution of the personal tax system from the Carter royal commission recommendations of 1966, which advocated taxing individual income, whether earned from labour, business, or investments, at equal marginal rates. Over the past 30 years, governments with an interventionist bent have chipped away at the concept of equal tax rates—while paying lip service to the Carter principles—by introducing an array of exemptions and tax credits on investment income to promote retirement savings and capital formation for small business.

The main conclusion of the Poddar-English paper is that nearly three-quarters of personal investment income now escapes taxation. As a result, the effective tax rate for investment income (taxes paid as a percentage of income) is much less than for labour income, a result that violates the Carter principles. The paper examines in detail the direct impact of the tax mechanisms available for sheltering investment income that have been responsible for the low incidence of taxation. These tax shelters include the registered retirement savings plan (RRSP), deferred profit-sharing plan (DPSP), and registered pension plan (RPP) exemptions, the exemption for principal residence, the dividend tax credit, the tax credit for labour sponsored venture capital corporations (LSVCCs), and the inclusion rate for capital gains.

This finding can easily lead one to reach the wrong policy conclusion—that, given the existing superstructure of exemptions, ameliorating adjustments to tax rates for investment income, even if justified on efficiency and fairness grounds, are largely irrelevant because of the small amount of taxable income arising from investments. This would be the wrong conclusion for two reasons. First, there is significant investment income in excess of the exemption levels that is taxed at high marginal rates and, second, the limited incidence of taxes paid on investment income is aggravated by the way individual Canadians have adjusted their investment behaviour, in response to the exemption structure, to minimize taxes.

* Senior vice president, Capital Markets, Investment Dealers Association of Canada, Toronto.

ADJUSTMENTS TO INVESTMENT BEHAVIOUR

The paper does not place sufficient emphasis on the behavioural factors that are key to determining the appropriate direction for tax policy. Individuals, particularly middle- and high-income individuals with income exceeding the retirement thresholds, have refrained from realizing capital gains on financial and non-financial assets to limit taxes on investment income. Statistics Canada data on household balance sheets estimate that in 1996 Canadians held about $650 billion in debt instruments and deposits, which, at prevailing interest rates, roughly translates into the reported $19 billion in interest earnings for that year. The balance sheet figures also show, however, that individuals held nearly $400 billion in stocks either directly or through mutual funds. The paltry $9 billion reported as *overall capital gains* in 1996—gains from financial assets as well as from non-financial assets such as real estate—is clear evidence that Canadians have held back from selling appreciated assets to avoid capital gains tax, a heavy 40 percent tax at the top marginal rate. It is not just the wealthy, but many in the middle class who accumulated stock gains through the bull market of the 1990s and have been reluctant to incur a tax liability by realizing the gains on those shares.

The tax incidence on investment income has also been low because Canadians have jumped with some alacrity into the tax exemptions available to shelter income, and governments have accommodated the process by continuing to tinker with the exemption structure to meet particular social and economic objectives. Over the years, governments have introduced a series of targeted incentives through tax exemptions and credits to meet economic objectives—typically incentives aimed at promoting small business capital formation. These exemptions have included the lifetime capital gains tax exemption, the $500,000 exemption for small business shares, and, more recently, the federal tax credit for labour sponsored venture capital corporations. Taxpayers have leapt into these programs to reduce taxable income. Investments in LSVCCs are attractive because the 30 percent federal tax credit is matched by an equal provincial credit in those provinces offering labour sponsored funds. Federal and provincial tax credits significantly lower the after-tax cost of these investments and, moreover, the LSVCC tax shelter can be combined with RRSP contributions, resulting in negative income tax paid.

LSVCCs have accounted for most of the growth in venture capital funds in Canada; assets in labour sponsored funds escalated fourfold in the five years between 1992 and 1997, and assets now total $4.2 billion. The phenomenal inflows into these funds have, in fact, outstripped the capacity of the funds to invest effectively in small business. For example, the Working Ventures fund in Ontario has invested only 40 percent of its portfolio assets in small business investments ($400 billion). While LSVCCs have been a popular instrument for reducing taxable income, the evidence suggests that they are not a particularly efficient one for channelling equity capital to small and mid-cap enterprise. Incentives that rely on the markets to channel savings to equity investments, such as lower capital gains tax rates, will have more success in promoting capital formation.

The tax incidence on investment income has also been low because the high marginal tax rate for investment income has encouraged some Canadians, with savings exceeding the exemption thresholds, to direct capital to offshore discretionary funds to avoid or defer taxes. There has also been an alleged increase in the non-reporting of investment income to avoid tax. Canadian governments have taken a different approach from that of their European counterparts in addressing the so-called capital flight problem. In Canada, the policy emphasis has been to shore up the existing tax structure by restricting the use of non-resident trusts and other offshore investments, and introducing the reporting of offshore investments exceeding $100,000. European countries, to retain savings within the indigenous economy, have reacted to capital flight differently by reducing the high tax rates on investment income. The Nordic countries (Denmark, Finland, Norway, and Sweden) have introduced the dual income tax (DIT) system, which taxes investment income at the lowest marginal rate for labour income. In the Canadian context, if labour income is taxed at the top marginal rate—say, a combined federal-provincial rate of 50 percent—interest income would be taxed at 26 percent (a 17 percent federal rate, and a provincial rate at 50 percent of the federal rate) and capital gains at 20 percent, well below the current 40 percent rate.

The Canadian response has been different, probably because the capital flight problem is viewed as incremental, rather than endemic, and able to be addressed by coopering up the existing tax system. More seriously, the defensive response suggests that government is not prepared to recognize (or does not believe) that the tax regime for investment income is too high, nor does it understand that, if uncompetitive tax rates continue to fester, capital flight may turn from a trickle to a flood.

Government reluctance to reduce the tax rates on investment income is certainly not because of the magnitude of the tax revenues forgone. As table 1 shows, the federal tax payable on investment income in 1996 totalled only $4.3 billion, less than 10 percent of the taxes on labour income. The corollary is that significant tax reduction in investment income, say by adopting the DIT system in Canada and lowering the investment income tax rate to 17 percent, would reduce the tax take on investment income by roughly $500 million, or 12 percent. This estimate, however, overstates the revenue loss, since any reduction of that magnitude in the tax rate—from 29 percent to 17 percent at the top marginal rate—would unleash investment activity generating higher tax revenues. The US experience indicates that lower tax rates on capital gains result in higher tax revenues, mainly from the increased turnover or "unlocking" of financial and non-financial assets, and from reduced tax avoidance. For example, under the Tax Reform Act of 1986[1] the maximum capital gains tax rate increased from 20 percent to 28 percent. Revenues from capital gains, based on the higher tax rate, totalled just $36.2 billion in 1994, about the

[1] Pub. L. no. 99-514, enacted on October 22, 1986.

Table 1 Canadian Federal Income Tax Payable by Type of Investment Income, 1996 Taxation Year

Type of income	Total income assessed	Federal tax payable
	$ millions	
Taxable amount of dividends	9,669.6	217.3
Interest	19,121.6	2,977.3
Net rental income	1,229.1	191.4
Taxable capital gains	9,315.5	903.7
Total	39,335.9	4,289.6

same level as in 1985, despite a much larger US economy and stronger equity markets in 1994.

REHABILITATING THE TAX REGIME FOR INVESTMENT INCOME

Poddar and English make an important statement: that a significant proportion of investment income exceeds the exemption thresholds and *is taxed at high marginal rates*. We estimate that this taxable income totalled about $10 billion in 1996. The low incidence of taxation, with a federal tax take of $4.3 billion in that year, simply indicates that individual Canadians minimize the heavy tax burden on investment income—it is certainly not evidence of a lightly taxed regime. Interest income is taxed at the high marginal rates that apply on personal income, and capital gains, which are not adjusted for inflationary gains, are taxed at 75 percent of this personal marginal rate.

The tax system for investment income is flawed in several respects and detrimental to capital formation, economic growth, and well-being in the country. The high rate of taxation discourages risk taking in the economy and capital formation in productive enterprise. The high tax rates on labour and investment income have been partly responsible for the collapse in personal savings rates in Canada, as after-tax income has been squeezed by high taxes and slow income growth, and also as high taxes have biased savings in favour of spending.

A serious indictment of the high taxation of investment income in Canada is that it is uncompetitive, particularly compared with the lower tax rates on investment income in the United States. Significant differences in taxation, particularly between countries such as Canada and the United States, with their highly integrated economies, inevitably result in the transfer of capital to the low-tax jurisdiction. Canada can ill afford the loss of scarce investment capital. Capital is migrating in several ways. It is channelled into direct investment in the United States and taxed at source in that country. And Canadians with capital or potential capital earning power are moving south of the border to take advantage of lower US taxes as well as attractive investment opportunities. Tax rates in Canada should arguably be *lower* than US tax rates to compensate for fewer investment opportunities and the prospect of lower pre-tax returns in Canada.

In addition to its high tax rates, Canada's tax system for investment income is inefficient. High tax rates encourage individuals to invest in low-risk, low-yielding debt instruments or in specifically targeted exemptions such as labour sponsored venture capital funds (LSVCCs) to minimize taxes. These targeted incentives distort after-tax returns and tend to misallocate capital to less-than-optimal investments. Furthermore, high tax rates on capital gains tend to freeze capital in existing assets to avoid taxation, and in this way restrain capital from migrating to productive investment as economic conditions change. For example, individuals have been reluctant to sell financial investments, particularly equities and non-financial investments such as income properties, that have appreciated in value—even if attractive investments exist elsewhere—because of the significant losses in real returns from paying tax at the high capital gains tax rates.

CONCLUSION

The direction for tax policy in respect of investment income is clear. Tax rates on investment income should be lowered to stimulate risk taking and productive capital formation, and to improve the competitiveness of the Canadian tax system, particularly vis-à-vis the United States. Effective tax rates on income, dividends, and capital gains should be lowered. One approach would be to adopt the Nordic DIT system, which would reduce the tax rate on investment income to the lowest federal marginal rate that applies to labour income. Also, the inclusion rate on capital gains should be reduced and taxable gains adjusted for inflation. Furthermore, the tax regime should be overhauled by streamlining the exemption structure to improve tax efficiency. Tax exemptions should essentially be limited to retirement savings and personal residences. Tax exemptions and credits should be replaced by greater reliance on lower capital gains tax rates. Such lower rates would not only provide sufficient incentive for risk investment, but also direct capital to efficient investment by relying on market forces.

The recommendation for lower tax rates on investment income contradicts the fundamental principle that has underpinned the Canadian tax system for over 30 years. But tax rates must respond to the structural changes in markets, which have greatly enhanced the mobility of capital. This integration of the global marketplace makes it imperative that developed countries harmonize their prevailing tax rates, particularly for investment income, to avoid the debilitating impact of capital outflows. Canada's future prosperity depends on a tax system that is responsive to these developments.