DESTRUCTIVE OR CONSTRUCTIVE TAXATION *

In any consideration of the effect of high taxation in Canada and its destructive influence, attention should be directed to certain events in history incidental to her founding and colonization, and to the development of her taxing provisions.

Canada came under English rule in 1758. Under French rule, financing had been accomplished by customs duties, by levies on the rich and abundant fur trade, and the other natural resources of the country. The land had been divided amongst the seigneurs and it was to them that the settlers paid their dues, which were in the nature of rent. These dues were in services and in kind, and in return the settlers received immediate and evident benefits. It was of no concern to them that of the goods they furnished to their lord, a portion thereof went to the King.

Prior to 1763, there had been no attempt made by England to derive revenue from the colonies by taxation, although there had been some regulatory duties and fees imposed. These, however, were in essence a means by which control could be maintained over navigation and other similar ventures and activities destined ultimately to become industries in which a substantial portion of the population would engage.

It was in 1763 that England first sought to derive revenue from the Americas by means of an excise tax payable directly into the British Exchequer. There appears to have been no attempt made to impose a similar tax on the Canadas.

While the excise taxes so imposed were not onerous, they were resented and are prominent in the history of the United States as being the cause of the war with the thirteen colonies which resulted in their Declaration of Independence in 1776.

After the American War of Independence, there was a great influx to Canada of United Empire Loyalists. They brought with them a feeling which they had shared with their former neighbours, namely, a deep-rooted objection to paying taxes for other than their immediate and local benefit.

By the Declaratory Act of 1788, England renounced the right to tax dependencies, but retained control over certain sources of revenue, stipulating, however, that all returns from such sources would be expended where collected.

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It was not until 1810 that Upper Canada felt that it could provide sufficient revenue for its own needs from taxation. Previously, the cost of all public works and improvements was met out of the British Army appropriations. In his famous report in 1837–38, Lord Durham says:

> There is hardly the semblance of direct taxation in Lower Canada for general or local purpose.

During the fifty years following Confederation, one or more Provinces sought by statutes which varied in nature to tax income, but the total amount collected was small. In 1906, income in Ontario bore less than 5% of the total tax levy.

Upon this background there was suddenly imposed a federal income tax in 1917. The rates were low and the exemptions generous. This condition existed until 1932. Since that time, there has been a progressive general increase in the rates and the incidence of the tax. This culminated with the imposition of the present high rates and lowered exemptions in 1942, following a substantial increase in 1941.

It is obvious that with such a background, a sudden leap from a position of comparative freedom from direct taxation to the position of one of the highest taxed peoples in the world creates dislocations and disturbances in our national economy. It is proposed to consider these, their possible effects and remedies.

Under the present rate schedule, the lowest initial tax rate is 37% (7% normal tax and 30% graduated tax), with these rates applicable on the first $500.00 of taxable income in excess of a reduced exemption. In effect, the rate of 37% was that at which over two million taxpayers first began to pay income tax. In 1939, this rate did not apply until income in excess of exemptions reached $95,000.00, and less than 483 taxpayers paid this percentage on only a portion of their income.

It is fully appreciated that with the incentive of war, high taxes were imposed and accepted. This does not mean, however, that high taxes are accepted as being continually necessary, or that the burden is not destructive and resented even while it is being assumed. This is amply borne out by history.

In 1380, Henry III found it necessary to raise the sum of £100,000 to prosecute a war against France. The provocation was great, the English coast being ravaged and pillaged, and trade disrupted. The amount was raised by means of a levy of three groats from every lay person in England. It was in fact a poll tax, the forerunner of the income tax. Each township was charged with its proportion, and the wealthy helped pay the amount assessed against the poor. The war provided victories and protection; but as Dowell says in his History of Taxation in England:

> This tax stands prominent in fiscal history as the cause of the peasant insurrection.

In the history of Greece, we read of the financial burden caused by war and how it formed a pretext for imposing heavy taxes upon the aristocracy. This is given as one of the chief reasons for the downfall of Athens, since the tax was borne almost entirely by those who helped create its prosperity.

Similarly, in the latter part of the Roman Empire, taxes were heavy and unjust. They were imposed because of war. Bury, in his History of the Later Roman Empire, says:

> The system of raising revenue in the later Roman Empire was so oppressive that there is perhaps no Emperor against whom a hostile critic could not have made out a case for charging with a deliberate design to ruin his subjects.

That the condition was indeed serious may be judged from a remark by the same historian in referring to the burden of taxation:

> Advocates are said to have suffered because people were so impoverished that they could not afford the luxury of litigation.

In later years, the same cause produced unrest and revolution. One writer states in a study of 16th century revolutions in Europe that they all had "in common a financial origin, all began as protests against taxation."

The same writer points out that the French Revolution broke out at a time when taxation was heavier in France than in any other country. It was said that taxes were absorbing up to 80% of the national income and that this condition was parallelled by those existing in Russia in more recent years.

The contributing factor to these earlier revolutions was not a direct tax on income. This form of impost was unknown in those days, although similar taxes, such as a poll tax, were in effect. There were, however, taxes upon many necessities of life, and in particular upon luxuries. Visible evidence of wealth was taxed. For example, both in England and France, a tax was based on the number of windows in a house. The result was a lowering of the standard of living and a refusal to create income because it was taken away by heavy taxation.

The effect of taxation has always been a factor in bringing social unrest to a head. While other conditions will no doubt be present, it seems abundantly clear from the lessons of history that excessive taxation is readily seized upon as a final excuse.

The proportion of the national income which may safely be drained off in taxes depends to a great extent upon the purpose for which it is to be used. If there is a direct and beneficial return, then a larger amount can be taken. The amount can even be excessive in times of national emergency or in case of war. At the beginning of the century, many writers considered 15% as an absolute maximum, and as late as 1929 the opinion was expressed that 12% was excessive.

Present rates of income and excess profits taxes are little short of confiscatory. The excess profits tax coming at the end of ten years of depression for many industries has now placed many businesses in the position of not having adequate resources to carry on and keep staffs together during the transition to peacetime. The cause, of course, in inability to build adequate reserves to restore impaired capital. A standard profit of $5,000.00 less tax keeps many firms impoverished. As a result, serious unemployment, particularly in the case of smaller units, is almost certain to ensue.

Statistics are available to show that excessive taxation reduces the amount collected. When the taxation burden seems too heavy, the taxpayer seeks means of avoiding it. Prohibition in regard to the making of an honest dollar inevitably must have the same result as prohibition with respect to liquor.

The Minister of Finance acknowledged in the last Budget speech that he hoped removal of the compulsory savings portion of the tax would help to relieve absenteeism, unwillingness to work overtime, and lack of application on the job. It is alleged that certain branches of industry, in order to obtain essential maximum production, have necessarily devised methods of encouraging workers.

It is not only the workers who require encouragement, if we are to have maximum effort and maximum production. When tax rates are advanced beyond a safe or reasonable level, a disproportionate burden falls upon a group comprising the most energetic and capable, who are in fact the greatest producers. This is largely attributable to the graduated rate schedule. Because the income level of those belonging to this group is above the average and in some instances moderately high, they are receiving little apparent consideration from the taxing authorities. As a result, there is a tendency on their part to relax their efforts. This has its effect upon the income earnings of the country and upon its economic production.

A large percentage of individual taxpayers are dependent upon corporations for employment. The prosperity of these individuals is accordingly largely dependent upon the growth and stability of our corporations. If our corporations are required to carry burdens of oppressive magnitude, the individual will be a co-beneficiary of the corporation's post-war ailments.

The greater number of Canadian companies have, under wartime conditions, suffered such hardships that without immediate relief, continuation of operation in the immediate post-war period will be difficult, if not impossible. Repairs have been accumulating, and as they accumulate they become more and more destructive to capital values and when finally made are less and less effective in restoration of the asset concerned. Shortages of labour and materials prevent present correction, with the result that profits are exaggerated and are skimmed off in tax. The throw-back of repairs and deferred maintenance now proposed will be effective only in case repairs are possible. If not possible, new equipment must ultimately be purchased. The write-off of such capital replacements at the accelerated rate suggested by the recent Budget's resolutions will only be possible if profits are earned consistently for a period of years.

Obsolescence arising from the tremendous pressure of wartime invention and development threatens to become a major headache for some industries. The present tax laws provide no relief for the resultant loss of capital.

Many industries are today flooding their peacetime markets. This is particularly true of the construction industry where buildings and residences erected for war purposes will ultimately be converted to peacetime uses.

For corporations with high earning capacity, high taxation leads to corporate extravagance creating a situation difficult to overcome when business declines.

Much of Canada's wealth is attributable to mining development. Heavy taxation simply does not mix with the speculative risk inherent in mining. As a result, venture or risk capital has been none too conspicuous in recent years, and prospecting and development have been at a low ebb.

An interesting article dealing with the restrictive effects of heavy taxation on the mining industry in particular appears in the July 13, 1944, issue of *The Northern Miner*. The illustration fits exactly a mining company earning $1.00 per share per annum before taxes, the shares of which on the basis of the ten times earnings yardstick are selling at $10.00 per share, and which company, after providing 40% corporations tax, distributes its earnings in full as dividend. On such a basis, with current depletion allowances, it would require nearly seventy years for a shareholder to recover his investment tax free, a thoroughly unreasonable length of time when the average estimated life of a profitable producer in Ontario (8 years) is considered.

While considering the drastic effects on income of high taxation rates, serious comment is in order respecting the slowly growing tendency to encroach upon capital. It has always been regarded as a basis of English and Canadian taxation that capital is free from tax. For many years this was undoubtedly true and the capital invested in this country was regarded as being secure. There are many reasons for the exemption of capital, and no doubt the one which most readily occurs is that destruction of capital destroys the source of all taxation. When it is sought to derive an annual slice of the tree rather than a portion of the fruit, there is an elimination of the source which cannot but have a serious effect on the general economy of the country.

One manner in which capital is being encroached upon is well known. Prior to 1940, income arising from certain types of annuities was free of tax. It may perhaps be true that there is an income element in some annuity payments, but if so, it can be readily ascertained. The mere fact that there is incorporated in the statute the words "annuities or annual payments" which depend for their interpretation on the judgments in the English courts does not justify the imposition under an income tax statute of a tax on capital. It is to be hoped that the Commission to inquire into the taxation of such payments will arrive at an equitable solution of the problem. If any amendment to our statute is necessary to prevent the gross injustice of taxing capital, it should be readily made.

In the Report of The Royal Commission on Dominion-Provincial Relations, the following Summary of Tax Recommendations appears in Book II, page 121:

> For reasons set forth in detail in the preceding divisions of this chapter, the Commission recommends that the Provinces should withdraw entirely from the following tax fields—
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> (a) income taxes (with an exception for premiums for social insurance within provincial jurisdiction);
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> (b) corporation taxes as defined in detail above;
>
> (c) inheritance (or succession duty) taxes.

Under the same heading, the Commission made the following observation:

> This introduces a final consideration, viz., the unfair and in some cases intolerable pressure on taxpayers in some provinces and on some provincial governments which would result if the plan should not be implemented and circumstances should force the Dominion to increase personal income taxes and corporation income taxes in competition with current or possibly higher provincial taxes and probably to enter the inheritance tax field as well. This would not only produce double taxation of crushing proportions but double taxation which would vary greatly as between provinces, entailing disadvantages to investment and free movement of individuals. It is important to note that under the present system, far from there being any security against this occurring, there is a strong tendency in this direction.

Pursuant to agreement between the Dominion and the Provinces, the latter withdrew from the field of income and corporation taxes, but the Dominion, contrary to the recommendations of the Commission, entered the Succession field without any arrangement for withdrawal by the Provinces.

As mentioned by the Commission, this has produced double taxation of crushing proportions, has entailed disadvantages to investment, has tended to kill the incentive to save and has raised a serious obstacle to the inward flow of American and other foreign venture capital.

The succession duties collected by the Dominion in the last fiscal period amounted to $15,019,831.00. It is difficult to reconcile this comparatively insignificant amount of revenue with the work, trouble and confusion occasioned by the introduction of this additional form of taxation by the Federal Government.

Unless the scale of taxation of Canadian corporations is kept within the limits of the corresponding imposts placed on industry in the United States and the United Kingdom, Canadian industry will suffer serious competitive disadvantages in post-war trade.

In the August issue of the *Monetary Times*, we find the following:

> Unless Canadian manufacturers are relieved of excessive tax burdens, they may not be able to compete in price and will lose out to American manufacturers; small wonder that there is uneasiness among producers of export goods.

A competitor in world markets and faced with stiff competition at home at a time when the trend seems toward lower tariffs, Canadian Industry (says the Toronto Board of Trade's

Sub-Committee on Averaging Taxable Profits, headed by K. E. Greenwood) is faced with the disadvantage of higher taxes than prevail in the United States and the United Kingdom. Notwithstanding the recent budget provisions permitting losses to be written off in previous and succeeding taxation periods, the above would appear to be a statement of fact, since in the United Kingdom double taxation of corporate income is to a large extent avoided.

The present system of taxing corporations on their profits and thereafter taxing the shareholders on the dividends received by them out of the balance of the profits, involves double taxation, which should be eliminated.

Consideration should be given to the British system, in respect of which the following comment appears in the October, 1943, issue of the C.C.A. at page 280:

> Under this, the corporation pays, in times of peace, what is in effect a withholding tax, which in turn is deducted proportionately from dividend distributions to shareholders. If the tax deduction exceeds the rate to which individual shareholders are liable, a refund is granted; and if the shareholders' income falls within rates of income tax higher than that applied to the deduction, additional tax is then collected from him.

It is interesting to note that the lower income groups would derive a larger proportionate benefit from such a plan than would those in the higher groups.

The liability of shareholders to taxation on undistributed income in the case of corporations owned by a small number of individuals seriously interferes with business adjustments made necessary through the death or retirement of a principal shareholder. Upon the death of a principal shareholder, his estate is subject to almost confiscatory tax upon the withdrawal of funds to meet succession duties. Immediate correction of this situation is essential if many corporations are to survive.

In considering the various problems with which Canada is confronted, there should be kept in mind the words of a great student written towards the close of the last century:

> There can be no doubt that a small nation with little accumulated wealth cannot adopt the same scale of outlay as a larger and wealthier one, and one of the rules of good finance is to observe moderation in the demands of the state on its citizens.

So far as Canada is concerned, we have the instance of the small nation with little accumulated wealth being subjected to heavier taxation than larger and wealthier nations. It seems clear that we have passed the danger line in taxation, and the capacity of the people of Canada to bear the burden. The remedy must be found.

The present burden of taxation is such that the contribution of every Canadian organization, with the exception, of course, of charitable institutions, is required. Corporate stability is impaired by increasing competition from tax-free government operations and other forms of business so that the smaller number is asked to shoulder the burden for the whole. Their exemption amounts to a subsidy which their competitors are obliged to pay and every increase in tax has constituted an increase in this subsidy and a corresponding reduction in the national revenue. It is grossly unfair that private industry should be called upon to subsidize and contribute to the prosperity of organizations with which they must compete. All forms of business should bear their fair share of preserving our institutions and way of life.

In essence, high taxation actually drives government into business in competition with private industry, as Premier Garson of Manitoba so aptly warned in a recent speech. He also predicted that heavy taxation on the part of the Dominion government would cripple the revenue sources of the Provinces and drive the latter into the creation of tax-exempt government-owned businesses in order to provide themselves with the necessary revenue to meet their responsibilities.

The Rowell-Sirois Commission, in referring to pre-war corporation taxes, said:

> The present complexity is beyond belief . . . They have grown up in a completely unplanned and unco-ordinated way, and violate every canon of sound taxation.

The above was a serious indictment of our taxing authorities by a responsible Commission. Some remedy of the situation referred to by the Commission is found in the agreement between the Dominion and the Provinces, the text of which is contained in Chapter 13 of the 1942-43 Dominion statutes.

It is unfortunate that political expediency prompts extravagant promises and expenditures of large sums, followed by an ardent search for required revenues. While business is required to earn before it spends, governments operate in reverse process. Until government planning precedes government spending, we will not have a sound taxation base.

During the last session of parliament, commitments reached terrific proportions. A small percentage of the total, namely, some $200,000,000, represented the estimated annual cost of Family Allowances. R. J. Deachman, in a recent article, points out that this annual charge is equal to the interest upon an addition to the National Debt of $7,810,000,000. He asks the question—"Was this the best alternative use our genius could provide for the expenditure of $200,000,000 per annum?" Questions such as this challenge the thoughtful consideration of all members of the profession.

The first steps taken to widen the tax base and increase rates encountered little opposition from taxpayers, due to emergency conditions and patriotic considerations. This encouraged those responsible for the original proposals and further drastic increases followed, resulting in the present taxing provisions. We have reason to be confident now that the crucial stages of the conflict are over and we should properly be considering the problems of the post-war period. This involves careful study and planning and elimination of the imperfect foundation upon which our present tax structure is built.

A great jurist of the United States, Chief Justice Marshall, once said:

"The power to tax involves the power to destroy."

Taxation can be destructive. It can kill initiative and cripple industry, create unemployment and drive out wealth and youth in search of greater opportunity.

But taxation can also be constructive. It can provide incentive which will encourage industry and create employment and attract wealth and youth by offering greater opportunity.

Hazlett, in his "*Dynamic Capitalism,*" says:

> I need not elaborate the well-known fact that taxation may destroy any business; that it may bring about government ownership and destroy private property; that it may bring a nation to war by developing an excess of military power over the nation's need; that it may liquidate certain groups to the advantages of others, and that it may undermine incentives to work or to save, the habits which build character in individuals and the wealth of nations. But these facts bring us to the conclusion that we must comprehend the correct principles of collecting and spending taxes before we can hope to achieve our own freedom or that of other nations.

So that the mistakes of the past may be avoided, it is suggested that we make serious study of the problems with which we are confronted, to determine what amendments in our tax law are necessary to permit industry to function normally and employment to be maintained at satisfactory levels in the post-war period. This would no doubt involve the substitution of taxation provisions which are constructive and provide incentive for those which are destructive and kill initiative.

A step in the right direction was taken by Parliament in the recent amendment permitting losses to be written off in previous and succeeding taxation periods. This is a welcome recognition by the Crown that where it shares the profits, it should also share the losses.

A further step in the right direction was taken at the last Session of Parliament when it intimated its intention of appointing Commissions to investigate and recommend solutions of three of our most vexatious tax problems. We look forward with confidence to the findings of these Commissions.

Very little reference has been made in this paper to the plight of the individual as a result of the drastic tax increases in the past few years. Most individuals, appreciating the tremendous financial demands on the government in wartime, have been bearing courageously very heavy burdens.

The balancing of individual budgets after providing for taxes and other non-controllable fixed charges is in many cases impossible. The individual's controllable portion of salary has reached the vanishing point. There is no opportunity for saving. The present limitation upon the reward for success is seriously affecting business activity and progress. Early study of this problem and some immediate measure of relief to the individual are essential.

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