Unlocking Canadian Capital: The Case for Capital Gains Tax Reform

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About the Author

Herbert G. Grubel is David Somerville Chair in Taxation and Finance, The Fraser Institute, and Professor of Economics (Emeritus), Simon Fraser University. He has a B.A. from Rutgers University and a Ph.D. in economics from Yale University. He has taught full-time at Stanford University, the University of Chicago, and the University of Pennsylvania; and has had temporary appointments at universities in Berlin, Singapore, Cape Town, Nairobi, Oxford, and Canberra. Herbert Grubel was the Reform Party Member of Parliament for Capliano-Howe Sound from 1993 to 1997, serving as the Finance Critic from 1995 to 1997. He has published 16 books and 180 professional articles in economics dealing with international trade and finance and a wide range of economic policy issues.

Preface

Many economists and entrepreneurs are convinced that the existing capital gains tax regime in Canada is unfair, and is bad for economic growth and prosperity; therefore, it should be scrapped or at least reformed. These views have provided the rationale for a major effort by The Fraser Institute to analyze the economic and distributional effects of capital gains taxes in Canada.

This effort began with a symposium of 25 economists and entrepreneurs, which was held at The Fraser Institute on June 18, 1999. Each participant prepared a short presentation, which responded to the resolution: “Canada’s capital gains tax rate should be equal to that of the United States.”

The discussion at the symposium ranged widely and did not lead to unanimous conclusions. However, the discussion helped me identify the main issues and existing literature. Out of it came the present book in which I present, to the best of my ability, an objective, scholarly analysis of economic theory and empirical evidence surrounding capital gains taxation in Canada.

As I discovered, there was little original Canadian research to draw on. On the issue of the distributional effects, for example, no Canadian study has ever replicated the results from US studies. These studies show that capital gains taxes are paid mainly by those with middle and lower incomes—once the gains themselves are removed from the income of the payers that year. Statistical evidence produced at The Fraser Institute shows that conditions in Canada are very similar to those in the United States.

On the issue of the revenue effects of lower rates or even the elimination of the tax, I had to rely entirely on the US experience since Canada has had only a few, minor changes in rates. As a result, econometric studies of their revenue effects are virtually impossible.

When I was completing my study, the Canadian Senate Committee on Banking, Trade and Commerce held hearings on the future of the capital gains tax. The expert witnesses at these hearings presented much useful information which complements my own study and is easy to read and understand, so I have included the official transcripts of these hearings in the second half of this book.

During the 1999 symposium two issues emerged which are central to any debate over the merit of capital gains taxation. First, it was argued that in the absence of such a tax, Canadians would shift personal and business income into assets, which could then be sold at an appreciated value. Such policies were considered to permit some to avoid taxes and make the entire tax system unfair. The policies would also produce economic inefficiencies.

Second, there was nearly unanimous agreement that inflation leads to inequities and inefficiencies since it causes taxes to be paid on phantom profits. However, many argued against introducing indexation of capital gains to inflation on the grounds that it was administratively too complex and costly.

The problem I faced in assessing the merit of these arguments is that they are not backed by empirical studies in Canada or elsewhere. Yet there are countries that have no or very low rates of capital gains taxation. Some countries index capital gains to inflation. During the 1990s, these counties grew annually at 2.2 percent, while OECD countries not in this group grew at only 1.2 percent. A second symposium will be held at The Fraser Institute in September 2000, at which the issues of income shifting and indexation will be discussed by experts from countries without capital gains, and by countries that index capital gains. I expect the papers presented at this symposium to result in a second Fraser Institute publication.

My thanks go to the John Dobson Foundation for financial support of this study of capital gains taxation in Canada, and to John Dobson for his personal help and encouragement.

—*Herbert G. Grubel*

Executive Summary

The defenders of capital gains taxation in Canada claim that capital gains taxes are needed to raise revenue, make the income distribution fairer, and improve economic efficiency. All three arguments are seriously flawed.

In 1992, the tax brought in about $700 million. This sum was equal to .3 percent of total taxes collected, and 1.9 percent of the personal income tax revenues in Canada. The net revenue is smaller than this amount because the government's costs of collecting the tax are high. The high cost is due to the complex issues surrounding the valuation and timing of capital gains. The tax also imposes high costs on the private sector which attempts to avoid the tax by outwitting armies of government agents and lawyers.

Revenue source

Ironically, the argument that the capital gains tax is needed to raise revenue is perverse. Evidence from the United States demonstrates clearly that lower capital gains taxation rates raise total revenue in the short run because lower tax rates induce the sale of appreciated assets and bring in more tax payments. There is strong evidence that lower rates also induce higher revenues in the longer run, even though taxpayers eventually run out of discretionary opportunities to realize their gains. This outcome depends on greater economic prosperity, which is created by the more efficient allocation of capital and the stimulation to demand fostered by greater wealth. Some distinguished economists, including Alan Greenspan, argue that overall tax revenues would be increased through this mechanism even if the capital gains tax were eliminated completely.

Fair income distribution

The fairness argument for capital gains taxation is based on misleading data. If one considers all sources of taxpayer income, 50 percent of all capital gains taxes are paid by those earning more than $200,000 a year. But if one considers the income sources *other* than capital gains of those who pay capital gains taxes, more than half of the capital gains taxes are paid by those with other, more ordinary incomes below $50,000. In other words, the bulk of the taxes are paid by lower- and middle-income earners who appear in traditional income statistics as high-income earners only in the year they realize the gain.

The capital gains tax introduces an important element of unfairness of its own because it taxes phantom gains that are the result of inflation. Since 1972, the interaction between inflation and capital gains taxation has resulted in very high real rates of taxation. Such taxation was not envisioned by the framers of the tax and has resulted in the virtual confiscation of wealth.

Economic efficiency

The efficiency argument for capital gains taxation is based on the notion that in its absence, business owners will be induced to shift other income such as wages, salaries, rent, royalties, interest, and so on, into the income of firms whose capital value increases correspondingly. The most popular of such methods for increasing the value of firms involves the excessive reinvestment of profits and underpayment of wages. These strategies can lead to the inefficient allocation of capital and the unfair avoidance of personal income taxes.

However, the capital gains tax introduces inefficiencies of its own because it encourages the owners of capital to hold on to it, even if more profitable investment opportunities are available. This lock-in effect depends on owners' investment horizons and the difference between actual and alternative returns. While there are no estimates of the size of the efficiency loss due to the lock-in effect, there is no doubt that it is substantial, and is responsible to a significant degree for the revenue increases observed in the United States in the wake of lower rates of taxation. There is also a strong presumption that the efficiency losses from the lock-in effect are greater than those due to the shifting of other income to generate capital gains, which would occur in the absence of a capital gains tax.

The capital gains tax also results in efficiency losses for Canada because it stimulates the "brain drain" of entrepreneurs and their "financial angels" (those whose advice and finance helps bring the entrepreneurs' inventions to market). These individuals typically accept low incomes in the early phases of their work in the expectation that they will be compensated properly through large capital gains once their start-up enterprise goes public or is sold. The capital gains tax rates in the United States are half those in Canada and attract many Canadian entrepreneurs and angels. Canadian prosperity and government revenues suffer as a result.

Recommendations

In the light of these considerations I recommend that Canada eliminate capital gains taxes. As a second-best policy, I suggest that the rate be lowered to, and kept at, that of the United States. The third best policy is to return the rate to the 50 percent level at which it was introduced in 1972.

The proposed lowering of rates should also be accompanied by a number of changes. One of these involves taxing at a higher rate the retained relative to distributed earnings to reduce incentives for excessive reinvestment of profits. The second suggestion is to index capital gains to inflation. Finally, I recommend the creation of "Registered Investment Plans." These plans are started with after-tax money, but pay no taxes on realized capital gains, and thus reduce the lock-in effect of the capital gains tax.

Part 1
An Economic Analysis of Capital Gains Taxation in Canada

Introduction

At the turn of the twentieth century, Canadian governments are blessed with large fiscal surpluses. Consequently, a widespread debate is taking place over their optimal use.[1] The consensus opinion appears to be that some of the surplus should be used on each of increased spending, debt reduction, and lower taxes, though there is much less of a consensus on the amount of money that should be devoted to each of these policies.

The prospect of lower taxes requires a study of the types of tax cuts to be made. The first chapter of this book argues that one of the priorities for reduction should be the capital gains tax. The analysis begins with an uncritical statement of three rationales for capital gains taxes: to raise revenue, to increase the fairness of the tax system, and to improve the efficiency of capital markets. The later chapters carefully examine the validity of the arguments in favour of the tax.

The second part of the book reprints from the public record the testimony given by a number of experts to the Senate Committee on Banking, Trade and Commerce late in 1999 and early 2000. This material repeats many of the analyses presented in the first part, but it also reveals the priorities and values of witnesses and the senators who question them.

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1 For some data on the projected surpluses and several papers on their use, see Grubel (1998b).

CHAPTER 1
The Rationale for Capital Gains Taxes in Canada

In 1999, Canada had a maximum rate of personal income taxation of capital gains equal to about 40 percent. The following presents the basic arguments in support of this rate.

Raising revenue

To fully appreciate the need for a capital gains tax to raise revenue, a brief review of the history of the tax in several significant countries is in order.

In the **United States**, the first capital gains tax was enacted during the Civil War at the same time that a personal income tax was introduced. These taxes were needed to finance the war, and were terminated when the emergency ended.

Early in the twentieth century, the US government took on a wide range of functions which needed to be financed by tax revenue. For this purpose, in 1913 the 16th Amendment to the Constitution of the United States was passed to legalize personal income and capital gains taxes. For the following eight years, the legality of capital gains taxation was challenged in the courts successfully. However, the government kept on collecting the tax, and in 1921 the Supreme Court decided that the tax was legal. Since then, the economic and political debate has focused mainly on the level of the rate and other details of its application. By and large, increases occurred when budgets were in deficit and decreased when they were in surplus. The ideological leanings of the President and Congress served to exaggerate or modify somewhat this principle for setting the rates.

In **Britain**, capital gains were not taxed even after the introduction of temporary personal income taxes in 1799, 1803, and 1842. The reasons for this treatment of capital gains are not entirely clear. Bartlett (1999)[2] speculates that it may have arisen out of the official position that these taxes were only temporary, so that it was unfair to tax one-time capital gains that might be realized during this temporary tax regime.

The Labour Party in the 1960s finally introduced a capital gains tax in Britain. It did so primarily to finance its social security programs. However, the tax was also introduced for another reason—one which is important in Canada. At the time, Britain had very high marginal income tax rates of 90 percent or more on personal income. To avoid these high taxes, owners of firms reinvested profits at a rate much higher than they would have done otherwise. They also paid themselves and other employees lower salaries and used other methods to increase capital gains, which could be realized without triggering a tax obligation for the companies' owners.

Such tax-evasion manoeuvres tend to have two important effects. First, they cause economic inefficiencies since they often lead to investment in projects within the firm that have a lower rate of return than other projects available in the economy. Second, they reduce the horizontal fairness of the entire tax system in the sense that the owners of the business are able to avoid paying taxes, or at least reduce their tax obligations below those payable by others with an equal amount of other income, such as wages, rent, interest, royalties, and so on.

Canada did not have a capital gains tax until bill C-259 was passed on June 18, 1971, and became effective in 1972 as part of a major overhaul of the entire tax system. As in Britain's case, the introduction of the tax was motivated to a significant degree by the need to finance the growing costs of the social security system and of general government spending. This expansion of the role of government in Canada during the 1970s was driven by an intellectual and political elite determined to copy the social democratic model, which was believed to operate successfully in Sweden and other industrial countries of Western Europe.

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2 My presentation of the history of US and UK taxation relies on this publication.

In sum, one of the main motives for imposing capital gains taxation in Canada, the United States, and Britain was financial need. During the nineteenth century, this need was caused by national emergencies. After the Second World War, especially in Britain and Canada, the need stemmed from the desire to implement the welfare state.

Levelling the income distribution

The second, and perhaps most important motive for introducing the capital gains tax in 1972, was the desire to create a fair system of taxation. To achieve this, the tax system aimed at assuring horizontal equity, which means that people with the same income paid the same amount of taxes. If one considers capital gains to be like other income, then capital gains need to be taxed. In addition, fairness was to be assured through the use of progressive income taxes, which impose progressive marginal tax rates to exact higher payments according to the ability to pay. During the post-War years, the top marginal rate of personal income taxation was 80 percent.

It may be worthwhile to illustrate briefly the concept of horizontal equity with a simple example. Consider George, who has a $100,000 salary, and Sally who earns an $80,000 salary, plus, in one year, $20,000 through the sale of an appreciated asset. (Such a capital gain may arise from the sale of shares worth $220,000 with an original cost of $200,000. Assume that after the realization of the gain, $200,000 is immediately reinvested and cannot be used for consumption.) If income is taxed at 40 percent, George pays a tax of $40,000. In the absence of a capital gains tax, at a 40 percent tax rate, Sally pays only $32,000. Yet both George and Sally that year have earned a cash income of $100,000 before taxes. Under the concept of horizontal equity, George and Sally should be paying the same amount of tax. This objective is achieved if Sally's capital gain is taxed along with her salary.

Horizontal equity also requires the elimination of special tax breaks which have enabled some to escape the high statutory personal income taxes. These tax breaks had proliferated during the first two decades after the Second World War because they were seen as a powerful instrument to direct spending and investment into socially desirable channels. But economists consider such tax incentives to be inefficient since they erode the tax base, requiring higher distortionary rates for other taxes. Such breaks are also seen by many as a hidden method of providing politically motivated subsidies to special interest groups, which escape the normal scrutiny given genuine expenditures constrained by existing budget revenues.

The absence of a capital gains tax in the post-War tax regime was seen to be one of these tax concessions, which provided inappropriate incentives and allowed high earners to escape the taxes they were supposed to pay.

The Carter Commission was designed to correct these Canadian tax system deficiencies. It recommended lowering the top marginal tax rate to 60 percent. It also recommended adopting a capital gains tax and eliminating many tax concessions that had crept into the tax code to direct resources into uses considered desirable by politicians, but which had turned into tax loopholes enabling the rich to avoid paying high marginal income tax rates. It was expected that under the proposed tax regime the *effective* rate of taxation on high-income earners would be raised, and the after-tax distribution of income would become more equal, even though nominal top marginal income tax rates were lowered from 80 to 60 percent. The entire system was to be both more efficient and "fairer" in the senses described in the preceding paragraph.[3]

The main provisions of the capital gains tax enacted in 1972 were that 50 percent of gains were included in reported income and taxed at the taxpayer's top marginal rate. With the highest marginal rate at 60 percent, and the exclusion rate at 50 percent, capital gains in effect were taxed at a maximum of 30 percent of their value. To exclude those with lower incomes from paying capital gains taxes, and to minimize the costs of administration, only capital gains in excess of $1,000 were taxed. No capital gains were due on the sale of homes and farms, nominally for social reasons, but motivated mainly by the fact that taxing these assets was very unpopular and fell on many in the lower and middle income groups.

For the purposes of later analysis it is important to note that the Carter Commission drew heavily on the work of Robert Haig (1921) and Henry Simons (1938), two highly respected US economists. They argued for the broadest possible definition of income as the base for taxation. According

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3 For a review of the Carter Commission Report and its objectives, see Bird et. al. (1999), especially Chapter 4, "The Legacy of the Carter Commission." The book also discusses the role played in the work of the commission by Douglas Hartle, who was its director of research.

to Haig and Simons, a person's annual income consists not only of the salary, wages, dividends, and interest earned during the period, but also includes the imputed value of services from the ownership of consumer assets like homes and automobiles[4] and capital gains, which accrued during the tax year. In passing the 1972 tax reform in Canada, politicians cherry-picked the Carter Commission recommendations. They chose to exclude from the tax base imputed income from consumer assets, and to make the capital gains tax payable only upon the realization of the gains, not their accrual. And, as already noted, they excluded capital gains on homes and farms.

The Carter Commission report was received enthusiastically by those demanding that the tax system be "fair." They made much of the need for horizontal equity by effectively using the slogan that "a buck is a buck" and that all bucks (of income) had to be taxed. They also emphasized the need for vertical equity by emphasizing that the capital gains taxes would fall mainly on the rich owners of business, who are able to pay them without hardship.

Data from the tax year 1992 in Canada may be used to illustrate the apparent validity of the proposition that capital gains taxes are paid by the rich. Individuals with incomes over $100,000 in 1996 paid 78 percent of all capital gains taxes received by the government of Canada. Those with incomes over $50,000 paid 92 percent of the total.[5] In assessing these figures, it is important to remember that the median family income in Canada in 1992 was $47,719 (mean $53,676).[6] For income earners consisting of families and unattached individuals, the median and mean

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4 Sweden, on its road to socialism during the 1970s, accepted the Haig-Simons definition of income to the fullest. It required income taxes on the imputed income from owner-occupied housing.

5 Fraser Institute Research Economist Joel Emes estimated this figure. To do so, he used the Social Policy Simulation Database and Model developed by Statistics Canada. During The Fraser Institute conference on capital gains taxation, Don Drummond, Associate Deputy Minister of Finance, indicated that families with incomes over $200,000 paid 50 percent of all capital gains taxes.

6 Half of all taxpayers have incomes below and the other half have incomes above the median. The mean income is calculated by dividing total taxable income by the number of taxpayers. It is higher than the median because the total includes some very high incomes.

incomes in 1992 were $36,710 and $44,042, respectively. That year only 8 percent of all families had an income over $100,000. Families and unattached individuals with income above $100,000 made up only 5 percent of the total.[7] The critical analysis below shows that these data are very misleading because most Canadians who pay capital gains taxes do so only once in their life, and in other years have much more moderate incomes.

Avoiding the loss of economic efficiency

The Carter Commission also drew attention to the inefficiencies caused by the existence of high personal income taxes and zero capital gains taxes. As noted above, this condition creates incentives for the excessive reinvestment of profits and other methods for shifting other income into businesses to increase their capital value. Professional economists have always considered this argument for capital gains taxes to be the most important and persuasive. They think this way mainly because such investment leads to the loss of output. For example, a firm's internal investment of profits may have a yield of only 10 percent, while outside investment might yield 15 percent. On a million dollars of profits reinvested internally rather than in the market, society loses $50,000 annually in output. Multiplied by the billions of dollars in business profits in the entire economy, the output losses are potentially very large. These social losses occur even though investors gain individually. The villain in the piece is the distortions caused by the structure of the tax system.

The losses of output caused by these tax distortions are a pure waste. They are in stark contrast to taxes on income or dividends, through which money is taken away from one group of Canadians but given by the government to other Canadians through social security benefits, the provision of public goods, or other expenditures. At a symposium on the possible reform of capital gains taxation held at The Fraser Institute in June 1999, the majority of economists present viewed the avoidance of the loss of efficiency as the most important argument in favour of capital gains taxation. Those opposing capital gains taxation noted that its existence caused similar efficiency losses, such as the lock-in of capital in existing and low yield use, and consequently argued that society is no better off. I will elaborate on this point below.

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7 These data are from Statistics Canada, *Income Distributions by Size in Canada, 1992*, cat. 13-207.

It should also be noted that the avoidance of personal income taxes through the shifting of other income into businesses for capital gains also reduces the fairness of the tax system in two ways. The very absence of capital gains taxation reduces horizontal equity because capital gains are not counted as income. In addition, the shifting of income into capital gains reduces vertical equity because those with high incomes avoid the payment of the progressive, high taxes the system demands. These issues have been discussed in the preceding section, but it is important to remember that the efficiency and equity arguments are linked inextricably.

In sum, there are three reasons used by politicians and some economists to justify the existence of capital gains taxation in Canada. First, the tax revenue is needed to finance general government services, social insurance programs, and subsidies. Second, the tax is needed to achieve horizontal and vertical equity in the distribution of incomes. Third, the capital gains tax is needed to reduce the inefficient use of capital, which is induced by incentives to shift other income into businesses for capital gains.

CHAPTER 2
A Critique of the Revenue-Raising Function

Any evaluation of the revenue-raising function of the capital gains tax must start with information about the amount of money the tax raises. If it contributes much to total revenue, it may be worth having even if it is undesirable on other grounds. If it produces little revenue, it may be worth lowering or eliminating, even if it causes some inequities and inefficiencies.

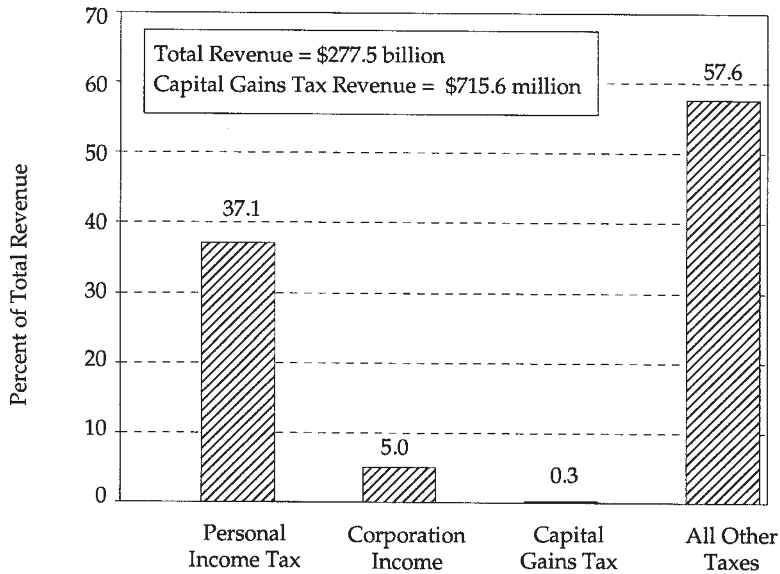
One would expect to find information about the capital gains tax revenue in government publications. Unfortunately, this is not the case. No information about it is included with the annual budget plan tabled by the Minister of Finance, which has data on revenue collected through the personal and corporate income taxes, sales taxes, import tariffs, and employment insurance. Estimates for capital gains tax revenue are conspicuously absent.

A search of other information sources at the Department of Finance, Statistics Canada, and international agencies, yields the same results. In 1998, the OECD published capital gains revenue statistics for its member governments. There were no statistics for Canada. It is obvious that the government of Canada has no official, published data on the revenue from capital gains taxation.

A personal inquiry at the Department of Finance about the data brought the recommendation to estimate the revenue from either of two published sources of statistics. One of these is the so-called Green Book, which annually gives summaries of Canadian income tax returns. Another source is the Social Policy Simulation Data Base and Model issued by Statistics Canada (SPSD/M).[8]

Joel Emes of The Fraser Institute used the SPSD/M to estimate the 1992 capital gains tax revenue collected by Revenue Canada for the federal

Figure 1: All Sources of Revenue, All Levels of Government, 1992



Sources: *The National Finances 1994*, Canadian Tax Foundation, Table 4.1; and Social Policy Simulation Data Base and Model, Statistics Canada.

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8 Efforts to obtain US statistics on capital gains were quickly successful. The OECD publication provided data for a few recent years. A call to the US Treasury Department led easily to a person who promptly faxed a long time-series on US capital gains.

At The Fraser Institute symposium in June 1999, Donald Drummond, Associate Deputy Minister of Finance, provided estimates of capital gains tax revenues in Canada for the years 1993-97. He noted that this information is available to anyone asking for it. Fraser Institute Research Economist Joel Emes' experience contradicts this assertion.

The table of data given to me by Drummond does not provide information about the methodology used in deriving the figures. Also, it gives "estimated" capital gains tax revenues collected from corporations. Why was the word "estimated" attached to this number? Are other numbers not estimated? I was under the impression that all revenue statistics are estimated, but of course, I could be wrong.

and provincial governments. It is instructive to discuss the calculations needed to make the estimate. The database reports for a sample of 76,000 taxfilers actual data or estimates of their total income from all sources and the amount of taxes paid. The ratio of the two equals the average tax rate. The database also gives the capital gains and losses realized by every taxpayer. The average tax rate was applied to the realized capital gains minus losses, and resulted in an estimate of the individuals' capital gains taxes paid.[9] The data package allows the results from the sample to be scaled up to reflect the total of all Canadian taxpayers.

Our calculations show that in 1992, the capital gains tax revenue shared between the federal and provincial governments was $716 million. This absolute dollar value is shown in relation to the values of some other government revenue sources in figure 1. As can be seen, in 1992 total revenues were $278 billion. Personal income taxes brought in $103 billion. Thus, capital gains revenues were equal to 0.3 percent of the total, and 1.9 percent of personal income tax revenues.[10]

Poddar and English (1999) put capital gains revenue in yet another useful perspective, which is shown in figure 2. They estimated that in 1996, federal taxes paid on *investment* income amounted to $4.3 billion (out of total revenue of $136 billion). Of this total, capital gains taxes were $904 million, or 21.1 percent.[11] Personal income taxes paid on interest made up 69.4 percent of the total, and dwarf the taxes paid on dividends and rental income.

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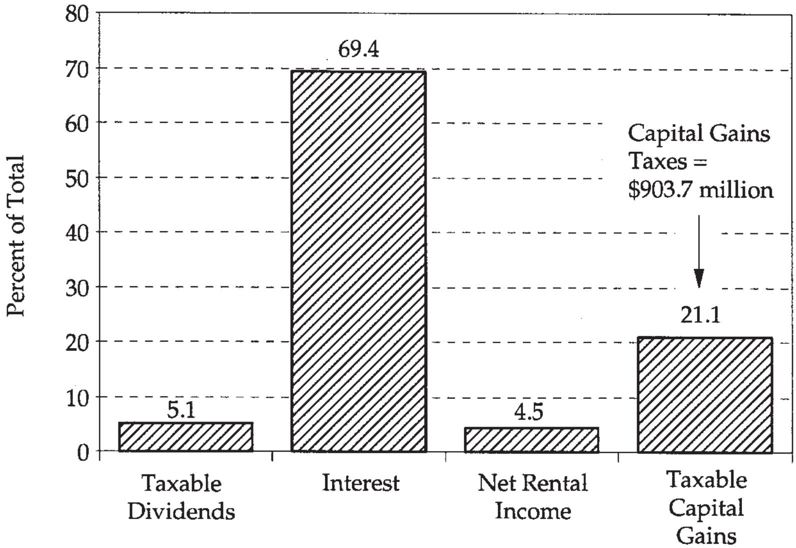
9 More precisely, we calculated for every taxpayer the following ratio: (taxable capital gains minus exemptions minus allowable losses from previous years) divided by (total income for tax purposes). We then multiplied this ratio by the personal income taxes paid to derive the estimate of the capital gains taxes paid. A more correct calculation of the capital gains taxes paid should apply the payers' marginal, not average tax rate to the realized gains. However, it is unlikely that this more precise calculation would raise the estimate by a significant amount.

10 Estimates of capital gains made by other private organizations for other years are very similar to those produced by Emes. See Hall (1999), and Poddar and English (1999).

11 The figure of $904 million given by Poddar and English contrasts with the $1,700 million found in the document supplied by Drummond and noted in footnote 5.

Figure 2: Components of Investment Income, 1996 Tax Year, Total $4.3 Billion Federal Taxes Paid



Source: S. Poddar and M. English, "Canadian Taxation of Personal Investment Income," *Canadian Tax Journal*, Canadian Tax Foundation, forthcoming.

The available information on the revenues from capital gains taxes suggest that they are small relative to the main other sources of revenue and the size of surpluses at the turn of the century. Therefore, eliminating or reducing the capital gains tax rate would not have a significant impact on the overall fiscal balance or the surplus available for spending increases, debt reduction, or other tax cuts. This fact has been confirmed by the *1999 Fiscal Update*, published by the Department of Finance. Lowering the inclusion rate of capital gains from 75 percent to 70, 65 and 55 brings revenue losses of $175, $375 and $800 millions, respectively. I return below to a further discussion of this estimate.

The cost of administration

Rational tax policy for revenue should consider not the gross amount raised, but the net amount after the government and private sector costs of administering it. As it turns out, the cost of collecting capital gains taxes is relatively high. There are many conceptual and practical problems in determining the size of capital gains. Most of these stem from the valuation of the assets when the tax was introduced or the assets were acquired. For many privately-held firms, who hold real estate, collections of art, and other goods in their portfolios, the true value of the assets the day the capital gains tax came into effect in 1972 is not known because they were not traded and there are no other, unambiguous ways of establishing value. The problem of valuing assets upon "deemed realization," which comes into effect when estates are probated, give rise to similar problems. Many types of assets have no ready market, and valuations involve important subjective elements, which government regulations must limit.

For this reason, a large proportion of Canada's tax code consists of regulations designed to clarify the valuation and timing of capital gains. The government uses many agents, accountants, and lawyers to monitor and enforce the relevant parts of the code. The private sector spends much money trying to stay ahead of Revenue Canada's attempts to close loopholes.

Unfortunately, it is not possible for outsiders to estimate the government and private costs of administering the capital gains tax in Canada and compare it with the same ratio for other forms of taxation. I urge the Minister of Finance to demand that his staff in the Department of Finance prepare such a study.

It would not come as a surprise for economists if such a study showed that the capital gains tax has one of the least favourable ratios of cost to revenue collected. The reason is that incentives to shift resources into other countries and holdings produces more such shifts the more mobile a factor of production is. For this reason, taxes on land are considered to be efficient. Owners cannot avoid paying taxes on it by moving or hiding it. Conversely, for this reason, taxes on capital are among the least efficient.

The dynamics of capital gains taxation— the short run

Most discussion over the desirability of a tax rate cut assumes implicitly that a cut would result in revenue losses. This is an intuitively appealing proposition. After all, if the taxation rate is lowered, taxpayers have to pay less on a given capital gain. Therefore, revenues will be reduced. However, this conclusion is unwarranted because taxpayers change their behaviour in response to tax rate changes. Such changes can be so significant that at the lower tax rate revenues remain unchanged, or even increase.

Such counter-intuitive increases in revenues after a decline in tax rates occurs both in the short and in the longer run. In the short run, the phenomenon stems from the fact capital gains taxes are due at the discretion of taxpayers. While income taxes have to be paid when income is earned, taxpayers can avoid paying capital gains taxes simply by not selling assets that have appreciated in value. As a result, taxpayers are able shift their sales to periods when rates are low and delay them when rates are high. Many delay realizations for as long a they can, which means that upon their death, the gains are deemed realized and heirs of the estate pay the taxes.[12]

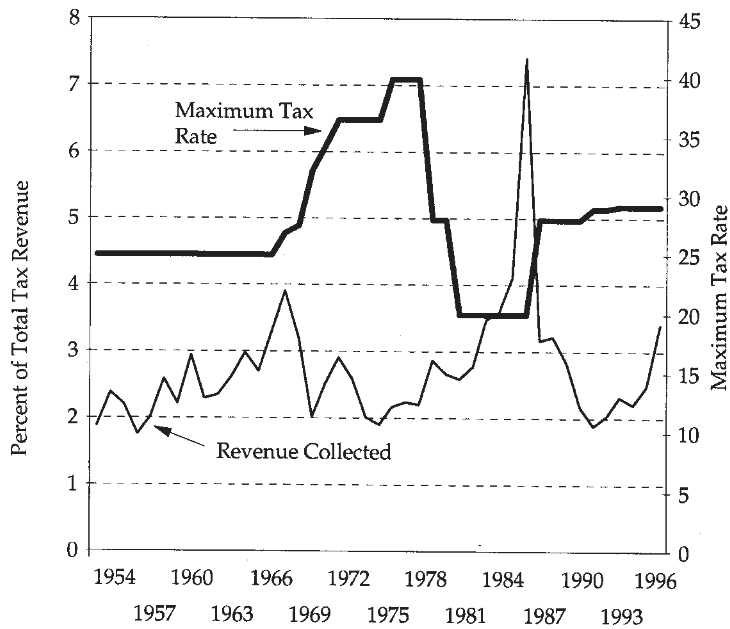
There is strong empirical evidence from the United States in support of the hypothesis that lower rates cause revenue increases. Figure 3 provides the evidence clearly. It shows US statutory rates of capital gains taxation and revenues since 1960. The revenues are adjusted for economic growth and inflation by expressing them as a percent of total government tax collections.[13] As figure 3 shows, revenues fell when rates increased in 1968 and 1987. Revenues went up when rates were lowered in 1977. The spike in revenues in 1986 occurred after the announcement that the rate would be raised from 20 percent to 27 percent in the following year.[14]

12 It is interesting to note in this context that the shifting of realizations of capital gains is not possible if taxes are due upon their accrual rather than the sale of the appreciated assets. The Carter Commission had recommended that taxes be paid upon accrual. However, as will be discussed at greater length below, this policy forces firms to sell assets every year or use normal profits to meet the tax obligations. When the legislation was drafted after the release of the Commission's report, the government accepted business' arguments that accrual taxation was unduly disruptive for business and threatened prosperity.

13 It may be useful to put US revenues into the following perspective. In 1992, US capital gains taxes raised $32 billion, which was equal to 32 percent of the corporate income tax revenue, 7.7 percent of personal income taxes, and 2.9 percent of total revenues. Source: *Historical Tables* (1996).

14 The US Treasury did not provide me with data for 1997 and 1998 because the revenue data are available only with a considerable lag. These data are of special interest since in 1997 the statutory rate was lowered from 28 to 20 percent, and some preliminary data suggest that there was an upsurge in realized gains and revenues.

Figure 3: US Capital Gains Taxes as Percent of Total Revenue



The information contained in the simple graph has been confirmed by more rigorous studies: a number of econometric studies used time series, cross-section, and panel data to measure the effects of changes in capital gains tax rates on revenues. These studies were reviewed by Zodrow (1993) (1995), Auten and Cordes (1991), and Reynolds (1999). These reviews came to the same conclusion, best summarized in the review by Auten and Cordes: "Cross-section and panel studies generally imply that the elasticity exceeds –1.0" (p. 185). In non-technical words, these findings imply that reductions in capital gains tax rates increase total revenue while rate increases lower revenues.[15]

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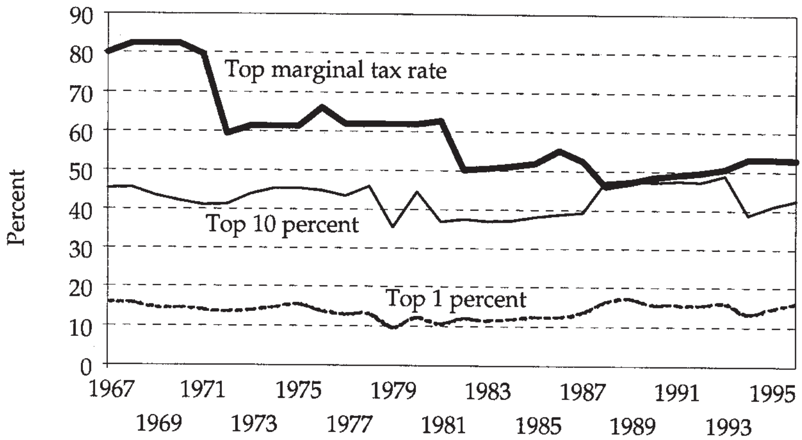
15 Elasticity is a measure of the responsiveness of one variable to a change in another variable. An elasticity of zero means that the lowering of a tax rate by any percentage does not raise revenue at all. An elasticity of minus one means that a 10 percent cut in the rate results in a 10 percent rise in revenue. Therefore, an elasticity of minus one implies that the revenue collected is the same at the lower and higher tax rate. An elasticity greater than minus one implies that the lowering of the tax rate raises revenue and an increase in taxes raises it. See the text below for the argument that elasticities change with the level of income estimates.

Figure 4: Percent of All Income Taxes Paid by Top Income Earners in Canada and Top Marginal Income Tax Rates



Note: The top marginal tax rate is the combined federal and provincial marginal rate for Ontario, for a single a taxpayer from 1993-1989. Source: Canadian Tax Foundation, *The National Finances 1994*, Table 7.13, p. 7:21 for 1993, and equivalent tables from the same publication 1967-88. Between 1967-1988 the tables did not specify that the taxpayer was single. The top 1 and 10 percent of all taxpayers were estimated from the total number of returns. The provincial and federal taxes paid by each group are expressed as a percent of all these taxes paid. Source: Revenue Canada, *Tax Statistics on Individuals 1995*, Table 2, p. 68 for 1993, and equivalent tables from same publication 1967-92.

Unfortunately, equivalent empirical studies for Canada are not available because there have not been enough changes in rates, the government does not publish information on revenues, and there has been no academic and government interest in the subject. However, some related empirical evidence is available and shown in figure 4, which plots through time the top marginal personal income tax rate and the share of all taxes paid by the top 10 percent and top one percent of all taxpayers. As the figure shows, the fairly steady decrease in the top marginal tax rate from about 80 percent in 1971 to slightly above 50 percent in 1993 has left virtually unchanged at around 50 percent the shares of taxes paid by the highest 10 percent of income earners.[16]

The counter-intuitive fact about the lack of influence of lower marginal personal income tax rates on the amount paid is due to two different factors. First, each tax rate reduction was accompanied by the closing of loopholes. Therefore, the lower tax rate was applied to a broader tax base. Second, taxpayers reacted by changing their behaviour. Tax evasion and avoidance, working in the underground economy, or outright cheating, which were worth the cost and risk at high tax rates, tended to be no longer worthwhile. In addition, the lower tax rates induced greater work effort, investment, education, and risk-taking. Unfortunately, no studies have been made of the relative importance of the broadening of the tax base and the dynamic adjustments in behaviour.

The basic incentive to shift the realization of capital gains to take advantage of lower tax rates is as strong in Canada as it is in the United States; in fact, it may even be stronger because Canadian tax rates are higher than those in the US. Canadians are no different from Americans in their desire to keep as much of their wealth as possible from the clutches of the government. The US evidence on the effect of these incentives suggests, therefore, that lower capital gains tax rates in Canada would similarly bring higher revenues, at least in the short run, possibly over a year or two.

Dynamics in the longer run

Many economists argue that the higher revenues at lower tax rates reflect opportunistic shifts in the realization of capital gains, and cannot last indefinitely. The stock of postponed realizations must run out eventually. Through time, fewer and fewer realizations take place. In the longer run, wealth-holders eventually draw on their assets to finance retirement. They do so of necessity, regardless of the capital gains taxes they have to pay. To the extent that unrealized gains continue to exist at death, capital gains taxes are due on their estate and their heirs have to pay it.[17]

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16 I have asked many people about their knowledge of the shares of all income taxes paid by the rich and how it has developed in response to lower marginal tax rates. Many, including my economist colleagues at Simon Fraser University, believed that the share of taxes paid by the rich was very small and falling. A minority, especially those in managerial positions in business, had the right answers.

17 When the capital gains tax was introduced in 1972, it was possible to put assets into trusts, which could be passed on to heirs without deemed realization of capital gains upon death. This loophole has been closed by limiting such tax-free inheritances through trusts to the grandchildren of the creator of the trust. In addition, shifts of trusts abroad trigger the tax obligation.

However, there are also many economists who believe that lower capital gains taxes will increase revenues in the longer run as well. Their conclusions are based on the argument that the lower capital gains tax rates induce increased work effort, investment, and risk-taking, and shrink the underground economy.[18] Incentives to acquire higher skills lead to more and better schooling. There will be increased geographic mobility of capital as it flows out of areas with high into areas with low or no capital gains taxes.

The complete range of effects of lower capital gains taxes is not easily foreseen. History abounds with examples about the pervasive effects of taxation. After the elimination of the medieval property tax based on the number of windows in one's home, houses were again built with the number of windows their owners preferred to take advantage of daylight and allow fresh air to circulate.

The main point is that lower capital gains tax rates are certain to increase Canada's economic productivity in the longer run. The big, unresolved question is whether such productivity gains are sufficiently large and so broaden the tax base that lower capital gains taxes generate permanently higher government revenues.

This empirical question is not unique to capital gains taxation, but also applies to the overall levels of taxation. The question has given rise to much controversy in the United States. On one side of this debate are the so-called "supply siders." They point to the tax cuts under President Ronald Reagan in the early 1980s as the driving force behind an unprecedented 8-year peacetime economic boom. They also argue that the tax increases in 1987 under President George Bush slowed the economy and lowered tax revenues.

The critics of supply-side economics suggest that the economic growth and higher tax revenues under President Reagan were due to the effects

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18 Lippert and Walker (1997) provide estimates of the size of the underground economy as well as the way in which taxpayers change their patterns of behaviour. For example, some people who presently repair their own homes and cars, will find it profitable at the lower tax rate to work in their own occupation and hire someone to do the repairs. Cheating on taxes through the non-reporting of income, barter, and cash transactions is lessened because the lower return from doing so makes it no longer worth the exposure to the risk of getting caught, fined, and possibly going to jail.

of stable prices, which followed the tight monetary policy administered by Paul Volcker in the early 1980s. They also argue that the Reagan boom was fed by traditional government deficits, which were caused by an increase in expenditures on the military, which more than used up the growing tax revenues. The experience under Bush is dismissed with the assertion that the economic decline was caused by normal business cycle developments and that without the tax increases the deficit would have been even larger.

The study of the long-run effects of capital gains tax rates on revenues and economic growth has similarly resulted in different conclusions. This is not the place to review individual studies. Instead, we draw on the conclusions of economists who have dealt with the issue in great depth.

On one extreme is the recently published book by Leonard Burman (1999), which draws heavily on the findings of a study co-authored by Burman with Randolph (1994). The author is pessimistic about the prospect that lower capital gains tax rates pay for themselves. In technical terms, the co-authored study found elasticities in the range of .3, which implies that lowering the tax rate by 10 percent brings a decrease in revenue of 3 percent in the longer run.[19]

The press release that accompanied the publication of Burman's book talks about the myths surrounding capital gains taxation. One of the alleged myths is: "Lower tax rates on capital gains pay for themselves because investors are willing to sell many more assets at low rates, thus generating additional tax revenues." The author claims the following to be the reality: "Careful research shows that, while the timing of capital gains is very sensitive to temporary variation in tax rates, overall realizations of capital gains are surprisingly insensitive to permanent changes in rates." He also concludes that low tax rates do improve risk-taking and

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19 The 10 percent reduction is merely illustrative. In fact, elasticities tend to be higher, the higher is the base rate to which the reduction is applied. For example, lowering the rate by 10 percent from a base of 20 percent, which brings the level to 18 percent, is likely to elicit a smaller response (and therefore larger reduction in revenues) than a 10 percent reduction from a base of 40 to the new level of 36 percent. This difference in response rate is due in part to the fact that the absolute level of reduction in the former case is less than in the latter. It is also due to the to the fact that at the lower rate, it pays less to engage in shifting through time than at the higher base rate.

investment in stocks, but "they also encourage investments in tax shelters that waste scarce physical and human capital."[20]

In a respected review of the literature, Zodrow (1995) examines the existing studies of the long-run effects of lower taxes on revenues. The estimates he reviewed are based on time series and cross-section data. He finds that the long-run elasticities reported by researchers have a range of slightly below 1.0 to considerably over 1.0, but that the average is greater than 1.0. In other words, the econometric evidence suggests that in the longer run, a 10 percent reduction in the capital gains tax rate leads to a reduction of at least 10 percent in revenue. The Burman-Randolph study is at the extreme lower end of this range of estimates studied by Zodrow, but Zodrow attaches considerable weight to it because of the usefulness of the panel data. Such panel data trace through time the behaviour of a sample of taxpayers and therefore contain information not available in time series and cross-section data.

At the 1999 Fraser Institute symposium on capital gains taxation, Zodrow presented an update to his 1995 publication. In it, he noted that Auten (1999) used the longest panel data yet available (12 years) and employed the same estimating techniques as did Burman and Randolph. Auten found an elasticity of .7, which implies that in the longer run, a 10 percent reduction in tax rates results in a 7 percent reduction in revenues. The review of a large number of studies leads Zodrow (1999) to the following conclusion: "[These findings] suggest a rough guide to policy-makers—a capital gains tax rate cut is very likely to yield a large short run realizations response more than sufficient to result in increased revenues, coupled with a long run realizations response that is significant but still implies a revenue loss" (p. 4).

On the other extreme of recent reviewers of the evidence on capital gains tax rates and revenues is Reynolds (1999). He concludes: "On average, the studies indicate that a 1% reduction in the (relatively low) US tax rate could be expected to result in a permanent increase of nearly 1% in annual realizations of capital gains" (p. 15).

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20 These quotations are from the press release issued upon the publication of the book Burman (1999). They are found on the web site of the publisher, The Brookings Institution in Washington: www.brookings.org/pa/ books/ burman0599.htm

All of these studies by economists, which concentrate on the effect of changes in the capital gains tax rate on revenues, miss the important point that the stimulation to the overall economy through greater efficiency also increases income, sales, and other tax revenues. The relevant question, therefore, is the extent to which the revenue gains from all other taxes match or exceed the losses from the lower capital gains tax rates.

I believe that the answer to this important question is responsible for the views held by two distinguished Americans who are very experienced in dealing with the issues and presumably have drawn on the best available, broad economic advice.

> The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital…the ease or difficulty experienced by new ventures in obtaining capital, and therefore the strength and potential for growth in the economy.
> —*President John F. Kennedy, Special Message to the Congress on Tax Reduction and Reform, January 24, 1963*

> The point I made at the Budget Committee was that if the capital gains tax were eliminated, that we would presumably, over time, see increased economic growth which would raise revenues for the personal and corporate taxes as well as the other taxes we have. The crucial issue about the capital gains tax is not its revenue-raising capacity. I think it is a very poor tax for that purpose. Indeed, its major impact is to impede entrepreneurial activity and capital formation. While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. I argued that the appropriate capital gains tax rate was zero.
> —*Federal Reserve Chairman Alan Greenspan in testimony before the Senate Banking Committee on February 25, 1997.*[21]

Comment on Canadian conditions

I offer the following comments from a Canadian point of view on the literature reviewed by Burman, Zodrow, and Reynolds. First, the elasticity estimates are based on US tax rates and economic conditions. This fact

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21 The quotations by Kennedy and Greenspan are found in Joint Economic Committee (1999).

has implications for both the short- and long-run estimates of elasticities in Canada. In the short run, the revenue increases in response to tax cuts can be expected to be larger than those in the United States because we have a larger stock of unrealized capital gains. This is so because a tax rate of 40 percent yields a higher return to keeping capital gains locked in than does the US rate at 20 percent.

In the longer run, the efficiency gains from lower taxes in Canada can be expected to be larger than the US gains. This is so because at the much higher Canadian tax rates, the economic distortions and inefficiencies are much greater. Therefore, the gains in output and revenues are likely to be much larger.

Second, supply-siders who argue that general tax cuts result in higher revenues believe that the lower rates stimulate economic growth through more work effort, investment, training and risk-taking, as was discussed above. The main reason supply-siders have not been able to persuade everyone of the merit of their position is the notorious difficulties encountered in efforts to measure the many determinants of longer run economic growth. These growth factors include capital formation, the labour force, education, infrastructure, the legal environment, freedom, technological advances and cyclical factors, to name just the most important.[22] It is even more difficult to establish empirically how these determinants of economic growth interact with taxation and create additional distortions.[23] A further and difficult empirical question involves the rate at which the distortions are eliminated once lower taxes are adopted.

The existing studies of the link between capital gains tax rates and tax revenues have not paid the needed attention to the effects that such tax cuts have on economic growth and the greater revenues brought about by the higher economic growth. For example, sets of panel data, which trace the incomes of taxpayers through time, simply do not contain needed information about structural changes in the economy. It is also not possible to take account of the extent to which the individuals have changed their behaviours or how personal attitudes, education, and general economic developments have affected their average incomes. In section 4 below, I discuss at some length the nature and strength of the effects which capital gains taxes specifically have on economic effi-

22 For a review of these issues see Law (1999).

ciency and growth. In this context, probably the neglect of these factors has biased downward the estimates of the effect of lower tax rates on revenues.

Third, related to the preceding point is the fact that lower tax rates raise the value of stocks in capital markets. Consider a firm with a given expected stream of future income, which discounted to the present determines the value of its shares. Now assume that the outlook for the firm's profits increases unexpectedly by a certain amount. As a result, the firm's share price goes up. By how much depends on whether or not the shares are subject to capital gains taxation and on how long the investor intends to hold onto the asset.

If the sale of the assets triggers a capital gains tax, in general investors value it less than if it did not. The higher the capital gains tax rate, the lower is the valuation of the shares for any given expected increase in the company's future income.[24] It follows, therefore, that a lower capital gains tax rate in Canada will raise stock market values and set off a virtuous cycle. Consumers will spend more since they have to save less to reach a desired nest egg for their retirement. The increase in consumer spending in turn will raise profits, business investment, government revenues, and economic growth. The accompanying lower unemployment and fiscal imbalances further increase the confidence of consumers and cause them to spend still more. In a virtuous cycle, improvements of

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23 Gerald Scully (1995) (1996) used a different and direct approach to the study of the effect of taxation on economic growth. He focused on the simple historic relationship between the two variables in the United States and New Zealand. Chao and Grubel (1999) used Scully's methodology to study the relationship for Canada. The argument in these papers is that at low levels of taxation the disincentive effects are less than the beneficial effects of spending on growth. However, as taxation and spending go up, the relationship is reversed. The disincentive effects outweigh the gains from spending on infrastructure and other productivity-enhancing projects.

The studies by Scully and Chao and Grubel show that present levels of taxation in the three countries studied are above those needed to maximize economic growth. These findings imply that lower taxes will increase economic growth and may raise revenue. Grubel and Chao found than in Canada, the optimal level of taxation is 33 percent of national income for all levels of government.

24 For a more complete analysis of this relationship, see Appendix B.

all of these factors further add to prosperity and higher stock market values. Lower costs of capital brought on by these developments will encourage more investment and raise labour productivity in the longer run and permanently.

During most of the 1990s the US economy has prospered and grown much more than has the Canadian economy. The preceding analysis suggests that at least a part of this difference in performance is due to the much lower capital gains tax rate in the United States. If this conclusion is correct, and especially if the US boom has brought permanently higher productivity and output, the lower US capital gains tax rates are directly responsible for much of the higher revenues collected by the US government during this period, and which are expected to last for several more years. My analysis strengthens the case of supply siders and those who believe that lower capital gains taxes lead to higher revenues from that tax.

Fourth, Canada has two mechanisms which affect the taxation of capital gains in an economically significant way. Under one mechanism, taxpayers and employers are permitted to set aside annually a legally determined maximum fraction of earnings. The income is before taxes and the funds are registered with the government. The funds have technical names like Registered Savings Plans (RSPs) and Registered Retirement Savings Plans (RRSPs). Income earned on these investments through interest, dividends, and capital gains are not taxable. Taxes are owed on the entire portfolio when the funds are dissolved or withdrawn for retirement. At that point, they are taxed at their owners' personal income tax rates.

Because of this treatment of capital gains in RRSPs, a substantial fraction of Canada's total capital gains is not taxed. These funds, therefore, are not subject to incentives to time their realization in efforts to minimize capital gains taxes. To the extent that proportionately Canada has a larger share of private pension funds in such investment vehicles than the United States, US estimates of the effect of capital gains tax rates on realization are higher than those likely to be realized in Canada. The extent of this bias is not known.

Second, Canada has a real estate rollover provision in the act regulating capital gains taxation. Thus, Canadians who sell appreciated real assets, such as land and buildings, do not have to pay taxes on their capital gains if, within 6 months of the sale, they reinvest the proceedings in a similar asset worth at least the same. These provisions are quite restrictive in practice since they apply only to reinvestment in narrowly defined functions. Nevertheless, this rollover provision also reduces incentives to time realizations in order to avoid capital gains taxes. This feature of the Canadian tax law, to the extent that an equivalent US law does not match it, also suggests that the short-run revenue gains from lower capital gains taxes may be expected to be lower in Canada than in the United States. The quantitative effect of this difference is not known.

Conclusions

The available evidence is clear and unambiguous for the short run. Lower capital gains tax rates bring higher government revenues for at least one or two years after they have been enacted.

The evidence on the longer run effects of lower capital gains taxes on revenues is not quite as firm as that on the short run. However, recent US experience strongly supports supply-siders in their view that the increase in entrepreneurial activity and economic growth is so large that total government revenues from all sources will also increase. If this experience holds in Canada, and there is every reason to believe that it will, lowering capital gains tax rates will bring only fiscal benefits, no costs.

However, it also worth exploring the quantitative effect under the extreme assumption that a cut in the capital gains tax rates leaves other revenues unchanged and that the most pessimistic estimate of the elasticity on capital gains tax revenue is correct. To do so, let us assume that the long run elasticity is .7, which represents the lowest estimate of a range found in the economics literature. Assume that the capital gains tax rate in Canada is lowered from 40 percent to 20 percent, or by 50 percent from its original level. This implies a decline in revenue from the capital gains tax of 35 percent, or roughly one third.[25] In 1992, capital gains tax revenues in Canada where $715 million. Therefore, the long-term revenue loss that would have been expected in the wake of a 50 percent cut in the tax rate would have been $238 million.

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25 The elasticity e is defined as the percentage change in revenue (dR/R) divided by the change in the tax rate (dT/T). The empirical estimates are that e is .7. Since e = (dR/R)/(dT/T) = .7, a simple manipulation of the equation and considering dT/T = –.5, dR/R = (.7)*(–.5) = –.35, or 35 percent, rounded to one third for ease of expression.

This loss of $238 million is trivial in relation to that year's total government revenues of $278 billion, of which income tax revenues accounted for $102 billion. To make up the revenue lost from the lower capital gains tax, rates on all other forms of taxation would have had to increase by .09 percent. If all of the loss were made up by higher income tax revenues alone, rates on that tax would have had to rise by .23 percent. Such variations in tax revenues are less than the statistical error found in the compilation of the estimates.

It is also worth noting that even if the figures on current capital gains tax revenues and elasticities were too optimistic, the effect of lower revenues still would be quite small if they are seen in the context of overall tax revenues. The fact is that capital gains tax revenues are a small proportion of all tax revenues.

Finally, it is important to remember the analysis above of the private and public cost of collecting the capital gains tax revenues. If the capital gains tax were abandoned completely, many government employees and private sector tax accountants and lawyers could be re-employed to produce goods and services valued by society more than the enforcement and manipulation of the tax code. A significant reduction in the rate of capital gains taxation would not eliminate the need for this manpower employed in the tax industry completely. However, the demand for such tax advice would shrink because at the lower rate it would pay less to search for and employ tax avoidance schemes and to take the risks associated with tax evasion. At the same time, Revenue Canada would need fewer employees to find and close such avoidance schemes and protect the system from evasions.

In sum, the revenue argument for capital gains taxation is flimsy at best. We can predict confidently that in the short run, lower rates would improve the fiscal situation of Canadian governments. There is also a high probability that, in the longer run, overall tax revenues would also increase, or at least remain unchanged. This might be true even if the capital gains tax were eliminated completely. A worst case scenario is that in the longer run overall revenues would drop slightly, but this drop might well be accompanied by savings in public and private costs of dealing with the tax, so that the fiscal losses are turned into net overall economic gains.

CHAPTER 3
A Critique of the Equity Issue

Recently I discussed the issue of capital gains taxation with an economist and high-ranking official of Canada's Department of Finance. I inquired about her views on the likelihood that lower capital gains tax rates might raise revenues in the short run. She thought that the prediction of this effect of lower rates on revenues was correct, but she doubted that the prediction held also for the longer run. I then asked: "Let us *assume* it can be shown that the effect also operates in the longer run. Under this assumption, would you and the Department still object to the lowering of the tax?" The answer was: "Yes, under these conditions we have to consider the equity implications of the tax."[26]

This attitude also is pervasive in the United States. Burman (1999) notes:

> On the face of it, the most appealing argument for a capital gains preference is that it might encourage more saving, lower the cost of capital for firms, and thus spur investment and raise productivity… This argument makes sense if one is willing to trade off other objectives—especially fairness—for the gain in economic efficiency.[27]

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26 The pervasiveness of the concept of fairness in the taxation system in the minds of Canadian academics is apparent from the fact that in the paper by Bird and Wilson (1999), the concept is mentioned at least once on every one of the 17 pages of text. And because the concept is considered to be familiar, no attempt is made in this article to define it conceptually or operationally.

27 Citation from page 42, taken from Reynolds (1999), p. 11.

The issue of equity and fairness

As already noted above, fairness in taxation involves two concepts: horizontal and vertical equity. Horizontal equity refers to the idea that Canadians with the same level of income and other circumstances should pay the same amount of taxes. Vertical equity involves the idea that those with higher incomes should pay a proportionately higher share of their income as taxes than do those with lower incomes. In other words, income should be subject to increasing marginal tax rates.

Horizontal equity

The rationale for horizontal equity in the tax code is based on a moral standard on which a broad social consensus appears to exist. Thus, most people consider it morally wrong if people with the same income pay different amounts of tax. Of course, moral standards of this sort are never absolute, and in practice, the Canadian tax code offers several exceptions. Thus, a person who has high medical bills or a large family should pay less income tax than a person with the same income but without medical and child care expenses. This outcome is predicated on the idea that "ability to pay" and "need" also should play a role. But it is interesting to note that even these concepts are not absolute. Lack of ability to pay and need caused by gambling debts is not acceptable as a legitimate reason for reduced tax obligations, even if the gambling debt is due to some medically caused addiction.

Another exception arises from the fact that not all forms of income are considered to be taxable. First, income which determines one's standard of living accrues to people not just in the form of money but also through services delivered by consumer durables like homes and automobiles. In fact, of course, these forms of income are not taxed in Canada, in spite of the Carter Commission's recommendation that they should be.[28] We have here the violation of the principle of horizontal equity, which is acceptable presumably because home-ownership has sufficiently redeeming social value and taxation should not discourage it.

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28 In Sweden the value of services stemming from the ownership of homes is imputed on the basis of the cost of renting equivalent quarters. This imputed value is then subject to income tax.

Second, the principle of horizontal equity is violated in the case of people who own a business. The business's profits are due to individual sacrifice. The owner uses after-tax income for investment rather than consumption, much like work occurs at the expense of leisure. But while income from work is taxed only once, income from investment is taxed three times. First, the business pays a tax on its profits. Then, the distributed, after-tax funds are taxed again as the owners' personal income. Finally, if the return to the sacrifice in the form of investment brings a capital gain, that is taxed also. In the view of many, this triple taxation of income from investment represents a serious violation of the principle of horizontal equity.

Third, capital gains taxes are collected even if the gains are due to general inflation, which increases all prices in equal proportion. Consider someone who owns a piece of land worth $100,000. It can initially be exchanged for five automobiles costing $20,000 each. General inflation, which doubles the price level, also doubles the market prices of both the land and cars. The land worth $200,000 in depreciated dollars continues to be exchangeable for five automobiles worth $40,000 each.

The owner of this piece of land, after inflation, has to report a capital gain when she sells it because she is assumed to have enjoyed an increase in her disposable income. However, this is not the case. If there had been no inflation, the sale of the land would not have triggered a capital gain and tax. The taxation of capital gains due to inflation clearly violates the principle of horizontal equity.

In sum, horizontal equity is a concept that provides a popular rationale for taxing capital gains. In practice, however, this principle is not absolute and is violated in several instances. These violations are acceptable to tax strategists and politicians when they agree with other social and economic objectives. In the case of medical or child-raising expenses, individual need is considered. In the case of the multiple taxation of returns to investment, it is assumed that the tax falls on Canadians rich enough to own businesses and whose extra payments serve the objective of vertical equity. The taxation of inflationary gains is justified on the grounds that the indexing of such gains to price changes involves excessively complex and costly administrative procedures.

In the light of these considerations I suggest that capital gains warrant another exemption of income from the tax base on the rationale for horizontal equity: the taxation of capital gains has serious detrimental effects on capital formation, risk-taking, the brain drain, and overall economic prosperity. The reasons for this effect on economic performance have already been developed in chapter 2. The fundamental efficiency implications will be discussed in chapter 4.

Vertical equity

Under a system of strictly proportional taxation of, say, 20 percent, a person earning $30,000 pays $6,000 in tax and someone with an income of $100,000 pays $20,000. This form of taxation is considered to be just by almost all Canadians since the amount of taxes individuals pay tends to be roughly proportional to the government services they consume. Thus, a rich person is more likely to use the services of institutions of higher learning for his children, of the police to protect his property, and of roads to drive on.

However, the perception of a fair system of taxation has undergone a gradual change through time. Now it is widely believed to exist when personal income taxes are progressive, when a person with an income of $30,000 pays 20 percent and one with an income of $100,000 pays 50 percent.

Canadians and people in most other countries of the world are divided in their views about the fairness of such a system of progressive income taxation. Those who oppose it see nothing fair in the reduced reward for hard work and risk-taking, and point to the disincentive effects on effort and therefore overall living standards. Because of the slower growth of national income under this system, eventually the poor have a lower absolute living standard than they would have had if economic growth had been greater.

Those in favour of progressive income taxation hold that as a human right people are entitled to a fair living standard and this should be enforced by the state. This argument is purely moral and based on what its proponents believe to be universal ethical standards. The concept of fairness in this context refers not to absolute but to relative living standards. What matters here is the *ratio* of the average income of the top over that of the bottom quintile or decile of the income distribution. The absolute standard of living of the poor is not quite irrelevant, but certainly secondary to the distribution of income. For this reason, the proponents of this view insist on the use of Statistics Canada's Low Income Cutoff measure, or relative income, to measure the progress of the fight against poverty. They reject vehemently the measures of absolute poverty produced by Sarlo (1996) and published by The Fraser Institute.

In Canada, those who advocate using progressive income taxation to provide greater vertical equity in the distribution of income obviously have carried the day. As an aside, it is interesting to speculate why this is the case. Public choice theory suggests that since the median income is always lower than the mean for reasons explained above, there will always be a larger number of voters whose self-interest lies in the election of politicians who favour income redistribution than there are who prefer proportional taxation.

Be that as it may, the relevance of the preceding discussion for the taxation of capital gains is straightforward. Since only those with high incomes can afford to save and make investments, so the argument goes, a capital gains tax will fall primarily on them, and increases the vertical equity of the income distribution.

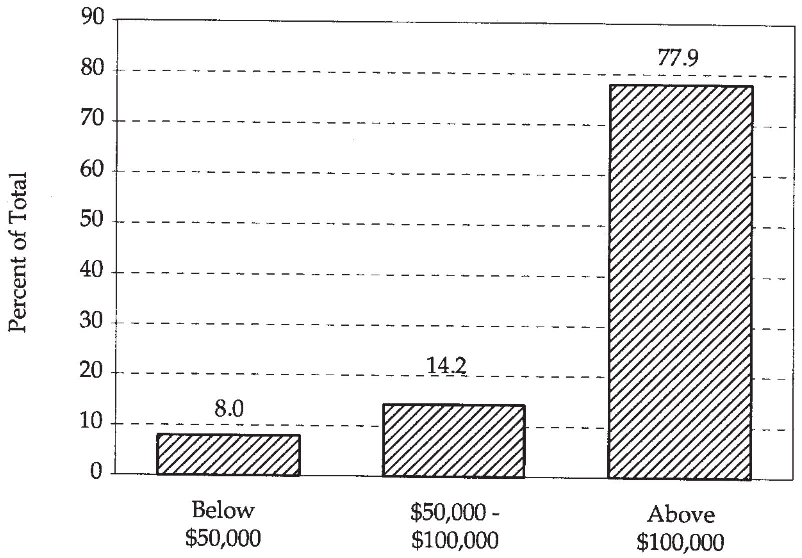
The rich pay the tax: some empirical evidence

When the capital gains tax was introduced in 1972, the ownership of capital was not nearly as widespread as it is today. While many owned homes and summer cottages, and there were many small farms and businesses, the ownership of shares and large businesses was concentrated in the hands of the rich. It therefore does not come as a surprise that politicians formulated the capital gains tax so that homes and recreational property, farms, and capital gains of less than $1,000 were exempted.

The view that capital gains taxes fall mainly on the rich is supported by income tax data published by Revenue Canada. Figure 5, compiled from these data by Joel Emes at The Fraser Institute, provides some details. Families with incomes over $100,000 in 1992 paid 78 percent of all of the capital gains taxes collected by Revenue Canada. Those with incomes below $50,000 paid only 8 percent of the total.[29]

29 According to Don Drummond of the Department of Finance, in recent years, 50 percent of all capital gains taxes are paid by families with incomes above $200,000. The basic data on which figure 5 is based did not allow us to calculate this figure.

Figure 5: Percent of Canadian Capital Gains Taxes Paid by Income Groups on the Basis of All Taxable Income

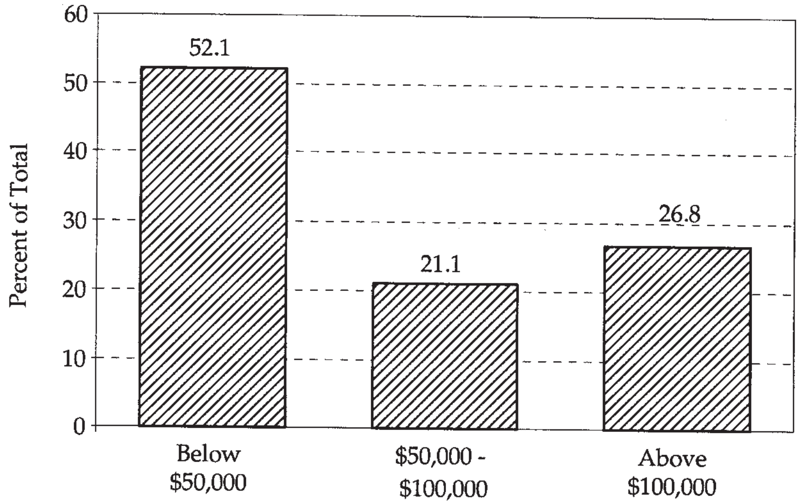


These income statistics need to be seen in the broader perspective of the overall distribution of income already discussed above. Thus, in 1992 average family income in Canada was $53,676. Only 7.9 percent of families had an income over $100,000.

However, a serious question has been raised about the interpretation of the statistics in figure 5. What is the income *other* than the capital gains of those who paid these capital gains taxes in 1992? It has been suggested that many of these taxpayers might be the owners of small businesses who sold their assets and intended to use the proceeds to finance their retirement. They are often elderly, and as business owners typically have paid themselves low wages, lived frugally, and reinvested most business profits during their working life. The capital gains reported that year are a singular event and push them into the high income tax brackets only for one year.

Furthermore, as noted above, when Canadians die and pass on their estate to their heirs, the accumulated capital gains are deemed realized. The estate of the deceased pays the capital gains taxes, and in that year the deceased is recorded as having had an income typically much above that before and from other sources. The income that year certainly was

Figure 6: Percent of Canadian Capital Gains Taxes Paid by Income Groups on the Basis of Total Income minus Capital Gains



Source: Calculated by Joel Emes from the Social Policy Simulation Database and Model, Statisics Canada.

much higher than the zero income of the deceased in later years. A similar process of deemed realization of capital gains is activated when a person emigrates. Again, the capital gains inflates the taxpayer's return that year, even if ordinary income was much lower in the preceding years.

We attempted to measure the bias in the measured incidence of capital gains taxes paid, which can be attributed to the high, temporary incomes of at least some of the payers. For this purpose, we selected from the Revenue Canada database all those individuals who paid capital gains taxes in 1992, calculated their income from other sources, and divided them into groups with less than $50,000, more than $100,000, and in between these two levels. For each of the three income groups we estimated the capital gains taxes they paid. Figure 6 presents the results of these calculations.

Figure 6 puts a significant dent in the argument that capital gains taxes are an important instrument for taxing the rich and equalizing incomes in Canada. More than one half of all capital gains taxes were paid by families with other incomes less than $50,000 in that year. Those with other incomes above $100,000 paid only about 27 percent. These facts represent strong evidence that capital gains taxes do not fall primarily on

Canadians who have very high levels of incomes from work and property. They are borne instead by members of the middle income class, who for some reason enjoyed a once-in-a-lifetime capital gain.

The facts about the distributional characteristics of the capital gains tax are beginning to find their way into the thinking of politicians. For this reason it is worthwhile to provide the following quotation from page 50 of the Report of the Standing Committee on Finance, published in December 1999[30] when Maurizio Bevilacqua was the Committee's Chairman:

> Although capital gains are primarily earned by higher-income taxpayers, this fact tends to be exaggerated. Capital gains tend to be realized in a lumpy fashion. Rather than being spread equally over time, they are concentrated and sporadic—this is particularly true of small business owners who earn capital gains when they sell their business. Consequently, the lifetime income of those who earn capital gains tends to be lower than it is in the year in which they realize those capital gains.

These findings are very important in assessing the benefits that capital gains taxes bring in governments' efforts to achieve vertical equity. Our results need to be replicated by other economists, for other time periods, and through the use of other databases. In particular, it would be interesting to study the extent to which those with high capital gains taxes in one year have lower regular income both before and after the years in which they reported these gains. Unfortunately, panel data, which trace the records of a given set of taxpayers through time, are not yet available in Canada. They are under construction in the Department of Finance and should become public in a few years.

In the absence of other Canadian studies of the incidence of capital gains taxes by income groupings, it may be useful to consider evidence from the United States. For this purpose, see table 1, taken from a publication by the Joint Economic Committee in 1999.

As table 1 shows, Americans with non-capital gains incomes of less than $30,000 file 41.2 percent of all tax returns that include capital gains, and

30 The precise reference is found under House of Commons, Finance Committee Report (1999).

Table 1: Who Pays Capital Gains Taxes?

Income before Capital Gains	Filers declaring capital gains (%)	Cumulative percentage	Share of capital gains tax paid (%)	Cumulative percentage
Under $30,000	41.2	41.2	29.8	29.8
$30,000-$39,999	11.1	52.3	5.3	35.1
$40,000-$49,999	9.3	61.6	4.6	39.7
$50,000-$74,999	17.4	79.0	8.8	48.5
$75,000-$99,999	8.7	87.7	6.0	54.5
Over $100,00	12.3	100	45.5	100

Note: Figures are in US dollars.
Source: Heritage Foundation, based on IRS Public Use Files for the tax year 1993, reprinted in Joint Economic Committee (1999), p. 39.

pay 29.8 percent of all capital gains taxes. The explanation for this phenomenon is that a significant fraction of families with such low incomes hold mutual funds, which legally are required to make annual capital gains distributions. The table also shows that those with incomes over $100,000 make up only 12.3 percent of filers but pay 45.5 percent of all capital gains taxes.

The data in table 1 suggest that capital gains taxes are paid not just by the "rich" earning over $100,000 of other income. Those earning less than $100,000 in fact pay over half of all capital gains taxes. Those with incomes below $30,000 pay a significant 29.8 percent of the taxes.[31]

In sum, the widely-held public view that capital gains taxes are paid mainly by the rich is false. Capital gains, which occur only once, make taxpayers appear rich that year. In fact, the majority of the taxes are paid by Canadians whose non-capital gains income places them in the middle and lower income groups. The case for using capital gains taxes to equalize incomes is considerably weakened by these facts.

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31 For very similar evidence on this issue relating to the year 1985, see Bracewell-Milnes (1993), p.25.

The size of capital gains due to inflation

In the preceding analysis I discussed the fact that the taxation of capital gains due to inflation violates the principle of horizontal equity. It is worth considering the magnitude of this effect.

Between 1972 and 1991, consumer prices in Canada rose 3.8 times. During that same period, the Toronto Stock Exchange Index of 300 Companies (TSI) rose 2.9 times. Consider a person who bought a representative sample of stocks in the TSI worth $100,000 in 1972. This investment in 1991 was worth $290,000. Its sale that year brought a capital gain of $190,000. Under the assumption that the capital gains tax rate was 40 percent, $76,000 in taxes was due. The investor was left with $214,000. However, because of the inflation, the real goods and services worth $100,000 in 1972 cost $380,000 in 1991. Our investor suffered a loss of 44 percent of the initial wealth in 1972.

One reason for this loss in real wealth was that during the years 1971-92 inflation exceeded the rise in stock prices by 24 percent. Nevertheless, the important fact for the present purposes of analysis is that an additional real loss of 20 percent was due to the tax paid on the fictitious capital gains during the period.

Another way of looking at the taxation of inflationary capital gains was presented by Victor Canto (1999) in an article in the *Wall Street Journal*. He presented the following example, worth reproducing here for further elaboration of the principle:

> Suppose you buy a stock for $100 and sell it a year later for $120. The nominal capital gain is $20; under the current law, the maximum capital gains tax will be 20 percent of that, or $4. But what if inflation is running at 20 percent during that year? In that case, inflation accounts for $10 of the gain, and the true economic capital gain is only $10. That means the effective capital gains tax rate is 40 percent, not 20 percent.

Canto used actual inflation and tax rates to trace the effective US capital gains tax rates through time. The graph showing this information reveals that in 1975, the nominal rate was 38 percent, and the effective rate 40 percent. During the following years the nominal rate was gradually lowered to 20 percent, but because of the rapid inflation, the effective rate rose steadily to about 110 percent in 1982. It then fell rapidly along with inflation following the credit tightening measures undertaken by Paul Volcker, who was the Chairman of the Federal Reserve Board at the time. Effective rates were about 5-6 percent higher than nominal rates between 1987 and 1993.

Since the inflation rates in the United States and Canada were very similar during these years, the difference between the nominal and effective rates of taxation in Canada also was very similar. However, because of the much higher levels of the nominal rates, Canadian effective rates were much higher.

These historic data are important for the future, even if in recent years inflation has been brought under control. One reason is that the fight against inflation is never won. There always remains the chance that it will flare up again, perhaps as a result of developments abroad or a change in guards in parliament, at the Bank of Canada, or the Department of Finance. Furthermore, the target range for inflation set by the Bank of Canada, as well as the actual inflation rates in recent years, may seem to be small—only 1 to 2.5 percent annually. However, through time, these low annual rates add up, as anyone knows who has gone through the process of financial planning for retirement. At an inflation rate of 1.5 percent annually, in 25 years the price level will be 45 percent higher. Investments need to increase by that amount just to maintain their real value.

It is interesting to note that nominal capital gains are also taxed in the United States. This fact has prompted Alan Greenspan, the Chairman of Board of Governors of the Federal Reserve in Washington to make the following statement:

> Actually I'd go to indexing. And the reason I would is that it's really wrong to tax a part of a gain in assets which are attributable to a decline in the purchasing power of the currency, which is attributable to poor governmental economic policy. So, for the government to tax peoples' assets which rise as a consequence of inferior actions on the part of government strikes me as most inappropriate.[32]

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32 Greenspan (1997).

Many Canadian and US economists share Greenspan's view. In spite of this fact, the governments of the two countries have not exempted from taxation capital gains due to inflation. The justification for this inaction is the alleged administrative complexity of such a regulation.

Exemption of nominal capital gains from taxation requires taxpayers to document over what time they have held the asset, and what the inflation rate has been. Issues arise from the choice of an appropriate index of inflation. Should one rely on the consumer price index, the wholesale price index, or the deflator for national income? There are accounting problems. Should the valuation of assets sold from a portfolio be based on the principle of LIFO (last in, first out) or FIFO (first in, first out)?

In my view, there are practical solutions to the conceptual and administrative difficulties allegedly associated with the exemption of nominal capital gains from taxation. The LIFO versus FIFO issue exists in the valuation of inventories for the calculation of company profits. Allowing companies to choose either method has solved it, since once the choice has been made, it cannot be reversed. I return to this issue below in the section on policy recommendations. Suffice it to note here that for many years Australia and Great Britain have not taxed capital gains due to inflation, though the latter country abandoned this practice in 1997.

The degree of unfairness resulting from the taxation of phantom capital gains is, of course, an increasing function of the rate of taxation. Therefore, lowering the rate would make the system at least less unfair, even if the tax cannot be indexed to inflation.

More on the multiple taxation of investment income

The multiple taxation of investment income has been discussed above and shown to reduce the horizontal equity of the income tax system. This fact has been realized by the government of Canada and has led to the present rule under which income from Canadian corporations can be used to reduce the personal income tax base. In effect, the double taxation of corporate income is eliminated to a considerable degree.[33] But this policy unfortunately has not been extended to the treatment of capital gains.

The elimination of the capital gains tax also has implications for vertical equity because the ownership of capital, especially through shares traded in stock markets, is no longer a privilege limited to the rich. In recent years, the ownership of corporations has become increasingly widespread through the ownership of mutual and pension funds by many lower- and middle-income earners. This fact underlies and explains at least part of the results of the incidence of capital gains taxes by the other income of the taxpayers noted in figure 6.

It is also worth noting that capital gains and corporation income taxes are borne only partly by the owners of capital. The ultimate incidence of sales and other taxes is analyzed in great depth by economists and it is well known that, for example, duties paid by importers are ultimately passed on to consumers through higher prices. But the incidence of capital gains taxes in this sense has been neglected.[34] Corporations, in order to attract capital for their enterprise, need to earn a rate of return for their investors, including capital gains, equal to that available to investors in other uses. So, if the government imposes a tax on these needed returns, the corporations raise the prices of the goods and services they sell. Through this mechanism, much of the corporation tax is passed on to the buyers of these goods and services, specifically, lower- and middle-income earners, who spend a greater proportion of their income than do the rich on these goods and services.

Summary of the arguments on equity

The equity argument for capital gains taxation is flawed for three major reasons. First, the tax does not fall predominantly on the rich. In fact, individuals who have only moderate to low regular incomes from other sources pay the bulk of capital gains. The capital gains shown in statistics on income and taxes typically accrue only once in a lifetime. The gains may be occasioned by retirement after a lifetime of work, saving, and reinvestments in business, or they may be arise when the estate of a

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33 New Zealand has eliminated the double taxation of investment income. To overcome the populist opposition to this policy, the government requires that corporations continue to pay taxes at the rate of the personal income tax. However, the corporations then issue certificates to their stockholders, which indicate that they have paid the income tax for them. The taxpayers then use these certificates to reduce their personal income tax obligations, which otherwise would have been payable on their dividend income.

34 This fact was pointed out in a short paper presented by John Chant during The Fraser Institute symposium on capital gains taxation in June 1999.

deceased person is taxed. Statistics on the income of those who pay capital gains taxes are inflated considerably by such once-only gains.

Second, the present system itself violates the principles of fairness—more precisely, horizontal equity—held dear by many Canadians. A large fraction of capital gains are due to general inflation. Taxing these gains is unfair since it amounts to confiscating personal wealth. This was never the intent of capital gains taxation. Such confiscation reduces incentives to save and invest. Canadians in general, not just the payers, bear the ultimate burden of the tax through lower productivity, income, and wealth.

Third, a further dimension of the unfairness of the present system arises from the fact that business profits are subjected to multiple taxation. Business pays taxes on profits. Dividends are taxed again in the returns of individuals. If success raises the value of the business, it gives rise to capital gains, which are taxed also. The unfairness and detrimental effects of double taxation of corporate income have caused the creation of tax credits on dividends paid by Canadian-held companies. However, these concerns have not led to an equivalent credit on capital gains due to reinvested earnings. The burden of this multiple taxation of profits and capital gains is also ultimately borne by all Canadians through lower productivity, income and wealth.

Chapter 4
A Critique of the Efficiency Issue

The most important *economic* argument in favour of a capital gains tax is its detrimental effect on the efficient allocation of capital. As was noted above, in the presence of high personal income tax rates, a zero rate of capital gains taxation induces the owners of businesses to excessively reinvest profits. As a result, some profits do not pass through the hands of the owners of the business. They bypass the market test for superior alternative investment opportunities. The capital gains tax is needed to eliminate this practice and raise the efficiency of capital use in Canada, so the argument goes.

No estimates of the size of the efficiency loss from the excessive reinvestment of dividends exist today, and obviously none existed when the capital gains tax was introduced. Theoretical arguments carried the day by supporting the politics, which favoured the use of the tax to create a more equal distribution of income.

The absence of any estimates of the cost of the excessive reinvestment of capital is unfortunate because, as it turns out, the imposition of the capital gains taxes designed to eliminate it, caused efficiency costs of their own. Sadly, the magnitude of these costs is also unknown. Therefore, we cannot provide an empirically-based answer to the crucial question whether the cure is worse than the disease, whether Canada has been made better or worse off by the capital gains tax in terms of economic efficiency alone.

Before I turn to a discussion of the nature of the efficiency costs caused by capital gains taxes, let me put the issue in a broader, historic context. During the post-War years, economists were convinced that market failures could be eliminated by imposing appropriate government policies.

One of the best-known market failures was considered to have been due to the existence of what are known as "natural monopolies" in transportation. The view was that on airline routes such as that between Toronto and Vancouver, granting exclusive operating rights to one or two airlines would enhance economic efficiency. These companies would be able to run their planes at higher levels of capacity than they could if there were many more competitors. The real cost of supplying the service would be lower. A government agency was created to ensure that the monopoly airlines would not make excessive profits and that the lower costs would be passed on to consumers.

After many years of operation, the reality turned out differently from the government's regulatory aims. There were no monopoly profits, but costs were much higher than they would have been under competition. As studies have shown, regulated monopolies are a fertile ground for unions to gain such wage rates and working conditions that large benefits accrue to their members at the expense of consumers. Management's incentives to operate efficiently and cater to consumers' wishes were stymied. The importance of these effects became dramatically obvious when it was discovered that a flight between Boston and Washington DC cost twice as much as a flight between Los Angeles and San Francisco. The distance covered by these two scheduled flights was the same, as was the quality and frequency of services.

The difference in cost was attributed to the fact that the Boston-Washington flight was regulated by federal authorities while the Los Angeles-San Francisco flight was not. The latter operated within the state of California and therefore had escaped the federal regulations.

In response to these findings about the unexpected cost of regulation and as a result of further research into conditions in other so-called natural monopoly markets, economists developed an important concept. They argued that there is a counterpart to market failures. It is government failures, which are caused by the regulations designed to eliminate the market failures. Therefore, the decision to introduce regulation must always be based on a calculation of the economic costs of the market failure relative to that of the government failure. The traditional way of assuming that regulation would eliminate all costs of market failures and create ideal economic conditions is false. Most of the time, government failures were more costly than the market failures.

I believe that the same conceptual apparatus should be applied to assess the merit of tax policies, which are designed to correct problems caused by an existing tax structure. It is inappropriate to argue that the economic cost of excessive reinvestment of profits by companies can be eliminated, without costs, by the imposition of the capital gains tax. This tax brings distortions, the costs of which may well exceed those they were designed to eliminate.

The importance of efficient capital markets

The payment of capital gains taxes in Canada is due upon the voluntary realization of the gains through the sale of appreciated assets. There are some exceptions to this rule. Capital gains in an estate are "deemed realized" upon the death or emigration of their owner. A registered retirement can be dissolved only upon payment of taxes, including those on accumulated capital gains.

Why would owners sell appreciated assets at their own initiative and thus voluntarily pay a maximum of 40 percent of their gains in taxes? Some of these sales are only partially voluntary. In the case of holdings of mutual funds, managers routinely sell and buy assets in the search for higher overall yields. By law, the owners of these funds must pay capital gains taxes, even though the proceeds are reinvested and if they had the choice, they might not have realized these gains. Other sales are made because the owners need the funds to finance retirement or purchase costly consumption goods like homes and automobiles.

Probably most assets are sold because owners have discovered profitable alternative uses for their money. In the absence of capital gains taxes, there would be a high turnover of investments leaving uses with lower rates of return for uses with higher rates of return. Only the costs of obtaining information about alternatives and the transactions costs associated with selling and buying prevent the movement of funds at very small differences in expected returns. The market incentives to keep money in assets with the highest rate of return are essential to the efficient operation of capital markets. Without such movement, the economy continues producing goods and services at lower profits than could be earned by creating firms and products yielding higher returns.

This process of reallocating capital is essential for economic adjustment and growth, especially during modern times, when science and technological developments continuously generate new profit opportunities.

The new information technology and biotechnology industries need capital, which has to come from somewhere. Current savings are not enough to finance all of these new ventures. At the same time that these new industries require capital, other industries are in decline because the demand for their product has slowed as a result of competition from new products or suppliers in other countries.

The free flow of capital between old and new industries is also important for labour and the unemployment rate. In Canada, the fortunes of the natural resource producing industries have been on the decline because of falling world prices, foreign competition, and the availability of substitute products. The government of Canada can do little to prop up these industries and save their workers from unemployment. What is needed is sufficient capital at a low enough cost to finance the development of new industries, which will provide the jobs lost in the older industries. And only private entrepreneurs and investors can be relied upon to make the right decisions in the search for new ventures with appropriately high returns.

Canada has lagged in the switch of capital and labour from the old into the new industries. The US economy has been the world's most successful in this dynamic process. While there are a number of explanations for this difference in the performances of the Canadian and US economies, the higher capital gains tax rates in Canada are responsible for a large part of this difference.

The lock-in effect

High capital gains taxes interfere with the dynamic, efficient reallocation of capital for the following reason. The cash received from the sale of assets is reduced by the capital gains tax. As a result, the new investment project must have a rate of return high enough for the investor to recoup the funds paid in taxes. The precise excess of the new over the old rate of return needed to make the switch depends on the size of the capital gain, the rate of taxation, and the expected holding period.

The nature and magnitude of the so-called lock-in effect of capital gains taxation can be illustrated with the following example. Consider an investment worth $1,500, which yields 7 percent in perpetuity. The investment carries a capital gain of $500 so that upon its realization, the 40 percent tax rate requires a payment of $200 to the government. Therefore, after the sale of the original asset and payment of the tax, the investor has $1,300 to place in another project.

The importance of the lock-in effect depends crucially not only on the rate of return on the new and old investment; it also depends on the length of time over which the new investment is expected to be held. Thus, over 5 years, the original investment at 7 percent grows to $1970 after reinvestment of all income and in the absence of any income taxes. For the investment of $1,300 to grow to $1970 in 5 years, the yield on it must be 11 percent. In other words, an investor with a time horizon of 5 years holds onto the appreciated asset just described and yielding only 7 percent unless the new investment yields at least 11 percent. Projects with returns between 7 and 11 percent go unfinanced.

Figure 7 allows insights into this relationship more generally. It continues the use of the preceding example. On the vertical axis, it shows the initial capital value of the appreciated asset of $1,500. The heavy line sloping upward from that point gives the value of this asset in following years, assuming a yield of 7 percent reinvested without the payment of transactions costs or taxes. On the vertical axis the graph also shows a starting point of $1,300 for a group of thin, upward-sloping lines. The starting point reflects the initial value left over for investment after the payment of the capital gains taxes and the lines show this capital growing at different assumed rates of return.

This graph can be used as follows. It allows one to determine the holding period required to make the new investment profitable for different rates of return. The lowest line, starting at $1,300, rises at a rate only slightly greater than the one growing at 7 percent and originating at $1,500. The number of years required to make the new investment profitable at this rate is very long and outside the range of the graph. On the other hand, the line representing a return of 9 percent shows that investment at this rate is profitable after 9 years. The graph can also reveal what yield is needed to induce the new investment at any given holding period. For example, a holding period of about 6 years requires the new investment to grow at 10 percent to induce the switch to it.[35]

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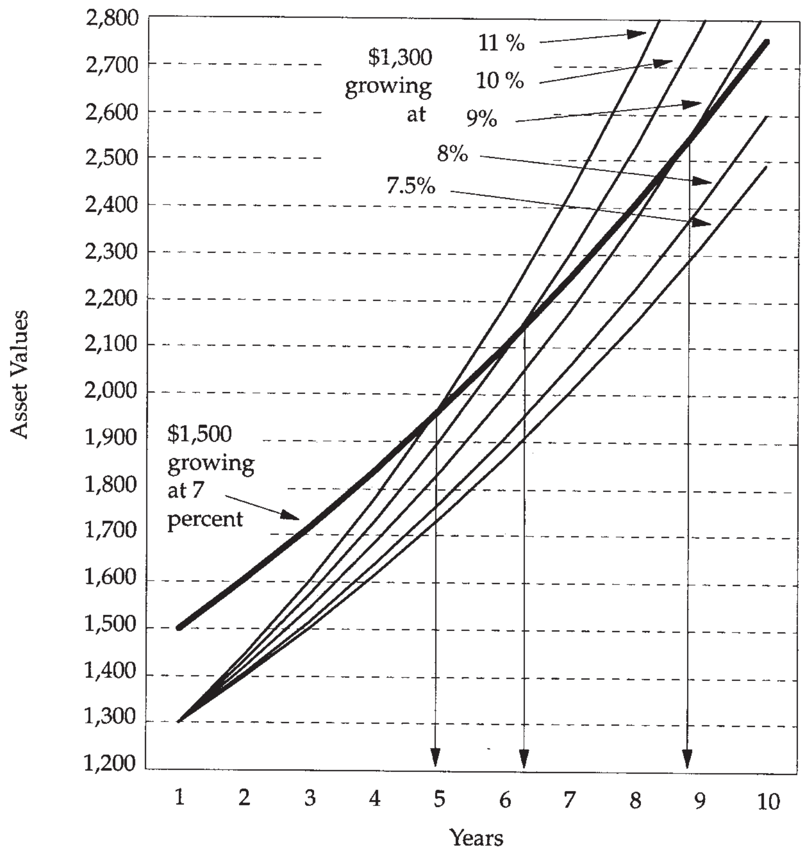
35 The same principles, which give rise to the lock-in effect, are also responsible for a reduced value of equities in the stock market. For a detailed analysis of this relationship between stock market prices and capital gains taxation, see Appendix A.

Figure 7: Simulation of Lock-in Effect



In principle, the output foregone by this lock-in effect is substantial for the Canadian economy. Consider an investment of $1 million, which yields 7 percent. If an investment yielding 9 percent is not made, the annual loss from this lock-in effect is $20,000. There are many billions of dollars in locked-in investments in Canada, and the costs in terms of lost output of capital and higher labour productivity must run into many hundreds of millions of dollars.

Unfortunately, I am not able to provide statistical evidence to back up my judgement of the magnitude of the losses from the lock-in effect. To estimate the losses, we would need to know the amount of realizable gains subject to taxation, the overall level of investments, their yield, and the average expected holding period of new investments. All of these figures have to be adjusted to take into account assets held in RRSPs and other investment vehicles, which allow the realization of capital gains free from simultaneous tax obligations. Perhaps an estimate of these data can be made through a sampling of investors. Such research is a job for a government statistical office rather than a private researcher.

The lock-in effect caused by capital gains taxation is very similar in nature to the effect of excessive reinvestment of profits in the absence of capital gains taxation. Both effects cause inefficiencies in the use of capital in Canada by introducing a wedge between returns on the use of capital subject to taxation, and its economically most profitable use. The crucial question for policy is the relative magnitude of the two. While we have no solid evidence, the following reasoning suggests that the potential costs from the excessive reinvestment of business profits are much less than the cost of the lock-in effect.

The excessive reinvestment of profits is limited to capital used in industry (and perhaps farming) because such reinvestment is not possible in the case of other asset holdings which can appreciate in value, such as art collections, real estate, and others. It is also limited by the transactions costs associated with taking business public and selling appreciated shares. A further barrier arises from the desire of most owners of small- and medium-sized businesses to retain control, which can be lost if the business goes public and shares are sold. Large corporations, especially those in rapidly-growing new industries, tend to reinvest most or all of their earnings because they have highly profitable, internal uses for the funds. In the late 1990s, firms using the Internet for their business have large and rapidly-growing capitalization values without the payment of any dividends. Such firms by definition cannot be induced to make excessive reinvestments of profits.

In support of the preceding analysis I will cite once again a statement by Alan Greenspan attributed to him by Jude Wanniski (1999):

> Alan Greenspan laboured in the Wall Street vineyards before he got his academic degrees in economics. He told me he had to spend decades trying to figure out how to convert capital gains to ordinary income, and couldn't figure out how to do it. As he put it in a conversation in his office at the Fed, perhaps a decade ago, any tax on capital gains is a tax on the national standard of living.

The lock-in effect, on the other hand, involves productive capital used in industry, and in addition, a range of other assets, which do not permit the excessive reinvestment of profits. Such assets include bonds, mortgages, and other fixed income earning financial assets and derivatives. They also include art, real estate held for private use like summer cottages, stamp collections and similar collectibles.[36]

The owners of the latter types of assets are locked in just like the owners of assets yielding monetary returns. The owners of an appreciated work of art will not sell it unless the yield on the alternative investment compensates them for the taxes due, and after a proper accounting for the psychic yield offered by works of art.

The economic growth of countries with and without capital gains taxes

I thought it interesting to compile a list of countries which have either no capital gains, or which index gains to inflation. This information sheds light on the realism of the policy recommendations presented below, especially the recommendation that the tax be scrapped entirely. It will also help with the organization of a symposium later in 2000, which will be devoted to the analysis of the problems encountered by countries without and with indexed capital gains.

As is well known, national tax codes are complex documents, difficult for non-experts to understand. However, the international accounting firm PriceWaterhouseCoopers regularly publishes some basic information which is sprinkled generously with footnotes and qualifications. Table 2 is from that company's *Worldwide Summaries 1999-2000*, without the footnotes and qualifications. Donald R. Huggett, FCA, kindly compiled this information for us.

The first group of countries consists of those that do not tax capital gains taxes at all. The second group of countries indexes capital gains to inflation.

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36 In the United States, capital gains taxes are not due when real estate, art, and financial assets are donated to charity. This fact is considered responsible for the much greater propensity of US taxpayers to will substantial estates to charitable institutions. Canada's treatment of capital gains as part of charitable donations is much less generous than that of the United States.

Table 2: Capital Gains Taxes and Economic Growth

1. Countries without capital gains taxes: Hong Kong, Netherlands, New Zealand, Singapore and Switzerland
Average annual growth in real per capital income 1990-97 = 2.2 percent
2. Countries which index capital gains to inflation: Australia, Ireland, Luxembourg, Mexico and the United Kingdom
Average annual growth in real per capital income 1990-97 = 2.3 percent
3. Remaining members of the OECD that have capital gains taxes: Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Japan, Korea, Norway, Poland, Spain, Sweden, Turkey, United States
Average annual growth in real per capital income 1990-97 = 1.2 percent

It is worthwhile to compare the economic performance of Groups One and Two with that of a reference group. For the latter I have chosen the remaining members of the OECD. These countries make up Group Three. The data on income are unweighted averages of the countries in the list published by the OECD, and cover the years 1990 to 1997.

The simple exercise of comparing the economic growth of these groups has produced some interesting results. The economic growth rates of those countries without capital gains taxes and with indexed gains are virtually twice those of the countries with capital gains taxes.

As noted above, the determinants of economic growth are complex and one should not put too much stock in this simple comparison of countries. However, the theoretical reasoning and empirical judgements about the cost of the lock-in effect of capital gains taxes (such as that of Alan Greenspan), find at least some support in these data.

Summary

In sum, based on what we know about the opportunities and incentives to engage in the excessive reinvestment of business profits, the size of the economic losses would be small in the absence of a capital gains tax. The losses would also be small relative to those caused by the economic costs of the lock-in effect affecting all forms of capital.[37] If this analysis is correct, Canadians would be better off scrapping the capital gains tax and taking the losses due to the excessive reinvestment of profits. If eliminating the capital gains tax is not feasible for political reasons, then a reduction in its rate would at least reduce the cost of the lock-in effect.

This conclusion is strengthened by the fact that the government can use other tax policies to reduce the incentive for the excessive reinvestment of profits caused by the absence of a capital gains tax. First, and most obvious, it could lower the top marginal tax rate on personal income. Lower personal income tax rates, for any given inclusion rate for capital gains, reduce the effective rate of taxation on the capital gains. The reduction of the top marginal income tax rates has many other benefits and has been recommended by many economists.

Second, the government could tax reinvested profits at a higher rate than distributed profits. Presumably, there is a rate of taxation of reinvested profits which would eliminate all incentives to reinvestment caused by the absence of a capital gains tax. Such a tax policy is used in Germany to achieve the same objective. It is not clear that the benefits of the tax are great enough to compensate for the costs of administering it and costs caused by new distortions are almost certain to arise. For this reason, it is important to study the German experience and that of other countries which have attempted to use taxes and regulation to reduce the incentives for the excessive reinvestment of profits.[38]

A tax on risk-taking, and the brain drain

Entrepreneurs and risk-takers are the main engines of economic growth in capitalist societies. They advance technology and develop new products and services. It is widely accepted that much of the economic growth

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37 For a supporting analysis and conclusion, see Bracewell-Milnes (1993). The revealing subtitle of the study is "The losses from high capital gains tax rates-–Why both the taxpayer and the tax revenue lose from the present excessive rates of capital gains tax."

38 The Fraser Institute is planning a symposium at which experts from countries with such regimes will discuss the benefits and costs of policies designed to reduce the excessive reinvestment of profits.

in last two decades has come from firms in the electronics, computer, information, and biotechnology industries.

Entrepreneurs' work is very risky, almost by definition. The innovations they come up with have to pass the market test and sell to consumers and industrial users at prices which make them attractive. Many entrepreneurs fail. For every Bill Gates there are thousands who do not succeed, and hundreds with much more modest financial success.

Entrepreneurs typically start with relatively little capital of their own. As they develop their innovations and the innovations show some initial success, so-called "angels" provide further financing. Most of these angels are investors who have made their money on similar entrepreneurial successes. Often they combine their financial investment with advice based on their previous experience as successful entrepreneurs.

If and when a new company's success continues, large profits are made and reinvested to expand capacity and make even more profits. Often for prolonged periods entrepreneurs and angels receive little cash income. They agree to such a low payout for their efforts and sacrifices because the value of their company increases through the reinvestment of the funds. They expect to be compensated for their work and sacrifices when they go public on the stock market and sell shares of their listed companies, or another company buys them out.

The fact is that capital gains taxes reduce the return that the entrepreneurs and angels receive from risk-taking, innovation, hard work, and low current compensation. The number of such risk-takers and the amount of money they are willing to put into the effort is reduced by the capital gains tax, the more so the higher is the rate. What we observe is the most basic law of economics. The lower the return, the smaller is the supply. This law holds for bread and entrepreneurs and financial angels. Canada has fewer entrepreneurs and financial angels than it could have because the government has placed such a high capital gains tax rate on the returns to their efforts.

One reason why the number of entrepreneurs in Canada is lower than it could be is because the United States has a rate of capital gains taxation half that of Canada. Agreements on migration under NAFTA have made it relatively easy for entrepreneurs to move their business and residences to the United States. A large proportion of entrepreneurs in recent times have found success in the electronic and information technology industries. Firms in these industries tend not to be tied to inputs or sales opportunities available only in Canada or in one location. The production space and markets for these industries are global, and entrepreneurs lose nothing by moving their business to the United States. The move may even create benefits through increased synergism with firms in regional industrial clusters in places like Seattle (computer software), Silicone Valley (electronics) and Los Angeles (application of electronics in the entertainment industry).

As a result of the brain drain of entrepreneurs, Canada loses the dynamism they would have imparted on the economy. The synergies they create through their work in US industrial clusters is lost to Canadian clusters, like those in the Ottawa Valley.[39] The shift of resources out of industries producing natural resources and into high-tech industries is slowed. Overall Canadian productivity and income suffers through the high capital gains tax rates-stimulated brain drain.

The quantitative effect of Canada's higher taxation of capital gains on the high tech industries is not known, but there are some interesting statistics bearing on the issue. In 1997, the value added by high-tech business as a percent of total value added in manufacturing was 16.4 percent in the United States, but only 10.5 percent in Canada. Per capita business research and development expenditures in 1997 in the United States were $410, but only $166 in Canada.[40]

In sum, high capital gains taxes in Canada have caused the drain of many entrepreneurial minds to the United States, along with the financial resources of those who finance their entrepreneurial ventures. This brain drain has caused the Canadian economy to grow more slowly than had they not emigrated, and has deprived it of the dynamic benefits brought by innovative entrepreneurial activities.

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39 For an analysis of these effects which economists call externalities, see Grubel (1998).

40 The data are from UNICE (1999), charts 4 and 9. This publication also has statistics on fast-growth companies called "gazelles," which create most new jobs. In the United States, for example, gazelles accounted for only 4 percent of all companies, but accounted for 80 percent of all jobs created between 1991 and 1995. Presumably, most of these gazelles operate in the high-tech sector. From 1990 to 1994 in the United States, gazelles comprised 19 percent of all mid-sized companies, but only 4 percent of such companies in countries like Germany and the United Kingdom. Unfortunately, the Canadian number is not available.

This loss of entrepreneurial talent and financial resources can be reduced significantly in the future by eliminating the capital gains tax. It can be reduced somewhat by lowering the rate at which capital gains are taxed.

Efficient and inefficient taxes

Professor Jim Mirlees of Oxford University received a Nobel Prize in economics for his work on the optimal level and structure of taxes. His work showed that all taxes induce people to change their behaviour to minimize their payments.[41]

The key ideas of optimum taxation can be understood by referring to an everyday occurrence familiar to many Canadians and described in a recent article by William Watson, an economist and columnist with *The Financial Post*. Last summer Watson used a weekend to paint the porch of his house. He did not like the job and was not very good at it. He would have preferred to write another article for publication and earn $600 doing so. But because the painter had wanted $500 for the job, and after taxes his writing would have left him only with $300, being an economist, Watson reasoned that by painting the porch himself, he was ahead by $200. (All dollar figures are in Canadian currency and made up by me).

Of course, it does not take an economist to take taxes into account when deciding anything. The painter himself set a price for his work that took taxes into account. The $500 price he quoted Watson included $200 in taxes he would have had to pay if he had taken on the job. He figured he needed at least $300 to use his time as a professional painter rather than use it to fix his own car, which a mechanic had offered to repair for $400. The mechanic's quoted price was, in turn, influenced by his expected tax bill, and so on throughout the economy. Importantly, each of the three people might decide that the after-tax income they are able to earn is not worth sacrificing a weekend to work, and instead take their kids fishing, or watch TV.

Because of the "tax wedge" between earnings and real income, the Canadian economy lost Watson's output worth $600, minus the value of his paint job of $300, for a net loss of $300. Similar calculations can be made

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41 For an applied study for Canada using these principles see Duclos and Gingras (1999).

of the losses incurred all the time by the tax-distorted work decisions of the painter, auto mechanic, and millions of others. The losses in national output are even greater if people choose leisure instead of work. All of the losses are attributable to tax incentives, which prevent people from using their comparative advantage to produce goods and services for sale.

In 1998, Conrad Winn's carefully-designed and stratified survey studied the effect of high marginal income tax rates on people's willingness to take on extra work. He asked Canadians the following: "Suppose someone other than your principal employer offered you two days of extra work each week for 10 weeks, where you would be paid overtime wages at your normal rate of pay. Would you definitely, probably, probably not, or definitely not accept the extra work?"

This question was asked of different sets of people. The first set was told that if they took they work, they would face a marginal tax rate of 50 percent, that is, they could keep half of their earnings after taxes. Of this group only 20 percent said they definitely or probably would accept the offer of extra work. The second set of people was told that their marginal tax rate was 30 percent, that they could keep 70 percent of their extra income. Of this group, 77 percent said they definitely or probably would take on the extra work. Finally, the third group was told that their marginal tax rate was only 10 percent, that they could keep 90 percent of their extra income. Of those, 86 percent said they definitely or probably would accept the offer of extra work.

These survey results are consistent with the personal experiences of many Canadians who either were themselves deterred from taking on extra work, or know of others who were deterred by high marginal tax rates. The results also support the general findings of the theory of optimum taxation and the empirical estimates of the costs of taxation prepared by the Department of Finance referred to above, even though the latter study approached the issue much more indirectly than did Winn.

In fact, efficiency losses are different for the different taxes used in Canada. On one extreme of a spectrum of taxes with these characteristics is the head tax, which is paid by everyone by virtue of living in a country.

This tax cannot be avoided except through emigration, which for most reasonable levels of the tax, is not a profitable alternative.[42]

At the other extreme of the spectrum are taxes on investments and capital, which can be avoided rather easily. In the first place, if the taxes on captial are high enough, people are encouraged simply to consume their income rather than save and invest it. Some of the consumption tends to bring short-lived pleasures like expensive foods, restaurant meals and holidays. Often the consumption involves making investments in consumer durables like homes, yachts, and art. These investments yield income in kind which cannot be taxed, but which does not add to measured national income and the productivity of labour.[43]

Taxes on capital also induce investors to shift capital into countries with lower tax rates. Many governments have dealt with this problem by taxing their citizens on their worldwide income. But enforcing these regulations is not totally effective, and capital taxes chase much investment abroad at the expense of the Canadian economy. A similar outcome stems from using the underground economy to avoid capital taxes. The risk of discovery and the accompanying fines and costs limit this activity, but some estimates put the underground economy at 20 percent of national income.[44]

An important effect of taxes on capital and capital gains is over-investment in human capital. If a person obtains education and training in a field that unexpectedly booms, that person can experience an increase in income from work, which is equivalent to a capital gain on a financial or real asset. But this gain in human capital is not subject to a capital gains tax. As result, a given sum invested in education is subjected to lower expected taxes than an equal investment in other assets.

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42 Margaret Thatcher was convinced by this argument and introduced legislation to force local governments to raise more of their revenues through a head tax. This policy turned into a political disaster and speeded her departure from power.

43 Swedes, who are subject to very high levels of taxation, own proportionately more homes, fancy automobiles, vacation cottages and yachts than the residents of other European countries with comparable income levels but lower taxes. This trend in Sweden has been encouraged by the ability to deduct interest payments on loans from the income tax base.

44 See the article by Mirus and Smith in Lippert and Walker (1997).

Overinvestment in human capital is also encouraged by the fact that returns from it in terms of wages and salaries are taxed only once. The same investment in financial or real assets is subject to multiple taxation, as discussed above.

There is nothing wrong with investing in education. However, capital used for investing in education is not available for investing in business, research, or development. The rate of return on human capital before taxes is driven by the tax to be lower than that on other forms of capital. Total productivity suffers and per capita income in Canada is lowered by this distortion of capital markets. Eliminating the capital gains tax, or lowering capital gains tax rates, will reduce this loss of output.

On the spectrum between the head tax and capital taxes are the other dominant forms of taxation in Canada. Of these, sales taxes cause the least distortion since they are difficult to avoid by any means. Payroll taxes are somewhat more distortionary since they raise the effective return to work and thus encourage the consumption of leisure. Personal income taxes are more like taxes on capital because they can be avoided by working less, emigrating to lower tax countries, and working in the underground economy.

Based on these kinds of considerations, the OECD (1997) published some data supplied by the Department of Finance. They are shown in table 3.

As table 3 shows, the losses in output suffered by using the corporate income tax are, by far, the largest. Capital gains taxes are very similar to the corporate income tax since they fall on investments and capital.

Table 3: Illustrative Real Output Loss from an Extra Dollar of Tax

Corporate Income Tax	$1.55
Personal Income Tax	$ .56
Payroll Tax	$ .27
Sales Tax	$ .17

Source: OECD (1997), p. 85; Notes found in original publication: Source: Department of Finance; Preliminary estimates.

The implications of these ideas for the structure of taxes in Canada are simple and very powerful. The level of income in Canada could be raised substantially by an increase in sales taxes matched by a reduction in the taxes on capital so that revenues remain the same. For this reason, many economists favour adopting a universal expenditure tax. Under this system, Canadians would be taxed only on the money they spend, not on their savings and investment, nor the income generated by capital. The flat tax proposed in an influential study by Hall and Rabushka (1995) would create such an expenditure tax system while retaining the present practice of collecting the revenue through a tax on income. Savings would escape taxation, and income from capital would be taxed at the same rate as income from work.

This is not the place to analyze the merit of a flat tax or the concept of a universal expenditure tax system. However, the basic principles driving economists' recommendations for such changes in tax policy have important implications for the capital gains tax. Eliminating that tax and replacing the lost revenues through higher rates on sales and other taxes would result in a substantial increase in economic efficiency, and therefore a higher level of income for Canadians. The mechanism through which these gains would be achieved has been spelled out above. There would be more investment, the elimination of the lock-in effect would make using capital more efficient, and fewer entrepreneurial investments would be shifted abroad. Reducing the capital gains tax rates would bring about these benefits in amounts that would be greater the more the rates are reduced.

Chapter 5
Policy Recommendations

In my view, the preceding analysis makes a powerful case for very fundamental changes to the capital gains regime in Canada.

First-best policy: abandon the tax

There are three basic reasons for this recommendation:

1. Capital would be more efficiently allocated if the lock-in effect of appreciated assets caused by the capital gains tax was eliminated. The drain of entrepreneurial brains and financial angels would be reduced. The excessive reinvestment of capital alleged to be a serious problem in the absence of a capital gains tax can be dealt with through a differential tax on distributed and undistributed profits.

2 The economic growth induced by eliminating the tax almost certainly would increase revenues collected from other sources to more than match the relatively small net revenues collected presently from the capital gains tax.

3 The fairness of the distribution of after-tax income would be affected only slightly. Presently, capital gains taxes are paid predominantly not by the rich, but by middle- and lower-income Canadians. The principle of horizontal equity is breached in the current tax code in several different ways when it serves other fiscal and social objectives well. It could and should be breached again in the name of the greater good for all Canadians.

Second-best policy: lower the rate

If politicians cannot be persuaded that it is in their and the public interest to eliminate the capital gains tax completely, the second best policy would be to make Canada's rate equal to that existing in the United States.

Under this policy, Canada would enjoy some of the benefits of the more efficient allocation of capital and greater economic growth mentioned above. In addition, the proposed rate deals with the fact that in today's world of high mobility of capital and people, Canada cannot afford to have policies that make investment and entrepreneurial activities less attractive than they are in the United States.

Canada has suffered long enough from a tax regime more inimical to economic growth than that in the United States. We cannot afford to continue policies that will further widen the gap in income between the two countries. The fiscal surpluses expected in Canada during the first years of the new century offer a splendid opportunity to make the Canadian tax system more competitive.

Third-best policy: return to the original 50 percent inclusion rate

Ranking third on my list of recommended changes is lowering the effective capital gains tax rate by lowering the inclusion rate for realized gains from 75 percent to 50 percent. Such a change would return the rate of taxation to the one adopted in 1972 after much public inquiry into its costs and benefits. Fiscal contingencies and emergencies motivated the subsequent increases in the rate. The increases were undertaken without a full understanding of the adverse consequences they would bring for economic growth and revenues. The fiscal problems have now passed, and the above analysis shows that lower rates would increase rather than decrease revenues.

Fourth-best policy: lower the inclusion rate to 65 percent

The House of Commons Finance Committee in its 1999 report (pp. 62 and 74) has recommended lowering the inclusion rate to 65 percent; rumours have it that this option will be accepted in the 2000 budget. The recommendation is undoubtedly based on testimony given by Professor Jack Mintz, one of Canada's foremost academic taxation experts at the University of Toronto, and President of the CD Howe Institute. He argues that at this rate of inclusion, the effective rate of taxation for capital gains is equal to the tax rate applicable to small business profits. While this policy eliminates an efficiency-decreasing distortion in the tax system, in my view this effect is minimal in relation to all of the other efficiency costs of the tax discussed above.

Minor policy changes

If the capital gains tax is eliminated, I recommend the differential taxation of retained and distributed earnings of companies. The difference in the rate can be set at a level that discourages the excessive reinvestment of profits and the use of other methods to shift wages, royalties, interest, and other income into company earnings. This policy has been in effect in Germany and while it complicates the tax code, at the very least it deserves in-depth study.

If the capital gains tax is retained, at whatever level, I recommend indexing capital gains to inflation. The reasons for this recommendation have been discussed at length in chapter 3. This policy may be cumbersome to enact, and require much difficult administration. However, the benefits are potentially so large that at least the policy deserves careful further study.[45]

If the capital gains tax is retained, at whatever level, I recommend creating what some refer to as Registered Investment Plans. Such investment vehicles are used widely in the United States and offer a tax shelter for investors. They involve investing after-tax income, but allow the tax-free accumulation of dividends, interest, and capital gains. In effect, assets in such an investment vehicle are not locked in. These Registered Investment Funds are desirable for government since they raise tax revenue at the beginning, while the Canadian RRSP plans raise it at the end when the funds are withdrawn. This characteristic of the proposed investment vehicle should make it attractive to some politicians and those concerned about the present taxation capacity of the economy.

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45 An attempt will be made to assemble at The Fraser Institute in 2000 tax experts from Australia, Ireland, Luxembourg, Mexico, and the United Kingdom to discuss the workings of partial or complete indexing practised in these countries.

CHAPTER 6
The Politics of Tax Reform

The economic and equity case for lowering and even eliminating the capital gains tax is very strong. However, it is very difficult to affect the desirable change for two reasons. First, tax policy is made, for the most part, by the bureaucracy at the Department of Finance. Here is a description of the policy making process in Canada by Winer and Hettich (1999):

> The most important phase of the tax policy process [in Canada] occurs within the federal bureaucracy, especially the Department of Finance, and is usually conducted in secret. Ministers heading other departments, including even the Prime Minister, normally exercise only minor influence. The secrecy of the tax policy process and especially the fact that most tax legislation is fashioned behind the closed doors of a non-partisan bureau makes it difficult for ordinary members of Parliament and representatives of interest groups to exert a direct influence on tax legislation as it is being drawn up. Influence may of course be exerted indirectly in the normal course of political debate. But on the whole, the tax policy process in the Canadian parliamentary system seems substantially more impervious to representation by legislators and lobbyists than does the congressional system." (p. 30)

Incidentally, the authors of this quote also describe the tax formulation process in the United States and show that it is much more transparent and open to input from affected interest groups as well as academic and other groups concerned about general welfare. Perhaps for this reason the capital gains tax is so much lower in the United States than Canada, and there appears to be continuous lobbying for the complete abolition of the tax and ever-lower rates.

While it is very difficult to penetrate the culture of the bureaucracy at the Department of Finance, as the authors point out, there are other routes to effect change. General political pressures can be applied to the government, and the Minister of Finance can impose his will on the bureaucracy. Creating such political pressure is not easy, but here are some thoughts on how it might be generated.

First, public education is needed so that the facts presented in this study are known more widely and the case against capital gains taxes is no longer seen as the case made by the rich in their own interest. In a sense, this study is part of such an effort, but I have no illusion about its appeal as a popular bestseller. It will be read by only a very few people, though their influence on public opinion is probably disproportionately large.

Second, the basic information contained in this study must be popularized and presented in ways that make it more accessible to the general public. It remains to be seen to what extent even the specialized business sections of national papers like the *Globe and Mail* and the *National Post* will pick up on the ideas, and whether they rate a press release by any news networks and services.

Third, the idea for eliminating the capital gains tax must be taken up by a political party in its attempt to appeal to a sizable and influential part of the electorate. I can envision the right-wing parties in Canada, be they the Reform Party, the Progressive Conservatives, the Canadian Alliance, or some new entity, making the proposal a major part of their platforms. The probability of this happening would be increased significantly if the United States lowered its capital gains tax rate further or even eliminated it. Additional stimulus would come from the German government's announcement that it would lower capital gains tax rates in December 1999.[46]

The ability to mobilize public opinion through an election campaign is very substantial, even on topics apparently too technical and remote from the self-interest of most voters. The problems created in Canada by the deficit, which threatened to spiral out of control in 1992-93, are an example in point. Public awareness of these problems increased steadily during the months leading up to the election, in spite of the denial of the

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46 See the editorial, "Germany's Quiet Tax Revolution," *Wall Street Journal*, December 28, 1999.

three major parties—the Liberals, PCs, and NDP—that they existed. I am particularly aware of this process since I was a candidate for the Reform Party in the 1993 federal election and campaigned heavily and successfully on this issue. In fact, the denial of the deficit and debt problems by the major parties was the main reason for my accepting the nomination to run for office.

An analogous opportunity exists for candidates vying for the leadership of major parties. They are in a position to elevate the issues greatly in the minds of their supporters and the general public. Such a process took place during the 1980s, when then-Prime Minister Brian Mulroney was on record opposing free trade with the United States and Mexico. However, leadership candidate John Crosbie, a long-term Member of Parliament from Newfoundland, took up free trade as a leading issue in his campaign. Only when the popular appeal of the policy became obvious did Mulroney embrace it and eventually make it the biggest issue in the 1989 election campaign.

Canada's Senate has taken up the gauntlet and at the end of 1999 held a number of hearings on the merit of capital gains taxation. Three of these hearings are reprinted in the following chapters. Readers will note that most of the senators indicated that they supported fundamental capital gains tax reforms. Unfortunately, media coverage of these hearings has been minimal, and it is difficult to know the extent to which the arguments presented by the expert witnesses have been noted by the bureaucracy, the Minister of Finance, cabinet, the Liberal caucus, and the opposition parties.

An afterthought on the big picture

In the bigger scheme, I believe that Canadians would be well served by adopting tax policies that have proven so successful in countries like Ireland, Switzerland, Hong Kong, and Singapore. These countries have offered investors and workers such low taxes that they have attracted very large amounts of foreign investment and highly skilled labour. They have encouraged their own citizens to keep their money at home, work harder, and take more risks. As a result, the economies of these countries have grown very rapidly. Ireland's per capita income exceeds that of the United Kingdom after it lagged behind it for most of history. It is now greater than Canada's. Singapore and Hong Kong may soon have per capita incomes greater than Canada's. Switzerland continues to be one of the richest countries in the world, in spite of a dearth of natural resources. In the appendix to this part of the study I provide some basic information on the relevant taxation regimes of several major countries, together with information on their recent rates of economic growth.

Canada *can* be the Switzerland of North America. The proposed changes to capital gains taxation are a small but significant step in this direction. Needed is the determination to bring about these changes in spite of present political opposition. I am convinced that if the general public fully understood the broad, longer run benefits of a low tax regime in Canada, it would richly reward the political party offering it. The ideologues consumed by notions of relative incomes and the sham definition of poverty they imply, may be noisy and have the support of some media, but they are small in numbers.

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Part II
Expert Testimony before the Senate Committee on Banking, Trade and Commerce

Expert Testimony before the Senate Committee on Banking, Trade and Commerce

The following contains the unaltered transcripts of testimony given by a number of experts to the Senate Committee, which were published by the Senate as public documents of the Second Session of the Thirty-sixth Parliament, 1999. The clerk of the committee has kindly made available to me an electronic version of these documents.

My own testimony is not reproduced here, since it would simply repeat the material in Part I of this study. Appendix B contains a paper written by Professor Reuven Brenner of McGill University, which served as the basis of his testimony and supplements the material he was able to bring to his presentation at the Senate.

The testimony of expert witnesses included in this volume serves two important purposes. First, the questions raised by the senators provide some useful information about the priorities and concerns of these politicians who pride themselves in offering the people of Canada "a second sober thought" on the laws and policies made in the House of Commons. Readers may find it interesting that senators from both major parties are surprisingly supportive of the idea that capital gains taxation in Canada needs to be changed, if not abandoned.

Second, the answers provided by the witnesses add nuances missing from my lengthy analysis above and show differences of opinion among the experts and with my analysis on some crucial issues. In particular, Professor Brenner adds broad international, historic, and business perspectives which stem from his own distinguished scholarly research and practical experience working as a consultant with business.

Professor Jack Mintz brings to his testimony the experience of many years of academic research on a wide range of fiscal and taxation issues. He also was the head of a committee appointed by the Minister of Finance, Paul Martin, which published in 1998 a searching study of business taxation in Canada. Through this and other work with government he has accumulated great political acumen, which together with his academic qualifications, make his testimony especially interesting reading.

Professor Vern Krishna teaches tax law and thus brings to the discussions the perspective of a person who has practical experience, broad perspectives, and up-to-date knowledge resulting from teaching and research.

The last two hearings of the Committee brought the expert views of men with much practical experience in the world of business, finance, and economic consulting. John Dobson and Ian Soutar have managed large investment portfolios with great success and have much first-hand knowledge about the impact of high capital gains tax rates on returns from savings and investment. Allen Sinai is the President of Primark Decision Economics, one of the largest and most renowned consulting firms in the United States.

Detailed biographical information about the witnesses is contained in the transcripts. The Senate Committee and authors have given their permission for me to use the official transcripts in this volume.

CHAPTER 7
Professor Reuven Brenner

THE STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE, EVIDENCE, OTTAWA
Wednesday, November 24, 1999

Senator Leo E. Kolber (Chairman) in the Chair.

The Chairman: Welcome, honourable senators. This is the first substantive meeting of our committee since we decided what our plan of attack would be for the coming session. Aside from whatever legislation will be referred to us, we have decided to discuss the various effects of our present capital gains tax regime in as broad a context as possible.

The Canadian economy is relatively small and open compared to the other major industrial democracies. In recent years it has become more internationally intertwined in the global economy. With the advent of the FTA and NAFTA, Canada has become more vulnerable to the business and economic conditions in the United States.

In practical terms, Canada is subject to the global competitive pressures in the markets for goods and services. That mirrors our productivity performance in the international market for capital and labour, particularly entrepreneurial skills. This competitive pressure also extends to the stance of public policy in many substantive areas, such as tax policy, trade policy, industrial policy, health and education policy and the regulatory regimes.

Because of the international mobility of resources, the committee believes that Canadian public policy makers must take careful account of substantive policy developments among Canada's trading partners in areas such as tax policy, if Canadian society is to flourish in economic terms. The ability of Canadians to find "good jobs" is a prerequisite to meeting this objective. The key policy instrument that structures the willingness of entrepreneurs to take risk, which sets the stage for a prosperous society in the global context, is taxation.

As a first step, the committee will begin immediately its fact-finding study in a domestic and comparative context. In other words, we will study Canada's policy on capital gains taxation. The committee wants to determine the real economic effects on such variables as savings, investment, cost and availability of capital and ultimately on job creation. In undertaking this study the committee has in view making recommendations to the Minister of Finance on how this tax might be improved in order to best benefit tax payers and provide better prosperity for all Canadians.

We are delighted to have with us this afternoon Mr. Reuven Brenner, who has written a provocative and interesting piece on capital gains tax, which has been circulated to you all. Mr. Brenner holds the Repap Chair at McGill's School of Management. He is on the faculty of DUXX, Monterey, Mexico, and is a partner at Secor, a well-known Montreal-based strategy-consulting firm. He also works with Gilder, Gagnon and Howe, a New York-based money asset management firm, and WEFA, a Philadelphia-based company. As well, he is a partner in the Washington-based Alan Reynolds and Associates, as well as Lamerac, a Montreal-based M&A boutique. He has done consulting work for corporations in Canada, the United States and Mexico, and is often invited to give speeches to both business and general audiences. He is on the board of two internet companies—Stria Communications, based in Montreal, and Assista, based in San Francisco.

Mr. Brenner is the author of six books, is a regular contributor to *Forbes*, *Global*, *The Straits Times* (Singapore) and is on the Board of Contributors of the *National Post*.

In 1992 he had the honour of receiving the Killam Award, which is given every year to 15 Canadians in the arts and sciences. In 1995 the *Masters and Mavericks of Modern Economics* dedicated a chapter to his works, which range from finance and currency matters to history. In 1999 the Cato Institute in Washington appointed him as Adjunct and the Royal Society elected him a Fellow.

Welcome, Mr. Brenner. Please tell us what you think of capital gains and then we will open the meeting to questions.

Mr. Brenner, Faculty of Management, McGill University: Capital gains taxes are frequently singled out for specific treatment. I shall explain this in a few basic steps. Prosperity is not based on the GDP numbers we see published in newspapers. Those numbers are not relevant to prosperity, as you will see in the simple example that I will give to you. You purchase a stock for $100. The stock's value drops by 50 percent and is now worth $50. Then the stock increases by 50 percent and now is valued at $75. Therefore, you have lost 25 percent of your initial value.

Now, when we publicly state that Canada is growing at a rate of 3 percent or 4 percent, I think people forget that in fact this is actually in devalued Canadian dollars. So, first, we devalue ourselves by 30 percent, and then, if we grow by 3 percent or 4 percent, some people may try to make publicity out of that, but in fact we have become much poorer. It is the growth rates that you must be careful to measure, whether in a monetary standard or in a devalued currency. Those are two completely different things.

Prosperity really means something else. It means moving capital away from the old human and financial capital to do something new. In order to do something new, we must experiment. No one knows what the future holds, so we are making a lot of mistakes. Therefore, the issue is whether there are better people who should be making the decisions about the future? More important, are there institutional arrangements in place to quickly correct the mistakes as soon as they are recognized? In this sense, when governments err in their decisionmaking about the allocation of human and financial capital relative to private markets, they tend to persist in their mistakes simply because they can cover them in various ways. One way is by raising taxes; another is by devaluating—two options that, fortunately, are not open to most private companies.

Once it is clear that prosperity means moving capital from the old to the new, then capital gain tax has a very clear meaning: it is really a tax on this switch and it has the effect of slowing down the process. I shall give you some very clear examples of what that means and how to quantify it.

Let me say first, though, that in public discussions much is made of the fact that the capital gains tax is a tax on the relatively rich and, therefore, on the basis of fairness, that is what should be done. However, that is a completely mistaken argument, because taxes are not always paid by the entity on which the government imposes the tax. The tax is only paid by those who cannot move either the capital or themselves.

I will give you an example. You may remember that a few years ago the government of Quebec increased the tax on cigarettes. The next day, all cigarette stocks went south of the border and were then quickly smuggled back into Quebec. In vain did the government impose a tax on cigarettes because, in fact, the tax was not paid. It was evaded and avoided. The same process takes place the moment you impose a tax on capital. Capital will not move to Canada, if it is taxed at a high rate, but will move to other countries, and capital that is here will, the moment it is freed, move out of the country.

In this sense, "capital gains" is really a misnomer and that is why the revenues from this tax are relatively minuscule.

How does it prevent switching to the experimentation? I will give a simple example. Take the fibre optics industry, which is currently one of the fastest growing industries. In fact, it was invented by an engineer working for General Instruments. For years he tried to promote fibre optics within his company but without success. In the end, an angel gave him a few hundred thousand dollars and he left his job at General Instruments and later established his own company. When that company had the IPO, the market value of his shares was about $200 million. Now, if there were no angels, this man would have continued as an engineer. That is what it means to finance the future, and that financing depends on capital gains. The higher the capital gains tax, the fewer angels we have.

In the United States, the capital gains tax is about 18 percent, whereas in Canada, the rate is about 40 percent. If our tax rate were lowered from 40 percent to 30 percent, that angel could finance many entrepreneurial ventures at much lower costs because he would have less costly access to equity. The reduction of tax on capital gains speeds up the flow of capital. It does not keep it locked. Thus, an engineer turned into an entrepreneur and created a multibillion dollar business. That is how Apple was created, and so forth.

This brings me immediately to the point now being discussed in Canada. Which tax should be cut if we want the strongest effect? We can consider three alternatives. One option is to cut personal income tax; another option is to cut corporate tax; and the final option is to cut tax on capital gains.

Why should capital gains, in my view, take priority? It is exactly for the reasons that I mentioned. Let us take the previous example with the engineer. Even though General Instruments had to pay somewhat less corporate tax, that did not necessarily mean that the management of the corporation would bet on that engineer. The ones who are betting on the future, in general, are the angels—the angels who were entrepreneurs themselves and experienced success. They took the entrepreneurial way, they have the network and they can do the matching. Therefore, the biggest bang for the buck comes when you lower the capital gains tax. If you lowered personal income tax, obviously people would benefit, but that would not allow someone who is earning $50,000 or $100,000 to become an entrepreneurial angel. If you compare the three options previously mentioned, I would say the fastest way to encourage entrepreneurial ventures would be to reduce the capital gains tax.

Today the federal and provincial governments realize that something is wrong. They have tried to compensate for the very high capital gains tax by subsidising various ventures. For example, Montreal is the biotech capital of Canada, or so it claims, because the companies pay only 40 percent of that cost and the government picks up the other 60 percent of the tab.

How many of the biotech companies existing in Montreal will ever be commercial successes? I do not know. Here we come back to the difference between governments approving and continuing to finance ventures and private angels or venture capitalists doing it. It is not the same process, nor the same people.

To give an extreme example, there are also a lot of media, movie and other businesses in Montreal that are similarly heavily subsidized. If a company like that had come out with a cartoon, with a mouse, would the government bureaucracy have ever financed such a venture? Probably never, and you would not have another Walt Disney.

So this is not the same process; it is not the same people. We have the biotech and other industries in Montreal today, but very few of them are commercial successes. We really do not know if it is just the pure transfer of wealth without creating very much.

In a few words, that is the skeleton of the argument that capital gains should be singled out and should get priority, and interestingly, as you may have noticed, it was reported in today's *Financial Times* that Argentina is moving in that direction; and the UK has just lowered its capital gains taxes. However, in Canada we are only debating it in terms of fairness.

I want to add one more point. In the example I gave of the engineer developing fibre optics and having shares worth $200 million, that is not an unusual value for human capital. You can see that almost daily when you look at trading in stock markets. There is a group of people called the "vital few." When those people go from one company to another, the market value of the respective companies can drop or rise by half a billion dollars.

Take as an example the CEO of Kodak, although he does not have as good a reputation as he had when he was previously the CFO of Motorola: the moment it was announced that he had quit his job, Motorola market value went down by $300 million; when it was announced that he had joined Kodak, their market value went up by half a billion dollars.

Imagine what might happen if Bill Gates said that he did not want to put up with the investigation, or torture or whatever you want to call it, and he moved out of the United States and came to Canada. How much wealth would be transferred from one place to the other? This tells us that some people, the vital few, have very high value. In a society in which envy is rationalized under the veil of fairness, we may end up losing those vital few. In such an event all of this wealth would not be created, because compensations of $200 million are considered to be too high. However, if you look at it historically, many people have been compensated at this amount.

That is my brief presentation.

Senator Tkachuk: With regard to the "vital few," in your paper you mention that business is no different from the arts or athletics or any other singular profession in which there are a vital few who move what happens in the economy or in the arts. One could say, for instance, that that is why Wayne Gretzky got paid so much money. It was because he filled the building. Frank Mahovlich used to fill the building, too.

We have heard a great deal of debate about the brain drain—people leaving our country because of the lack of opportunity and because of high individual tax rates. I agree with you that capital gains tax has a lot to do with the fact that they are leaving the country, especially in the business world. Would you comment on that? We have had people saying that there is really no brain drain, that that is a myth.

Mr. Brenner: First, what you were saying, using Wayne Gretzky as an example, is well documented. I do not have the numbers before me, but I gave statistics to the *National Post* that show how one individual can make a huge difference. Before Michael Jordan joined the Chicago Bulls, the company was bankrupt. There was no attendance, nothing. The only thing different was that he joined and pulled up that team. Yes, he was the same type as Wayne Gretzky. In that case you could see how much value was created just by one individual. There is a big difference between a good team and a good team under one inspiring leader. I am sorry that I did not bring the numbers with me.

It is good that you mentioned sports, because we say all the time that people are our assets and yet the only business in which the people are actually on the books is professional sports in the United States. In no other business do the people appear on the books. That is why it is so misleading. You really cannot learn the value of a company by just looking at book values. When you look at the professional sports in the US, then Michael Jordan appears on the balance sheet at the value of his contract.

On your question about the brain drain, we only have approximate numbers. For a couple of reasons we do not know the exact number of young people or entrepreneurs who are leaving Canada for the United States or other places. One of the reasons is free trade. Since the Free Trade Agreement, Canadians who have post-secondary education, for example, a master's degree, can get a kind of temporary visa for the United States; they do not appear under immigration but under something else. It has become much easier just to move. Students who finish at, say, McGill with a master's degree in engineering or computer science often move to the United States, and they do not appear in the statistics at all as if leaving for the United States. Therefore, whatever numbers exist underestimate the movement by far.

There is also a big difference in quality. Someone with a degree in engineering from some other country may enter Canada. There may also be an engineer who finishes his degree at Waterloo and moves to the United States. That does not mean that the two are the same type of engineer. There is something called self- selection.

Let us look at Waterloo again. I would not say that this is scientific; it is more anecdotal. However, if you were to ask the people at Waterloo, they would tell you that the top of the class will all end up in the United States. Those who are not at the top of the class will stay in Canada. That is a big difference. There is a big difference in quality and quantity.

Statistics Canada measures the quantity but not the quality. Thus, I do not buy all their numbers. If we look at the composition of the mix of people leaving Canada, they are computer engineers, scientists and physicians, and Statistics Canada does have the composition and the ages.

Obviously they do not know their potential in the US nor how much they will earn there.

Senator Tkachuk: I have a question on the capital gains tax itself. The government publishes a book that I find rather fascinating and humorous. The book is based on the assumption that the government holds all the wealth and every tax break granted is a cost or an "expense" that the government incurs.

In my view we should eliminate the capital gains tax all together. What would be the cost, if any? I do not believe there would be any cost, but I would be interested in hearing your opinion.

Mr. Brenner: No. In fact, in all the countries where capital gains taxes were significantly diminished, there was such an effect on the income-generating side that other indirect taxes more than compensated. There is plenty of evidence on that. In every country where capital gains taxes were significantly lowered, incomes increased for the very simple reason, as I said earlier, that this is a tax that can be easily avoided by simply not selling one's asset. How much income does holding assets generate for the government? None. The principle is very simple: when such a tax is lowered, the capital starts flowing faster and revenue is produced.

We touched on a more important point and one in which the Senate can play a role. It is not possible to make a significant change in tax policy unless the language of public discourse is changed. That is not something that happens easily from one day to another. Senator Tkachuk's example that a lowering of taxes is somehow termed a cost for the government shows the absurd language that is in use. That absurdity must be explained. There are many other absurd terms used in political discourse today, but it is not a short-term process to effect language changes.

As an example, people talk all the time about job creation. In my view, that is also very false language. The wealth of the country depends on the types of jobs you are creating. The government can always create jobs. I grew up in a communist country for the first 14 years of my life. The statistics said that 99 percent of the people were employed there. So what? If the country has devaluation and taxes and closed capital markets, the country will be made so poor that it cannot import any capital. Then people will shovel snow with a spoon. Sure, plenty of employment is created; everyone will work like crazy. Everyone also will be very poor. It is as simple as that.

False language in public discourse is so ingrained that it will take some time to educate people that not every created job is worthwhile. It matters a great deal what types of jobs are being created.

Senator Kroft: I do not know quite where to begin. You set up so many enticements for me. The question of outflow of people or brain drain is a subject of great debate; there are many views and many analyses. I do not want to press you for your sources now, but have you very specific numbers and very real evaluations of that situation? It would be helpful to the committee's work if, at your leisure later, you could provide to us the support that you have for these numbers.

Mr. Brenner: On that, there are two things. Are you asking how I go, in the text illustrations, from the 100,000 to the $200 million.

Senator Kroft: No; how do you get the $100,000? What are the nets? A lot of data is being tossed around. I read different numbers all the time. We will hear much about that question, so I would be interested in knowing just how you arrive at those numbers in net terms. That would be very helpful.

Mr. Brenner: Yes, okay.

Senator Kroft: I will move through the various aspects. I would also like to pursue something on which I take quite strong issue with you. Before I get too involved in differing with you, I want to be sure I have understood you correctly. You are talking about the reasons people move. You make the statement that those who move in order to search out greater opportunities, rather than differential taxes, are on the wrong track.

I believe that people move for opportunity and that, if there is a tax benefit, that is not part of the mix but is lower down the line. You are really taking a very strong slam, if I can use the vernacular, at the suggestion that people move primarily for opportunity. I would like to have you expand on that a bit if you would.

Mr. Brenner: Regarding opportunity, take the example of the engineer who was working for General Instruments. A person like that, an innovator, works on a project and he wants to see it brought to life. He did not know when he moved that he would have an IPO that would bring him a $200 million value. That is not what I am saying. The point is that that engineer would not have been financed by the angel under another tax system.

For example, there may be many good engineers in Canada today who simply need the backing of a financial angel to bring their dream to life, but if the angel is facing a 40 percent tax here while just 20 minutes south of the border he is facing only an 18 percent tax, where will the financing likely be raised? It will be raised there and not here.

I am linking the two things, the pursuing of opportunities and the financing of dreams. I am not saying that that engineer ever thought he would have $200 million, but he did want to see that fibre optics project brought to life. That is it.

As an extreme example, Israel today saw one of its biggest booms when, suddenly, 800,000 immigrants came from Russia, many of them engineers and scientists with good ideas. Those ideas obviously were not realized in Russia. Why they were not realized? The people were the same. The issue is not the ideas. The issue is whether, in one environment relative to another, the ideas can be commercialized.

I do not say that this is a tax issue only. We would be on the wrong track to think that. People want to experiment. They have dreams. Some cities in Canada are only 20 minutes north of the US border, so the residents there have only a 20-minute difference between paying a 40 percent tax or an 18 percent tax. Which place will attract that critical mass of people who can put their own plans into place? The critical mass is crucial and it is linked to opportunity. People do not bring their dreams to life alone. Other people are needed.

I used to work with some American companies. Many times they put in a condition. For example, despite the Internet and so forth, they are not ready to finance them even in Boston or New York. They are ready to give the money, but only if they move to Silicon Valley. It is that strict.

Even under the same tax system, they want them to be closer to that critical mass of talent so that the information and knowledge can flow quickly and the matching of people can happen and people can reconfigure quickly.

Now, here we are, just 20 minutes north of that place, and we want to tax these types of experiments at more than double what they do there. That is what I meant by opportunity.

This links back to your first question about how I arrived at the numbers. First, on the 100,000 people who left Canada, that number was estimated by Statistics Canada and is their number. How did I calculate the wealth? In my example, I considered someone who made $100,000 a year. With that $100,000, at a 5 percent discount, the wealth is about $2 million. You multiply and arrive at those numbers. That is what I did, and that is all.

The historical context is very clear. Consider a place like Hong Kong. Hong Kong was a port of fishermen. Hong Kong did not become what it is today because suddenly the fishermen became entrepreneurs. Hong Kong was made when the communists threw everyone out of Shanghai without a penny. All those people arrived in Hong Kong with a tremendous amount of knowledge and entrepreneurship, and they rebuilt everything from shipping to textiles or whatever.

You can go back further in history, and it is the same story. Amsterdam was the miracle of the 17th century. That was where you had the first stock market in the world, and very sophisticated derivatives were traded there. It is not the fishermen who did that. It was the first federal type of republic that was tolerant toward all religions. The Jews of Spain and the Huguenots from France and Protestants from all around arrived there, as well as the bankers from Italy. They made Amsterdam what it was. Most of the capital in Amsterdam belonged to foreigners. That is how that city came to such a scope.

I can go on with as many examples as you want. Historically, the movement of people who followed where they could be financed brought a place either to very quick ascendance or into quick oblivion. I will tell you how Amsterdam declined. When England wanted to catch up with Amsterdam, they told the entrepreneurs that, if they came to England, they would get a monopoly on their trade. In fact, we live even today with the inheritance of these power politics. That is where the 17-year patent protection comes from. England promised that any foreign artisan or craftsman who came to England would get a monopoly until he trained two to three generations of apprentices. Since apprenticeship was seven years, that is 14 plus 21 divided by two, and rounded it is 17 years. That is the origin of the patent law that exists still day. That is how they got the entrepreneurs out of Amsterdam and the financial market moved to London.

If you want, I can go on with endless examples about how places prospered and fell behind.

Senator Kroft: That is a fascinating piece of economic history, but I hope we can continue as a committee to keep our focus on capital gains tax. It is still not clear to me that these connections are necessarily so. I would like to conclude with your general perspective. I found that an astonishing paragraph, but perhaps in some way you can link it to your thesis. You indicate that politicians have an interest in preventing a country from being prosperous. My concern is that, if you start with a premise like that, it is difficult to know where you will end. It does not incline me well toward what follows in your other views, unless I perhaps can understand that more clearly.

Mr. Brenner: I will give you just one example, that of Mexico, but I can go to almost every country around the world. Ask yourself this question: Why have Latin America and the Asian countries, which are democracies with elections and so forth, remained poor? I will give you the statistics on Mexico. Only 1 percent of the population, after 70 years of democracy, has an annual income above $10,000, officially. Let us say that the numbers are wrong and three times as many have it. I think you must also ask yourself this question: How did a country like Argentina, which was one of the richest countries between the two world wars, become one of the poorest countries?

If you go to these countries and see what is happening there behind the facade of words, you can see that this is exactly the game that was being played. Once again, there is nothing new about it. Catherine the Great always said that she would invest as much in education as was necessary to win the next war but not as much as to bring about an internal revolution. More or less, that is the policy that shaped many Latin American and Asian countries.

The Chairman: We will have trouble getting that one across. This is fascinating, but we must try to stick to the issue. I appreciate what you are saying.

Senator Tkachuk: Senator Kroft opened this up. He asked a question.

Senator Kroft: I referred to the report. I am trying to understand. I have a concern that we be effective and focused. Therefore, I am trying to bring major statements—iconoclastic statements, in some cases—into focus to ensure that they do indeed relate to the subject at hand.

Senator Tkachuk: Then let him answer the question.

Senator Kroft: I did not say a word.

Senator Oliver: Thank you for your presentation. We are lucky to have you here today.

As you know, this is the beginning of our study on capital gains. We know what the Canadian capital gains situation is. Based on your research and your experience, it would be very helpful to me if you could tell us briefly what some of the other major countries in the world have done vis-à-vis capital gains tax. In your paper, you mention Taiwan, Australia and the U.K. I would be interested to hear about countries such as Holland and Sweden. What has happened there in relation to their capital gains tax?

Some people have said that Canada should completely eliminate the tax, and that that would solve our problem. A number of other jurisdictions have said that they should keep the tax but develop a new public policy. For example, if you have a capital gain on a real estate deal and you dispose of the income on that gain within three, four or five years, there would be no tax. That is one public policy possibility. What do you think of some of those possibilities vis-à-vis what has happened in some of the states in Europe such as Holland?

The Chairman: When you say "dispose," do you mean reinvest or just spend it?

Senator Oliver: Reinvest. In Holland, for instance, they say "reinvest in some other like business."

The Chairman: That is clearer.

Mr. Brenner: First, The longer you keep the capital, the lower the tax is. This idea has been proposed in a couple of countries. I think it is wrong, because you get into all types of fiscal manipulations. It makes the system very complicated and you give a lot of jobs to lawyers and accountants. You want to speed up the transfer of capital, not lock it in. However, you tend to give the wrong incentives. By holding the capital longer, you are locking it in. If you had withdrawn it more quickly, you could have invested it in something new. In that sense, those are mistakes. That is why many people have said, with regard to this particular tax, that the optimal rate is zero. You want to speed it up.

Senator Oliver: Is that your view?

Mr. Brenner: Whenever Mr. Greenspan gives testimony, he always says that it should be zero. I would not say that that is my only view, no. Absolutely not. I tried to explain why, in this particular case, the number zero arises. It would speed up the process where I begin to move away from the locked capital and move quickly into new experiments.

You must put this in the broader context, because the capital gains taxes are zero in both poor countries and rich countries. That is to say, you can have a zero capital gains tax, but the country will not be successful if you close the financial markets there. I am not saying that a zero capital gains tax is the remedy for everything. There are plenty of poor countries in which the capital gains tax is zero.

Concerning what happened in Sweden and Ireland, and so on, the general evidence is that wherever the capital gains was significantly lowered you then experienced booming new experiments and new enterprise. I am not saying that that is the only factor, but if we want to choose between three factors, it is the entrepreneurs and the angels who finance new companies.

Let me give you another example. The Scandinavian countries are often portrayed as welfare states, and yet they succeed. For example, today many people use Nokia and Erickson products, which are the two best wireless companies. Why do those companies come from Finland, then, and not from the United States? Again, this relates to a superficial debate. Finland has been doing well because it was among the few countries in the world where telephone companies were never regulated. In the 1930s, Finland had 850 telephone companies; over the years those were reduced to about 45. They had a very competitive environment and their employees were prepared. The moment telecommunications became deregulated around the world, they were ready to take advantage of the situation because of their background—that is to say, because that happened to be their competitive advantage because that sector had never been regulated in Finland.

The Chairman: What do you think would happen if we brought our capital gains tax back to zero?

Mr. Brenner: You would immediately see a lot of movement toward experimentation in different areas, especially wherever there was a critical mass of talent. Also, it would attract a lot of the talent that left this country to return to Canada.

Senator Oliver: In the terms of reference that our chairman gave outlining what this committee is beginning to study, he stated that "the committee wants to determine the real economic effects on such variables as savings, investment, cost and availability of capital, and ultimately on job creation." Assuming that the capital gains tax in Canada becomes zero, would you mind commenting on that?

Mr. Brenner: Let me go backward, because this is important. Capital would be instantly available; a lot of capital would flow here. There would be a lot of job creation. They would be good jobs, not the types of jobs that we artificially create or sustain through taxes. That would be the first effect.

What would be the effect on savings? That is not important. Savings can be negative. The moment Canada establishes itself as a credible booming country after so many years of decline—and, if the rest of the world is ready to put their savings in Canada—why shouldn't Canadians benefit? I can save much less if the rest of the world savings can flow into Canada. I do not think savings are an issue at all.

Let us take, for example, the parallel with the successful company. If people give credibility to management and I have access to the capital markets but no retained earnings or profits, my stock and market valuation will continue to rise in spite of the fact that I have "negative savings." That is not an issue.

Senator Oliver: Savings is one thing, but there are also investment, availability of capital and job creation.

Mr. Brenner: All those things are increasing. Savings will probably decrease, but that is not important.

Senator Mahovlich: Mr. Brenner, what effect would it have on our dollar if we were to go to zero?

Mr. Brenner: It would go way up.

Senator Mahovlich: I am all for that, but what happens to our exports? We have people who rely on a low dollar. The country would be in turmoil.

Mr. Brenner: Considering the previous comments, I do not know how I can answer that question because it goes in a different direction.

Senator Oliver: It concerns productivity.

Mr. Brenner: No, not so much productivity; rather the issue of currency, monetary standards and exports.

Today we are living in a world of floating currencies, which happened when the Bretton Woods Agreement for a fixed exchange rate disappeared. Why did that disappear? It disappeared because, at that time, the popular fad was that central banks could print money and, somehow, that would bring about prosperity rather than inflation. With all the different regimes—that is, in France, in England, in the US, and so on—all the central bankers were printing money at different rates. Yet they wanted to maintain a fixed exchange rate. Obviously, you cannot do that, because the one who is more disciplined is selling exports, which hardly produces goods for a worthless piece of paper.

Senator Mahovlich: What year was that?

Mr. Brenner: That occurred in the '70s. That is why the argument in favour of floating rates came in. Floating, however, was not the remedy. If you are in any business, you want to sign a contract. You want to stay in that business and you do not want to go into the exchange rate business. For example, you are in the machinery business or the mine business, or whatever, and that is what you want to do; so you try to sign a contract so that you know what you are getting into. The floating exchange rate did not allow that. That is why you had, simultaneously, the development of this huge derivative market in which you try to ensure that you will continue to stay in your line of business and not inadvertently depend on how the central bankers pursue their various ideas about floating.

Senator Mahovlich: I do not know if the Prime Minister enjoys my saying this.

Mr. Brenner: He should not, but it was one mistake after the other. After you make a lot of mistakes, it is not easy to correct them.

Senator Mahovlich: That is just like a hockey game.

Mr. Brenner: Absolutely. It is similar. If I make a lot of mistakes, it takes time to rectify them.

I absolutely agree that you cannot do these things abruptly from one day to another. That is not the purpose of this presentation. It is to see it as a kind of anchor and to see where we are heading.

You have touched on another issue. The senator did not like my comments about politicians. Nevertheless, it goes back to that. One of the reasons that the export business, not only in Canada but around the world, has been "subsidized" by devaluations is that politicians depend on immobile people much more than they do on those who are mobile. They can count on their votes. Mines and forests are not so mobile. Therefore, you help them out because you gain their votes. It is almost impossible to separate these two things.

In response to what you are saying, yes, it will not be easy. It will take time to adjust these businesses to a monetary standard. That is why these things cannot be done from one day to another. They must be done gradually.

Senator Mahovlich: We have had some very wealthy people in the past, many of whom you have probably studied, such as E.P. Taylor. He moved a lot of money out of this country and down to the islands. What are your comments on that? Do you think that the government should have allowed him tax relief to put money into Newfoundland, for instance, to create jobs?

Mr. Brenner: Do you mean that he should have been forced to pay a kind of exit tax?

Senator Mahovlich: No. Do you think he should have been given special incentives?

Mr. Brenner: That is not the solution for this country. You can give incentives to one very rich guy to keep his money here. However, even if he keeps his money here, that will not bring so much. You want creation of wealth and the free movement of capital.

One of the other mistakes frequently made in these discussions about redistribution, job creation and fairness is that somehow, if you take away the money from the rich, then the poor people will become rich. That does not work. It does not work because, even if you take from the richest and give to everyone who is poor, the poor will each receive only $100. Then you are finished and the rest of the capital from the rest of the world will not come here. Your brains will be leaving to another country that will not deal with these kinds of games. The fact that somehow you entice a very rich guy to hold his $5 billion, for example, in this country, is neither here nor there. Those are very small sums you are talking about.

I was reading in today's *The Ottawa Citizen* an article about Canada becoming the fifty-first state of the United States. I think that argument is completely wrong. Perhaps there is a way to look at Canada with 30 million people as a kind of fifty-first state of the United States, but the conclusion does not follow. California is also just one of the states. That does not mean that California will adjust itself to the rest of the United States. Each state has its critical mass of people and its advantages, which can be developed under the proper tax system that retains and attracts better people.

Senator Angus: Professor, I apologize for not being here for your opening remarks. I was in my office reading the Carter report on tax reform, as well as your very fine article that appeared in today's *Financial Post*. It occurred to me that, perhaps, people like yourself who are advocating an abolition of the capital gains tax are not approaching the matter correctly. Let me explain why I am saying that.

Back in the 1950s and 1960s, when I was in university, as well as subsequently, there was no capital gains tax in Canada. I studied in the United States in the early 1950s. They had a capital gains tax while we did not. There was tremendous prosperity in Canada and a great flow of capital into our country. There was industrial development going on. It was a great time to be a Canadian.

In 1971, as far as I can determine, we brought in the capital gains tax. What were the reasons used to justify the bringing in of the capital gains tax at that time? We all know the history. Since then, it has gone up gradually. I think you will find most people agree with the situation in which we find ourselves, as explained by you. That is to say that the problem is that it gets put into the perspective that only the rich people are interested in removing it, that this is just a rich man's game with no political sex appeal and it is a terrible thing even to address it. Yet, reading and rereading your papers, as I have done since they were circulated to us by the Dobson Foundation some months ago, it is such an obviously good case why can we not make it better?

Do you agree that, perhaps, you have gone about it from the wrong side? Could we not go back to the way it was in the 1950s and 1960s, which is, perhaps, the kind of situation to which you would like to see us return, from a fiscal point of view? The effects of not having a capital gains tax were there in living colour. It is not a case of your being wrong; they really were happening.

That is a long-winded way to ask my question.

Mr. Brenner: Some people here want historical perspective, while others do not. It is hard to satisfy everyone.

Senator Angus: The name of the game is to get somewhere with your arguments.

Mr. Brenner: I shall try to use my arts of persuasion in responding to your points, senator.

First, why were capital gains introduced and why was inflation pursued in the 1970s? The truth is, as I mentioned indirectly before, this did not take place only in Canada. The late 1960s and the 1970s were the heyday of what I would call the Keynesian fad. The idea was that, somehow, the government can be the solution for everything. Thus, it was linked with something broader. As to why I think that became popular at the time, it was the result of a wrong inference from a particular situation.

When the US succeeded very quickly in catching up with the Sputnik and sending their man to the moon, people thought that, if that could be sold so well by the government, then how come we cannot declare war on poverty and solve all the problems of the world? The big difference between sending people to the moon and solving problems on this earth is that the moon does not change its orbit in response to what we are doing. However, people do change their behaviour in response to what we are doing. That is a big difference. Somehow, that difference was, I would say, out of sight and mind.

I shall go back to politics once again. The Keynesian view had great appeal. It is still used in public discourse today. You have asked why we cannot go back to correct the situation. We cannot, because we are using the wrong language in public discourse. The fundamental reason behind the Keynesian model and why the government has to interfere and spend is that investors are irrational and government bureaucrats are making much more rational decisions.

Obviously, such a model translated to mathematics would have great appeal. Once it is adopted that government spending is good and government bureaucrats know better how to spend and when, you go slowly to increased spending, in many ways. Members of the government bureaucracy, and not only in Canada but in western Europe and the US, were almost compensated for coming up with new ideas and new programs. That is how the system was changed in response to this global idea.

It was combined with the idea that the central bank can print money and, as long as there is unemployment in the range of 7 percent to 8 percent, there would be no problem. Twenty years later, when they noticed problems with that idea, they changed the vocabulary to the "Phillips curve," saying that somehow there is a trade-off between inflation and unemployment and all types of macro-economic fads. We are now slowly getting out of it, but it will take time, because the public must be re-educated. This must be debated with other language.

We always hear the term "job creation." That is the wrong language, because it matters what type of jobs you are creating. Also, when the government says it "invests," that is an inaccurate word. The government spends. Is that investment? If I spend on a highway that goes to the village of my constituents, a road which no one uses, that is not investment but spending. If I build a golf course, is that investment or spending? This is a play on words. To become investment, there must be some very good mechanism in place to correct mistaken decisions from persisting too long. This is what we do not have within government today.

Senator Oliver: Unless it generates a nice rate of return.

Mr. Brenner: Political return.

Senator Angus: Professor, it comes through clearly in your paper and in what you have said today that, if we reduced or even abolished the capital gains tax, we would have a stronger currency, more capital investment, more employment generally, a stronger economy, and greater prosperity for all Canadians. What could be a better election platform?

However, people do not believe you when you say that. I believe you, but people think that is because I have a lot of unrealized capital gains and therefore a personal interest. It is a compelling story. All of those things are "motherhood" things. Any politician would love to say that the government is doing this because it will create greater prosperity, a stronger dollar, and a better country to live in every respect.

Perhaps one way is to say that we made a mistake, that Keynesian economics were badly conceived and wrongly applied in this country, and that when we did not have capital gains tax things were a lot better.

I urge you to come up with credible ways to make the politicians believe you, especially the ones who wear red hats, because they are the ones who have the power to do it with one stroke of the pen. In the last three months, I have probably spent 200 hours alone with the Minister of Finance, and he does not want to know. He does not want to hear about it. It is absolutely politically incorrect for him to contemplate it. He is smart, he is a patrician, he has capital gains of his own in his blind trust. Politicians just do not believe that they can get the message across to the people.

This is a golden opportunity. The chairman of this committee has decided, at his own risk and peril, to institute this study, and we are all his willing horses.

Mr. Brenner: I will give you a pessimistic answer, but this is how I read political and business history. People do not make major changes unless forced to so. Companies make major decisions when they fear competition or are close to bankruptcy. Historically, governments have not made major changes unless their credit rating was cut and they could not bribe—although that is a strong word—their constituents into obedience. It has been 10 years since the fall of communism. I know that has been attributed to many things, but I believe it happened simply because the country was bankrupt. If the Russian government had had more money to pay for the military and for the bureaucrats, it would not have fallen. The major revolution in Japan and the French revolution happened when those governments did not have access to credit, to money. That is one element.

Senator Angus: It is a negative one, with all due respect. You are saying the reason I cannot give positive answers is that the government will resist major change. We know that, but we have to give it a carrot that is delicate and nice to eat.

Mr. Brenner: I will proceed to the next one, and this is where the government can be pushed into action. This is the debate that is going on today in Canada. The opposition try to say that Canadians are falling way behind, to which Mr. Chrétien answers that Canada is the best country in the world, that by all the OECD and United Nations bureaucratic studies we are number one. The debate is on whether we are really falling behind the United States or are still up with them.

Although over the last year the *National Post* has succeeded in putting this debate in the public sphere, it is not enough. Newspapers are one thing. On the federal level, there is not an effective political opposition, and these types of debates only happen when there is an effective political opposition. That is why this debate is not taking place.

Senator Angus: But it is a no-brainer, professor. You have said yourself, on all the five key points, that it is a no-brainer, that it is good for everyone. It is not a sop to the rich. This would be the greatest thing for Canadians. Somehow we have to make the people believe it.

Mr. Brenner: Senator Kroft did not like my starting point that this debate is not taking place, because the politicians want to stay in power, but I shall go back to that point. Unfortunately, I must disagree with your statement that this would be good for all Canadians. That is not true, because the more that financing goes through government, the more power the government has, including the power to appoint friends or people who are not fully qualified, people who may not be the head of a state-owned enterprise if they did not belong to the Liberal Party. Those Canadians would not have a chance of heading those operations if we moved toward the system we are talking about.

Senator Angus: That is a cynical approach, I must say. You may be right, but, in my view, we must impute some good faith to the elected representatives of the people.

Senator Kroft: I would like to return to several very specific points. Your point about looking at what one might call the velocity of capital, or doing everything possible to avoid capital becoming stale and embedded is an important point and very relevant to the question of capital gains tax.

I would like to look to the US on two things, and also in the context of this massive intergenerational transfer of wealth that is occurring. A very important aspect, as I am sure you would agree, of public policy now is how that gets tapped into; and does it get tapped into in a way that is productive?

The tax world is a world of tradeoffs. First, has the US found much that is positive in the capital gains rate? It is intriguing to me, and always has been, as to why they have their capital gains tax rate where it is. Perhaps it is for the same reason as here. Although it is at 20 percent or whatever it is, it is not zero. There is a powerful constituency even in the enlightened US to keep it where it is or higher.

Senator Oliver: There is a move afoot to reduce it now.

Senator Kroft: There is movement constantly both ways and the 20 percent has been a saw-off in those two moves. The other thing that we must never lose site of, and it concerns both the intergenerational aspect and the inclination of capital to move, is that, while we have our estate and capital planning industry, they also have theirs. We have no gift tax. They have a gift tax.

They have found another way of intruding on the public purse in the way of the capital transfer value. Perhaps they have made a judgement that it is bad to transfer capital value from one generation to another, and they have a severe regime of estate taxation. On the supposition that the government needs revenues to work on and there are tradeoffs, what would your comments be if we were to step into the American position? Take it the other way around, so that the transfer of capital from one generation to another was heavily taxed but the realization of current capital gains was less heavily taxed or not taxed at all.

Mr. Brenner: Taxes are always a matter of compromise. Nothing is perfect. However, there are two issues here. First, if you try to impose too high a tax on something, then people will avoid it or evade it. We have seen that in Canada with the black market and so forth. Second, economists work out theoretical models about this tax or that tax, but they never take into account what happens if capital moves south and people go into black markets. Also, people tend to find wonderful loopholes. Whatever tax the US has, there are plenty of ways to avoid it. You must remember that, when you write a tax code, that language is never so precise that a good lawyer and some good accountants cannot violate it.

You went in another important direction, regarding the question of fairness and mobility and about how the rich may or may not stay rich. Just looking at the United States, *Forbes Magazine* publishes annually the list of the 400 richest people in the US and in the world. You will notice that in the United States, in contrast to any other country, there is a huge turnover in that list. The people who were at the top 10 years ago in the United States are almost out of the list or are very close to the bottom, while those who are at the very top now, who are the called the "Silicon Valley aristocracy," were nobodies 10 years ago. They did not have a penny.

When people mention inequality, it is big mistake to link the capital gains tax with that debate, because inequality has two meanings. You can have the same statistical measure for inequality in two countries. However, that does not matter, because the interpretations would be very different, if in one country it is all the time the same people who are at the top, in the middle, and at the bottom, while in the other country the people move up and down. If you compare that measure across countries, you will see that one of the biggest movements is in the United States, and there is even greater movement in places like Hong Kong—the kind of esoteric, accidental places, I would call them.

Why do they have that greater movement? I would say once again that it is because of two things. One is their tax regime and the other is the extent that their capital markets are democratized. The two are linked in my view because the angels will give seed money to the newcomers, and they have a chance to go up. If you do not have that market, whether because of bad taxes or because you regulate your financial markets, the poor are prevented from succeeding. They stay at the bottom.

Perhaps I did not understand your question correctly, but I thought that that was the direction you were going in. I am glad you raised that question.

I will return to what was said about the gift tax versus the estate tax in the United States. Most of the fortunes go from one generation to another because there are trusts and a lot of ways to avoid paying inheritance tax.

Senator Angus: There are no deemed dispositions.

The Chairman: They have estate tax, but we have deemed realization on death, which means that 40 percent of what we accumulate during our lifetime is paid out upon death. That makes a huge difference, believe me.

Senator Tkachuk: I was particularly interested in the exchange between Senator Angus and you about how cynically you view politicians. I have a lot of empathy for that as a Western Canadian. I am in favour of lowering the capital gains tax or eliminating it, because in the East you have a huge manufacturing base here and the falling dollar continues to subsidize it further and further. The weaker the dollar becomes, the harder it is to have the political incentive for changing the capital gains tax.

We import in the West. We think that the reason we have this situation is that we are all risk takers out there looking for oil and gas and everything else, which is all capital gains. In the East you have a lower manufacturing tax on companies as well. Therefore, politicians have been acting cynically with the country. Are there any credible economists left in Canada who think that capital gains tax should be raised?

Mr. Brenner: You are asking the wrong person.

Senator Tkachuk: You must travel and go to forums. Have you ever heard an economist say we should raise the capital gains tax because it would be good for the country?

Mr. Brenner: It would not be said too loudly. Actually, I do not think I have ever heard of increasing it. However, let me say something about manufacturing. Someone asked how you would pursue it with the public. I will give you an example about what that means in a place where there are no capital gains taxes. How quickly could the manufacturing base adjust?

You asked me a question about the early '70s. You may remember that at that time one of the most popular fashion items were wigs for women. They were changing them three times a day. Most of those wigs were produced in Hong Kong. That fashion disappeared after two years. There were 22,000 people at the time employed in that industry in Hong Kong. All of the factories closed except for two. Within less than two years, those same people worked in the electronics business.

We here live with the idea that somehow people cannot adjust. The attitude is that if a fisherman never fishes for another fish in his life, he still has the right to be called a fisherman. If you had a lower tax that would finance experiments, including training, you would then see from other countries' experiences just how quickly people would adjust.

Certainly, if you give them the ability to stay fishermen forever and fish in the ocean called Ottawa rather than in a real ocean, then why not?

Senator Tkachuk: Are the only people left the ones who say we have it just right or the ones who say we should lower or eliminate capital gains tax? Is that what the only credible economists we have left are saying? I tried to find books in the library by people who would actually have an argument for it. There are not any moderates left who are in favour of increasing capitol gains taxes.

Mr. Brenner: I doubt that you would find anyone in favour of increasing it to 40 percent when the US is at 18 percent, at this stage.

Senator Tkachuk: I do not think so. I will make a big leap here, because I do want to get back to Senator Kroft's point of narrowing down the focus, but everything is politics.

On the question of capital gains, we actually tax options. Once an option is granted to a member of the board of a company, an executive of a company or an employee of a company—a lot of McDonald's employees and managers have options—and once they exercise those options, we charge tax in Canada. It seems a strange thing to me. Nonetheless, I want to get your views on that. Should we tax them when they are exercised or when they are sold?

The Chairman: You are saying taxed at a regular rate, not even capital gains.

Senator Tkachuk: At a regular rate, like earned income.

Mr. Brenner: Stock options are mainly thought to be effective to attract the top management. Once again, I do not think you can tax in that way, because the whole world is open to compete for top management. Therefore, you cannot discuss this in isolation as if we could set our rate for Canada independently. We must do it relative to Detroit, or wherever this top management could move. These are the most mobile people.

Since they are the most mobile, you cannot determine your tax in isolation.

If in the United States they are taxed like that, then that is more or less the range in which you can tax them here too. That is it.

Senator Tkachuk: Thank you.

CHAPTER 8
Professor Jack Mintz

THE STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE EVIDENCE, OTTAWA
Thursday, November 25, 1999

Senator Leo E. Kolber (*Chairman*) in the Chair.

The Chairman: Honourable senators, on your behalf I should like to welcome Professor Jack Mintz, who is the Arthur Andersen Professor of Taxation at the Joseph L. Rotman School of Management at the University of Toronto. He has been the President and Chief Executive Officer of the highly esteemed C.D. Howe Institute since September 6, 1999. He has been a visiting scholar with the International Monetary Fund in Washington; a visiting economist with the Department of Finance in Ottawa; Chair of the Technical Committee on Business Taxation, Government of Canada from 1966 to 1967; Editor-in-Chief of International Tax and Public Finance; and author of numerous publications on tax policy, corporate taxation and the comparative tax system. Mr. Mintz probably holds a view diametrically different from the witness we heard yesterday.

Welcome, Professor Mintz. Please proceed.

Mr. Jack Mintz, President and Chief Executive Officer, C.D. Howe Institute: Mr. Chairman, thank you for having me once again to your committee. I enjoyed my last visit very much. I am looking forward to our discussions today. In fact, I had promised the committee's former chairman that I would come back to talk about business taxation some time down the road. I just want to say to you, Mr. Chairman, that my commitment stands. If you ever get to the matter of business tax, I will be quite happy to talk about those issues as well.

Today, however, I will talk about capital gains taxation in Canada. I will make some recommendations as to where I think we in Canada should go on this issue. Capital gains taxation is probably one of the most difficult areas of tax policy in the tax system, not just in this country but in any country. Why is this so? Let me give you some normative arguments that have been given for and against taxation of capital gains.

I will talk about some of the practical problems that are involved with taxing capital gains, and then I will talk a about the inconsistency of world wide experience when it comes to taxing capital gains. Finally, I will describe where I think Canada should go with respect to some of these issues.

First, let me turn to the normative argument for taxing capital gains. The proponents of taxing capital gains follow what have been well known principles in income taxation, which has been based on the concept of comprehensive income, which would include all sources of income, including capital gains as another source of income. This was argued by Simons in the United States in the early 20th century. It has been an important principle of income taxation. It was adopted by the Carter report in Canada when it recommended the taxation of capital gains in the 1960s.

The income tax proponents argue not only that capital gains should be taxed, but that they should be taxed on what is called an accrual basis, not a realized basis—in other words, when the value of assets changes from one period to the next, the argument being that this gives economic power to individuals to purchase goods and services, and therefore, should be captured as part of the income base and be fully taxed.

That is one particular view, and it has been challenged over the past number of years. There are two sorts of challenges that are important, at least in terms of the normative discussion of taxing capital gains.

The first view, which gives a very different argument, is one given by consumption tax proponents. These are individuals, and I would fall more into this camp, who argue, or at least recognize, that the taxation of the return to savings is a double tax on earnings of individuals. In other words, when people earn income, they pay tax on their wages and salaries. If they then consume their income right away, they will not pay further income tax. However, if they put their money into a bank account or into an equity share, and earn income, either as capital gains, interest income or dividends, they will pay tax on that income. So they are paying additional tax on their savings. Therefore, savers are discriminated against under an income tax compared to consumers.

Thus, the consumption tax proponents would argue that one should eliminate the double tax on savings, which is therefore not just having no capital gains tax but having no tax on dividends and no tax on other forms of savings. An alternative base, which is the one we currently use in the Canadian tax system, is to allow people to deduct their savings from the income base. They earn the income within a plan that would be subject to no taxation; then, when they withdraw money from that plan, they are subject to tax. That, of course, is what we do under our pension and registered retirement savings plan systems in Canada. It is a form of consumption taxation under the so-called income tax system that we have today. So one normative view that goes against the taxation of capital gains is based on consumption tax principles.

A second argument goes back probably to the historical argument about the fruit on the tree. It is the argument that you want to tax the fruit and not tax the tree, which is a legal argument about taxation of capital gains. The concept behind that argument is that capital gains reflects the income being earned on assets. If that income is subject to tax, then in principle, if there is any increase in the income, or any expectation that the income will rise, then since that income is already being taxed, capital gains is also being taxed at the same time.

That is an argument to suggest that capital gains should not be subject to tax at all, as long as you are fully taxing other sources of income. Otherwise, you would have a double tax on the gains that are being received from assets.

In principle, we have actually recognized that in the Canadian tax system, through the integration of corporate income and personal taxes; we have not fully recognized it, but at least recognized it in part. In Canada we have a corporate income tax that applies to income earned by businesses. Let us say that there could be income taxation of real estate income. However, at the small business level the corporate income tax rate is approximately 20 percent. That is the average rate for federal and provincial purposes.

When people reinvest their profits, share values will go up by the after-tax profits of the firm. Those share values may be subject to personal tax. However, we set the exclusion rate for capital gains so that, in principle, a person will be subject to corporate income taxes and capital gains taxes.

The combined rate would be equivalent to the top personal rate when it comes to small business income.

Therefore, we have a rough approach for integration. We do the same thing with dividends by having a dividend tax credit as an offset for the corporate income tax paid by corporations. So when you look at the total corporate income tax and personal income tax on dividends, it is also roughly equal to the top personal tax rate on other sources of income. Therefore, the capital gains exclusion rate and the dividend tax credit rate are set in order to accomplish rough integration at the small business level.

The problem is that many corporations are taxed at higher rates. Income above $200,000 in a Canadian controlled private corporation may be subject to a higher rate. Therefore, the integration mechanisms that we have, which are the dividend tax credit and the exclusion of capital gains from income, are too little relative to the higher corporate income tax rates in the system. I will come back to that point later on.

Let me talk about some of the practical problems involved with capital gains taxation, at least the accrual approach that has been suggested by the income tax proponents. One of the first points that we must recognize is that no country in the world taxes capital gains on an accrual basis for all taxpayers and for all sources of capital gains. There is some accrual taxation that is market-to-market value rules for financial institutions and insurance companies. We use it in Canada, and there are a few other countries that use it as well. Generally, however, we tax capital gains on a realized basis—in other words, only when the assets are actually sold.

Why do we do that? If we try to tax people on an accrual basis, people may have to sell assets in order to meet their tax liabilities. In other words, let us say I am holding some shares of Bell Canada, for example. The value goes up over the coming year, and I will be getting an accrued capital gain. However, I do not want to sell the assets right away. If I have to pay taxes on the accrued value of capital gains, but I do not have enough income to pay those taxes, I may have to sell some Bell Canada shares just to meet those tax liabilities. That could certainly be a problem for small businesses and farmers, et cetera, in terms of their assets.

For that reason, no country has accrued capital gains taxation. Another reason is that it is very difficult to value all assets on a market value basis from one period to the next to do accrued capital gains taxation, particularly when you are talking about private company shares, real estate, and other things. There is a lot of subjective evaluation involved, and we do not have observed market values to easily measure those things. As a result, the valuation problems suggest that you would never go to accrued capital gains taxation.

We tax capital gains on a realized basis. This has actually two important impacts, and this should be understood. First, because people only get taxed when they actually sell assets, there is an incentive not to sell the assets—in other words, to defer any capital gains taxes that might be held in order to avoid any taxes on that income. This is referred to as the lock-in effect. As a result of the lock-in effect, people sometimes end up holding inefficient portfolios of assets in order to avoid paying capital gains taxes on some assets that they might otherwise dispose of in order to buy other assets. That can have an economic cost.

In Canada, we also have another aspect that mitigates some of the lock-in effect. We have deemed realization of capital gains at death, rather than having the estate taxes. As a matter of fact, all OECD countries have one or the other: either they have deemed realization of capital gains at death or they have an estate tax.

The United States does not have deemed realization of capital gains at death. They do have an estate tax, but the estate tax is on a smaller group of taxpayers than you would find if you applied deemed realization of capital gains at death in the United States. As a result, the US experience, as well as studies on the impact of capital gains taxes on government revenues and the economy, cannot easily be used in the Canadian case. The Canadian tax system is somewhat different than the US system and that has to be taken into account. For example, reducing capital gains tax rates in Canada would not have the same impact on realizations as it would in the United States because we have deemed realization of capital gains at death.

However, I do not want to understate the importance of the lock-in problem, because I do think that it is something we must worry about.

Another problem under capital gains taxation is the treatment of losses. Most countries do not allow full refundability of losses. In other words, you cannot deduct capital losses from other sources of income. Most countries will usually limit it to other capital gains. Because we only tax capital gains on a realization basis, people can time their losses and their gains in order to minimize tax liabilities. In fact, if we did have full refundability of losses against other sources of income, people might try to time their sales of assets in order to create losses that could then shelter other forms of income from taxation.

That is the reason we do not have refundability. Once that is recognized, a problem is created in the system in that we then discriminate, under the capital gains tax, against risky investment and entrepreneurship. The reason for that is that the government is quite happy to share the winnings, or gain, that a person may realize through the disposal of a capital asset. However, the government is not there to fully share the losses. The government may allow you to write off the losses over time, but that is only if you have future gains. There is a time value loss associated with an inability to achieve a complete write-off of those losses right away. Thus the capital gains tax actually discriminates against risk-taking and entrepreneurship. That is one reason it is important to achieve a lower capital gains tax rate.

The last important issue is inflation. We must remember that even though we do have relatively low rates of inflation, we tax that nominal gain associated with inflation. If you bought an asset even just 20 years ago, the real gain, once you correct for the impact of inflation on the purchasing power of your money, is reduced significantly. That does increase the effective rate on capital gains. It is only partially mitigated or maybe even fully mitigated for those taxpayers who can borrow money to purchase assets that are subject to capital gains taxation. When you borrow money, you are able to write off your interest expense without any adjustment for inflation. This interest also reflects payment to compensate the lenders for the erosion of the purchasing power of those borrowed funds as a result of inflation. Thus we see a partial shelter against the impact of inflation on capital gains taxation. As a result, most countries have not indexed capital gains for inflation at all or, if they have indexed, they have worried about what do in the case of leveraged purchases of assets.

Those are four difficulties that I am attempting to explain. There are some important problems to be dealt with in the capital gains tax system. These problems create difficulties when formulating tax policy. There is no simple solution. When we look at actual international experience and what other countries do, we see that there is no consistency with respect to tax policy. I will give examples. Some countries have, either today or in the past, fully taxed capital gains. The United Kingdom still fully taxes capital gains as part of income. They are now looking at proposals to lower the capital gains tax rate in the United Kingdom. Interestingly enough, the United Kingdom taxes dividends at a lower rate than capital gains. Thus, one could actually make a very strong argument that the United Kingdom should lower its capital gains tax rate and move away from full taxation as an effective method to integrate corporate and personal taxes.

The United States went to full taxation of capital gains in 1986 as part of the reform measures. We must remember that in the American system there is no integration of corporate and personal taxes so dividends are fully taxed. Therefore, when they moved to full taxation of capital gains, they were attempting to eliminate the differences between dividend and capital gains taxes. That elimination of differences was necessary in order to curb the strong incentive to shift income from dividend forms into capital gains, thus reducing tax payable.

The United States retained that system until the early 1990s when they raised personal income tax rates. However, they did not raise the capital gains tax rate, which stayed at 28 percent. In 1997, to be applied in 1998, the United States moved to a system in which they reverted to a pre-1986 system of different tax rates based on the length of time assets are held.

Some countries actually impose a tax penalty on the length of time an asset is held. The longer the asset is held, the greater the tax penalty or the higher the tax rate imposed on that asset will be. That system can be seen in Japan and Korea with respect to land assets. They use that system to capture the deferral advantage of holding assets longer under the capital gains category. In other words, they are attempting to move to the concept of accrual taxation of capital gains but, since they cannot use the accrual method, they have chosen instead to tax the longer-held assets at a higher rate.

We have had systems that have had some indexation for inflation. The United Kingdom and Australia are examples of that. The United Kingdom abandoned indexation for inflation for the capital gains tax system a few years ago. Australia, in its recent reform, eliminated indexation for inflation as well.

Some countries will tax gains at a lower rate than other forms of income. Canada is an example of that. We have our exclusion for capital gains. Some countries will have tax rates that vary by the holding period of the asset. I have mentioned the United States where there is full taxation of gains if the disposed assets are held less than one year. There is a 28 percent rate if the assets are held from 12 months to 18 months. The 20 percent rate will be changed to, I believe, 18 percent next year with respect to assets that are held for more than 18 months.

The Chairman: They are bringing the time frame from 18 months to a year and the rate from 20 percent to 15 percent. That is the proposal.

Mr. Mintz: France and Italy also have rates that vary by the length of time the assets are held. However, this system can be problematic.

Tax rates that vary by the holding period make the financial derivative industry very happy. That was the experience in the United States prior to 1986. I would suspect that many exotic financial derivatives are now being considered in the United States with their new system. Those derivatives occur because one can time the losses and gains in such a way as to take advantage of the full write-off of losses against the half taxation of any capital gains, depending on the length of time assets are held. Thus, it is possible to drive down or eliminate altogether the capital gains tax.

The United States in 1986 was so concerned about this that they went to the full taxation of capital gains. Now, they have returned to a system in which they have placed restrictions on losses whereby the losses can only be written off against gains that are fully taxed. Therefore, they are protecting the capital gains tax by restricting claims for allowable losses to the gains being held. This has been an interesting change because this is something quite different from the pre-1986 system.

We can talk about this system later but it is a far more complex system and leads to greater complexity in the tax system when there are differential tax rates dependent on the length of time the assets have been held.

Another aspect of the capital gains tax system is the rollover treatment. Most countries will have at least some form of rollover treatment that allows the taxpayer to defer the payment of taxes on capital gains. This will occur, for example, in share for share exchanges, amalgamations and certain mergers.

Germany has a very interesting system. They tax capital gains. Although I do not know all the details of their system, I know that they have a rollover type of provision whereby you are allowed, within a year, to purchase another type of asset that allows you to defer the capital gains on the asset rather than pay the full tax on it. In the Canadian system, and in most systems, if I am holding Toronto Dominion Bank shares, for example, and I sell them to buy Royal Bank shares, I will pay my capital gains tax on the Toronto Dominion Bank shares, even though I exchanged them for another form of bank shares. In Germany, that would be allowed to go as a deferral of capital gains tax. In my example, the Toronto Dominion shares would be used as the cost basis for determining the capital gains tax to be paid eventually on the Royal Bank shares, if they are used for consumption purposes.

That is an interesting system. I have not given my full thought to the implications of that in terms of tax planning. However, it is one that you might want to think about.

When you see what goes on across countries there is absolutely no consistency in the approach to capital gains taxes. In large part, you must look at the capital gains tax and try to do the best you can to keep efficiency and equity in the tax system and not let compliance and administrative costs get so high because of all sorts of things you must do to protect the tax system or to improve fairness in it.

Prior to 1972, Canada did not have a capital gains tax. As a result, there was a tremendous amount of legislation and problems in the system. People would try to convert dividend income into capital gains income that would not be subject to taxation. That was referred to as surplus stripping. As a result, the main reason Canada went to taxation on capital gains in 1972 was to create some balance and efficiency in the system, as well as to minimize the compliance and administrative costs of trying to run a system with differential tax rates on income and capital gains.

The other important principle in Canada is that we try to integrate corporate and personal income taxes, as I have already mentioned.

I will conclude with four or five proposals that should be considered in Canada today. First, I suggest that, in the next budget, we immediately move to a two-thirds inclusion rate for capital gains. The reason for that is that next year in Ontario the top rate will be 48 percent. The dividend tax rate will be about 32 percent. At an inclusion rate of three-quarters, the capital gains tax rate will be 36 percent, which is higher than the dividend tax rate. If we go to a two-thirds inclusion rate, we would bring rough parity, at least in Ontario, to dividends and capital gains tax rates. I recognize that these numbers vary by province depending on the tax system. However, given the size of Ontario, and the fact that many of the other provinces are in similar positions, except for a few cases, Quebec being one of them, there is a strong argument to move to a two-thirds inclusion rate next year.

Second, we need a comprehensive approach to the whole issue of capital gains taxes, personal income taxes and corporate income taxes. First, we will be lowering personal income taxes in this country. I suspect that in a few years' time we will be looking at rates in the 40 percent to 45 percent range. In two years' time, Alberta will have a top rate of about 42 percent, which assumes no action will be taken by the federal government.

However, I suspect we will see some changes at the federal level over the next two years. Thus, a 40 percent top rate for income in this country is not an inconceivable concept. If that is true, then the question is: Can we afford a further exclusion of income from capital gains? This partly depends on the dividend tax credit. If we keep it where it is, which provides rough integration for the small business level but underintergrates large corporate income, then we cannot do very much on the capital gains exclusion rate unless we create a large imbalance between capital gains tax rates and dividend tax rates.

However, if we start looking seriously at the business tax system and we lower general corporate income tax rates, consider increasing, perhaps, the small business tax rate and have just a single corporate income tax rate in Canada of 25 percent and we move up the dividend tax credit to reflect that 25 percent tax rate, we could have a one-half exclusion of capital gains from income.

In other words, I can see a very good reform whereby we would have a single corporate income tax rate in the system, just as many countries have today, and have much lower personal income taxes, which I think many people in the small business sector would find favour with. Eventually, we could have a one-half exclusion rate with an approximate 20 percent capital gains tax rate in this country. That is a reform that is, I think, quite possible to achieve over the next several years. I suggest that we have to look at that within the balance of what we are doing in terms of the whole tax system.

My third proposal is to consider some special incentives for capital gains. The lifetime capital gains exemption is not working well. It is being abused in some cases. It was meant for small businesses. However, it applies to all Canadian-controlled private corporations. Many companies have been converted from public to private corporations, in part to take advantage of the lifetime capital gains exemption, as well as the small business deduction. Basically, we have a system that does not encourage the growth of businesses.

If you look at the United States, you will see a system that does encourage such growth. They have a partial taxation of capital gains on initial public offerings of shares. One-half of the capital gains tax rate will apply to the initial public offering of shares. By the way, they define small businesses as those with roughly $55 million to $58 million in assets. In Canada, we define a small business as one with $15 million in assets.

We should try to change the labour-sponsored venture capital corporate fund system. The system has not been working well. There is a great deal of data that show that the returns on funds have been inadequate, except for a few. In fact, they have been well below the market. This is partly because the credit has encouraged too much investment in ventures with high risk and very low returns. In my view, a better system would be to enhance our RRSP system by creating a new fund that would not impact on the limits for RRSPs. In other words, this would give another opportunity for people to have tax-sheltered savings. They could invest in venture capital funds. If there are any changes in those venture capital funds, they would not be subject to tax. As long as it stays within the fund, there would be no capital gains tax for that purpose. This would also give a new form of retirement savings for individuals. There would be some limit on how much would be allowed.

My last recommendation is on stock options. I spoke to this committee last year on this topic. My argument is to move to the US treatment for stock options and to eliminate the current tax penalty in the tax system against stock options. At the moment, this is less favoured compared with cash distributions to workers.

Senator Hervieux-Payette: Mr. Chairman, since we will have to be doing a great number of comparisons, it is important that we have all the data with respect to the major players in the market.

Professor Mintz, we had one of your papers on taxation of businesses distributed to us. We will need that in order to continue our study, and sooner than later if possible. I do not know if that will come from you, but it would help us. Indeed, it is crucial information.

The pension fund does not pay capital gains. It would be interesting to see the statistics on how much capital gain is not taxable because it is in pension funds, compared to the savings held by individuals who are paying personal taxes on whatever is left in their pockets to invest. That amount is shrinking. It is perhaps 20 percent. Do you have an answer to that?

Mr. Mintz: Those numbers are available and can be downloaded from the Department of Finance web site. Some papers were written by Tom Wilson, Steve Murphy, Michael Smart and Jim Pesando for the Technical Committee on Business Taxation. The papers deal with income trusts but contain some data on stocks in trustee pension plans—and in RSPs, which is the same argument—versus stocks that are subject to tax. Unfortunately, I cannot remember those numbers right now. I am sure you can get more up-to-date numbers from Tom Wilson or from the Department of Finance.

You are correct that there has been a growth in assets that are in the form of pension plans and registered retirement savings plans. As a result, capital gains in those plans, in principle, are not subject to taxation, at least not on an accrued basis. The only time tax is paid on the increase in the value of those assets is when the funds are withdrawn from the plan. That data is available.

Senator Hervieux-Payette: We need an accurate picture on how much tax is being paid. We always have the impression that the poor minister of finance will go bankrupt.

My pet project is the employee stock-ownership program. Links have been shown to productivity, to participation and to transparency of the technical information given to the employees. You mentioned stock options, too. Taxation there applies both to the company, on what it can deduct, and to the employees. The young generation of entrepreneurs in the high-tech companies may resist the so-called brain drain if they can stay here and participate in the growth of their companies.

Do you think we have a competitive framework for ease-up in Canada compared to the US? There they have a much larger distribution of shares to their employees. Is that because of their culture or is their taxation system acting as an influence?

Mr. Mintz: I have not looked at the degree to which Canadians hold employee stock ownership relative to the United States, or at the factors that might cause differences between the two. I cannot comment specifically on that.

In the Canadian tax system, the stock option is not deductible from the corporation, as you have mentioned. It is effectively subject to capital gains tax at the individual level. In the United States, a granted stock option is not deductible or taxable in the hands of the individual; and that is also true in Canada, I should mention.

Income gain, which is the difference between the value of the grant and the exercised price, is treated in two ways in the United States. First, the difference between the exercised price and grant price is fully deductible for the corporation. It is fully taxable in the hands of the individual. The second treatment is called a stock ownership incentive plan, where the difference between the exercised price and the grant price is not deductible for the corporation and not taxable in the hands of the individual.

When you go through the calculations in Canada for small businesses, it is not a problem, because the corporate income tax rate and the capital gains tax rate achieve rough integration. At the small business rate, in fact, you are allowed to defer. You do not have to pay tax at the time the stock option is exercised. You are allowed to defer it at the small business level.

For large corporations that is an issue, because the large corporate tax rate, of course, is much higher than the small business tax rate. There is no incentive in Canada for large, tax-paying corporations to issue stock options, at least for tax purposes. That does not mean they will not do it. They may do it for other reasons. However, there is a tax disincentive.

Senator Hervieux-Payette: So the Nortels of this world are not very encouraged by our tax system. That size of company has no big incentive to go through that program?

Mr. Mintz: Such companies do not actually pay much corporate income tax, because of the R&D tax credit. If the corporation is not paying tax, it has an incentive to issue stock options, rather than paying wages or cash to the employees.

Senator Angus: Mr. Mintz, you have confirmed that we had no capital gains tax in Canada prior to 1972. This tax came out of the Carter reform study. We seemed to be doing very well before we had a capital gains tax. There seemed to be a greater incentive for entrepreneurship and start-ups of businesses and industrial development.

I have read your material. It seems that you are not in favour of abolishing the tax. Perhaps you could put your reasons on the record. Why not get back to what I thought was a very constructive climate for our economy in pre-1972?

Mr. Mintz: To compare pre-1972 and today, you must factor in many aspects, not just the capital gains tax system. Other things were benefiting the Canadian economy at that time, such as the rising resource prices during the 1950s. I would agree that there are still lessons to be learned from that time.

My big problem on moving to the elimination of the capital gains tax is the creation of tax-planning problems. How do we convert income into capital gains if it is tax free? This goes back to 1972 and the reason for bringing in a capital gains tax then. We wanted rough parity between dividend taxes and capital gains taxes. Corporate re-organizations, estate planning and a whole slew of other tax issues can become very complicated if we open up the differences between dividend taxes and capital gains taxes.

I would not argue for higher capital gains taxes relative to dividends; however, as soon as we open up the differences in those tax rates, we open up quite significant problems in terms of tax planning. Then the government must address that through very complicated tax legislation. It could also lead to an undesirable erosion of the tax base.

To address our problems in Canada, we should not simply eliminate the capital gains tax. I do worry that the capital gains tax rate is too high now relative to dividends. I also worry that the tax rates are too high. Tax rates must come down in this country. Lowering tax rates and undertaking some serious business tax reform in combination could lead to a significant reduction in the Canadian capital gains tax rate. The tax should not be eliminated; I am not going that far. However, we could have a much better system with much lower capital gains taxes similar to those found in the United States.

By the way, people keep referencing the 15 percent or 20 percent tax rate in the US, but one must remember that there are also state taxes on capital gains there. I am not sure how much more, but something should be added to that number.

Senator Angus: As a general statement, is it fair to conclude that eliminating the capital gains tax in a vacuum, and absent those very complicated measures, would lead to an abuse of the conversion of regular income into capital gains in order to beat the system? You used the more civilized phrase of "tax planning." So you agree that the tax base would be eroded by a straight-across-the-board abolition?

Mr. Mintz: Right. There has not yet been a good study completed in Canada. Tom Wilson and I are doing at least one study, which we hope to have finished very soon.

When the US looks at realizations, they often do not fully take into account the problems involved with converting income into capital gains as part of the loss in revenues that might occur if the capital gains tax rate is driven below the dividend tax rate. They have done that in the United States. That is an issue. You might want to check with people in the US who worked extensively on that topic about some of the actual calculations.

Senator Angus: That is helpful.

On another point, you mentioned that our treatment of deemed realizations upon death is integral to the Canadian approach to things. In other words, it is not necessarily good or bad, but it is part of the package that came with our 1971 tax reform. It strikes me that a deemed realization is unfair given the way families are set up. A traffic accident or an unfortunate happening can wipe out pools of capital in the country that have been developed by sweat and toil and hard work. I have never thought that the concept of deemed realization of capital gains is good public policy. In fact, I think it is very bad. I should like your comments.

Mr. Mintz: Clearly, I would disagree with that as long as we try to maintain an income tax system. That is why I like consumption-based systems. I agree with you somewhat that it is wrong that if you earn income, save it and then earn more money, you will end up being subject to tax again on that, whereas if you consume it right away, you are not subject to tax the second time on that income.

But leaving that issue aside, as long as we maintain an income tax base in this country, we must have, in my view, something at the time of death. All of the OECD countries have either a deemed realization of capital gains at death or an estate tax. In Canada, prior to 1972 we did not have deemed realization of capital gains at death, but we did have an estate tax. That estate tax was abolished at the federal level at the time that deemed realization came into effect.

It would be unfair to have both estate tax and deemed realization of capital gains at death because that is a double tax at that precise time. I believe there are only two countries that have both. One of them is Spain. Most countries will do one or the other.

Senator Angus: Does the United States have deemed realization?

Mr. Mintz: No, they do not. They do have estate tax, which is on a much narrower group of individuals.

Senator Meighen: I want to ask you about your preference for a so-called flat rate of capital gains taxation versus a variable rate. For example, pursuing the line Senator Angus was discussing, would there be any particular advantage, in your view, to having a lower rate of capital gains deemed realization upon death as opposed to the normal rate?

As you know, the Minister of Finance already started down the track of different rates when he, in my view, very wisely lowered the rate of capital gains taxation on gifts of shares to charities in Canada. I only wish that he would listen to the overwhelming anecdotal evidence—and you may have empirical evidence—that this has unlocked a great deal of money for hospitals, universities and charities.

In Canada, we tax 75 percent of the gain at a relatively high rate, while other countries tax 100 percent of the gain. What is your opinion of taxing 100 percent of the gain at a lower rate? Or do you prefer 75 percent or 50 percent of the gain at a higher rate?

Mr. Mintz: The problem with differential rates goes back to the tax planning opportunities that are created with it. Prior to 1986, people could set up, for example, a hedge. They could have two assets, one held more than a year and one held less than a year. Some losses are realized that are fully included in the income, and half the capital gains are subject to tax on an asset held for more than a year. A simple financial derivative was constructed that effectively eliminated all capital gains taxes. That would be a good thing for people who want to get rid of capital gains taxes.

Senator Meighen: These derivatives seem to accomplish that, and in other fields too. We have heard overwhelming evidence that in the area of foreign content, which is limited, as you well know, to 20 percent in this country in pension funds, derivatives get around that now. The mutual fund companies are out selling this to everyone.

Mr. Mintz: With the system that we now have, there is not much incentive to try to create derivatives in order to convert income into capital gains or to eliminate capital gains taxes altogether. It is not as easy in our system.

Some thought must be given to the concern about the tax planning opportunities that are created. I do not think that anyone should make recommendations without giving some thought to the potential erosion of the capital gains tax in its entirety, unless that is really what you want to accomplish in the first place.

The second point is in regards to the 75 percent rate versus the 100 percent rate. In my view, the exclusion rate should be driven by trying to get some rough parity between the dividend tax rate and capital gains tax rate. There is nothing sacred about the 75 percent rate.

Bringing personal income tax rates down, which happened in Ontario recently, actually allows an increase in the exclusion rate for capital gains. In Ontario, when the personal tax rates were lowered, the dividend tax rate went down faster than the capital gains tax rate. Therefore, you must increase the exclusion rate for that purpose.

I will return to my previous point. We have driven our capital gains tax rate based on the dividend tax rate, in which the dividend tax credit plays an important role. If we still try to maintain a low small-business tax rate and a low tax credit for dividend purposes, then it does not give much room on the capital gains exclusion rate. However, I would argue for a much more sensible system of having a higher corporate income tax rate on small businesses and a higher dividend tax rate. I would argue further for a recommendation in the technical committee of a corporate distribution tax. It would then be possible to have a higher dividend tax credit and to move to a much higher exclusion rate for capital gains. That would be good, sensible tax policy.

The Chairman: This is a study about capital gains and what good that tax can do. I am slightly worried that we are getting a little too technical in our questions. I may be wrong. I understand that it is a technical area.

Senator Kroft: I have a simple question that I was going to ask before the chairman's remarks. My independence should be understood. We have been talking about technical elements of the tax. What conclusions have you drawn from your study regarding the relationship between capital gains tax levels and effective investment and risk-taking activity? Would you indicate your thinking in that area?

Mr. Mintz: First, past studies have not shown a large impact on the effect of capital gains taxes on aggregate investment, and that is because most investment is undertaken by large public corporations that operate in a world economy and fund their investments not only from Canadian savings but from foreign savings as well. Changing the capital gains tax rate has an impact on domestic savings and increases it, but that does not necessarily translate into more domestic investment. It may lead to more Canadian ownership of investments and assets and drive out some of the foreign ownership, but it does not necessarily lead to more investment, because investment will be determined by the world interest rate or the world return rather than the domestic return. That is just in the case of public corporations.

The bigger issue is in the case of entrepreneurship. That is the important one. The studies have been too few and far between to get a handle on that. More work needs to be done, particularly in the Canadian case, to understand the impact of capital gains taxes on things like venture capital and others. A couple of studies have been done on venture capital and the impact of R&D and small business deductions. There was a study done for the technical committee, which you can also download off the Department of Finance website, that looked at the growth of small businesses and the small business deduction. However, no one has really looked at the capital gains tax rate in detail in that particular case. That is an area for further study.

The Chairman: Who could we invite here to tell us about it?

Mr. Mintz: Tom Wilson and I are doing a study using the Institute of Policy Analysis model. We are looking at the impact of cuts in capital gains taxes on government revenues, employment, investment, et cetera, keeping in mind some of these impacts. However, when looking at the aggregate economy, the impacts tend to get muted because of the issue about large public corporations and the difference between their behaviour and the smaller entrepreneurial economy; but we will try our best to take that into account.

Senator Kroft: What is your timetable for this study?

Mr. Mintz: We are almost finished.

The Chairman: Could you contact us as soon as it is finished?

Mr. Mintz: Yes, I will.

Senator Tkachuk: If there was a relatively significant reduction in the capital gains tax, would that have an effect on the Canadian dollar?

Mr. Mintz: Let me think that through a bit. First, if you cut the capital gains tax rate and encourage more equity ownership and more ownership of domestic assets in Canada, that will lead to less foreign savings coming into the country or greater export of foreign savings. That will have some impact on the Canadian dollar in the sense that it would reduce the demand for Canadian dollars. It would lead to some devaluation, but that would allow us to export more and import less.

Senator Tkachuk: I got lost at the end.

Mr. Mintz: The point is that, if you have more domestic savings, you will have less capital inflow from abroad. That would cause the Canadian dollar to depreciate somewhat, but that would allow companies to export more and the trade balance would improve.

Senator Tkachuk: Therefore, a decrease in capital gains tax would cause our dollar to go down?

Mr. Mintz: Yes.

Senator Tkachuk: Now we have two economists disagreeing on that. That is interesting.

Mr. Mintz: I am just using the basic macro-trade balance model.

The Chairman: One of our problems in trying to achieve what we are hoping to achieve is how to sell it. That is the big problem for the people who have to get elected.

Senator Kelleher: How to sell what?

The Chairman: How to sell what we are hoping to achieve.

Mr. Mintz: Are you talking about increases in capital gains taxes or decreases in capital gains taxes?

The Chairman: Decreases. Are there any studies that show that a decrease in capital gains taxes redounds not only to fat cats but to middle-income people and even lower-income people?

Mr. Mintz: Most capital gains are actually in the upper-income groups in the economy.

The Chairman: What do you call an "upper-income group"?

Mr. Mintz: I define that as $100,000 or above.

The Chairman: We were told that 85 percent of people who pay capital gains earn less than $100,000 a year.

Mr. Mintz: That is right, but I am speaking of the aggregate amount of capital gains. Certainly there are capital gains earned by lower-income people. There are also a lot of capital losses in the economy, which means that the impact on risk-taking, which I mentioned earlier, is very important.

I would think that cutting the capital gains tax rate would encourage more entrepreneurship and risk-taking, and I think that would have a positive impact on the economy.

The Chairman: What study can we look at that says that?

Mr. Mintz: I am just going basically by the application of theory. One must look at the total effect. I agree that there is no empirical study to give numbers on that. This is simply the impact that I would expect.

The Chairman: The Department of Finance says that if we cut capital gains to what they are in the United States, in the first year there would be a windfall because of unlocking profits, and that would persist for about three years. They say that in the fourth year there would be a cost of $1 billion. However, I do not know what the basic premises are. What about all the money that will be made by reinvestment? I do not even know if you can get such a number.

It seems to me that those kinds of studies are destined to die because they are not taking into account the full effect.

Mr. Mintz: So far, the studies on realizations that have been done in the United States suggest that you do get some more reinvestment, and people would agree with that, but you do not necessarily make up for the total potential loss experienced by moving realizations up early and having fewer realizations in the future.

The Chairman: Is there nothing about job creation?

Mr. Mintz: I am only saying that these are studies that have been done in the United States. In the study that we are currently doing through the Institute of Policy Analysis we will be able to take into account aggregate investment impacts and employment impacts in terms of the impact on the revenues of the government, which will mean that we will make up some of the loss in capital gains taxes in the future through more investment in the economy.

Senator Meighen: There is a 1994 US study that, I am informed, said that after five years there would be a $300 billion rise in the US in GDP and an increase of some 877,000 jobs. Even applying a 5 percent factor, that is still pretty good.

Mr. Mintz: I suggest that you try to get a survey done of all the studies done in the United States. We have just done such a survey and have found that they are somewhat over the map. However, you will generally find that you do get increases in investment that can measure and can be factored into the realizations and revenues that governments get. Most of the studies in the United States show that, if you do not take into account behavioral impacts, you will get a certain long-term loss in capital gains tax revenues by lowering the rate. You may get some short-term pick up and long-term loss in capital gains. That is assuming no behavioral impact.

Senator Meighen: That is not only capital gains. You are not talking about other forms of taxation.

Mr. Mintz: Other taxes too. I am saying “without behavioral impacts.” Once you take behavioral impacts into account, you will get some pickup in tax revenues, although it does not make it up fully. I can make that survey available to you right away, because we have that done.

The Chairman: Would it have the same effect if you just cut capital gains and forgot about the integration you talk about?

Mr. Mintz: The same effect as what?

The Chairman: Increase in investment, increase in entrepreneurship, increase in jobs.

Mr. Mintz: It depends. If you carry out some of the reforms I have suggested, such as lowering tax rates, and improving the tax system, you will have a much bigger impact on the economy compared to doing only one thing.

The Chairman: Well, we will not get anything done on capital gains if they do not do something about everything else.

Mr. Mintz: I agree on that.

Senator Tkachuk: I had an intervention on your comment, Mr. Chairman, on the effect of eliminating a part of capital gains and how that affects the ordinary worker in Canada. I do not think that is a big stretch. Right now, our capital gains tax is high because it is tied to income. Taking 75 percent on a 50 percent tax rate makes it an effectively high rate of 37 or 38 percent in my province.

The ordinary income-earner pays no capital gains on his savings for old age. He puts his savings into an RRSP and they are tax-protected. Surely, he would not want that taxed. Pension funds, as Senator Hervieux-Payette pointed out, are not taxed, but no one would argue that such a huge accumulation of capital has not had a profound effect on our Canadian economy. Many of our companies in Canada are effectively owned by large accumulations of capital.

With capital gains, we want to spread that out so we can promote entrepreneurship. Reducing the capital gains tax, we hope, is a reward for risking one's capital rather than saving it or simply earning income by working for a living. Hopefully, any extra money will be put into entrepreneurship and risk to provide the same benefits as saving in tax shelters. We can make a very strong argument that reduction of capital gains provides jobs, opportunities and still pays a tax even though we are arguing for a lower tax. A person who wants no risk can pay no capital gains at all by saving in an RRSP and hopefully paying a lower rate when spending those funds after the age of 65.

Mr. Mintz: I agree with your statement about the capital gains tax rates and I am including the integration issues. If you try to tax capital gains like other sources of income, you do deter risk-taking, because we do not and we never will have capital losses being fully deducted from other sources of income. You put a very high penalty on risk-taking arising from taxes. That argues for a lower tax rate on capital gains compared to other sources of income because you want to at least take away the tax penalty on risk-taking. On that part, I do agree with you.

I know that in terms of my recommendations I am driven by a technical issue, which is the conversion of income into capital gains, but I am very sympathetic with the argument that we should try to lower capital gains tax rates. However, I suggest doing that through good tax policy. Good tax policy would mean right now reducing the capital gains tax rate to bring parity between dividends and capital gains and then adding further reforms to get the best "bang for the buck" as you are suggesting.

The Chairman: Thank you, Mr. Mintz. Please send us the additional information that you have available and we will invite you back later to discuss it.

CHAPTER 9
Professor Vern Krishna

THE STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE EVIDENCE, OTTAWA
Wednesday, December 8, 1999

Senator Leo E. Kolber (*Chairman*) in the Chair.

The Chairman: We have a quorum. We are delighted to have as our witness today Professor Vern Krishna. He is a tax counsellor. He holds a Bachelor of Commerce from Manchester University, an M.B.A. and an LL.B. from the University of Alberta and an LL.M. from Harvard Law School. In addition he has a Diploma of Comparative Law from Cambridge University. He teaches business and taxation law at the University of Ottawa Law School. He is the director of the CGA Tax Research Centre. He is a commissioner of the Ontario Securities Commission and the author of several leading works in taxation, including the *Fundamentals of Canadian Income Tax*. He is the editor of *Canada's Tax Treaties*, and managing editor of *Canadian Current Tax*, a monthly publication on tax matters. He was formerly Chief of Tax Policy and Legislation in the Department of Finance. Welcome and please proceed.

Professor Vern Krishna, Q.C., Faculty of Law, University of Ottawa: I am delighted to be afforded the opportunity to address you today. I have distributed a paper which is an amalgam of some other pieces that I had done and some new material with some new statistics. I thought that I would speak to this paper itself and let the paper become part of the record.

The issue that we have in front of us is a very old one. I want to talk about what the problem is and some of the policy considerations that go into balancing the issue. I want to argue a case as to why there should be a preference for capital gains and what the trade-offs are, touch up on some international issues and competitive considerations, and then offer some tentative solutions which should be considered.

Our tax law has always preferred capital gains. For example, capital gains are taxed at a lower rate than other forms of income. At the inception of our tax system we did not tax capital gains at all, so the preference was 100 percent. We moved from there to the Carter Commission study back in 1970 or 1971—January 1, 1972, really—to a system of 50 percent of inclusion. Since then we have raised the tax on capital gains to two-thirds in 1988-1989 and then to three-quarters in 1990 where it is today.

There is no ideal capital gains tax. There never has been and there never will be. One hundred years from now, the question of what is the ideal capital gains tax will be debated in this Chamber. There is no ideal income tax because all tax law involves a compromise between competing values. Those competing values carry different weight amongst different members of the population and legislators, and at different times in our history.

There are basically only five competing values in any tax system. First and foremost, a tax system exists to generate revenue for public spending, and therefore revenue generation is an important consideration, or the converse of that, the revenue loss from a proposal.

Second, there is the issue of fairness, however we describe it. Most people will agree that a tax system should be fair. There are points of departure of opinion as to what actually constitutes fairness, but most people will agree that it should be fair. I have never in my professional or academic life over 25 years ever heard anyone say that the tax system should be unfair. I have heard many differing opinions as to what each person thinks fairness is.

Third, a tax system should be neutral and it should not distort economic decisions merely for tax purposes.

Fourth, tax systems should be sensitive to economic considerations and, in the context of our discussion today, particularly to competitive considerations and international tax models. That has become increasingly important over the years. It was not an important issue when the tax system was initially devised in the First World War. It was not even that important an issue when the Carter Commission reported in the 1960s and the new tax system came in, in 1972. It is absolutely imperative today because the world has become closer, trade more mobile and global, and capital is moving at a very rapid rate in either direction and can move very quickly over electronic systems.

The final consideration we need to take into account is administrative complexity and the amount of time, energy and cost that both government and taxpayers must put into administering a tax system. Those five considerations need to be balanced in some way. In any room made up of any constituency, different people will balance those five considerations in different ways. I am not here to suggest to you that I have any ideal tax system in mind for the capital gains tax or any other tax, but I will try to suggest an optimum system, one that works better than it does not; it may not be the best, but it balances the various considerations in an optimal manner.

I will now take you through the theories of income because I know from prior testimony that you have been exposed to this. In essence, there are different meanings of income in different branches of the field. What we are concerned with here today and in our existing tax system is a legal definition of income as opposed to an economic definition of income. There is an important difference between the two. An economist talks about income as an accretion in wealth. A lawyer talks about income as the realization of wealth. In fact, if I may put this into a wider context, we do not in Canada or in any other country have an Income Tax Act, in the pure sense of the term. We call it an Income Tax Act, but we actually have a tax on transactions. By that we mean we only recognize income when it is realized and a transaction occurs. Until that time, there is no tax on any accretion of wealth, which an economist would call income and which is widely recognized as income all the way down to Haig and Simons, the famous economists who first thought in those terms.

Page 4 of my material has a table. We start with the proposition that income is a surrogate measure of ability to pay. It is not the best measure of ability to pay. It is merely a surrogate measure of ability to pay. If we look at who is paying the capital gains tax in the country, you will see that income levels all the way down from those who report no income to those who report income in excess of $250,000 all have capital gains. It is distributed right through the system.

Approximately 83 percent of the people reporting capital gains are in income levels below $70,000. In the column of $60,000 to $70,000, 83.2 percent of individuals reported capital gains. The distribution of capital gains is substantially in the bottom, up to $70,000. However, the other observation is that, on the last line, 37 percent of the value of capital gains is attached to people with income levels over $250,000.

Although everyone realizes some amount of capital gains, the greatest single component is realized by people with incomes over $250,000. That is neither surprising nor new. People with capital generally realize capital gains, and people need capital in order to trigger a capital gain and to invest to make income. Nevertheless, it is an issue that affects more than simply a single constituency of society or the rich. It affects income levels all the way through, albeit with different effect.

Naturally, the converse is that there will be some revenue lost if one reduces the capital gain. There will possibly be some revenue increase from unlocking capital gains. I will come to that in a moment.

The next issue I have, and these are not in any particular sequence, is the administrative complexity. The United States has said that in their estimates—and we do not have comparable estimates here so I cannot quote Canadian figures to you—more administrative time and effort is spent on capital gains than on any other single provision of the internal revenue code. There is no reason to believe that our experience would be substantially different. It is a source of considerable complexity in the tax system. Inevitably, as soon as you draw a line between two forms of income, one taxed at a higher rate than the other, that line will be attacked. People will want to cross that line to get from the higher income to the lower income. That is to some extent inevitable.

Senators, I think the meat of the issue is whether we want a preference for capital gains. What is the alternative? The alternative is we tax capital gains at 100 percent and treat it like any other form of income and there will be no preference. The second alternative is to give it preferential treatment, which we do right now; we tax it at 75 percent. The third issue is what the amount of preference should be. Is 75 a good number? Or is 50, towards which Australia is going, a better number? Or is 20 or 15, to which the United States is headed, an even better number? Perhaps the best number is back where we started at zero.

There are three problems with capital gains as opposed to other forms of income. Before I mention the problems, however, there is first of all an attitude that capital gains do not actually constitute income. I have described that. It was an attitude early on in the tax system, but it is not one that I want to dwell too much upon. Capital gain is a form of wealth. It comes about through the appreciation of capital and it is now pretty well accepted. So the real question is, should we give it preferential treatment?

The first problem with capital gains, which I describe at page 6, is the bunching effect. The bunching effect means if you buy shares in year one for $20 and sell the shares in year five for $120, the gain of $100 reflects the unrealized accrual of gains over five years. The triggering event is the transaction of selling the shares, which then triggers the capital gain. Until that time, the gain is simply accruing and developing and it has no adverse consequences on the taxpayer.

That can be unfair to some taxpayers, and particularly lower-income taxpayers, because is it bumps you up from one rate bracket to another at the lower income brackets. We have seen in the numbers that everyone has capital gains going all the way down to zero income. The bunching effect can bump you up from the 17 percent bracket to the 26 percent bracket, or from the 26 percent federal bracket to the 29 percent bracket simply because the income is bunched and is realized at one time. That is a very real problem. I will describe later how some countries address that problem and what the possible approaches are. It is an identifiable problem and characteristic of the capital gains tax, unlike other forms of income which generally flow more evenly and without that lumpiness or bunching effect.

The second problem with capital gains is that it has a lock-in effect. If you have an accrued capital gain, you have a real incentive not to sell and move your capital into another use. For example, a taxpayer with an unrealized gain of $100 or $100,000 or whatever, would trigger a tax of approximately 40 percent in Ontario at this time if he or she sold the underlying security, which means in order to justify the economic decision, you have to pay the tax and reinvest $60 and get back to your $100 in order to be in the same position. Unless you have an investment that will appreciate at that rapid rate, you will very seriously consider lock-in and not sell.

Indeed, that is why some people, like Warren Buffet, when asked what is the best time to sell a security has answered, "Never." Our system does permit that to some extent. We trigger capital gains on debt. There is a deemed realization on debt, but we have an exception for that, and we allow a rollover of the assets to our spouses until the time that the spouse dies. Then the realization is deferred to the second death unless the spouse remarries and leaves the property to his or her next spouse in which case you have a second generation.

The Chairman: Could you give that example one more time? I am having some difficulty with it.

Mr. Krishna: Assume that you purchase stock at $1 and it now has a value of $101, so you have an accrued gain of $100. If you sell that stock at that time and realize the gain of $100, you must pay a capital gains tax of approximately $40 immediately. If you pay $40 immediately, that means you have only $61 in effect left to reinvest because you have bartered with $40.

The Chairman: Yes, but that is $60 more than you had before.

Mr. Krishna: Yes, it is $60 more than you had in cash before, but not in wealth before.

The Chairman: It is not really wealth if it is taxable at some point.

Mr. Krishna: Here is the nub of the problem. Once you have given away $40 to the government and you have only $60, in order to come back to the level that you were at before you sold at $101, with the first $40 of recovery in your appreciation you are just getting back to where you were before you even sold, insofar as gain is concerned. The problem with that and why it has a lock-in effect is that you will be very hesitant to sell that security unless you can be assured that your subsequent appreciation will rise at a much more rapid rate; otherwise you are no further ahead, if you merely go back to $100.

Senator Kenny: That assumes that all of your decisions are tax driven.

Mr. Krishna: I would not go so far as to say that all of your decisions are tax driven, but for most commercial decisions regarding stock ownership, one of the serious factors to consider will be your tax effect.

This lock-in effect is generally regarded as being inefficient because it does not allow capital to move such that it can be put to the most effective usage.

The third problem with capital gains is that part of the gain is illusory. This is related to the bunching effect and the timing effect. If you bought a share for $1 in 1972 when the system came in and you own it to this day—and let us assume that the gain and the share is worth $100 so it has appreciated 100 times—your accrued gain is $99. You will be taxed on the $99 or three-quarters of it. However, your gain is not $99 because the purchasing power of $99 when you realize the gain is nowhere near the purchasing power of the dollar back in 1972 when you acquired the asset; there is an inflationary component in the gain that is triggered at the time you sell the asset and you have to pay taxes. The problem is that you are taxing an illusory gain.

Different countries have taken different approaches to resolving this problem. They continue to do so. There are basically three broad solutions to the problem. Each variation of these three solutions has existed in Canada and elsewhere. One, you can allow averaging of gains. Australia, for example, under its existing regime allows an averaging of your gains over five years. The purpose of their rule is to move away from the bunching effect and spread it out over five years.

Two, you can allow indexation of capital gains. If you bought a share at $1 in 1972 and you sell it for $100 in 1999, you can index the $1 cost up to its inflated value today and then tax only the real gain. For example, suppose that $1 has a purchasing power equivalent to $30, then your real gain is only $70, and not $99. That is just an estimate; I have not done the calculations.

Australia uses an indexation system at this time. Back in the late 1970s and early 1980s, Canada had a form of indexation for capital gains in our system because inflation was running so high at that time. We had inflation rates of 12 percent, 14 percent or 15 percent. This problem was exacerbated at that time. It is obviously not as acute today with inflation being fairly benign. However, the cumulative effect of inflation is quite substantial, even though in each individual year it might be quite small.

There is another way to address all of these problems, and that is the way that we have right now. In a rough and ready form of justice we simply say we will address bunching and we will address indexation and all of these problems with mobility of capital by taxing a lesser amount of the gain, so we choose a number. There is no magic in the number. The number was 50 percent in 1972. It went to two-thirds in 1988. It is up to three-quarters now. It is a rough and ready form of justice. You say, "All right, we know there is an inflationary component. We know there is a bunching effect. To keep the whole thing simple, let us tax a lesser portion of it."

Interestingly, Australia has a bill proposing to do away with averaging, do away with indexing and go back to 50 percent inclusion. That bill has cleared the lower house but I hear it has run into some difficulty in the Australian Senate. They are attempting to negotiate a resolution to the problem.

Our situation is more difficult and exacerbated because apart from all of the problems that we have discussed, we have one other very real concern and consideration to take into account. That is international competitiveness. When we talk about international competitiveness we look at Australia, Britain and Sweden and all those other systems that have similar problems, but the reality is that our neighbour to the south is our principle trading partner. We are their largest trading partner. The mobility of capital and human resources across the border is enormous and very fluid. Therefore, we cannot completely ignore what is happening in the United States in respect to this matter.

Let me read to you an e-mail I received from Vancouver dated Tuesday, December 7. It says, "Vern, here is what"—name—"and I hope to achieve with an offshore trust. Shelter our shares that will be issued to us in January. Have them assigned to a trust initially rather than to us. Even if the proposed federal tax laws come into play, we would hopefully still recognize some benefits to the taxation issue. My situation is such that I own nothing in Canada and I have no problem having no ties in Canada." That last sentence is the key.

This young man, about 28 or 29 years old, is the son of a person who lives in Ontario. He was born in this country, his parents and grandparents lived in this country, and he has lived in this country all his life, yet he is quite willing to move out of the country. Why? Because, he says, "I will have 2,942,500 shares to deal with in January 2000. That is why I need to understand what can be done with it." He is afraid that if he sells those shares when he is tied to Canada, he will be taxed on 75 percent of the gain—approximately 40 percent. My job is to get him out of that situation and I will have him out of the situation by January.

Now he is moving to the United States. The United States has a very accommodating capital gains rate of approximately 20 percent. They are talking about moving down to 15 percent. That will place a great deal of pressure on the Canadian tax system in respect to capital gains.

Much has been said and I have read much in the newspapers on this issue. The chairman of Nortel and other very distinguished people in the high technology industry state that there should be some preferential form of treatment for the high tech sector. I disagree. I do not think you can have a preferential form of system for any one sector. It would create inordinate problems. It is target inefficient and you would never be able to contain the sector itself let alone define what is high technology, which is always changing.

I think it would be better if Canada had a more competitive capital gains tax system across the board in respect of shares, regardless of sector. A reduction of the inclusion rate to 50 percent, back to where Carter started in 1972, would bring us in line with Australia but not in line with the United States. A reduction of the inclusion rate to 20 percent would be that much more significant. Of course there would be a revenue loss, but economists tell us there might also be some revenue enhancement from the releasing of capital gains and the unleashing of capital gains. Certainly the United States experience suggests that when President Reagan reduced the rates in that country, there was no substantial revenue loss. In fact, some argue that there was quite a revenue gain.

A reduction of the inclusion rate to 50 percent or 20 percent—and that is a question of picking a number based on revenue considerations in part—is a balancing of competitive considerations against revenue loss. There is some loss in equity of fairness—the lower the rate goes, the higher the unfairness to high-income groups. There is no doubt about that. However, our tax system already has certain preferences in respect of capital gains on shares.

We exempt shares of small business corporations to a maximum of $500,000 now from tax. Properly structured, a family can take advantage of that and increase that exemption of $500,000 per taxpayer quite easily to $2 million to $2.5 million in an average family of two spouses and two children.

The concept of exempting capital gains is already entrenched in the system. We exempt certain forms of capital gains, the most famous of which is the principle residence exemption. That is a capital property on which we have no difficulty whatsoever saying that the gain is entirely exempt. Similarly, we exempt capital gains on family farm corporations up to a maximum of $500,000. So the notion of exempting capital gains is not alien or foreign to our system. It is simply a question of defining the exact boundaries and parameters of the exemption.

Canada would, in the trade-off of these five considerations, enhance its competitiveness and retain its talent—perhaps on a revenue neutral basis though I will not be dogmatic about that; it depends on the level—at no increase of administrative complexity, which will remain a constant, and admittedly with some minor trade-off in the fairness and equity of the system as certain income groups will benefit more than others.

It would be a difficult task to devise any system that is perfect; in my judgement it is an impossible task. The best we can do is arrive at an optimal solution that meets the needs of the country at the present time.

Senator Tkachuk: My first question is about the statistics on the income groups that realize capital gains. I am referring to the chart on page 4 of your brief. You say that 37 percent of the value of the gains accrued to individuals with income of more than $250,000. Would those statistics be skewed because of the accrual method of capital gain?

In other words, when young people start small businesses or begin accumulating stocks or investments, their income level is low but they are still involved in capital investments. At some future time when their businesses are successful they will realize a capital gain. The figures in your chart represent those people who file actual returns that have value now. That does not mean that there is not a whole bunch of lower-income people in their 30s and late 20s who are in enterprises and businesses and are saving through buying stock or maybe accumulating stock options—and hopefully they are not being forced to sell them because of the income tax laws. Those people will of course dispose of their stocks when they are ready to retire or when they want to make other business investments. In other words, it is not just high-income people who have investments, they just happen to be high income by the time they realize those capital gains. Would that skew the numbers?

Mr. Krishna: That is a perceptive way of looking at the numbers. It is absolutely correct. It goes back to the two issues I identified with the problem of capital gains. One is realization: the gain is triggered only when you realize it. Two, income is bunched so that it is all realized in the year of the disposition. That is true in the case of a small-business person who starts off at a young age, builds up a business and at age 65 sells off the business. The gain is then all realized in that particular year. By that time the person is very successful and the gain itself will put him or her into an over $250,000 bracket. For example, if you have taken a gain over a lifetime of $3 million in the sale of your business and what have you, you are automatically kicked into that category and appear to be wealthier than you are, because that gain has accrued over 30 years. That is right.

Senator Tkachuk: I believe capital gains are too high. That aside, there are two things that bother me on the fairness issue. I want to know what your feelings are and what you recommend to the committee. The first is the question of options. Most committee members know how options are dealt with, but I will review it quickly for the record. The option is a way to pay your employees or your board of directors or your top management. You want them to become part of the company, yet when they exercise an option they must sell their shares rather than accumulate them because they have a tax problem.

It was reported in the paper today that there was quite a sell off of options at Nortel. That is bound to happen because if you exercise them when the stock goes high, which is when you want to exercise them, you are automatically taxed, and therefore you are forced to sell them to pay the tax.

Senator Meighen: Do you mean sell, rather than exercise the options?

Senator Tkachuk: If the stock is $20 and if you have an option of $10, you will want to exercise, so you must sell it to keep the stock.

Senator Furey: First you exercise, and because of the tax implications you are forced to the next step.

Senator Tkachuk: Maybe I did not say it correctly, but thank you. That is the first point. The second issue is the question of how we treat the capital gain. We really say that 25 percent of that gain is set aside for risk or whatever reason and we treat the other 75 percent as income. For example, if Senator Oliver makes $1,000 capital gain, after you take off the 25 percent off, at his tax rate he would be paying 50 percent of $750. If he loses it though, he cannot treat it the same. In other words, if it had gone the other way and he had lost $1,000, he could not deduct that $750 from his income. Right?

Mr. Krishna: That is true.

Senator Tkachuk: Only against future tax gains. Would you advise that those things be changed? Would that make a big difference in the revenue of the country? Those are small measures that I think we could do in a minute if the minister does not want to go to big measures.

Mr. Krishna: I try to address this issue at the bottom of page 8 and the top of page 9 with a small example. It goes back to the triggering event, which is realization. What you have identified is absolutely right. The Nortel situation is very fortunate for those who are in it. The employees of Nortel will have a very pleasant Christmas. However, the reality is that when they exercise that option, not only are they taxable, but they are taxable on it as employment source income, not as capital gains. That is a very hard hit for the reason you mentioned. They took their compensation in the form of stock options at a time when they were undertaking risk. They did not realize at the time how enormously wealthy they would become, but with the benefit of hindsight we know what Nortel has done in only six months. That is a factor to take into account in fairness.

On the last page of my paper I state that "The equal treatment of those in fundamentally unequal circumstances is unfair. Competitive considerations warrant different rules if the underlying economics justifies differentiation." By that I mean the equal treatment of employees in regular source employment income. For example, working in town here with the government with an indexed pension plan is not the same as working in the high tech sector.

But we should not use only the example of Nortel because that is the successful one. There are many in that industry who do not see the success that employees of Nortel have been lucky enough to see, and many who take risks may not realize the value of their stock options. We know for example that only about two years ago Corel had to reduce the exercise price on their options because the stock had fallen so low that nobody could exercise their options and make money. People who had sacrificed their regular compensation in exchange for options were now being deprived on both sides.

I agree with you that that is an issue that goes to fairness. One suggestion I have is to defer the tax consequence until the sale of the stock, and not upon the exercise of the option. That is a part-way measure that alleviates the problem. Then, do not treat it as employment source income, which is fully taxable, but treat it as a capital gain at whatever rate you choose to recommend for capital gain. That will help a lot.

Senator Tkachuk: What about the second issue on the question of the loss?

Mr. Krishna: The problem of the loss is very acute because of our entire income tax system. It will take you well beyond the capital gains arena into many other areas of the tax law. Under our income tax system, unlike the United States, we compartmentalize income and losses into particular pigeonholes that are very tight, and you can only apply capital losses against capital gains. That is endemic and systemic in the system. It can cause enormous harm.

For example, a taxpayer makes an investment, loses half a million dollars, goes bankrupt, has a capital loss, goes and works in employment. The tax system says, "We will allow you to use the $500,000 loss you suffered, but only against capital gains." The taxpayer says that he has been wiped out. He does not have $5 in the bank. He is on unemployment income now. But in his pigeonhole he can only offset one against the other. He will pay full tax on his employment source income. That is systemic in our tax act. It takes the issue much beyond capital gains. This confinement of income by source is a very real problem.

Senator Kenny: You demonstrate clearly in your chart that most of society pays capital gains. You do not mention anywhere it in your paper, but I wonder if you have come across studies anywhere that you could share with the committee that would indicate what percentage of Canadians earning $30,000 to $35,000 or less, for example, understand that they pay capital gains tax.

Mr. Krishna: I suspect that 30 percent to 35 percent of Canadians do not understand what kind of tax they pay in so many different guises—the income tax, the employment tax, CPP and all of these. At the end of the day, I think it is fair to say that even most educated Canadians and sophisticated Canadians do not understand the full amount of the tax they pay. I know no particular study on what that percentage would be, but it would be a good percentage.

Senator Kenny: My point is that most people see capital gains as a rich person's issue. I was wondering if you could direct the committee to any studies that would indicate what the awareness is of capital gains or whether the typical Canadian understands that they are paying a capital gains tax.

Mr. Krishna: I cannot direct you to any particular study. I can observe that most Canadians pay it and do not know about it, and where they pay it and do not know about it is actually through their mutual fund holdings. Ordinary Canadians buy a mutual fund or a monthly subscription plan to a mutual fund. All those people must pay their capital gains on an annual basis and they receive their reporting slips. Some of them may be quite surprised, particularly in years where their funds do very well and they get these large numbers, that they are actually taxable. Unfortunately, I am not aware of any study that provides the exact numbers.

Senator Kenny: The answer to that question has a major impact on the political dynamics of how one treats it.

You have made the case here—to use your words—that a preferential adjustment of capital gains tax would be a valuable step forward. You were comfortable that there would be no loss in revenue and in fact you thought the government would achieve an increase in revenue. A previous witness suggested to us that to mess with the capital gains tax in any way, whether to increase it or decrease it or move it in anyway, would be counterproductive in that there is such extensive tax planning in the country right now that you cannot deal with the capital gains tax as a separate entity. The only way to address it is with comprehensive tax reform. Would you comment on that please?

Mr. Krishna: Each of us is born to live through three tax reforms. I have been through two of them, back in 1972 with the Carter Commission when I was a very young man, then in the mid-1980s when we went through tax reform. I am waiting for one more to occur. Reforming an entire tax system, taking the entire statute and changing it as we did back in 1971, is such an enormous task that I would be surprised if any government would want to undertake it soon. Changing bits and pieces of it is more realistic.

I do not subscribe to the view that the reduction of the capital gains rate of inclusion from 75 percent to 50 percent, just to select of a number, will cause any greater disruption than a reduction of the normal tax rate, as we have witnessed in the Province of Ontario over the last three or four years, has done. It is simply an effective reduction in the tax rate. If your tax rate drops from a normal rate of 40 percent in the case of capital gains to 35 percent, it will have no adverse effect.

There is one area though that will need a consequential adjustment if you reduce the capital gains inclusion rate. Our system is designed in such a way that we try to keep the taxation of dividend income and capital gains income approximately equal at the top end of the scale. There is about a 3 percent difference between the two even now. In Ontario in 1999, ordinary income is taxable at 48.75 percent. Dividend income is taxable at 32.92 percent, and capital gains are taxable at 36.57 percent. There is a difference of approximately 3.5 percentage points between dividends and capital gains. Now, it is not very large, but I do not think you would want it to be much larger. A consequential adjustment to dividend inclusion and tax rate would be required.

Senator Meighen: Do you have any idea from any academic work you may have done what percentage of total capital gains revenue comes from the sale of publicly traded shares—in other words, from the sale of property or the sale of paintings or the sale of whatever would it be? Can you tell me whether it would be a large or a small proportion?

Mr. Krishna: No, sir, I cannot tell you that. Under our reporting system, taxpayers do report the disposition of shares on a form, but Revenue Canada does not report or print that statistic out that way. There is no way of getting at that information.

Senator Meighen: What would be your opinion on taxing capital gains at a different rate depending upon the length of time that the asset has been held? Some jurisdictions, like the United States, apply a lower rate if the asset has been held over a longer period of time.

Mr. Krishna: Australia is moving that way. They are moving to this reduced inclusion rate of 50 percent provided that the asset is held one year. That is quite normal. The philosophy is that you want it to be a capital gain, not an income gain. You do not want people who are flipping and day trading to get all these benefits. Those are not the people to whom this is targeted. I think a one-year horizon is reasonable, and of course you can become more sophisticated than that and say that you will have a graduated decline depending on how the time increases. The trade-off is between complexity and competitive considerations at that time. In my judgement the Australian-US experience, a one-year test, is as good as any.

Senator Meighen: It would not add that much complexity, would it?

Mr. Krishna: Not the one year.

Senator Meighen: It might do something to help the perception that the individual who is engaged in flipping—which is legal but nevertheless seems wrong to some people—should make a great deal of money having put their money at risk for a very short period of time. I do not pass judgement on that, but certainly that is a feeling that they do not deserve to keep all those gains.

My next question has to do with the whole area of locked-in capital and rollovers. In talking about Mr. Roth's speech the other day, you said that you did not think it was appropriate in capital gains application to favour one area over another. In one of our studies, we had some testimony to the effect that in the United States there are rollovers permitted provided you stay within the same defined class of assets. If you started a high tech company, did extremely well and sold it and then reinvested that in the high tech industry, you would not be taxed or would be taxed at a lower rate on your capital gain. There are those who strongly favour that, particularly in areas such as high tech if we want, as Mr. Roth mentioned, to encourage people to stay in this country. Do you have any comment on that?

Mr. Krishna: To repeat my earlier balancing of various considerations, we do have in the present income tax system many rollovers. The Income Tax Act is littered with rollover provisions where we do not pay capital gains tax on many transactions.

Senator Meighen: Such as?

Mr. Krishna: Transfer of a business from a sole proprietorship to a taxable Canadian corporation. We do that on a tax-free basis. An exchange of shares we do on a tax-free basis. Mergers. Winding up. We spend 90 percent of our professional life arranging transactions to avoid the capital gains tax. I speak against my own best interests here this afternoon. The Act is littered with them: rollover on the purchase of a replacement property; rollover on transfer property to a spouse; rollover on debt to a spouse.

Senator Meighen: Are there too many or one more would not make a difference?

Mr. Krishna: No. I am saying it is not a foreign concept at all. The United States has done it with the principle-residence exemption. That exemption is available only if you reinvest in another residence and only up to the amount that you reinvest, so you do not receive a rollover for the excess that you put in your pocket and walk away with.

I have no difficulties with the concept of rolling over. There is some merit to it. The difficulty is in defining the boundaries of what is loosely called the high tech sector. I have lived with the statute long enough to know that when you put pencil to paper and try to define a particular sector, the system will run into inordinate administrative complexity giving rise to litigation and uncertainty. That is my only concern. It is not that I do not agree conceptually with it. I think a broader reference available to all achieves the same result with less of a price.

Senator Meighen: With regard to the argument of more revenue, less revenue, my own anecdotal evidence is that since the finance minister very wisely, in my view, reduced the rate of capital gains tax on gifts of appreciated shares of publicly traded companies to charitable organizations, this has had a terrific unlocking effect. Certainly in those charitable organizations that I have some knowledge of, it has been of immeasurable help in dealing with a situation where the government is pulling out of support and they are looking to the private sector to replace that support. The sooner we can get some hard data on that and hopefully expand that measure so that there is no capital gains on such a transfer, the better we will be. Do you have a comment on that?

Mr. Krishna: I believe it was a very good proposal. At the University of Ottawa and in the Faculty of Law—and this is anecdotal evidence as well—we have been the beneficiaries of that type of transfer of shares to us from successful entrepreneurs. Some of our graduates have done very well in various sectors—the markets have been very strong over the last five years—and some of those people have come back and donated appreciated shares to us. I agree. Without going into minute scientific study, there is enough evidence out there to suggest that it is having a beneficial result.

The Chairman: It is not as good as the United States though?

Mr. Krishna: No, it is not. However, our rules are not as generous as those in the United States, in part. The other part is that the United States has a very long tradition of donor giving, particularly to educational and artistic institutions.

The Chairman: When our Department of Finance gave the example to show how well we had done vis-à-vis the United States, did they not skew the figures to the extent that their basic premise was that Canadians who give to educational and medical facilities have an average base cost of 40 percent of the stock they are giving, when in fact the largest givers have a zero cost? We have not scratched the surface on this question and we will come back to it.

Senator Fitzpatrick: In Canada, a large amount of the investment has been locked in for a considerable period of time. I presume there has been a significant appreciation in value. Have you done any studies or do you have an opinion on what kind of an impact unlocking those funds by a reduced capital gains tax, or no capital gains tax for that matter, would have? As a result of unlocking funds, people could take a gain and those funds could enter into the equity market in new equity opportunities in Canada. What effect could that have on our economy?

Mr. Krishna: There have been studies on this, particularly in the US because they went through this exercise under the Reagan administration, and there was evidence of a sufficient outpouring of capital gains when the unlocking occurred. Again, there is no reason to suspect that our behaviour would be substantially different.

The lock-in effect has no beneficial consequences to society. Unleashing the lock-in effect does two things: it triggers the tax, albeit at a lower rate, that otherwise would have been 6deferred; and it diverts the capital into its most efficient use. Both of those are advantageous so I would be hard pressed to argue a case against unleashing the lock-in effect.

Senator Fitzpatrick: I think an argument can be made for two levels of taxation so that investments are held for a certain period of time, rather than having a continual rollover or disinvestment, so that there is an opportunity to create an asset value or a wealth value.

Mr. Krishna: Yes, I think that would be better. You should have one or the other. If you have a time test of one year, as was suggested a few moments ago by Senator Meighen, then you do not have the rollover to supplement that, because then you are giving a double-barrelled benefit, so to speak; you are giving the lower rate with one year and then deferring that by rolling over into a new asset. By that time, you might as well not be taxing it at all.

The Chairman: On Senator Meighen's question to you about people flipping stock, is it a fact that if you flip stock often enough you are classified as a trader and you will pay regular tax no matter what you do?

Mr. Krishna: That is probably true. I have written on that issue. The law is fairly clear on that. Day traders do not read the law though; they go into their computers and they trade away. *The Wall Street Journal* from yesterday has a wonderful article on the life of a day trader that is well worth reading. They would not be investors; they would not be eligible for the capital gains rate. They would be traders. Their income would be regular income. The difficulty is that it takes so much administrative effort to distinguish between those two categories and so much time in our courts is spent fighting the issue that it is a very inefficient way to resolve the problem. It is very expensive for society to resolve that problem.

Senator Angus: Have you had occasion to read any of the transcripts of our hearings thus far?

Mr. Krishna: I have read two of them.

Senator Angus: The first one?

Mr. Krishna: I have read Jack Mintz and Professor Brenner.

Senator Angus: When Professor Brenner was here we discussed what Senator Kenny has referred to as the political dynamic, which is very key to this whole exercise we are doing. Can you suggest to us a road map or some ways, some new language or code words that could be used in describing the process of reduction or removal of the capital gains tax that would make it acceptable to the people at large? As you know better than most, perception is 99 percent of the reality.

I used the phrase “no brainer” in one of those hearings the other day. I am persuaded that the freeing up of all this capital that would otherwise be freed up except for the tax on it would be good for all Canadians at all levels of this society. It would increase employment, encourage investment in new industry and so forth, particularly the new economy. Then it would be part of what some are calling the new prosperity for all Canadians. That seems to be a desirable thing. Yet when we talk about this subject, we get back sort of a gut reaction, “It is a sop for the rich. It is good for only 2 percent of Canadians or less. Why would you even consider it?” With that kind of an atmosphere, politicians, even the less skilled ones, stay away from this issue. Could you be helpful there at all? We will be able to bring quite a bit of evidence out in our study. I am hopeful that we will be able to show that it is not a retrograde thing. But how do we sell it? How do we dress it up or explain it?

Mr. Krishna: You are now drawing me into your arena, senator. There I am not an expert and I am very timid to enter. You are right; it is an issue of perception and misperception. If society will do anything in this regard, it must educate its press, its media, who do not have an understanding or do not come to the subject with an innate understanding of it. This is a large, complex subject, and even students of mine back at the university shudder when they enter the class. It is not a subject that they like. It is difficult. They stay away from it. They do not understand it, and that is true of society in general.

The other misconception that we must move away from is nomenclature. Part of this is the government's fault, particularly in the days when government was raising taxes a few years ago. Every time the government wanted to raise taxes, it would say, "We are taxing only the rich and the very rich," and it would introduce a surtax. Then it would introduce a surtax on the surtax. Ontario has done that and the federal government has done that and every other government has done that. The population and the media would read this and think, "That is okay because they are taxing only the rich. They are not coming after me."

The reality is that what governments call rich starts at $65,000. In Ontario today, the 48.75 percent bracket starts at $65,000. At that amount you have two surtaxes. That is not an income level that I would call rich. There are fairly ordinary people earning that amount of money.

Senator Angus: That is why senators are paid $64,000. We are ordinary people. We want to identify with all Canadians.

Mr. Krishna: You are just avoiding the surtax.

Senator Angus: You have it right. I think nomenclature is the key word. My question really was whether you have any suggested nomenclature to help us deal with this. I thought I might suggest one word that seems to work in public policy areas, and that is the word "fairness." We should start using the word "fairness" in reverse and demonstrate in a dialectical way how the tax that we are talking about is not fair. The deemed realization, for instance, is dreadfully unfair to a whole body of people who are affected directly or indirectly by for example a car accident, when suddenly a whole business is destroyed and there are employees and workers. That is not fair. We as a committee need help with the nomenclature we use.

Mr. Krishna: I can think about that and get back to the committee. Off the top of my head, on the way up we indoctrinated the population that if they were earning $65,000, they were super rich. Even the Harris government, which has reduced taxes over the last number of years, has only reduced the rate to 48.75 percent on the rich down from about 54 percent, yet the public thinks that the reduction is 30 percent. It is not 30 percent because what he did was reduce the rate, reduce the threshold levels and jack up the surtaxes. So the net effective rate has only dropped about 5 percentage points—which is good and I do not criticize him for it—but it is not as enormous a reduction as the public perceives. There again is the gap between reality and perception.

Risk-taking, entrepreneurship, is a value that society treasures and that the country has been founded upon. It is something ordinary Canadians can identify with because they want to be afforded opportunities to take risk and to derive the benefits of their risk-taking in the form of financial reward. That strikes a cord with ordinary as opposed to simply an exclusive group of people. I would be inclined to promote that.

Senator Angus: That is right. I am looking for further buzzwords or phrases. One that occurs to me is "standard of living." If we could establish the direct link between our diminishing overall standard of living in this country and this kind of tax, if we could get people at all levels of income to understand that their shrinking disposable income and the relative purchasing power of that shrinking income are diminished by this kind of tax, or, in reverse, would be enhanced if we removed the tax, we could start to get somewhere, but today nobody wants to touch it for those very reasons.

Mr. Krishna: It is a difficult issue. You have more experience in this area than I do. I think back to the standard of living I enjoyed at a modest income level of $18,000 when I was first teaching at Dalhousie University. I look to the standard of living that I now have with a slightly higher income, and I am not quite sure that there has been much change. The numbers have changed, but the living standard perhaps was even a little better when we were younger at Dalhousie.

Senator Angus: Another thing that happens with the diminishing standard is the brain drain. People are definitely leaving because of the tax structure. We have the evidence on that. Somehow we have to find a package that fits together with the nomenclature.

Senator Hervieux-Payette: Here is something to consider when you reflect on how to sell the package: I have the feeling that with the Caisse de dépôt et placement du Québec, the Fonds de solidarité FTQ and some other institutions in Quebec, owning shares and making capital gains is less dramatic than in other places and has been supported by the labour union movement. We have had a tax exemption for those who invest in the Fonds de solidarité, and that has created a new dynamism for ordinary workers to invest in the economy of their province. Like Quebec, Alberta has some kind of tax incentive to invest in small cap. Perhaps there is a difference between those two provinces and the rest of the country in people's attitudes towards capital gains. If people understand better, they are more likely to invest in their own economy and of course realize some capital gains.

Senator Furey: My understanding is that your suggestion regarding rollovers is really a deferral, not only of the tax, but of all the problems that have been associated with the tax—the illusory gains and the failure to index cost. Would such a mechanism be so attractive to investors that it would have a significant impact on mobility?

Mr. Krishna: I do not understand your question.

Senator Furey: When you talk about the ability to rollover investments from investment A to investment B without attracting immediate taxes, you are really talking about deferring the tax until an actual sale of the asset; correct? That is essentially just a deferral, not only of the tax, but also a deferral of the problems that you have highlighted as being associated with the tax—the illusory gains, the failure to index costs, and all the other things you talked about. Would that be attractive enough to investors to have a significant, positive impact on mobility?

Mr. Krishna: In my view, it would have a very substantial impact on mobility. About 95 percent of all tax planning energy and time is spent on deferral. To us, time is money. If I can devise a plan to defer something by five years, it is very useful; by 10 years, it is more useful. By 30 years, I have in fact mathematically eliminated it. We do not want to make things disappear. All we want to do is delay them so inordinately that by the time you come to pay the tax, you have earned income, the time value of money, the time value of deferral, and you are paying with inflated dollars. By the time you pay your tax 30 years from now, the dollar's purchasing power will be comparatively modest.

Senator Furey: You do have the off-setting effect that you spoke of earlier—illusory gains, not having a rapid cost index, all those other problems as well.

Mr. Krishna: That is right, so you balance out the numbers. To conclude where I started, the solution Australia is now considering of moving back down to 50 percent or lower, which we did in 1972, is probably the most optimal compromise of a complex array of issues.

The Chairman: Thank you for being with us today.

Chapter 10
Mr. John Dobson and Mr. Ian Soutar

THE STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE
EVIDENCE, OTTAWA
Wednesday, February 23, 2000

Senator Leo E. Kolber (*Chairman*) in the Chair.

The Chairman: Honourable senators, this afternoon we are resuming our study on capital gains tax. We have two groups of witnesses. Our first group is from the Formula Growth Fund and Pembroke MGMT. I will first introduce John Dobson, the chairman and founder of Formula Growth Limited, in Montreal. Parenthetically, I am an investor in that fund and it is doing extremely well.

Senator Angus: That sounds like a conflict.

The Chairman: Mr. Dobson is a graduate of McGill University and the Harvard Business School. He is president of the John Dobson Foundation and was appointed a member of the Order of Canada in April 1997.

Joining Mr. Dobson is Ian Soutar, an officer and partner with Pembroke Management Ltd. of Montreal. He is a graduate of McGill and the London School of Economics. He has been with Pembroke Management since 1968. Before that, he worked for All Canadian Funds and for Sun Life Assurance Company of Canada. Welcome, gentlemen. You have some prepared statements, so please proceed.

Mr. Ian Soutar, Chairman, Pembroke Management Ltd.: Honourable senators, Mr. Dobson and I are pleased to have the opportunity to appear before your committee to discuss the issue of capital gains taxation. Although we have very strong convictions about this topic, we were hesitant to make a submission to this committee because of the generally perceived view that the comments of successful investment professionals about capital gains are self-serving. However, having been encouraged by Senator Angus to speak out on this issue, we concluded that we should appear before you.

Capital gains taxes took effect in Canada at the beginning of 1972. Since that time, Mr. Dobson and I have vehemently believed that it was a bad idea for Canada. We continue to believe that the economy and our citizens have suffered significant economic consequences as a result of this action. Canada was one of the best performing nations in economic terms before 1972. Since that time, the economic level of our people has slipped substantially relative to the US and many other nations. We believe that a substantial cut in the capital gains tax would be the single most important action that our government could do to improve the economic well-being of all Canadians.

We believe that is why Australia recently decided to cut its top marginal capital gains tax from 47 percent to 23.5 percent for assets held for one year, and why Germany has just announced an elimination of capital gains taxes applying to stock sales by corporations. That follows the significant US cuts of recent years.

We applaud your committee's study of this important issue and urge you to use whatever authority you have to get the message to all Canadians that a high rate of capital gains tax is bad for all Canadians, not just the privileged few.

By way of background, Mr. Dobson and I have been investors in emerging public growth stocks since the 1960s. Pembroke invests in both Canada and the US. Formula invests only in the US. Formula used to invest in Europe and had one-third of its fund in Japan in the early 1970s. We have each invested in thousands of companies over the years. Formula has a compound annual return of 17 percent for 39.5 years. To give you an idea of what that means in terms of the power of compounding, $9 invested at the start of the fund is now worth $4,700.

We believe that our most useful contribution to the committee would be to present a number of actual investment cases that were affected by capital gains tax. Before doing so, we would like to comment on several macro areas where we differ significantly from the academic economists and, we believe, the federal Department of Finance.

First, as investors, we are interested in wealth creation. That appears to be a bad term in Canada—so bad that it is neither used nor discussed. In short, Canadians appear not to want successful creators of wealth, as Americans clearly do. For example, there are only five Canadian foundations with assets over $100 million, two of which are institutional. Bill Gates is a hero in the US, but he would not be in Canada. To sell capital gains reduction, we thus have to replace discussion of wealth creation with discussion of the positive role of capital on the creation of jobs. Everyone accepts that the creation of jobs in the private sector requires someone to have capital.

Second, economic models and academic economists seem to give no credit to the effect of changed personal behaviour of investors if the incentive system is changed. Their models are static and show the same results for the growth of the economy if the capital gains tax is 40 percent, 20 percent, or zero. We see from our investing experiences that that is clearly untrue in practice. In fact, only recently have some orthodox economists in academia begun to recognize the role of innovation and technology in economic growth theory.

On January 24, 1963, President Kennedy said: "The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital ... the ease or difficulty experienced by new ventures in obtaining capital, and therefore the strength and potential for growth in the economy."

Third, Ottawa and academic economists like Jack Mintz appear to us to be obsessed with the technical issue of the tax relationship between capital gains, dividends, and the small business tax. In the world of public investors, this is not an issue. Today, the Dow Jones yields 1.4 percent. Most investors in equities invest for capital appreciation or at least a combination of yield and growth."

In the last sentence of his presentation to your Senate hearings, Jack Mintz said: "I know that in terms of my recommendation I am driven by a technical issue, which is the conversion of income into capital gains, but I am very sympathetic with the argument that we should try to lower capital gains tax rates."

Our number one question, which appears rarely to be addressed, is what is the correct capital gains tax rate to provide maximum economic growth for the benefit of all Canadians. Our answer is zero, or at least no higher a rate than our nearest competitor, the United States, and that view is shared by Alan Greenspan. As noted on page 15 of this submission, Mr. Greenspan said: "The point I made at the Budget Committee was that if the capital gains tax were eliminated, that we would presumably, over time, see increased economic growth which would raise revenues for the personal and corporate taxes as well as the other taxes we have. The crucial issue about the capital gains tax is not its revenue-raising capacity. I think it is a very poor tax for that purpose. Indeed, its major impact is to impede entrepreneurial activity and capital formation. While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. I argued that the appropriate capital gains tax rate was zero."

I will conclude this section with a quote by Bruce Bartlett, a well-known US expert with the National Center for Policy Analysis:

> While there are many people who argue for a capital gains preference, and even support lowering the tax to zero, few have grounded their case on the fundamental principle that capital gains are not income. They should make this argument consistently because it raises the case from the realm of political expediency or even economic efficiency to the level of principle. Doing so at least gives advocates of lower capital gains a firmer foundation when confronted by those making a principled argument for not doing so, on the grounds that the capital gains should really be taxed like ordinary income.

In appearing before your committee, Mr. Dobson and I wish to stress that at our age we are not so concerned with any benefit to us. We are concerned with giving younger generations of Canadians the same great opportunities that we have enjoyed. As you will see, a 40 percent capital gains tax seriously eliminates opportunity and significantly contributes to the brain drain. It also reduces the incentive to create wealth that we believe is a benefit to all Canadians.

Mr. Dobson will now give you a number of examples.

Mr. John Dobson, Chairman, Formula Growth Limited: I will discuss this topic from my perspective of a very fortunate Canadian, and I will give you several case examples.

I got involved in investing at a young age because my father put $100 in my account every year. I was never allowed to touch either the capital or the dividends. From that, I learned the value of investing. I should like to pass this principle on to younger generations. I want young Canadians to have the same advantage that I had. To that end, I have come up with these exhibits.

As you will see from Exhibit 1 [following this transcript], the power of compounding interest and the effect of negative capital policies is one of the great wonders of the world, and many people do not appreciate it. This exhibit sets out the time factor with which we are dealing. The conclusion is that $1,000 compounded at 20 percent for 40 years untaxed becomes $1.5 million, while $1,000 compounded at 20 percent for 40 years with annual capital gains tax at 40 percent becomes $93,000.

Over 40 years the government receives, if taxed annually, $22,000. I might add that if the government only collected the tax at the end they would have $600,000. This excludes the devaluation of the currency—the Canadian dollar has gone to 25 cents over the last 25 years—and also the buying power in international currency, which was 72.5 cents in terms of the US dollar when I did this in 1997. This is at the centre of everything that we think of and what we want to teach people about long-term investment and, if you invest in savings, understanding what you can have, what the country can have, and the growth. What has happened here is that an individual ends up with $1.4 million of wealth creation and the government gets $22,000. It is not a very good deal for Canada.

The case is very extreme. We have taken many years, but we are looking at someone over a longer time period. Forty years is reasonable. Some people start at age 25 and we want to see what has happened by the time they are 65 years old.

Senator Meighen: Did you say the individual ends up with $1.4 million or loses $1.4 million?

Mr. Soutar: Sorry, senator. He ends up with $93,000.

Mr. Dobson: Instead of $1.5 million.

Senator Meighen: The government only gets $22,000.

Mr. Dobson: That is right. I apologize. I should read more carefully.

This example is extreme from two points of view: First, 20 percent is a lot, but we have done it at 17 percent; second, we are taking it every year you pay the capital gains tax. That is not that likely to happen. We build a case that is extreme in order to show the absolute importance of savings, growth, and compounding. A 17 percent rate is a much higher than most people would have, but I can give you figures at 12 percent or something else in the question period.

Let us turn to Exhibit 2 [following this transcript]. I take out of that two things. In case A, a compound return of 7.9 percent over 25 years with 5 percent inflation, 40 percent capital gains tax, and portfolio turnover every three years would produce zero real gain, or 100 percent capital gains tax.

Mr. Soutar: That is very close to the return that one has had by investing in Canadian stocks over that period of time. I think the return has been approximately 9 percent or 10 percent. In effect, after taxes and after inflation, there is no real return.

Mr. Dobson: If you made less than 7.9 percent you lost real value. As Mr. Soutar says, not many people have done much better than that.

Case B looks at wealth creation over 25 years. What happens if the individual lives in Hong Kong, in Canada, or in the US? The answer is that he has 4.7 times more money in Hong Kong than in Canada, and 2.2 times more in the US than in Canada, because of capital gains tax.

You may wish to turn now to Exhibit 3 [following this transcript]. I start with a child who gets $1,000. I got $100 a year from my father. You might be interested in this question of inflation, which does go on. My father got paid $100 a year in 1900 when he started out. That shows you what happens to the dollar over a period of time.

Investor No. 1, the child, receives $1,000 for 21 years, reinvests at 20 percent return, and turns the portfolio every three years. We picked three years because serious investors like John Templeton or Peter Lynch or our fund feel it is necessary to change in and out at an average of every three years. That gets into a bit of lock-up later on. The child would get $270,000 after 20 years, but the taxes eat down to $177,000. The capital forfeited to tax and lost return is $92,000; in other words, 37 percent of the investment gain has been lost, partially because the child paid taxes, but equally because there have been fewer chips available to be invested because the money has been taken out and paid to the government. I would have that much less if I were coming along now compared to when I started. I was lucky because there was no capital gains until 1972 and I was born in 1928.

What about a graduate coming out of school? Interestingly enough, the average guy graduating out of McGill School of Commerce gets $41,000 this year.

The Chairman: Where are we?

Mr. Dobson: We are at the bottom of page 6, and I am talking about Exhibit 3.

Investor No. 2 is the McGill commerce graduate. He saves and invests $5,000 a year for three years, invests with 20 percent return and pays a capital gains tax of 30 percent. In Quebec we pay 39 percent at the maximum, but he would pay less because he is in the $41,000 bracket, not in the $60,000 bracket, although he will get up to there pretty soon. That graduate would have $21,800, but with tax payments he has $19,700. Really, 30 percent of what he makes on his investment in his first three years he loses because of the capital gains tax.

Investor No. 3 is a secretary, and we try to deal with a secretary whom some of you might know or know of who was referred to in some of the hearings. A high-level secretary, like she was, starting today, might get a $40,000 salary. She invests $5,000 for 10 years with 20 percent investment returns. With zero tax, the secretary would have $155,000 versus her actual after-tax total of $113,000. She forfeits $42,000—37 percent of her investment gain.

Senator Angus: That is 39.7 percent.

Mr. Dobson: Right. There is no inflation factor in here. Only 27 percent of that is to taxes. What we are trying to show is that many of the people we have in our fund, or in our society, are lower-income people who are working their savings. They are generally not considered to be the people who are making capital gains. These are real people. We are not talking just about rich tycoons.

Now I move to real cases from our fund; these are actual figures. The first fellow, investor No. 4, is a golf pro. He invested $3,612 in our fund in January 1971. You can see that he had a market value this year of $340,883. Now, he had to pay a capital gains tax of $63,200. This is very important to understand because he had to get that money from some place. He actually saved it outside and did not take the money out of the fund. If he had used the fund to pay his capital gains tax, he would have had taxes on selling the fund. He has an unrealized gain of $71,772. Total taxes paid were $134,920. It looks large. Again, we are not talking about what is lost on the value of the currency or the international buying power?

The next investor is a doctor friend of mine who started when we started in 1960. He had $4,000. In 1971 this fellow was worth $23,500. That was before there was any particular capital gains tax. This year he is worth $2.5 million. He had to pay $410,000, which he had to find some place, and he has an unrealized gain of $466,000, for total tax of 39.6 percent.

Again, the real returns for investors 4 and 5 are much lower because of inflation and currency losses. In addition, they have had to save up that money. I am repeating myself but it is important to understand how we crucify long-term people by this process.

Investor No. 6 is the sort of case you get if you wander around the community. This is a retired doctor, highly respected. He had an argument with his trust company because, over the years, it managed his money very conservatively and his assets were not growing. He finally got rid of the trust company with a lawsuit and then he had advice in the form of a financial planner, although not us. For a while the portfolio was in balance, but then a couple of years ago a bank stock went up a tremendous amount and so did a US pharmaceutical. Both he and his financial planner felt that both stocks should be sold. However, his capital gain was so large that he decided not to make the change, and both stocks declined significantly. This locked-in factor is enormous and experienced by many portfolio owners and managers.

At Formula, we consider keeping a stock that will grow at 12 percent to be equal to selling it and replacing it with a stock that will grow at 20 percent. As a professional portfolio manager, I think that is grim. If we sell the stock, we can replace only a certain number of dollars. We can put 60 percent back into the gain, but we must pass 40 percent to the government. Therefore, we have that many fewer assets. There is a big economic loss from staying invested in lower investments and not switching to newer, faster growing companies. There are dozens of cases involving that. Wherever we go, we hear that kind of thing.

The next example involves the son of one of my friends. He was a computer geek. He went to the University of Waterloo and then moved to Kanata. At one point, he and two of his friends started their own computer software company that specialized in computer security. Recently, it was sold to a big company that helped finance it: Newbridge. The entrepreneur was asked by his father: "How much money did you make, son?" The son responded to the father: "Before tax or after tax?" The father then asked: "I guess after you have had your 18-month stay-in and earn-out period, you will probably start again?" His son replied: "I made a lot of money. I might start again, but I will not start in Canada because of the capital gains tax." Those are good young guys in the modern world and that is an actual case from highly respected people in our community.

We play golf and we talk about some of these cases. In fact, that is where the previous story was heard. There is also the dentist and MBA from Concordia who wants to be heard. He entered our discussion by stating that he did not want to follow the lead of many of his friends who say that he is foolish not to take his funds offshore. He is upset and dumbfounded by the number of them who tell him he is stupid not to do what the rest of the people are doing. That is pretty sad, but it is realistic with the 40 percent rate. Again, like the lock-in effect, the government gets no revenue when money is moved into the tax-free areas. If you take your money offshore, the government gets nothing.

The Chairman: When you bring the money back, do you not have to pay tax?

Mr. Dobson: Yes, but you can use the internal buildup in the meantime. You pay 100 percent. They are trying to get an internal buildup, like the British system. You definitely pay the tax when it comes back, but you have all that money working for you. You get the $1.5 million as opposed to the $93,000 in our earlier case, and the government would get $600,000.

Senator Angus: What do you mean by "internal buildup"?

Mr. Dobson: You pay a certain amount of tax to the government, but then the funds available to you have been lost to earn on in future years. That is roughly equal to the taxes. It is a very big factor. You have $100 on day one and you pay 20 percent to the government. You then start with $80. You have lost some of the assets, which will compound at whatever rates we use.

Investor No. 9 is an example of probably the biggest negative of all, which is the loss from entrepreneurs who never get started because of the effects of high capital gains tax. First, for those who choose to remain in Canada, there are not enough angels to finance start-ups because of the lack of wealth creation. Second, Canada loses when Canadians set up in the US rather than in Canada because of the perceived uncompetitive climate suggested by a 40 percent versus 20 percent capital gains tax. That correlates directly with job creation. Either we have jobs in the private sector created by entrepreneurs and accountable to them for what they are paying people—hopefully productive jobs—or we look to government to create jobs with questionable economic value and accountability. The current Human Resources debacle is a case in point.

Senator Angus: It is shameful.

Mr. Dobson: Investor No. 10 is next. In our fund and all mutual funds, new entrants must assume the unrealized gain in the fund upon entry. If you entered our fund on January 1 this year, at $4,400, you would know we have approximately $2,200 of unrealized gains. At the end of this year, our fund might be $4,400, or it might show a loss from purchase price. If the managers sold all stocks with unrealized gains, the new investor would get a tax slip for his percentage of $2,200, even if the value of the fund did not increase.

It is interesting to note that unit trusts in the UK are not required to pay capital gains taxes. In other words, the fund manager can change the portfolio and the investor will pay capital gains tax only once he sells his underlying units in the fund. The significance of that can be seen in Exhibit 1. The individual would end up with $900,000 versus the $93,000 that was given in the example—that is, if the 40 percent tax payment were deferred to the end of 40 years. If that happened, the government would get $600,000, as we saw in that earlier case. While this example is extreme, the lock-in factor is serious. It is hurting wealth creation because it keeps investors in old holdings instead of newer ones. Many of these things hurt investors because of this capital gains tax that they must either defend against or do something about.

Concerning cost and regulations, the revenue that the federal government receives from capital gains stocks is not very significant. Your committee no doubt knows all the figures from the Finance Department. The cost for collections and policing must be subtracted against the revenue. The problem is that you have an asset. You must keep track of the date of the asset, whether it goes up or down or sideways, within one year or five years. Because the capital gains tax is applied over a long time period, it is very complicated to score and to keep.

For individuals, look at the unproductive costs for the material in the private sector. You have H&R Block doing tax returns, lawyers, accountants, administrative costs of the RRSP, and so on.

Senator Hervieux-Payette: What about job creation?

Mr. Dobson: I am talking against the service we provide. While we receive fees, we are saying that it is wrong to have so many intermediaries who add to the unproductive cost.

RRSPs are better than nothing, but they often provide for bad investment performance because of small amounts and administrative costs, plus the 80 percent Canadian content. Other troubling problems arise, such as investor-owned units in the fund in a personal holding company. The geniuses tell us that you should have your own personal holding company when you have US assets. If you do, then you pay a capital tax. If you have it in your own name, you do not. I have it in both, and so does Mr. Soutar. On one account, we pay a capital tax; on another account, we do not. Things like that go unsaid but in the real world add up to the total cost and annoyance that is caused by the capital gains tax.

Mr. Soutar: In conclusion, Canadians' well-being has been substantially lessened by the high capital gains tax that has been imposed by our government. First, the tax significantly reduced the wealth creation process. Second, the lock-in effect of the capital gains tax has badly affected returns by keeping Canadians from switching into higher-returning assets. Third, this high tax has either prevented our most talented entrepreneurial business people from getting started in Canada because of a lack of angel financing, or has driven them from the country. It is important that this message is communicated successfully to the people of Canada. Our reduced capital gains tax will not just help the rich. It will materially help all Canadians to enjoy a higher standard of living by creating the wealth that is needed to provide our citizens with better education, health care, or whatever else we choose collectively to spend it on.

Senator Angus: Mr. Dobson and Mr. Soutar, we appreciate your coming up here today and the excellent paper and appendices that you have presented. We have been engaged in this study for several months now. We have had a variety of what you referred to as "academic tax economists."

Some of their evidence has been conflicting and also confusing. Perhaps you can help—as you already have—in terms of clarifying some points.

I have two questions. First, you spoke about the lock-in effect created by this punitive capital gains tax in Canada. You are advocating an abolition of the capital gains tax, which would obviate the lock-in effect. If that happened, where would those locked-in funds go? What would happen to those funds?

Mr. Soutar: Those funds will not go under the mattress or disappear. This money will be reinvested in higher-returning assets. It will be invested in business formation. It will be supplied to various charitable organizations. It will be spent on consumer goods. It will go back into the Canadian economy.

Three things will happen when the capital gains tax is either substantially reduced or eliminated. First, there will be a surplus of money that will go to the government because lower tax rates will encourage a number of investors to turn in their investments. They have been sitting back, reluctant to pay the capital gains tax. The funds will go into higher-earning assets. Second, money will be invested in higher-earning assets, which will create more wealth for the good of all Canadians. Third, the funds will be recycled into all kinds of economic activity, which will benefit all Canadians. Locked-in funds have an enormous adverse impact on the economy, on job creation, and on the prosperity of all Canadians.

Study after study in the United States has shown that when capital gains tax rates are cut, there is a substantial improvement in economic activity generally as a result. The economies of Ireland and New Zealand are cases in point. I do not believe there is any case in the world where capital gains tax rates were reduced without resulting in a substantial improvement in economic activity and well-being for all citizens. That is why politicians reduce capital gains. Politicians do not reduce tax rates because they do not want to get access to funds. Politicians love to have hold of the money so they can control it. They do not understand what a destructive process that is. Leaving money to accumulate and create greater wealth, in the hands of productive individuals, benefits economies substantially.

Canadians do not have a choice. We are totally non-competitive with the vast majority of our Western competitors. If we do not reduce capital gains tax rates, we will continue to lose our best and most talented people to the United States and other countries. Our citizens will not benefit as they should.

Believe me, if tax rates on capital gains are reduced, people will think they are in the midst of an economic miracle. In my opinion, you will almost immediately see an improvement in our currency. You will see a substantial increase in capital investment in this country and a substantial improvement in our domestic economy.

Senator Angus: You have made some very positive and adamant statements. You have referred to studies and texts. Are you comfortable that the evidence is out there? Is this a wish list that you have? Can you affirm that there is concrete evidence to sustain the points you are making?

Mr. Soutar: Absolutely.

Mr. Dobson: I agree with that. I would also cite Germany as a good example for our proposition. Germany has a banking system and there is interlocking money backwards and forwards. Germany has also totally removed the capital gains tax rates on companies. They have done that because they want the money to flow around and be re-addressed from the old economy to what is now referred to as the new economy. Countries will be efficient and modern. To do that, you must get the money out of the old economy and move it into the new economy. You must find the money some place.

When a country like Germany finds it necessary to go to that extreme, they are not fiddling with the capital gains—from three-quarters inclusion to two-thirds inclusion, or 65 percent—the figure is zero in Germany. I do not live in Germany, but that is a piece of evidence other people in the world have found. To be competitive and to deal with unemployment, that is what they must do.

Senator Angus: On the subject of the new economy versus the old economy, or the restructuring in Canada, we want to get away from being hewers of wood and drawers of water and to advance into this new economy. We have heard that said repeatedly in another study done by this committee with respect to the availability of equity capital for start-ups and for new business in this country. Canada is apparently lagging behind our neighbours, partners, and other OECD countries in participating in the new economy. Even in our traditional resource-based companies, we have lagged behind in retooling to take advantage of the new economy's technology and to make companies more efficient. Is that what you are referring to basically? Would the removal or the reduction of the capital gains tax help to alleviate that situation?

Mr. Dobson: That would do a great deal to alleviate the situation. In Canada we have the problem of what we refer to as "angels." There is venture capital money available, often institutionalized. If you want to start up something you go around, as we did in the Montreal community, and raise funds. We collected $134,000 and that is how we started. You cannot do that today with all the regulations. Rather, money in the hands of friends and relations is made available to move into this area.

Senator Angus: You say that is not there today in Canada?

Mr. Dobson: There is some, but nowhere near the degree that is available in other places, particularly in the United States. We just do not have that much wealth in our country. If you want to start a team like the Expos, you had better have, in year one, a Charlie Bronfman. We had 30 of them, but Mr. Bronfman ended up with almost sole control, along with Hugh Hallward and Lorne Webster. Money is needed to get things going.

The second issue is something many people lose sight of. If one is to invest in something like that, one must be able to come up with a second and a third round. Mr. Soutar and I are not usually in the start-up business but occasionally we do get into it. We know from experience that if you put money into such things, you must be prepared to give a second shot and a third shot. If you are going to put in some money, you need to look and see who else in the community might take you out.

The Expos are a good illustration. They had 30 investors at the beginning who dropped by the wayside, one by one, and eventually they all went out. On day one, it was great and 30 players were ready to tee up, but one must be able to find the future equity. If one cannot find future financing and take-out, then one must decide whether to go in at all.

Senator Angus: We hear time and again that Canada, being so close to our large neighbour to the south, should have a comparable regulatory system, be it in banking or taxation or in other economic conditions. If we follow that lead, using the US as a model, I suppose we would conclude that their approach to capital gains might be instructive. What would you have to say about that proposition?

Given Canada's relatively small size, our open economy and the fact that we are apparently more than 18 months behind in taking advantage of

Internet commerce, and given that we do live next door to the world's largest economic engine—the elephant—should we have a lower capital gains tax in Canada in order to attract new money and to increase the wealth and prosperity of all Canadians?

Mr. Dobson: At The Fraser Institute symposium on capital gains, they gathered 20 or 25 experts, including two or three Americans. They asked, should Canada have the same system as the United States? The answer from them was clearly no.

Senator Angus: Why not?

Mr. Dobson: We should have our own system. What are our needs?

Senator Angus: I take it you agree with those who say we should not have the same system? Is that your evidence?

Mr. Dobson: I do not think it matters. What matters is the rate of the capital gain, because that is what the decision whether or not to invest in Canada will be based on. The issue is not whether to copy their system but, rather, how we can compete for overseas investments and retain Canadian investment.

Senator Angus: Rather than the Americans getting it?

Mr. Dobson: Or whoever else. Today our people are going to Ireland because that is currently the hot place. We must look at what is good for Canadians and what is needed. If we need capital for jobs, someone must have the capital. As Alan Greenspan said, the worst thing to penalize is capital and capital gains. You need that to get it going. Do not buy the American system holus-bolus, but, directly on your point, if our capital gains tax was 3 percent to 5 percent less than the American tax, that would signal to the world that this country wants to grow and to move from the stages that you spoke of earlier.

Senator Furey: I wish to follow up on a point that Senator Angus made earlier. Mr. Soutar, do you think we would get the same results with tax deferral rather than total elimination of the tax? Would we get the same capital mobility and hence the same investment opportunities with tax deferral?

Mr. Soutar: Any substantial reduction in the capital gains tax would have a positive impact on the country.

Senator Furey: Would you consider a deferral a substantial reduction?

Mr. Soutar: Deferral of the tax through a vehicle with a rollover provision that would allow the accumulation of wealth, which is the important factor here, would be a substantial improvement. It should be done over a long period of time so that greater wealth can be created, because that will benefit government revenues as well as the individual citizens of our country. That would be a substantial improvement.

If I were fashioning the tax myself, I would cut the rate very substantially. I would not get too technical in terms of creating vehicles for deferral, because that complicates life. The simpler, the better. However, a substantial or total deferral of taxes over a substantial period of time, such as the career of an individual, for example, would be a substantial plus in terms of the wealth-creation process and the encouragement of entrepreneurial activity.

Senator Furey: That would probably be easier to sell to the general public.

Mr. Soutar: That may well be. Our mission is to make this appealing to people and to educate people about the benefits. It is always perceived, even in the United States where they really believe in capitalism, to be a sop to the rich. It is generally thought to be such because people do not think about the implications. I strongly believe that this is a very unfortunate perception caused by lack of understanding of the process. Once you understand the wonderful power of compounding over long periods of time, you realize that the nation is losing enormously by not letting the egg grow to a great size. A deferral would definitely help in that process.

Senator Oliver: You said in response to other senators that you welcome reducing capital gains tax to zero. The Minister of Finance is not interested in increasing allowable foreign content quickly up to 10 percent, but would prefer to move 2 percent a year.

Could you explain to the Canadian public whether there is any danger in jumping from 75 percent to zero? What negative effects can possibly come to the Canadian economy, or Canadians, by suddenly, in one fell swoop, removing the tax?

Mr. Soutar: There are bound to be some minor negatives. There has always been a concern that people will attempt to turn income into capital gains through various tax mechanisms in order to avoid paying income taxes. However, I believe that the negatives associated with the elimination of the capital gains tax are so minor in relation to the benefits that all Canadians would enjoy that they are not worth worrying about. I do not get caught up in the technicalities that the tax experts do about the fairness of one versus the other. I think there would be minor cheating in the system, but the benefits would be so enormous to all Canadians in terms of job creation and general prosperity that it is really not worth worrying about.

Mr. Dobson: In the deferral mechanism there are two things to consider. The first, about which we do not know enough, is the British model of unit trusts. In that model, the manager can buy and sell stocks within the mutual fund without triggering capital gains for the investor until he redeems from the fund. That defers the tax and would be of benefit to many lower-income people in Canada.

Second, Jack Mintz is very interested in what he calls a rollover. Like Mr. Soutar, I do not like vehicles. I prefer to have it clean and simple and for people to own their own stocks. However, if we must have vehicles, we could put all our stocks in a vehicle, switch them from the old to the more aggressive, if that is what we want, in order to build up wealth for Canada, and any time we take it out we pay tax on it. We can devise vehicles to do that. The starting point, however, is to realize that we have a big problem because Canadians are not educated in the ramifications.

Senator Kenny: Mr. Dobson and Mr. Soutar, I should also declare that I am an investor in Formula Growth.

You have made the point about the value of compound interest and about the impact of the erosion of inflation. You made the case for reduced or no capital gains tax: benefits to the investor, benefits to the government, benefits of keeping entrepreneurs at home.

I am struck with your statement on page 1 where you say: "We believe that a substantial cut in the capital gains tax would be the single most important action that our government could do to improve the economic well-being of all Canadians."

I assume that you have considered income tax and the GST. You have not really addressed that question here, unless I have missed it. Would you explain why you feel that this action would be preferable to other actions that the government might take?

Mr. Soutar: Neither Mr. Dobson nor I is an economist and we are really not capable of giving you any kind of quantitative study that could justify that statement. We have seen the incredible response in Ireland, New Zealand, and other countries when they cut capital gains tax. One of the reasons we quoted Alan Greenspan, who has much credibility throughout the world, is that he believes this is probably the most important thing that can be done for the good of an economy, and he is a highly qualified economist.

That is a feeling we have. We have that feeling because we have been in the investment business for 40 years and have seen the enormous ramifications of compounding wealth over many years and what that does in terms of wealth creation. We think that that wealth creation process will happen faster with lower capital gains tax and that it will have a dramatic impact on capital investment in this country, and that is where we think the whole wealth-creation process takes place. However, I cannot prove that with any degree of satisfaction for you.

Mr. Dobson: A few years after his term, the British chancellor who put that ruling in for the mutual funds was asked by the head of the Adam Smith think tank in London what his biggest regret was. He said his biggest regret was that he did not change—either completely eliminate or very significantly reduce—the capital gains tax for individuals. He did it for the pool accounts but not for individuals. After he was out of office, that was his biggest regret, so there is evidence.

Senator Kenny: For the purpose of my next two questions, let us assume you are right. Let us posit that. I think it is important and useful that you have come forward and said that the creation of wealth is a desirable thing. You do not hear that very often in Canada. It is not part of the culture here. Why do you think it is not part of the culture? Why do you think people feel fundamentally uncomfortable with the idea that creation of wealth is a good thing? They do not think it is necessarily a bad thing but they are not prepared to say it in the positive. Why are so few people prepared to come forward, as you have today, and speak out in favour of it?

Mr. Soutar: That is an excellent question. We believe part of it is the fact that people are not educated at an early stage about the benefits of wealth creation. There is a perception generally that, if people get rich, they are getting rich by some shady activity, whatever it may be. I also think there is a mentality in this country of envy—if the government does not do it for us it is not right—and a mentality of dependence, where people would rather have the government do things for them than do them themselves. However, it is unfortunate that we do not have a more positive attitude about this issue. We seem to pride ourselves on writing articles in newspapers about people's salaries, about how much money they are making and about their stock options, and it is a very negative spin that we seem to put on it collectively, rather than putting a positive spin on it and saying is it not wonderful that someone is getting rich because, if he or she gets rich, it will benefit all of us.

Mr. Dobson: The capital gains tax started in 1972, and one of the interesting question is this: Why did it start and who started it? We have our senator here from Nova Scotia. My parents come from Nova Scotia. One night I was having dinner with Bob Stanfield, and I said, "Mr. Stanfield, you are a good Nova Scotian. You were in the Conservative Party at a time when the capital gains tax was put in, and you encouraged or did not speak about the damaging effect of the capital gains tax." He said that while he did not believe in the capital gains tax, when he came from Nova Scotia and went to Toronto, they persuaded him that this was a very rich country and that, in fairness, the riches should be spread around partly by charging a capital gains tax.

I think that has a lot to do with it. We had the world by the tail in the earlier years, with Expo '67 and even before that. When I came out of Harvard Business School in 1952, this was the country in the world young people went to. All of a sudden, it got a little overdone and people felt, "Gee, it is not quit fair. Let us share it." Little consideration was made of the damage or the significance to a young country when you discouraged and blocked capital in the early stage. That led to the attitude Mr. Soutar is talking about.

I might add that a big part is in our schools and colleges. Economics, in particular entrepreneurship, is not taught in most schools, although they are starting to in Nova Scotia. There is little education. The economists—my dear friends—are giving a tremendously misleading statement about facts of life to our students in the schools. I will be specific on that because I am making quite a strong statement. We, back CIAR—the Canadian Institute of Applied Research—put up some money from our foundation, for the economic growth part. A meeting was held here in Ottawa. I came to the meeting. Learned economists were there talking to each other and they came up, about five years ago, with the astounding idea that, in economic growth theory, innovation and technology were not part of it and did not appear. I said, "Give me a break. We have been investing for 30 years or 40 years in companies that are growing. Here is what is going on in the practical world. You are telling me that the economists have now discovered that this is what is right?"

We also talked in the paper about static growth, including the American budget office. If you change the incentive system, allowance must be made for the result—that is, lower taxes, increased GNP and revenues. The thinking is so entirely different from the concept here, with people like us who are dealing with the dynamic growth companies. I was referring to Fonorola Inc. and other growth companies a few minutes ago. We have to have people who do that.

Senator Kenny: You have led right into my third question, which is with respect to the implication that wealth creation is a zero-sum game to some extent. If someone is getting wealthy, they are doing it at the expense of someone else. The principal argument for a capital gains tax has traditionally been fairness and equity. You have touched on that, but why not hit it directly now for us? How do you answer the criticism that comes forward that it is only fair and only just? That is why we have capital gains now and that is why we are likely to continue to have it, because no one is answering that question.

Mr. Dobson: It has to do with an increased size of the pie. If you talk to the taxi drivers of Montreal, they want business to boom. They want to see some more fat cats. There are not enough of them around. If you talk to the beggars and the various people in the street, for them to get off welfare they need someone making the pie bigger, particularly in the private sector. The problem we have in Canada today is that we have far too much percentage of the gross national product going to governments. If you change the system and you expand the pie and have everything booming, you help the poorer people whom we want to help, many of whom need help. We have to make the safety net better and bigger, and the only way we can do that is to increase the pie. So what are we going to do to increase the pie? We have to create some more productivity, wealth, whatever you call it, and to do that we have to have some capital, if we are going to do it in the private sector.

I heard in the Senate, and this afternoon in the House of Commons, words about the government investing in this, that, and the other thing—and how the money was being spent. The government then decides they are going to solve the problems. We have many unemployed people so they are going to make their best efforts to do it. In my society, I would have much less government, and an incentive system where the private sector would significantly increase the amount they do, and I have no doubt in my mind, at the age of 71, that the poorer people in Canada would be much better off because we would have a bigger pie to divide up.

Mr. Soutar: Is it fair that the citizens of Canada have fallen substantially behind their neighbours to the south over the last 30 or 40 years? Is it fair that our currency has declined substantially over the last 25 years? Is it fair that we as Canadians feel impoverished when we visit Western Europe or Asia?

This issue about fairness gets in the way of what Mr. Dobson is talking about, which is making the economic pie larger for everyone. I believe that, if Canadians understood the process of wealth creation and the benefits they would derive from it, they would overwhelmingly vote in favour of a reduction in capital gains tax, even if some individuals benefited more than others. Let us face it, in the world, all is not fair.

Senator Angus: Nor equal.

Senator Meighen: I share the views of our witnesses today. You have put it very well in response to good questions from Senator Kenny. It is necessary that people get out and articulate this. Let us look at other countries—even leaving the United States aside, although it is staring us in face. Let us look at all the evidence. Countries like Germany, New Zealand, and Ireland may have just as much reason as we have to be suspicious. Nevertheless, they went ahead and did it. Do you have any information to bring to us as to how that came about? I do not think it was a referendum or a plebiscite. They did not have the example of the United States being next door. Perhaps they had good vision across the Atlantic, or maybe it was political leadership. I do not know. Do you?

Mr. Soutar: In the case of New Zealand and Ireland, they were so desperate that they were prepared to try anything.

Senator Meighen: I hope you are not saying that we should wait until that happens here?

Mr. Soutar: Economically, we have been getting very close to that. It is a tragedy that we are losing our best and brightest people. They are going outside of this country. Much of that is motivated by the opportunities that they have in other countries because of the tax situation.

If we are talking about keeping a country going over the next 20 or 30 or 40 years, then this is something that we all must think about seriously. All of us here are concerned about this country; that is, the well-being of this country, the well-being of our citizens, and having this country around for the next 50 or 100 years. If we cannot keep our best and our brightest people here, we run a serious risk of becoming irrelevant in terms of a key economy and maybe even one day becoming part of the United States. I think we are facing a crisis of proportion that requires us to move decisively on this issue.

Senator Meighen: I agree. Given that scenario, what would you say about the possibility of a reduction in this budget—and this seems to be mooted about in the press and leaked by the government—from an inclusion rate of 75 percent down to 66 percent? Will that have a negative effect, no real significant effect at all, or a very positive effect?

Mr. Soutar: I think it will have a positive effect. Any move in the reduction of capital gains tax will help. If what is being leaked in the press is to take place in the budget, it is nowhere near enough to do the kind of good that we need to do in this country. We must move decisively on this issue. If the government moves in a minor way, we should reinforce our efforts to make this issue better understood by all Canadians. It will have a benefit—there is no question about that. However, it is not enough. It is fiddling at the margin and will not do what we should be doing for the good of our citizens.

Senator Meighen: I have a more technical question. It is my understanding that, although the Americans have a capital gains rate of 20 percent now, they have a state tax or death tax, which we do not. Is that the trade-off? Suppose you could wave your magic wand and tomorrow we would have no capital gains tax. Would you add an estate tax?

Mr. Soutar: First, we do in effect have an estate tax because of the deemed realization upon death. If we had to make that trade-off—and we are already paying estate duties here because of that deemed realization—an elimination of capital gains tax and some form of estate tax is in the best economic interest of all Canadians. Sure, it stops people passing money from one generation to another, but it is not necessarily good for the children to be passed money anyway. I should like to see the government encouraging the people who are out there creating wealth, building businesses, and doing things such as employing people. That is where the activity will benefit our country the most.

Senator Meighen: I wish to ask you about your investor No. 10. I think Senator Furey touched on this with his questions about deferral. That is similar to what we are told—and I hope you will pardon me for referring to yet another leak—may occur in the budget with respect to options, whereby taxes will only be payable on an option when it is sold rather than when it is invested.

Mr. Soutar: The move on options is being forced on the government. It is reluctantly doing this because we are moving so many people out. High profile businessmen who head up companies such as Nortel are saying, "If you do not do something about this, we are going to move more jobs than we are moving right now out of this country." This is a reaction to that reality as opposed to saying, "Let us do something of a positive nature. Let us make this place really attractive. Let us get Americans to come to Canada and build jobs and businesses and invest in the new economy. Let us get this place going." What do we do? We sit back and fiddle at the margin and react in a negative way when we are being forced in a crisis as opposed to taking a positive, proactive attitude and doing something that is really positive for the country. It is simple. Everyone sitting around this table knows how easy it would be to get this country really booming again. It was booming before we imposed this capital gains tax and it has been suffering ever since. It is almost as simple as that.

Senator Meighen: There may have been one or two other factors.

Mr. Soutar: Of course, there were other factors.

Senator Meighen: What about the different rate of capital gains tax depending upon the length of time the asset is held, as is case in the United States and some other jurisdictions? You would not be in favour of it in principle, since you prefer no capital gains tax, but what advantages and disadvantages do you see for that? In some quarters, it is said to address the question of fairness. People who flip assets would not get the same benefit as those who hang on to them for a considerable period of time.

Mr. Soutar: If I had my druthers, I would not worry about the difference between a day trade and a 10-year trade. Let us face it. There are some significant differences. If someone owns a foreign or growth fund for 40 years and gets and pays tax on that fund over a 40-year period of time, when the value of the currency has gone from $1 to 25 cents over that period of time and they are paying on the nominal amount of dollars to start with, it is a very unfair thing. That is one of the problems you have and it is one the reasons that people talk about different tax rates depending on length of time.

To us, investing is not day trading. To us, investing is backing good people and providing capital for businesses to grow over the long term. I am sympathetic to the idea of having a lower tax rate on a longer-term gain because of the inflation effects, et cetera. Frankly, when you start doing those things, you complicate the process and add enormous numbers of people who have to police and audit the activity on the part of the government and set all kinds of workloads on the part of individual investors. I would try to keep it as simple as I could.

Mr. Dobson: We have that now. If you are making a large amount of your money by trading or your main business is deemed to be trading, then you have another situation. There is a vehicle now that deals with that. It is a very hazy vehicle that has a lot of personal judgment as to whether the guy is a trader or not a trader. Traders pay one thing; investors pay another thing. You must decide which camp you are in. It is a grey area.

Senator Kroft: I had several outstanding questions, most of which were covered by Senator Meighen. We all want to get to the same place. The rigour of the debate and the discipline is very important. A recasting of your paragraph on page 1 would be helpful on future performances because it overstates, perhaps, the importance of capital gains.

I have an observation combined with a question. Basically, we are all in agreement on this point. I do not think you are trying to convince us on this particular issue, and we have quite a bit of consensus within our group. This concerns the cultural issue about wealth, which is so fascinating to me. Somehow, we tend to blame this on government. I want to test a proposition on you. Governments have a tendency to take polls and respond to what they learn in them. Perhaps that is the form of leadership in the 20th century, and that is the real world. Over the last year or two I have been interested to learn that the meaning of the word "wealth" is very different from what it was even a decade ago. There is not one financial institution that does not now offer "wealth management services." We never saw that before. If there was such a thing, it was down at the end of the hall and it was called "private client services." Now there are ads that tout "wealth management." There are even some ads that talk about "wealth creation."

We are frustrated with why governments do not do what seems to us to be obvious. The question I want to put to you—and incidentally I am lumping you in generally with the investment industry and investment management—is the following: Is the reticence of the marketing of what you do not a big part of the root of the issue? As I say, I think we have come some way. But, if the investment industry was saying more aggressively, "Let us create wealth for you. Wealth is good," I think more might be done in a cultural sense, which is very much at the root of what we all agree we are talking about here. Government will not suddenly decide that wealth is good. However, if all of you are out there running full-page ads saying, "Let us help you create wealth," do you not think it would have an enormous impact on the cultural problem we have?

Mr. Soutar: Our industry has done a bad job of selling the benefits of wealth creation to all Canadians. We have a responsibility to do it. I agree with you entirely.

Mr. Dobson: I would add that you have to watch out for those obstacles. If in 25 years you have to make 7.9 percent to break even because someone made those the rules of the game, it is hard to convince people to go out and play with those extreme factors. That is based upon 5 percent inflation. The actual rate of inflation is 5.3 percent, which is what I pay when I sell something today that I have owned for 25 years.

The current inflation factor that Jack Mintz uses is 2 percent for 20 years. At that rate, you still lose one-third of your money over 20 years. There are structural things, such as penalties, including the regulatory authorities whose job it is to ensure that somebody does not get stung for doing something. All that interferes with progress. We sit on conference call after conference call, and the lawyers in the US refer to the Safe Harbor Act. You have to ensure that you pay no attention to what they say because it may not be right.

The regulatory authorities, which I have touched on a bit, and the taxation make it unattractive for a certain number of people. I probably could not start Formula Growth Fund today. I came out of industry; I had not been in the business. The Quebec Securities Commission would have thought that I probably would not be very suitable to run a fund. So you see there are these regulations that interfere with the people who want to go.

The Chairman: You cannot be arguing against regulatory bodies. Perhaps not everyone is as honest as you are.

Mr. Dobson: The question would be overkill. What they gain is better than what they lose by having it there, economically.

Senator Kroft: The bulk of my questions have been pursued. I was delighted with Mr. Soutar's response. I am coming to the conclusion that this cultural issue will be changed much more dramatically outside government than inside government.

Senator Hervieux-Payette: Between lowering the percentage and holding it for one year so that the money does not start to roll too fast, which do you prefer? Would you prefer that it go down quite low and have a cooling off period of one year? Do you consider the criterion of holding the stock for one year to be a negative? It seems that it is the case in some OECD countries.

Mr. Soutar: The most important thing is a substantial reduction in the rate. If there were a time period of one year, it would not bother me.

Senator Hervieux-Payette: Let us say we are overjoyed next week with a massive reduction in rates. In light of globalization, what is there to assure us that all the money will be invested in our country? More and more, with globalization, more production can be done at much cheaper rates with the manpower in countries where there are no labour laws, no minimum wages, and where there are some educated people. I think of countries like India that have many computer science experts, engineers and so on. How do we ensure that if all this money is moving around it is not moving out of the country?

Mr. Soutar: I do not think we can be assured that all the money being made will be invested in Canada. Some of it will go outside the country. The most important thing is to make us competitive with other countries. Let us face it—Canada has a lot to offer people. We have a very small population, lots of fresh air, lots of good water, a low crime rate, and a population that is generally sympathetic to looking after the poor. There are a many wonderful things about Canada that have kept us all here, not just money.

At the same time, we have fallen behind very substantially on the economic front. In my opinion, cutting the capital gains tax rate will mean more money invested in Canada than is invested right now. I do not know how many millions or billions of dollars have gone offshore; however, I suspect that it is a fairly substantial amount, because of taxes.

Some of that will come back. Certainly, other people will look to Canada as a great place to come and invest if the capital gains taxes are reduced.

We have well-educated people and a great labour force. Many people here speak more than one language. We have all kinds of advantages. This is a very attractive place. The OECD tells us that all the time. However, in my opinion, where we are really uncompetitive is on this issue of capital gains tax. Yes, some of the money will go out, but more of it will be invested here. In general, I am very certain that we will be better off as a result of a lower capital gains tax rate.

Senator Hervieux-Payette: Our interest rates were always higher than those of the United States. Our rates are now lower. Do you not think that is also creating a distortion in the whole system? What is the rationale? We were told that interest rates would go down when we had low unemployment and low inflation, which we now have. Now, of course, the interest rate is very low, lower than the rate in the United States. They have lower unemployment than we have, as well as lower inflation. What is prompting us to have these interest rates?

Mr. Soutar: I am not an expert on that issue. However, in my opinion, the reason our interest rates are lower than the rates in the United States is the fact that our unemployment rate is still higher than it is in the United States. We still have available resources here, although they are shrinking very rapidly. Our rate of inflation is lower. Therefore, our central bank feels that the risks of inflation are lower here than they are in the United States. I think that the US Federal Reserve is quite concerned about inflationary prospects, which is one reason they are moving quite aggressively in terms of trying to tighten up monetary policy and increase interest rates. However, I am not an expert on that subject.

The Chairman: Thank you, gentlemen. You make your points in such a way that the public can understand them, which is very helpful.

Exhibits to John Dobson and Ian Soutar Presentation

Exhibit 1: The Power of Compound Interest
Effect of Negative Canadian Policies

$1,000 compounded annually at the following rates over a 40-year time period produces the following returns: (40 years is taken to illustrate a young person of 25 saving until retirement at 65).

20%	$1,500,000
15%	268,000
12%	93,000
10%	45,000
9%	31,000
8%	22,000
6%	10,000

$1 doubling annually for 20 years produces $1 million.

Three government actions cause the investor to receive significantly less.

1. *Capital Gains Tax:* A rate of 40% applies to taxable income above $60,000.

2. *Inflation:* Since the arrival of the Capital Gains Tax in 1972, the purchasing power of the Canadian dollar has declined to 25%. The Capital Gains Tax rate is much greater than 40% when applied to the real purchasing power of the original investment dollar.

3. *Currency devaluation:* Since 1976 the purchasing power of the Canadian currency has dropped from $1.00 to $0.72 in terms of the US dollar. Investors preserving their purchasing power by owning foreign assets must also pay a capital gains tax on this loss.

Let's look at some scenarios:

- $1,000 compounding 20% for 40 years = $1,500,000
- $1,000 if you pay 40% on capital gains as tax annually = $93,000
- $1,000 held for 40 years and pay 40% capital gains tax at termination = $900,000
- $1,500,000 would be worth in 1972 dollars = $375,000
- $1,500,000 would be worth in US purchasing power versus 1976 = $1,081,5000

Conclusion

Excluding the big inflation and devaluation losses — the 40% Capital Gains Tax results in the following:

- $1,000 compounding at 20% for 40 years untaxed = $1,500,000
- $1,000 compounding at 20% for 40 years with annual capital gains tax = $93,000
- Government receives over 40 years if taxed annually = $22,000
- Government receives if taxed only at end of 40 years = $600,000

The individual loses $1,407,000 of wealth creation so that government gains $22,000!! Not a great trade-off for Canada!

Clearly, to create wealth and take advantage of savings, the investor should aim for long-term holdings and high rates of return. It is difficult to build a competitive country with this attack on wealth.

Canada's great growth years of the 1950s and 1960s took place before 1972 when Canadians enjoyed **NO** capital gains tax.

Exhibit 2: Wealth Creation Means Job Creation
The Effect of Capital Gains on Real Returns
Submitted to the Vancouver Symposium on Capital Gains Taxation—The Fraser Institute, June 1999

Case A: Capital Gains Tax Effect on Real Return

Compound Rate of Return	Real Return after Tax	True Capital Gains Tax Rate*
5.0%	-1.9%	137%
7.9%	0.0%	100%
10.0%	1.4%	86%
15.0%	4.7%	69%

Assumptions: 25 year holding period.
5% inflation rate.**
40% capital gains tax.
Portfolio turns over every three years.***

If the inflation assumption is changed to 3.5% the respective true capital gains rate would be 107%, 81%, 71%, and 59%.

The return required to break even as a real basis would be 5.6%.

Case B: Actual Experience of Formula Growth Fund Investors

Customer	Capital Gains Tax Rate	Initial Investment	Terminal Investment
Canadian	40.0%	$1,000	$25,814
American	20.0%	$1,000	$57,767
Hong Kong	0.0%	$1,000	$120,062

Conditions: 25 year holding period.
21.1% compound annual rate of return.
Portfolio turns over every three years.

Conclusions

A. Capital creation is much more rapid in lower tax regimes: Hong Kong and the US create wealth at 4.7 and 2.2 times the rate of Canada, respectively. This means that assets will increasingly be owned by investors from lower tax regimes.

B. Investors must invest aggressively to overcome the effects of inflation and capital gains tax (not a traditional Canadian approach to investing).

C. The government must set up the RRSP vehicle as a measure for helping Canadians to look after themselves, not as a wealth creation vehicle.

Notes

*Proportion of real return paid to government.
**Canadian actual rate has been 5.3% over the past 25 years.
***Actual turnover of Peter Lynch, John Templeton, and Formula Growth.

Exhibit 3

Investor 1

Child gets $1,000 per year for 21 years
Reinvested at 20% annual return
Turns over portfolio every third year

With taxes Income below $8,000: 0%
Income between $8,000 and $25,000: .75 x 35%
Income between $25,000 and $60,000: .75 x .45%
Income above $60,000: .75 x 52%

Year	Gift	Return	Realized	Tax Paid	Capital
1	1,000	200			1,200
2	1,000	440			2,640
3	1,000	728	1,368	0	4,368
4	1,000	1,074			6,442
5	1,000	1,488			8,930
6	1,000	1,986	4,548	0	11,916
7	1,000	2,583			15,499
8	1,000	3,300			19,799
9	1,000	4,160	10,043	536	24,422
10	1,000	5,084			30,507
11	1,000	6,301			37,808
12	1,000	7,762	19,148	2,926	43,644
13	1,000	8,929			53,573
14	1,000	10,915			65,478
15	1,000	13,297	33,141	7,210	75,574
16	1,000	14,715			88,289
17	1,000	17,858			107,147
18	1,000	21,629	54,202	14,318	115,458
19	1,000	23,292			139,750
20	1,000	28,150			168,900
21	1,000	33,980	85,422	26,189	177,691
Total	21,000	207,871		51,180	

Capital forfeited to taxes and lost return = $92,340.

Investor 1 continued

No Capital Gains Taxes

Year	Gift	Return	Realized	Tax Paid	Capital
1	1,000	200			1,200
2	1,000	440			2,640
3	1,000	728	1,368	0	4,368
4	1,000	1,074			6,442
5	1,000	1,488			8,930
6	1,000	1,986	4,548	0	11,916
7	1,000	2,583			15,499
8	1,000	3,300			19,799
9	1,000	4,160	10,043	0	24,959
10	1,000	5,192			31,150
11	1,000	6,430			38,581
12	1,000	7,916	19,538	0	47,497
13	1,000	9,699			58,196
14	1,000	11,839			71,035
15	1,000	14,407	35,946	0	86,442
16	1,000	17,488			104,931
17	1,000	21,186			127,117
18	1,000	25,623	64,298	0	153,740
19	1,000	30,948			185,688
20	1,000	37,338			224,026
21	1,000	45,005	113,291	0	270,031
Total	21,000	249,031		0	

Investor 2

McGill Commerce Graduate Saves $5,000 per year
Reinvests at 20% annual Return
Capital Gains Tax Paid of 30% on Returns

Year	Savings	Return	Realized	Tax Paid	Capital
1	5,000	1,000			6,000
2	5,000	2,200			13,200
3	5,000	3,640	6,840	2,052	19,788
Total	15,000	6,840		2,052	

Capital forfeited to taxes and lost return = $2,052.

No Capital Gains Taxes					
Year	Savings	Return	Realized	Tax Paid	Capital
1	5,000	1,000			6,000
2	5,000	2,200			13,200
3	5,000	3,640	6,840	0	21,840
Total	15,000	6,840		0	

Investor 3

Secretary Saves $5,000 per year
Reinvests at 20% annual return
Capital Gains Tax paid of 30% on returns

Year	Savings	Return	Realized	Tax Paid	Capital
1	5,000	1,000			6,000
2	5,000	2,200			13,200
3	5,000	3,640	6,840	2,052	19,788
4	5,000	4,958			29,746
5	5,000	6,949			41,695
6	5,000	9,339	21,246	6,374	49,660
7	5,000	10,932			65,592
8	5,000	14,118			84,710
9	5,000	17,942	42,992	12,898	94,755
10	5,000	19,951	19,951	5,985	113,720
Total	50,000	91,029		27,309	

Capital forfeited to taxes and lost return = $42,032.

No Capital Gains Taxes					
Year	Savings	Return	Realized	Tax Paid	Capital
1	5,000	1,000			6,000
2	5,000	2,200			13,200
3	5,000	3,640	6,840	0	21,840
4	5,000	5,368			32,208
5	5,000	7,442			44,650
6	5,000	9,930	22,740	0	59,580
7	5,000	12,916			77,495
8	5,000	16,499			98,995
9	5,000	20,799	50,214	0	124,793
10	5,000	25,929	25,959	0	155,752
Total	50,000	105,752		0	

CHAPTER 11
Dr. Allen Sinai

THE STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE EVIDENCE, OTTAWA
Thursday, February 24, 2000

Senator Leo E. Kolber (*Chairman*) in the Chair.

The Chairman: We are continuing our study of the capital gains tax. This morning we are extremely delighted to have with us a man with the worldwide reputation of Dr. Allen Sinai, who at this moment is Chief Global Economist and Chief Executive Officer of Primark Decision Economics, Inc. He is also Chief Global Economist of the WEFA Group. Previously, Dr. Sinai served as Chief Global Economist, Managing Director, at Lehman Brothers. He is a pioneer in econometric model building and the use of economic information systems for forecasting, analysis, and monitoring of the economy and financial markets.

Dr. Sinai is adjunct professor of economics and finance in the Lemberg Program of International Economics and Finance at Brandeis University. He has also taught at the Sloan School of Management at MIT, at New York University, Boston University, and the University of Illinois. He is also a member of the *Time* magazine board of economists.

That is a highly abbreviated CV. I read the complete one last night, and that took quite a while. Over the years Dr. Sinai has been consulted by administrations from both political parties on key economic issues, including the Clinton administration and the Bush and Reagan administrations. Welcome, Dr. Sinai. Please proceed.

Dr. Allen Sinai, Chief Executive Officer and Chief Global Economist, Primark Decision Economics, Inc.: In a new era of government budget surpluses in the United States, Canada, and elsewhere, country after country will be facing new and pleasant fiscal and societal choices: how to optimally use fiscal surpluses to achieve economic and social goals. Ongoing federal government budget surpluses will be a reality in the US under most macroeconomic scenarios, and also for Canada. Conservative estimates are as much as $96 billion over the next five years. That is a figure in the November economic and fiscal update of the Ministry of Finance, which probably is too low given how things look going forward in the Canadian economy.

Other countries, such as the United Kingdom, Finland, Denmark, Ireland, Sweden, and Australia, are in budget surplus situations now, and more countries, particularly in the Eurozone, are likely to see surpluses emerge as a consequence of structural reductions in the growth of outlays, efficiencies in the government sector, and cyclical gains in tax receipts from what likely will be an extraordinarily long, vigorous global business expansion.

How each country uses federal government budget surpluses will shape its economy in the dimensions of domestic economic growth, employment and unemployment, inflation, international competitiveness, profits, standards of living and investment returns, and will shape its society in profound ways. Budget choices in terms of the use of budget surpluses may be, perhaps, the most important economic choice facing a country such as Canada. It is much more pleasant but no less significant than was the tough task of eliminating budget deficits in the 1990s.

In this statement, I look at capital gains tax reductions generally and analytically, mainly in the context of the US experience and in terms of possible applicability to the Canadian situation. I will discuss four points: 1) the pros and cons of capital gains tax reduction; 2) effects on economic activity, jobs, entrepreneurship, productivity and potential output growth—the latter being a proxy for the sustainable rate of economic growth, or potential standard of living for an economy or a country; 3) effects on saving, investment, and new business; and 4) the role of capital gains tax reduction in enhancing international competitiveness in an increasingly globally competitive world economy.

Since every country with fiscal choices under conditions of budget surpluses starts with a different set of initial economic conditions, public debt and currency conditions, and political and social settings, prescriptive commentary on an individual country must be cautiously and carefully taken. However, the US experience may offer some insights that apply to Canada, so I will offer some observations and perspectives on the Canadian situation.

The main perspective for Canada is that reductions in the rate of capital gains taxation for individuals and corporations would be an appropriate use of budget surpluses to promote economic growth, jobs, saving, investment, entrepreneurship and innovation, new business formation, and increased potential output at a low cost in lost tax receipts. As one tax measure in a full program of debt reduction, tax reduction, and increased government spending targeted at productive areas such as health care—which is part of any country's infrastructure—education, and information technology, capital gains tax reductions have a lot to offer.

Depending on the unlocking effect, which is a unique feature of capital gains tax reductions, the revenue loss likely would be minimal, and the "bang for a buck" in gained output-per-dollar of lost revenue quite high. Also a perspective on Canada, given that the Canadian economy is heading for full employment, increases in the potential growth or supply side of the economy would be welcome.

Finally, the incentive effects of marginal personal income tax reductions, combined with reductions in capital gains tax rates, can be quite powerful in stimulating work effort, jobs, entrepreneurship, innovation, and new business—a major dynamic now in the world at large. The incentives of the Canadian tax system will need to be internationally competitive in order to attract business, workers, entrepreneurs, and the new technology necessary to be competitive in an increasingly competitive, technology-based global economy.

Let me turn to pros and cons of capital gains tax reduction. The use of capital gains—the presence or absence of them—varies widely around the world, but there is no doubt that the trend is toward lower, less, and in some cases no capital gains taxation in most of the countries in the world. There are no capital gains taxes in Belgium, Hong Kong, the Netherlands, Singapore, and Taiwan. There are no long-term capital gains taxes in Germany; there is a six-month holding period. There are very limited capital gains taxes in Japan. And in the United States, there is only a maximum 20 percent rate on long-term capital gains for individuals, with a one-year holding period. Against those countries' use of capital gains taxation, you find quite high effective capital gains taxes in countries like the UK, Sweden, and Canada. Capital gains taxes are being taken down in the UK. The effect of tax on capital gains for individuals in

Canada is not so high at the federal level relative to other countries, but it is when taken in conjunction with the personal, marginal, and provincial tax rates on income that are applied to 75 percent of any capital gains.

In the United States, periods of lower effective capital gains taxation—absolutely and relative to the tax rates on ordinary income—have been associated with strong economic performance, active job growth, increased entrepreneurial activity, and an increased standard of living, particularly over the past decade. While one cannot attribute the performance of the US economy to capital gains tax reduction alone or to reductions in marginal personal tax rates that effectively lower the capital gains tax rate, the association is striking.

In tax policy, there are a number of criteria for judging any tax. In the case of capital gains taxation, they number six. First, there is fairness or equity, often called equal treatment under the tax law of equals. The second is distortions in relative prices, or the efficiency of the tax. The third is the cost of capital. The fourth is the effect of a tax measure on international competitiveness. The fifth is the degree of taxation of capital in a growing economy. The sixth is the effects on growth and macroeconomic performance. This last criterion has received relatively little attention, with most studies of capital gains taxation being microeconomic in nature and few performed on the full scale of the macroeconomic effects.

In many countries, the political and social weighting of the fairness criterion for judging capital gains taxes has been very emotional. It has boiled down to a "rich versus poor" issue. This is less an economic issue than it is a societal and political issue. Certainly for affluent families and poor families, it is a big emotional issue. There is and has been a belief that reducing capital gains taxes was unfair, favouring the very rich versus the poor, and increasing and making more unequal the distribution of income. Those arguments are defensible on many grounds, and every country must decide the weight to be placed on a given tax measure relating to fairness versus the other criteria that I listed in terms of making a judgment on policy. I do not quarrel on emotional grounds on this fairness issue. I simply point to the other criteria with regard to capital gains taxation as generally being quite favourable to lower capital gains taxes as a tax measure.

In the modern global economy, where international competitiveness and the internal mobility of resources, labour, and financial investment are quite crucial, the criteria for judging capital gains against other forms of tax reduction probably would carry different weights than used to be the case. These days, in more and more countries, even the poor are tied—directly or indirectly—to the equity market, with more ownership across more income levels, and middle-income and high-income constituencies increasingly outright share owners of capital, especially in the United States, through direct participation in equity markets, indirect participation because of retirement plans, and increasingly through compensation that takes the form of equity ownership or stock market participation in companies where individuals work.

Capital gains tax reduction generally gets a positive grade on the criterion of distortions in relative prices or tax efficiency, depending on initial conditions. It also gets positive grades on the cost of capital and international competitiveness dimensions. Whether capital gains taxes are onerous in terms of the taxation of capital in a growing economy varies from situation to situation, but in most countries capital is taxed more times than it should be under standard dimensions for judging taxes. The effects of capital gains tax reduction on macroeconomic growth and economic performance relative to the revenue loss of the tax reduction receive positive marks in my work. Only the fairness criterion could unambiguously be viewed as a negative, depending on societal objectives.

On the fairness issue, a lot of work has been done in the United States by the American Council for Capital Formation. I believe you had a witness from the ACCF. They present evidence arguing that it is not as unfair as normally thought. I prefer to stand back on that issue—rich versus poor, fairness versus unfairness—and look at the other criteria, which I think would, in the modern world, receive much higher weight than ever before. What do capital gains tax reductions do to the economy?

What I have to say here is based on work in computer-model simulations with a full system of the US economy that includes numerous processes and channels on how capital gains taxes affect financial markets, the cost of capital, economic activity, entrepreneurship, potential output, and the feedback on tax receipts, because of what reducing capital gains does to the economy, stock market, and capital gains realizations. My analytical and discussion comments are drawn from years of research encompassed in this rather large-scale model of the US economy that is updated through the middle of 1999 and therefore captures much of the new economy factors and tendencies that have emerged in the United States in recent years.

There are limitations to work based on econometric models. These models, in a sense, are backwards looking. They are based on data that cover periods of time in the past and structural situations that may not be the same in the future. They are, by their very nature, averages in the quantitative results and in the responses that they show when one asks questions of them. However, as rough approximations and a disciplined quantitative way of obtaining the truth of history and, perhaps, for the future of what various policy changes will do, they are, I believe, very useful.

I cannot tell you that the work that I have done with this model of the US economy necessarily exactly applies to the Canadian situation. However, we do study Canada in detail and follow its policies. It is very much, in its generic processes, like the business cycles and systems that exist in the US economy, as are many other economies we study, analyze, and predict, including the G-7 countries and altogether some 46 countries around the world. I feel reasonably confident that what I am about to say to you about how capital gains tax reduction works will roughly have applicability here. At the same time, I want to be clear, in a "truth in lending" full disclosure sense, not to tell you that I could say as a scientist that this is the absolute truth about the Canadian economy. It is, for you, information and I certainly have my views on how capital gains tax reduction might be used and applied in the Canadian economy as a consequence of the work that I have done.

What capital gains tax reduction does is increase savings, capital spending and capital formation, which, in turn, helps economic growth. That, in turn, helps increase jobs, productivity and, through the productivity increase, the potential output of an economy.

The increases relative to what might have happened otherwise are definitely significant but, I would say, probably small to modest in magnitude. We are not talking about a tax measure that would raise economic growth in aggregate demand the way large reductions in marginal personal income tax rates would. We are talking about a tax measure that I believe has the effects that I will describe, but that is fairly modest in the dollar amounts.

You must pay to get the benefit of capital gains tax reduction in the sense of reducing tax receipts *ex ante*. Per dollar of lost revenue, though, the effect is a very powerful stimulant to the economy. It does not cost much to use capital gains tax reduction. Its leverage is quite high in terms of the ratio of output and jobs created per dollar of tax loss. It cannot fully pay for itself, as some might argue, through massive increases in unlocking unrealized capital gains. It might do so for a very short time, but the feedback effects on tax receipts from capital gains tax reduction are raising income, raising corporate profits. That is standard in terms of stimulating the economy.

That creates some tax receipts that help pay for the initial tax reduction. In this case, a higher stock market would create some increased wealth, increased spending, increased jobs, increased income, increased profits. That also brings some extra tax receipts. Then there are the capital gains realizations, unlocked and that come from a better stock market, that bring increased tax receipts to the government even though the capital gains tax rate has been lowered. There are more revenue-feedback effects that come back to the government as a result of this tax measure than are to be found in any other tax measure that exists.

The reductions in statutory capital gains tax rates and in the effective capital gains tax on individuals raise the after-tax return on equity to shareholders and reduce the after-tax weighted average cost of debt and equity. That leads to a higher stock market as individuals shift investments toward equities. It increases household wealth through a balance-sheet effect of increased valuation on the holdings of equity assets. That, in turn, has a positive effect on consumption.

By the way, the effect on consumption is nowhere near as strong as the effect on consumption caused by an increase of one dollar in income. Nevertheless, it is still a significant positive effect on consumption that increases output, business profits and, in turn, provides the wherewithal and incentive for business capital outlays on equipment and plant to rise. That, in turn, produces higher real GDP.

New business incorporations will rise as well with the increase in economic activity and the increased incentive effects that come from lower capital gains taxes. There is a supply-side entrepreneurship effect. Jobs are increased, along with earnings and corporate profits leading to increased consumption and greater economic activity. That, in turn, induces more spending on consumption and investment and increases expected future earnings in stock market valuations. That reduces further the cost of capital, inducing more entrepreneurial effort.

This is the set of simultaneous interactions and the virtuous circle that goes on from reductions in capital gains taxes on individuals mainly and, to some extent, on corporations as well. As this activity goes on, it induces additional tax receipts at the federal and provincial levels from individuals and corporations on income, sales, excise, and social securities taxes. So to some extent, the static or *ex ante* cost of the capital gains tax reduction is reduced.

It is important in evaluating this tax measure and, I would argue, all tax measures, to look at it in terms of the initial costs—almost an initial investment in terms of lost tax receipts—and then try to find out how much of that initial cost is recouped from the positive effects of a tax measure to see the *ex post* or net tax cost of such a measure. On budget work in the United States, our budget committees have moved to this concept. It took a long time before they analyzed tax measures in this way, making distinctions between *ex ante* and *ex post* tax receipts.

A significant channel for the effects of capital gains tax reduction is the so-called "wealth effect" on consumption. In the model of the US economy that we use, the propensity to consume wealth through increased stock price appreciation, if it is permanent, is about 5 cents on the dollar. The lags are a year and a half to two years. One dollar of disposable income, when it rises, perhaps because of a new job, causes 70 cents of additional consumption, we estimate, after a year or two.

In addition, realized capital gains that result from lower capital gains taxes are spent to the tune of 11 cents per dollar of realizations over a year and a half. The wealth effect in this sense is enhanced. This is a new finding of our recent work—5 cents on a dollar of increased wealth over 18 months or two years. As capital gains are realized to take profits, 11 cents gets spent.

In the United States, 20 cents maximum goes to the federal government. The rest is saved. The saving is sprinkled over an accumulation of financial assets or a paydown of liabilities. To the extent that there are capital gains realizations that occur after the capital gains tax is reduced, it is important to remember that the government gets some of those gains, households spend some of those gains, but the bulk of it is saved in personal savings that show up in holdings of other financial assets or paydown of liabilities.

Through significant effects on incentives to entrepreneurship, saving and capital formation, increases in productivity, efficiency, and potential output I find occurring, national savings in the United States has gone up. In our analysis of capital gains tax reduction, though, depending on the impact on consumption, that may not happen to the personal savings rate.

Capital spending also is higher from a reduction in capital gains tax as a result of a lower capital cost and increased economic activity. Depending on the unlocking that occurs at new, lower capital gains tax rates and the increased realizations that generate new tax receipts, the *ex post* cost of the capital gains tax reduction can be very small.

In our work, we have this endogenized in the model. The revenue feedback effect makes the net cost of capital gains tax reduction rather small. When one looks at the ratio of the benefit-to-cost in terms of output or jobs, rather high ratios emerge. The ratios are high; the absolute amounts of the jobs creation and the growth of GDP are nowhere near as much as you would get, however, from personal income tax reduction.

More than any other tax policy, capital gains tax reduction has the best chance at minimizing the loss in tax receipts, net, relative to the gains in economic activity, entrepreneurship, productivity, and potential output.

What about capital gains tax reduction in the Canadian situation? I would make the following observations. Reducing personal income and/or capital gains tax rates should stimulate consumption, business capital spending, savings, investment, jobs, the stock market and productivity, entrepreneurship and new business formation, and potential output at a low cost in terms of lost tax receipts, certainly for capital gains tax reduction. The magnitudes would not likely be large from capital gains tax reduction, but would still be significant compared with the macroeconomic effects from other tax measures that would be much larger.

Indeed, in the case of the US these days, our work suggests that large reductions in marginal personal tax rates should not be undertaken because the US is very close to full employment and there is an aggregate demand or inflationary effect that occurs, and much less of a potential supply-side effect. Preferred would be capital gains tax reduction, because it would not raise aggregate demand nearly so much, but would help the supply side of the economy and thus not be inflationary, as large reductions in marginal tax rates might be.

The diagnosis of the Canadian situation is not the same, though, and I would not make the same argument in terms of marginal tax rate reductions on income or profits, taxes on corporations, or whatever is proposed or comes out in the budget next week, being too large. Canada is far behind the US in terms of how close it might be to full employment. In our view, it is not that close to full employment and does not have an inflation issue staring it in the face, so reducing marginal personal income tax rates in conjunction with capital gains tax reduction would be a very powerful tax measure to take, and a very powerful use of the budget surpluses.

For Canada, capital gains tax reductions are not, nor should be, the only use for government budget surpluses. I have highlighted them because of the nature of this session, but let me say clearly again that, in looking at the Canadian situation in a prescriptive sense, and though I should be cautious and humble in prescriptions for the Canadian economy, there is no doubt that capital gains tax reduction would be a positive measure to take at this time and going forward in this country.

For Canada, the budget surpluses should also be used in other ways. Debt reduction and the ensuing fall of interest rates because of lower debt outstanding will release funds for the government to spend in other uses that could be more productive than interest paid on the national debt. Part of any budget surplus use should be in paying down debt.

Selective increases in government spending also are desirable in this country with the federal budget surpluses and could add to the productive potential of the economy if concentrated on those aspects of the economy that would produce higher potential output. This would, in my view, include spending on higher education and K2 to K12, infrastructure outlays in public investment by the government, and quality-of-life expenditures such as health care. Let me emphasize that health care is part of the infrastructure now of any country, and so expenditures that were efficiency-creating or helped promote market solutions in what is in most countries inefficient resource use in health care would be positive. Then there is the funding of information technology and new technology endeavours through the private sector. That would be a proper use of federal budget surpluses.

Other tax reductions would seem appropriate in the case of Canada, given that tax receipts as a proportion of GDP are approaching previous highs. Reductions in marginal personal income tax receipts along with capital gains tax reductions could provide incentive effects that would increase the supply side of the economy commensurate with demands.

Finally, for Canada, perhaps the most important aspect of capital gains tax reduction lies in the enhancement of its international competitiveness, especially vis-à-vis the United States—the now gold standard in many new and highly competitive business and financial activities. So long as marginal personal income and capital gains tax rates are much lower, absolutely and relative to ordinary income taxes, in the US than is the case in Canada, resources—labour, financial, and investment—will flow to the United States, draining Canada of important productive resources for its economic future and for maximizing the standard of living for its populace.

The Chairman: Thank you, Mr. Sinai.

Senator Meighen: Mr. Sinai, we appreciate your attendance here and the delicacy with which you put forward your prescriptions. I guess I will declare myself. To nobody's surprise, I find your prescriptions attractive and full of good common sense.

Obviously, as you have pointed out, there are pluses and minuses to everything, and capital gains tax reduction carries with it certain consequences. You have underlined that the major reason for hesitating to bring about a capital gains tax reduction would be because of perceived or real inequitable consequences.

Indeed, last night we had a very eloquent witness from Osgoode Hall Law School, a professor of taxation, who made that point. It was his central point. He spoke forcefully against any idea of capital gains tax reduction on the grounds that it was basically inequitable. I think you have dealt with that, but I wish to put to you one or two of the other arguments that Professor Brooks raised, and see what your comments would be.

He also said, by the way, that there would be considerable loss of tax revenue following a capital gains tax reduction, but I think you have dealt with that in your presentation thoroughly.

I will list his other points in no particular order. He said that not taxing capital gains as ordinary income very likely leads to increased economic inefficiencies. He went on to say that the so-called lock-in problem caused by taxing capital gains is only serious when investors sell their assets, and not every year as the gain accrues. He said it was not as serious as it has been made out to be.

The other point was that a preference for capital gains adds enormous complexity to the tax system; in particular, it imposes a large dead--weight loss on the economy because of the transactional complexities that it introduces and because of the wasteful tax planning it encourages. He alluded to the situation in Canada prior to the introduction of capital gains tax in 1972, when everybody did back flips in order to try to turn any income into capital gains income so as to avoid or reduce the tax burden.

Finally, he argued that it makes absolutely no sense to try to subsidize small or risky businesses by providing a tax break for all capital gains.

I am sorry to throw all those at you but perhaps you would like to comment on some of them.

Mr. Sinai: With respect to tax revenue (although you said I dealt with another perspective on that) in countries where they have reduced capital gains taxes, you do not find the expected loss of tax revenues that people argue. It is just the opposite. It may not necessarily be due just to capital gains tax reduction; it may be due to the climate in the overall economy at that time. What you tend to see is surprisingly high tax receipts. Therefore, I would argue the opposite: if you lower capital gains taxes, even by itself, the surprise will be better tax receipts than you think. I do not think my model work captures the full extent of how this, in the context of an entrepreneurial climate in a country, really works.

You had a question about the tax efficiency of not taxing capital gains as ordinary income, saying there was an argument that it is inefficient. I actually argue the reverse. We tax capital in most countries more than once, through various devices, and when it is earned. That is the case of appreciated values of businesses, for example, not necessarily in the case of a secondary piece of paper you buy on the stock market whose price is bid up through supply and demand in the market but through activities that produce gains in the value of an asset that are related to the business becoming more productive. The risk-taking that is involved in that endeavour seems to me to require, in a market sense, a higher return in order to induce that risk taking. We know that a lot of the jobs growth in the US, and perhaps here in Canada, comes from small business. Risk-taking should properly appear after taxes are paid. That suggests that it is inefficient to have the same tax rate you would have on ordinary income earned by a wage and salary worker where the risk to capital and the risk of enterprise are much lower.

The unleashing of locked-in capital gains upon capital gains tax reduction is pretty well documented now in the US case, the scientific work having been quite massive. The debate is how long the benefits last, and whether you end up some years down the road having fewer realizations and losing money. I do not think there is much debate any more on the unlocking of large amounts of funds, which then brings in tax revenues to government. Some of that unlocked money is spent, but a large part is saved. Our work says a large part is saved, which is a positive aspect. I am not too fond of the lock-in argument.

Transaction complexity does vary from society to society. The distinction between a tax rate for short-term versus long-term holdings is probably worthwhile because of the amount of complexity involved in the kind of day trading that is now going on in stock markets. That does not necessarily mean the process is opening up money to go into a new enterprise, it is simply what goes on day to day. If capital gains taxes were applied to that kind of trading, it would be a very complex situation. However, the answer to that is zero capital gains tax. The answer to the complexity is not to have a capital gains tax at all. I am not quite there, but I know Chairman Greenspan of the US Federal Reserve is on record as saying many times that it is so distorted, he thinks the rate should be zero.

Why subsidize all capital gains? That is actually a very good question. It is difficult in law to make those distinctions because of politics. However, I have sympathy for that viewpoint in the following kind of situation: I buy a stock and one year and one day later I have a nice appreciation. I may know nothing about the stock; the money I used to buy it may not go anywhere except through the financial system and not actually fund some new business that needs funding to get started and that can get it only from venture funds or from equity-market IPOs. It may be that the capital gains preferential treatment I get on that is not quite the same thing or should not be the same thing as what I should get if I put up risk money for a new enterprise that some day has a major productive input on jobs. The rationale for it is that all these transactions, one way or another, will show up in the equity market. The equity market then will affect the cost of capital, which affects new productive business enterprise. You have to live with some of the non-productive capital gains preferential treatment in order to get the productive uses for real legitimate new businesses and funding of new and existing businesses that go to the market all the time.

Senator Meighen: Mr. Sinai, in 1997, the United States reduced its capital gains tax rate from 28 percent to 20 percent. According to my very poor math, that is about a 28 percent reduction.

According to the leaks that are flying all around this city, the government is proposing—we will know on Monday—to reduce the capital gains tax from 75 percent to 66 percent, which, according to my math, works out to about a 10 percent decrease. There is quite a difference in the percentage reduction between the two countries.

You said you were not as far along as Chairman Greenspan in terms of advocating no capital gains tax, and I recognize that any reduction would be dependent upon things such as simultaneous reduction in the personal marginal tax rates or reduction in corporate rates or whatever. Are there any other criteria that you would suggest should guide legislators in making these decisions?

Mr. Sinai: If that turns out to be the case, it is just a reduction in what is subject to the ordinary income tax in terms of capital gains; it is an exclusion, which is actually the most minimal and least powerful way to do it.

If marginal tax rates come down at the same time, given the change in the exclusion and the lower marginal tax rate, you would get more than a 10 percent reduction in the effect of the capital gains tax rate. I think that would be positive.

From everything I read, it looks like there will be some reduction in marginal tax rates, as there has been in the last couple of years. More may be going on in capital gains tax reduction than the 10 percent number that is being floated around. I would say it is not enough on a continuum. The exclusion, if it is 66.67 percent, is way too high.

The problem is that there is not a difference between the ordinary and statutory capital gains tax rate that properly provides incentives for risk taking and entrepreneurship in a country such as Canada. I might add that, when you look around the world at what other countries are doing, you will see that some are making and some have already made a much bigger leap down. The UK, for instance, probably will make a much bigger leap down.

What you have described sounds like a minimal step. It is in the right direction, but it is far short of what would be optimal and, I would argue again, an optimal use of the budget surpluses that will continue in this country in part because the cost of capital gains tax reduction *ex post* is really small.

Senator Kenny: Our witnesses last night, Mr. Dobson and Mr. Soutar, argued that a capital gains tax reduction was the single most important thing that government could do to stimulate the economy. They spoke about it being better for investors, increasing government revenue, and keeping talent in the country. They argued that it was a fair thing to do because the pie would be bigger and therefore the folks at the bottom end would benefit.

You do not appear to be arguing that capital gains reductions by themselves are the single most effective prescription for the economy. If I understand you correctly, you are arguing for a more complex solution; is that right?

Mr. Sinai: Yes, I think that is correct. My judgment is that personal income tax rates are too high in Canada, absolutely and relative to other countries in terms of creating the proper investment climate. This country has magnificent fundamentals that ought to be attracting investors from all over the world, and your people ought to be happy and find, in after-tax terms, wonderful opportunities here, but that does not appear to be totally the case.

The marginal tax rate reductions will have larger incentive effects. They also have a risk of more spending. However, I do not think that is a big risk to the Canadian economy at this time.

My favoured prescription would be a combination of marginal personal income tax reductions and bigger capital gains tax reductions than appear to be forthcoming, in order to kind of hurry this country along to get competitive in terms of the tax climate as it applies to individuals and businesses.

The work I have done in the United States does not give the same power to economic activity from corporate profits tax reductions or reductions in the capital gains tax in corporations as it does on the individual side. You know there is only so much money to go around and there are other uses for this budget surplus, including debt reduction, which is very important, and targeted spending in government. There is not an unlimited amount of money to put out; thus, some sort of staging or sequencing strategy probably makes sense.

If the budget comes out as it sounds like it will, the criticism I would have is not enough capital gains tax reduction at this time. The cost of doing more would have been very little.

Senator Kenny: Leaving aside the coming budget, because it is a mug's game to guess what will be in it, why would one favour a reduction in corporate capital gains over a reduction in marginal income tax rates, particularly at the lower end, when in Canada, as you say, there is still capacity left and we are not as likely to be pushing the inflation envelope? It deals quite directly with the social problem. You avoid the social problem of fairness, for the obvious reason.

Mr. Sinai: Is your question why someone would make those recommendations?

Senator Kenny: Why would you not make them? Why would you not favour tax reductions at the bottom end? You know it will have a stimulative impact on the economy. You know that you do not have to address the problem of fairness, so why would you not weight your recommendation in that direction?

Mr. Sinai: I have tended to be impressed by the incentive effects of across-the-board marginal rates of reductions at all income levels. Much of the funding in market systems does come out of high-income levels. There are higher proportions of income saved at higher income levels than at lower income levels. Therefore, my own reaction has tended to be across-the-board reductions in marginal tax rates as opposed to skewing them at the lower end, unless there is a societal objective to do that for the lower-income people or a desire to narrow income inequality or something like that. However, in terms of economic incentive effects, I prefer across-the-board tax rates accompanied by capital gains tax reduction.

Senator Kenny: There is a societal question, and let us address it. Perhaps one of the principal arguments against capital gains reduction is that there is a sense—accurate or not—that there is a growing disparity between the top end and the bottom end in this country. Could you tell us how you would explain to lower-income Canadians why a capital gains tax reduction would be of benefit to them?

Mr. Sinai: Whether they can see it or not, it will create a lot of jobs for the amount of money the government spends to levy that tax reduction, and poor people may find that they are working when they might otherwise not have been. Even though they cannot see any direct benefit, it is an indirect benefit based on the stimulus to the economy, which sometimes, whether we like it or not, comes out of the pockets of risk-taking, affluent individuals and families who are looking for higher returns in after-tax terms and have the funding to make that happen. They have extra savings and they are looking to deploy them.

That is not the case for lower-income families or poor families, but in countries that have friendly tax systems, that is to say where there is not a budget deficit issue, where they are friendly in terms of personal income, corporate, and capital gains, there is usually a very strong jobs growth climate.

Senator Kenny: Could poor taxpayers not have the same benefits if the marginal tax rate of people earning $35,000 a year and less were lowered?

Mr. Sinai: No, it would be a lot less. They would spend all that money and more, which would show up in consumption, which, if you were close to full employment, would generate some inflation.

Senator Kenny: However, you just said that we are not. You said that Canada has more room than the United States.

Mr. Sinai: Yes, but you would get the allocation of funds mainly on the consumption side. Some of that would generate additional investment in new business, but most of it would be for the things lower-income families normally buy, the basic necessities of life, which would not lead to creation of new capacity or new investment.

Senator Kenny: Does buying TVs not create new jobs?

Mr. Sinai: It creates jobs in that particular area, but it will not create the same number of new business enterprises that may raise the productivity and potential output of an economy, nor will it create the capital that will go with what workers do to improve productivity growth, which ultimately will improve their standard of living. That is very difficult to sell to an individual who does not understand it.

It is trickle down. Trickle down actually happens. I hate to admit it. I grew up in Detroit and I came from a very poor area, but we learned that trickle down really does work, and people who cannot see that they are helped by it are helped by it.

Capital gains tax reduction will, net-net, cost less than many other things. The marginal tax rate reductions for lower income levels will bring some revenue feedback so, in part, *ex post* will be paid for, but the numbers in the US are something in the order of 20 cents on $1 of revenue feedback, so it still costs the government 80 cents. In the case of capital gains tax reduction, we get revenue feedback effects of 40 cents to 45 cents on $1 spent. Therefore, it is not fully paying for itself, but that is an extra 25 cents the government gets to do something with, and individuals cannot see that.

Senator Kenny: Your arguments are compelling, but they are very hard to translate politically. That is a challenge faced by this committee. We are in dire need of translators.

Mr. Sinai: Half of American households are now in the stock market, so rich versus poor is disappearing as an issue in the United States. In the politics of the United States, many Democrats who have never been in favour of capital gains tax reduction are now okay with it because the nature of the constituency is changing. That will probably happen here in Canada as well. It may be a little early for that, but when many Canadians—rich and poor—are tied to how the equity market does and have ownership in their own companies through options and the like, as is the trend being set by the United States, the nature of their understanding, or at least appreciation, of some of the benefits probably will change.

I do not know this country well enough to know whether you are at that point. From your comment, senator, you are obviously not, so it is not an easy sell. As a political matter, it is very difficult for any government to stress this particular tax measure by itself, because it is complicated, it has many emotional connotations, and you may not have enough vested interest in terms of the constituency to go for it. However, in the United States that constituency has changed very quickly. Half of our households now have ownership in the stock market. One of my fears is that we will become so tied to the stock market in incentives and participation that our economy will be at risk if something goes wrong, and then we will have a biased vested interest to ensure that the stock market always rises, and policy-makers should not be thinking about that. They should be doing the right thing, and the stock market will do what it will do if policy-makers do the right thing.

Senator Tkachuk: If the government decides to lower capital gains, should there be, as some have argued before us, a relationship between the tax on capital gains and the tax on dividends and interest income?

Mr. Sinai: In the United States, we do not have a preferential tax on net income. We also have additional taxes at the state level on that income. Thus, dividends are taxed, and the money that creates them taxed a lot of times at the corporate level. We do not have double taxation but triple taxation. We then have another tax, an estate tax. The accumulation of the dividends in an estate is taxed yet again. Analysts such as myself regard all that taxation as wrong and distorted.

It is tricky to install a tax system that gets around the double taxation of dividends. It is tricky to have a tax system that taxes dividends at one rate and capital gains at another. I do not think I would tamper with that. As distorted as it is, I would not tackle the taxation of dividends and try to change that.

Senator Tkachuk: You mention the rate of capital gains. I think you said that we have a 75 percent effective inclusion rate for capital gains. I am getting less and less concerned about the political argument. The United States may lower capital gains and many Canadians think that the Americans do everything for the rich, but when that socialist paradise in Germany lowers capital gains it will make a lot of people think about what is happening in the world. That leads to my next question.

We have economic arguments that are strong for lower capital gains. There are also strong moral arguments for lower capital gains. However, the paper today states that Canada is a sieve for investors' money. Some $135 billion has been lost to foreign markets in the last 10 years. There are now strong competitive reasons for lowering capital gains. We are losing our people, which is a tremendous loss to our country and something that we are all beginning to feel. Both the rich and the poor are losing their sons and daughters. All this money is flowing out because other countries are seeing the light of day and are lowering capital gains.

While you did not exactly say what the numbers should be in Canada, could you tell us what you think the competitive capital gains should be in Canada so we will not lose so much of our capital as well as our people?

Mr. Sinai: There are two ways to respond. One is specifically on the capital gains tax rates and methods of capital gains taxation itself, or as part of an overall tax system. In this country, you must create a tax climate that is attractive, in an opportunity sense, for businesses and individuals. That means both reductions in personal income tax rates and capital gains taxation. You would probably move competitive rates or levels toward those of the US. That is the major competitor in North America.

You are absolutely right to notice the move in Germany. I would argue that it is a competitive matter. That is what global competition is all about now. Thank God we are not competing in a war sense among the major powers. We are not devoting resources to armaments to fight wars or to get ready for them. Our competition is now economic. That is the playing field. It is a country issue. It is competition for people, money, and wealth. It is a fun game. All the countries of the world will play it and be very intense about it. Germany will be there, just as your instinct says it will. You do not want to be last in line. That would be a big mistake. If you are last in line, whoever is leading the party that presides over being last in line will be out of office as quickly as constituents can put them out.

You need to look at and study it—and I cannot give you specific numbers—to ensure that you are competitive. Although it is a total kind of climate sense, taxes are a big part of it, competitive with the US. On capital gains tax reduction, while the Canadian capital gains effective tax rates are way out of line, you have provincial add-ons as well. If the maximum effective tax on capital gains were 37 percent—that is, if it were a 66 percent exclusion—and it went down to 33 percent or something like that, it would still be too close to the ordinary income tax rate, and far above the US rate, and you would not have done enough.

Senator Tkachuk: My last question relates to something Mr. Sinai said about following US politics. There is a big debate going on down there in the Republican Party. You said that you would argue against decreasing the marginal tax rate in the United States because it may put inflationary pressures on the economy. However, if people do not spend it, then the government will spend it on something that people may or may not need, and put inflationary pressures on the government. Are you arguing that excess money should be used and placed on the national debt?

Mr. Sinai: Remember that I said the initial conditions vary from country to country. Only at one's own risk should one traipse into the territory of advising a country what to do when you are an outsider to that country. I have not been tender about that. I am giving you unequivocal notions here. I said that the initial conditions are important to take into account. That is hard to explain in politics. Even the phrase "initial conditions" tends to put one off. You politely said that you were not quite sure that you understood what I said. Economists are not known for being clear in terms of what they say.

Concerning the US situation, it looks like we are close to full employment. We have a tight labour market. Those marginal tax rate reductions proposed by candidate Bush, as an economic matter, will produce, in my view, too much demand-side stimulus, given where we are. In the early 1990s I would have been all for it. For example, when we had a lot of slack, I would have been happy to see him propose a capital gains tax reduction, which is, by itself, a more scalpel-like approach to the situation in our economy than to put a $483 billion tax cut in front of the American people. I think it is turning out to be a political loser for him. The best use in the United States of a lot of the budget surplus largesse we have would be debt reduction at this time and selective use on the government side, with an understanding and thinking about what the proper role of federal government is in the new world. It is a different world from 20 years or 30 years ago. The US is kind of anachronistic in its government apparatus.

There is another side to these big tax cuts coming from candidate Bush, which is to get the money out of Washington before they spend it. The other part of tax reductions, which is mostly non-economic and political, is the propensity of central governments to spend money if they have it, a lot of times not in a productive way. That reasoning for the big tax cuts coming from the Bush candidacy is probably the most defensible. We have a lousy history in Washington of spending money, when we had it, wastefully.

Senator Tkachuk: We do that here, too. Do not take it personally.

Mr. Sinai: That is the rap of all central governments. Actually, that is a good argument for lower marginal tax rates. Simply tell people that we want to budget the government spending side. If we do that, we will get more productive, efficient government spending. That is a pretty good way to look at it.

Senator Kroft: Language means a lot. Perhaps we could find another expression for "trickle down." "Vertically stimulative" might be more helpful.

I have a specific, semi-technical question that Senator Meighen was kind enough to leave for me to ask of you today. However, before I ask that, on the lock-in, could you comment briefly on what you think of our system and estate duty, which ultimately is still an encouragement, even though a cost to pass on, as opposed to the deemed realization at death that we have? We do not have estate tax, as you probably know. The revenue take is through deemed realization at the moment of death and a capital gain imposed at that time. I do not know how familiar you are with this. I am wondering if you felt that that would have any impact on the calculation of a lock-in effect.

Mr. Sinai: It is an intriguing question. Let me be sure I understand it. I have always hoped I would live forever and I hate to think about estate and death taxes, so I do not know that much about it. Are you saying that unrealized capital gains in an estate get taxed at the capital gains tax rate?

Senator Kroft: At the moment of death, you are deemed to have realized all of your unrealized gains, and you are taxed at the capital gains rates at that point, so there is a single generational simulation of lock-in.

Mr. Sinai: Then that would mean that two moments before death, individuals would quickly get that out of their estate.

Senator Kroft: Assisted by the fact that we have no gift tax.

Mr. Sinai: That is a terrible distortion. To have that situation is itself something that ought to be changed. Even an estate tax is better, in my opinion, than what you have just described.

As far as how much that locks in capital gains, I guess there is a lot of giving away of estates, and the capital gains get locked in in an intergenerational transfer. What is in the law when there is a transfer with no gift tax and the appreciated gains sit in a member of the family's portfolio? I suppose they just sit there and then the family member goes through the same issue. There is an incentive for lock-in built into the way estates apparently are taxed, from just listening to you now. I do not know the details of this in Canada.

Senator Kroft: I thought that it was something you had had a reason to turn your mind to.

Mr. Sinai: No.

Senator Kroft: I will now shift ground. I should like to come back to those who have a belief that something important could happen in the economy because of a significant reduction of capital gains tax. It gets to a point where it becomes a bit of an act of faith. You, with Senator Kenny, make the point that it is difficult to communicate the point politically, but there is a "believe me, it will happen" sort of thing. Are there any particular aspects of the tax that might help focus on the investment or entrepreneurial sides? Are there ways that you can construct the tax that help direct it?

For instance, you made a passing reference to the length of hold. It would seem to me that if you created a greater capital gains tax benefit to a longer hold, forgetting the market-type transaction, it would be more of an encouragement for an angel investor to invest in a business and help it grow, because the incentive would be there to realize farther down. Are there techniques, either tax or no tax, or would you have two or three specific techniques that might be most stimulative to affecting behavioral change?

Mr. Sinai: Each would involve some judgment that has its political pluses and minuses. There are certain kinds of fund flows and funnelling of funds that more directly might lead to new productive enterprises than just the coining of money on a secondary market stock market gain. One could, therefore, set capital gains tax rates differentially depending on how the capital gains arise and from what source. It probably has been considered by others who have dealt with this issue, and I think it would be difficult administratively and transactionally. It might be difficult politically. However, that would be the right way to do it.

You really price through differential capital gains tax rates but make a judgment as to what is more productive and what is less productive. In some sense, you do that when you have a different holding period. When you say you must leave the money invested for a year or more, that is a statement or judgment that two weeks to a gain is not the same as leaving money at use for a year or more, and so the reward is larger in after-tax terms for taking the risk of putting that money to work for a longer time or for the likelihood that that money will go to a more productive enterprise than the example I used of day-trading. You can design a system that will do that.

You run into complex administrative and also explanatory difficulties in what already, when it comes to capital gains tax reduction, is not easy for the ordinary voter to understand unless they have actually had some capital gains, paid a tax, and not liked it. Then it becomes easy to understand.

Senator Kroft: In principle, you think those things are effective.

Mr. Sinai: Absolutely.

Senator Kroft: You made a comment that deals with the concern that many of the lawyers, tax analysts, and economists talk about and that I have some echoes of from pre-1972 days, which is the complexity, the restructuring, and the transactional costs—all of the things that go on to recharacterize income into a capital gains form. We had no capital gains tax then, and it was a thriving industry. I was a bit confused because I thought you said that, in this respect, to go to a zero tax would be simpler than going to a lower level of tax. I do not quite understand why.

Mr. Sinai: Your point is well taken. That really means you would not have to make distinctions between alternative capital gains tax vehicles. You just know that whatever the source of capital gains, you pay zero tax on it, and it would not matter which vehicle you were in. There was a whole industry around the differences in tax treatment that came out of subtleties.

Senator Kroft: There are different types of capital gains.

Mr. Sinai: Yes. The whole industry of unnecessary resources grew up around that. You would still have the industry of finding ways to reduce the tax take through doing capital gains vehicles versus earning ordinary income. That has negatives as well because if there were zero capital gains tax, there would be many investments done purposely just to get the tax take down, and they would not necessarily be productive investments. That was a rationale in our country for producing equal tax rates. Now we have gone back to a significant differential between ordinary and capital gains tax rates and we have a big stock option industry that has grown up around American business and that is working wonders right now for productivity but some day may not.

I might add that the ownership and the treatment of stock, when you hold for a year or more with a preferential tax rate, has been a major incentive, I think, on the managerial side and the worker side of the American economy, and has had a large effect on our productivity growth. That effect has not yet been fully studied or understood, but when the history books are written on this episode in the US and the tremendous surge of productivity growth that we are seeing, I have no doubt that the "maximize shareholder value" mantra of the US will have had a lot to do with it. I have little doubt that some day we will overdo it and it will become excessive and we will run into instability problems from it, because that is the nature of the way these things go. However, it has been a very powerful motivating force for higher productivity in the US, and I will be amazed if it does not get copied all over the world.

Senator Graham: Mr. Sinai, I found your discussion very interesting, and your arguments quite compelling.

You mentioned that the Canadian economy is heading for full employment. What is your definition of "full employment"?

Mr. Sinai: That was a forecast comment. The unemployment rate is in the 6.6 percent to 6.8 percent area. On the labour market side, in the new economy world—you will be amazed at this answer—I think you can get your unemployment rate down to the 4 percent to 5 percent level without having any inflationary problem.

You are still a ways away from that, but job growth has been outstanding in this country. The unemployment rate is moving down rather rapidly and, of course, you are losing some people to other parts of the world as they seek opportunity elsewhere. The labour force growth may slow down. I think that the unemployment rate will move down sharply over the next year or two. This country will be surprised at how low it can go without an inflationary consequence.

Senator Graham: Conversely, there are those who would say that there are skilled employees from other parts of the world who are coming into the country in greater numbers than those leaving in this so-called brain drain, depending upon which economist you are talking to, or maybe which political party is putting forward the case. I think the people around this table are interested in improving the economy and creating jobs regardless of what side of the table we sit on.

The national unemployment average is 6.8 percent, I think. You have mentioned that we may be heading for 5 percent or 4 percent. This is one of the most difficult countries in the world to govern given the size and the complexities of the regions and the fact that the great mass of the population lives in a 250- to 300-mile corridor along the Canada-US border.

I am going back to what Senator Kenny was saying. It alludes to the difficulty of marketing this proposal because of our diversity. The unemployment rate in Newfoundland and Labrador is 20.5 percent. The unemployment rate in Eastern Nova Scotia, where I come from, is listed officially with the average in 1999 as 18.2 percent. Unofficially, it would be more in the order of 30 percent to 40 percent, because there would be a lot of people who have given up and who are not registering. Halifax is doing fine. It has an unemployment rate of 6.9 percent.

As I have said time and again, we cannot have two kinds of Nova Scotians—Halifax Nova Scotians and all the other Nova Scotians. That applies to much of the country. The unemployment rate in Northern Quebec is 16.2 percent. In Hull, Quebec, the statistic is 7.2 percent. In Ottawa, it is 6.5 percent; in Toronto, it is 6.2 percent and in Hamilton, it is 5 percent. In Calgary, Regina, and Saskatoon, it ranges between 5 percent and 6 percent.

Senator Meighen: I am looking for a question, senator.

Senator Graham: I am merely pointing out, with respect to the statement made that we are approaching full employment, that that is not true in many regions of the country.

It is a difficult country to govern. I am looking for some approaches by which we might sell your theory. What is the best way? Is capital gains tax reduction a better way than providing, for instance, grants and loans to stimulate economic growth in industry in the various parts of the country that need it the most?

Mr. Sinai: You are quite right about the distribution of unemployment. My own comment was based on the national aggregate, which we look at. Behind any aggregate is always a lot of detail.

It is quite a variance. Actually, I am quite intrigued and interested in that variance. It is much larger than in the United States. There is a higher frequency of high unemployment rates relative to the national average probably in this country than there is in the United States where the distribution of unemployment rates across the states is closer to the national average, based on the numbers that you have recited, senator. That is an unfortunate dimension. It is not one you are happy with, I am sure. It is not one with which anyone should be happy.

How do you deal with it? I think that it will be taken care of in part by strong growth in the Canadian economy, above the potential rate of growth in Canada, which can be tolerated without any policy restraint for quite some time. I probably differ on that view from many people, including, I would not be surprised, the Bank of Canada.

I had the same view for years in the United States. My view was that we could run the unemployment rate down a lot lower than anybody thought we could. I was almost a lone voice in my profession and in policy circles arguing that there was no such thing as a natural rate, and if there were, it was under 5 percent. I have the same view on Europe. They, too, will get a lower unemployment rate without inflation than they think.

In the case of Canada, it gets back to the range of things you do with the extra money you have on the budget in terms of stimulating the aggregate economy and taking the chance that you do not run into a full-employment barrier. I am now more convinced than ever, given your statistics, that you might run into a full-employment limit in a few places, but not generally throughout the country. Let growth roll at a higher number without trying to restrain it from the monetary side. That is the first thing.

Second, the use of the budget surplus is not one measure. It should in large part be a tax reduction, which will have strong aggregate demand effects. There should be some spending increases, which will create some additional demand and also, depending on those areas that the government spends money on, help the potential supply of the economy. There should be some debt reduction. All three uses of the surplus are the way to go. As I have said before, my only regret is that you are not doing more capital gains tax reduction.

No one measure alone sops up those pockets of unemployment because they are coming from different sources. I imagine some of those high unemployment rates are tied to agriculture and maritime kinds of activities. I do not know the details of some of the other areas where the unemployment rates are so high. A strongly growing economy, helped by significant tax reductions of various sorts, is the best answer I can offer on the macro side to take care of the excess unemployment problem. I think it is superior to loans or grants and aids to specific segments of the population to deal with pockets of unemployment.

Senator Graham: You used the term "full employment." What number do you attribute to the term? Is it 5 percent, 4 percent, 3 percent? What would you regard as full employment given the fact that some people are unemployable?

Mr. Sinai: I will waffle on this one somewhat by saying that I have not studied the Canadian situation in terms of what I might offer for a full-employment rate. We have it, of course, in detail in the case of the United States, and have had for years. All I can do at this point is to give you that range — 4 percent to 5 percent. If, in three or four years from now, we have a raging inflation problem once you get close to that, I am okay with you having me come back and saying to me, “You were wrong on that particular issue.” However, I am willing to bet you a dinner at your favourite restaurant here in Ottawa that I will be closer to right than wrong. I cannot give you a precise number on what is specifically the full-employment rate.

With regard to the unemployable, I have two responses. I take what is something of a doctor’s approach. Use all the technology at your disposal to keep the patient alive, unless the patient really has almost no chance of survival, in which case you let the patient go, as old age and death approach. With regard to unemployment and jobs, I have never accepted as a policy matter, or as a citizen of my country, the notion that we cannot do better. I absolutely reject the view that there are those who are unemployable. I will not accept it. What we have to do is look for ways to find a lower unemployment rate consistent with price-level stability. Where we see what looks like unemployable situations, we have to use the apparatus of government, either by working through the private sector or directly, to make those people employable.

Let me give you an example. In the US we have a Democratic administration that revamped and revised the welfare laws. We now have working in the United States—and you can anecdotally see it every day in almost every place where retail goes on—people who you know have never worked before. Four years ago, many people in our country said they were unemployable. They do not speak the language. They cannot even add and subtract. However, there are machines that have pictures on them that they can see and they press a button and it then makes change for them, or it pulls out the hamburger at McDonald’s for them. These so-called unemployable people are employable. They may be earning minimum wage, but they are earning money for the first time in their lives. I think many are off the streets of Harlem or urban areas where they were engaged in crime. The US crime rate is way down. And guess what? They are not unemployable any more, and we have a 4 percent unemployment rate in our country. We do not have an inflation problem.

If we say there is some absolute number on unemployment below which we cannot go, or if we say there are unemployable people, as opposed to looking for ways to lower that unemployment rate consistent with price-level stability and finding ways to make the unemployable people employable, then that is just too defeatist for me. I am not being critical but talking about philosophy that may stem from the fact that I saw incredible pain and suffering in the city of Detroit where I grew up when we had times of high unemployment. I absolutely will not accept it. It is like you will not accept "no" for an answer. I will not accept "no" for an answer to what we or any country can accomplish in terms of achieving low unemployment and putting people to work.

The Chairman: Thank you, Mr. Sinai. You have been a breath of fresh air.

When you were reading your remarks, you omitted one sentence that I was hoping you would say something about. On page 2 you state: "Capital gains taxation has been little studied in the context of macroeconomic performance and international competitiveness."

Are you aware of any seminal studies being done in Canada? We find it hard to come up with any. There was one published recently that was reasonable. Do you know anything about the work that is being done in Canada on this subject?

Mr. Sinai: No, I do not. I will be happy to inquire. The issue is quiet in the United States now because no one is proposing it. It was not quiet some years ago. A lot of macro work was done. A good deal of work that was actually negative came out of the congressional library office or something like that. I will be happy to provide you the citations on what I know has been done on the US. I think almost nothing other than the study you have cited has been done in Canada. You may end up having to commission some work to be done on the issue, if you want more work on it.

The Chairman: On behalf of the committee, thank you very much, Mr. Sinai.

The committee adjourned.

Appendix A
Capital Gains Taxes and the Valuation of Assets

The same principle which produces the lock-in effect caused by capital gains taxes also results in the lower market valuation of stocks. Consider two assets identical in every respect relevant to their financial valuation. They pay $100 in perpetuity. The discount rate is 10 percent. Therefore, the market valuation of these assets is $1,000. However, one of these assets, A, is not subjected to capital gains taxation, while the other, B, is.

Now assume that the expected earnings of both assets rises to $200 in perpetuity while the interest (discount) rate remains at 10 percent. The value of asset A increases to $2,000 since the investment of this sum at 10 percent in any other asset brings the same annual income of $200. What happens to the value of asset B subject to capital gains taxation of, say, 40 percent?

The answer to this question depends on the investor's expected holding period. The valuation procedure can best be understood by considering a holding period of one year and assuming, initially, that asset B is worth $2,000, the same as asset A. One year after the unexpected doubling of the income stream on both assets, the investor in A can sell it and take home $2,200—that is the capital value and one year's earnings. The owner of asset B, on the other hand, has to pay $400 capital gains taxes, and therefore takes home only $1,800—that is the after-tax capital gain, plus one year's income.

The preceding analysis leads to the following important conclusion. On the day after the announced increase in earnings, a potential investor interested in placing his money for one year will be willing to pay $2,000 for asset A and $1,600 for asset B. The difference in the market valuation of the two assets is attributable solely to the existence of a capital gains tax on asset B.

The gap in the valuation of assets A and B is a decreasing function of the holding period because the present discounted value of the capital gains tax due far into the future diminishes rapidly. The gap is an increasing function of the capital gains tax rate since it increases the value of the future tax obligation for any given holding period.

The illustration just presented leads to the same conclusion if asset values in an economy increase because of a lowering of the market interest rates, given an unchanged flow of annual earnings. Thus, an asset worth $1,000 based on a perpetual stream of $100 annual earnings and an interest rate of 10 percent will double in value to $2,000 if the interest (discount) rate falls to 5 percent.

My analysis is abstracted from many other factors which influence the valuation of assets, such as the riskiness of the forecast for future earnings and opportunities for dealing with this risk through diversification. However, it reflects enough of the important factors relevant to the valuation of financial assets to permit the following conclusion.

The stock market boom of the 1990s arose from a combination of firms' higher expected earnings and lower interest rates on government securities. Such favourable developments affected both the Canadian and US stock markets during this period. Interest fell by nearly the same amount in the two countries. Earnings increased somewhat more in the United States than in Canada, but not by a margin large enough to explain the much smaller growth in stock market averages in Canada. A large proportion of the difference must be attributed to the existence of a capital gains tax rate at 40 percent in Canada and of only 20 percent in the United States.

Appendix B
Capital Gains Taxes in Context

by Reuven Brenner, Faculty of Management, McGill University[47]

Explaining the Issues

Prosperity requires that people abandon old ways of doing things and old industries, and bet on new ways and new ones. To achieve that transition, capital must move from yesterday's industries to those of the future. The move is a bet.

People have a vision of what these industries may be, though nobody knows their precise shape and form. They experiment. Experiments must be financed. And financing requires mobility of capital: people having the incentives to switch money from one enterprise to another. It does not require a degree in economics to understand that if this switch is taxed—and capital gains taxes are a tax on just such a switch—the incentives to shift resources out of the old and toward a better match diminish.

If they diminish, that means a number of things.

Angels, venture capital firms, and merchant and investment banks finance ventures. As noted above, they do not know either what will succeed and what will not. But they have experience and skill in so shaping financial contracts as to best insure that mistakes will not last too long—experience and skill that governments' employees lack. The sooner financial resources can be switched, the sooner they put an end to mistaken allocation of capital—human, physical and financial. Since every mistake is a cost, the sooner the mistake is corrected, the better off

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47 This brief was written at the request of the John Dobson Foundation, whose members I thank for their support.

society is. The longer the mistake persists, the poorer society becomes, the costs adding up at compounded interest rates.

If one compares two countries, one with greater incentives to switch, and the other fewer incentives to do so (other things being more or less the same), the one with the greater incentives will see more new industries emerging. The latter country will experience a higher rate of capital formation, higher growth in wage rates (since capital is formed at a higher rate, the productivity of human capital is increased, too), and also greater tax receipts for governments.

The reason for the latter is simple: Except in situations of distress, people do not have to pay capital gains taxes. Taxpayers can either avoid buying assets subject to this tax, or defer selling assets they already own, staying locked in longer than would otherwise be the case. In this sense, one can still say that, as with lotteries, the capital gains tax is a voluntary tax, but which, because of the lock-in effect, brings about stagnation. Also, as explained below, a relatively high tax does not lead to redistribution of incomes so much as it leads to a redistribution of taxpayers.

High-taxed and poor people may volunteer to bet, say, $10 on lotteries a month, on average, in the hope of getting rich (especially when governments close through high taxes other avenues for such hopes). They know well that, on average, this means a $5 dollar tax (if only 50 percent are redistributed in winnings). However, there will not be many people volunteering to pay the 40 percent capital gains tax in Canada, in particular when capital gains stay at 20 percent in the US—just one hour car ride for most Canadians.

The results are that Canadians will lock-in their gains, family businesses will more likely not go public, market capitalization will be lower in Canada than in countries with lower capital gains taxes (say, as percentage of the GNP) since it is better for companies to take on debt, capital markets will be less developed and less efficient (and companies become more leveraged than would be the case if capital gains taxes were lower). Thus, the tax base is diminished. The latter effect is more pronounced as the difference between capital gains in the US and Canada becomes wider. US companies can be expected to hold Canadian stocks and make investments. But they would not be paying taxes in Canada.

The higher tax rate discourages capital formation for a number of other reasons. When capital is mobile, the after-tax return on it has to rise to the internationally competitive level. This means that in the higher-taxed country, capital must become relatively scarce for the international rates to become roughly equalized. This is achieved in part through the adjustments listed above, and also by fleeing the country. The scarcity then means that entrepreneurs have greater difficulty financing their ventures. They can then move out of the high-taxed country, which has the effect of diminishing capital formation since it is the "vital few"[48] who attract financing to build up capital. Some just lower aspirations, which also means lower capital formation. Both effects also mean a lower tax base.

The approximately 100,000 high-skilled people who left Canada for the US in 1997 allow one to make a rough estimate of how much capital is being lost. Say their average annual income was $100,000 (since the migrants were scientists, engineers, physicians, and other high-skilled people, this number is in the ballpark). At a 5 percent discount rate, that amounts to $2 million of wealth. Multiply by the approximately 100,000 who left, and the figure comes to a $200 billion wealth transfer from Canada to the US. Those who link the move to a search for greater opportunities rather than differential taxes are on the wrong track. As shown above, the two things are directly linked. (Of course, there are unique opportunities in the US with 250 million people unavailable in Canada with just 30 million. But not all 100,000 have James Cameron's ambition of re-thinking and re-sinking the Titanic).

The effect of scarcity of capital which leads to the scarcity of "a vital few" also means that the burden of Canada's higher capital gains taxes are shifted to lower-skilled employees who are less mobile.

Last, but not least, the main issue with respect to taxes is what are the alternatives?

Given that countries compete for capital and that capital is mobile (the human one too), tax rates cannot be based on models that discuss taxes

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48 "Vital few" has a very straightforward meaning. When most people quit or join public companies, nothing happens to their stock prices. However, there are a few whose move, once announced, changes the market capitalization of the respective companies by hundreds of millions, and even billions of dollars, up or down. Those tormented by envy but masking it with egalitarian veils don't want to acknowledge this. But it is a very simple, observable fact. Just as the arts, sciences, and sports are moved by the "vital few," so are businesses.

and government spending within national borders—in isolation from what is happening to tax rates elsewhere—and expect to have the desired effects.

A government's has a choice between allowing its country to fall behind others whose fiscal system is more sensitive to incentives, or lower taxes and prosper.

For Canada, most of whose population lives within one hour of the US border, the comparison must be made with the US fiscal system. Even if the Canadian fiscal system became similar to that of the US, Canadian governments could spend more and offer better safety nets because of a number of reasons: the US spends more on the military (in percentage terms); the US has problems with minorities; Canada is rich in natural resources.

The rents from the occasional high prices are distributed over a small population base, and can provide for more of a safety net than the US could provide for its citizens, even if the US had exactly the same fiscal system.

In addition to the above, there is one particular reason for the timing of lowering the tax: Canada's aging population. Most young people start up with a wide variety of human capital, which they hope to channel in the best directions. As one grows older, the incentives to renew one's human capital diminish, and incomes go down. To sustain a standard of living, financial capital must substitute for the depreciating human capital. Yet capital gains taxes prevent the accumulation of such capital, and we all know what happened to governments' promises of social security benefits, medical care and IOUs.

If it's so simple, why is this not done?

The recommendations above assume that politicians want the country to prosper, which is obviously not true. It is not true in Canada, and it is not true in other countries. It is not true now, and it was not true in the past—speeches to the contrary notwithstanding. Words are cheap. Politicians want to get to power and stay there, claims about a democracy's ability to prevent this from happening notwithstanding. The evidence is clear-cut. Latin American and Asian "democracies" would not still be poor, with just a handful of the same people at the top, if politicians were genuinely interested in their people's welfare. Mexico, for example, is a democracy on paper. But one party has ruled for 70 years, and 95 percent of the people were poor and stayed poor.

The way politicians and an establishment manage to achieve this, yet pay lip service to democracy and citizens' welfare, has been by controlling financial markets either directly through regulations, or indirectly through taxes. There is nothing that gives politicians more power than closing capital markets one way or another. That makes people dependent on government financing. To explain their actions, politicians then subsidize scribblers to rationalize their views (within universities in particular), invent jargons, and then even pretend that their policies are based on "serious research" and are "scientific."

Discussions on capital gains taxes must be put in this broad perspective. If not, the discussion can be easily diverted from substance to form. For let there be no doubt about it, there are countries with 0 percent capital gains tax that stay poor. Argentina, Bolivia, Costa Rica, Ecuador, Malaysia, etc. all have zero capital gains tax. But it is also true that Hong Kong, Singapore, Switzerland, and Germany have zero percent rates too. Discussing capital gains taxes in isolation, just as discussing taxation in a country in isolation of what is happening elsewhere in the world, misleads.

Thus, whether one likes it or not, the overall incentives given by the Canadian fiscal system must be compared with the one provided in the US. Falsehoods abound. For instance, Mr. Chretien has frightened Canadians by saying that US citizens pay $30,000 tuition at universities (when less than 1 percent of US students pay that fee). Statistics superficially show that standards of living in the US and Canada are comparable—although a closer look reveals either that they compare the costs of a Canadian family owning a much smaller house and much older cars with their American counterparts, or that United Nations bureaucrats devised an arbitrary, bureaucratic index of well-being. Such falsehoods will not keep the electorate's eyes closed for long. People do not have to study economics to see that the slipping Canadian dollar and slipping real wages make them poor—falling some 30 percent behind their US counterparts.

Politicians are reluctant to diminish taxes, capital gains taxes in particular, and are reluctant to open up financial markets because the resulting prosperity would make it quickly visible that private financing of entrepreneurs brings about prosperity, unlike financing people with government acting as intermediary. The reason that so many whining groups are against tax cuts—and a cut in capital gains taxes in particular—is that the cuts would show quickly that prosperity is brought about by having private sector institutions rather than government policies. The reason financial markets do a better job in this respect than governments is not that venture capitalists, banks, and other financial intermediaries do not make mistakes. They do. And they make major ones. But they make fewer mistakes than governments do, and they must put a quicker end to them. The reason is that governments can tax, inflate, and devalue to cover mistakes. Even if government bureaucrats were as good at decisionmaking as those working in the financial sector, the political incentives make them act differently. By "covering mistakes" through the aforementioned actions, capital remains locked in the old, and switching to new activities takes place to a lesser degree.

One reason that governments correct mistakes more quickly in some countries than others is that they have fewer natural resources. Yes, natural resources have been a curse. Their occasional high prices bring windfalls to governments, with which they can then bestow "gifts" on constituents, creating illusions of prosperity, with devastating long-term effects on the country's political culture. There are no free lunches in this world, and this is the cost countries pay for being endowed with natural resources.

Since every mistake is a cost, the more projects are being financed by governments, the greater the costs on society and the less the prosperity. This is because bigger mistakes are made by government and they last longer than in the private sector. Financial markets do not have such luxury. The decline of the country persisting with mistakes, and locking its capital—financial and human—in the past is gradual. And that is another danger.

People are very good rationalizing declines, in particular if governments subsidize the media, "educational" institutions and "think tanks." The floating Canadian dollar drops? That's not bad. It keeps people employed in "our" traditional industries, maintaining "traditional" communities. OK, so we do not import the newest technology and equipment. Well, we can live with smaller cars, smaller houses, update our computers and get the electronic gadgets later. A "consumer society" destroys the environment, doesn't it? So we fall behind in our learning. No problem. Let's teach our kids self-confidence, and they will quickly catch up.

Let us also compare apples and oranges, the cost of living in smaller houses and older cars and equipment with those of larger houses and newer cars, and, see, Canada continues to look comparable to the US. OK, Canadians travel less abroad, to the US in particular. Let's put a spin on this too: at least they discover their own country. This is how, slowly, imperceptibly at first, people rationalize themselves into decline. By the time they wake up, the vital few have left, and the country has lapsed into mediocrity.

Canada has been accumulating fiscal mistakes for the last few decades, starting with the good intentions, but utterly misguided Trudeau administration—and has been falling further and further behind its southern neighbour. The fastest and best way to catch up would be to give incentives to build up capital quickly. One way to achieve that would be to lower capital gains taxes even below the US level. As explained above, zero would be the proper rate. It would allow a fast correction of the mistakes we have been accumulating because it would allow capital to be switched rapidly to the "future" rather than staying locked in the past.

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