How Tax Barriers Stifle North American Capital-Market Efficiency -- and How Their Removal Would Deepen NAFTA Integration

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As we approach the 15th Anniversary of the Canada-U.S. Free Trade Agreement – and almost a decade after welcoming Mexico to the club – we have a significant opportunity to deepen our economic relationship throughout the North American space. In taking stock of the progress we've made and the opportunities that beckon, we shouldn't forget that while trade issues are often the bailiwick of foreign affairs departments, taxation policies – the purview of finance and treasury departments – have a critical role in the future development of NAFTA. I am convinced that the three NAFTA partners must focus on their tax systems as the key to dismantling the barriers to North American capital-market efficiency which, in turn, will improve the prosperity and well-being of all our citizens.

A critical lesson of the last decade of the 20th century is how useful it is for economies to open themselves to greater trade in goods, services and capital. The North American Free Trade Agreement has without doubt promoted dramatic economic gains for the three signing countries. Canadian and Mexican exports to the United States have risen to unparalleled levels, while the United States has provided a secure market for many commodities, including energy. NAFTA is living proof that free trade brings with it a higher standard of living. World Bank and IMF studies have come to the same conclusion: countries lift the prosperity of their people by opening up trade and eliminating tariff barriers used to protect domestic industries.

So, if there are substantial economic gains from free trade, why shouldn't we go further than the current agreement? Several prominent Canadians have already proposed just such a move – Allan Gotlieb, a former Canadian Ambassador to the United States, and Wendy Dobson of the University of Toronto, have put forward proposals for a "grand bargain" or "big idea" that would deepen NAFTA.

As part of that big idea, we should dismantle tax barriers to North American capital-market efficiency. Investors can benefit with higher risk-adjusted returns from their investments if they are able to purchase at less cost securities offered by North American business. Business will benefit from the removal of tax barriers to capital-market efficiency by borrowing in markets where they can benefit from the lowest cost of capital. Eliminating barriers would also enhance competition among security exchanges in North America. Consumers who can buy less-expensive products and workers who will have higher incomes due to improvements in productivity will also benefit.

At present, there are three important tax barriers to North American capital-market efficiency that should be eliminated. These include withholding taxes on cross-border flows of income, dividend integration systems that discriminate against securities offered on other North American stock exchanges and corporate tax rules that distort cross-border investments. I will look briefly at all three.

Withholding Taxes

One of the lessons that we can learn from European economic integration in the 1990s is the importance of dismantling withholding-tax barriers to cross-border flows of capital.

Withholding taxes on interest, dividends and other cross-border payments impose an extra level of tax on inter-country flows of investment when residents are unable to credit them against tax liabilities payable to their home governments.

In the Canada-U.S. context, withholding taxes impose significant costs on cross-border flows of capital. Currently, the Canadian government raises as much as C$2 billion annually in withholding taxes on dividends and a further C$150 million in interest. The U.S. government raises C$300 million in withholding taxes paid to Canadians in dividends and interest.

In a 2001 C. D. Howe Institute publication, I estimated that the elimination of interest-withholding taxes in the Canada-U.S. context and the withholding tax on arm's length interest for all other countries would increase capital investment in Canada by C$18 billion. Similarly, the elimination of dividend-withholding taxes would increase capital investment by C$9.5 billion.

I also estimated that the effective tax rate on capital in Canada would decline by almost 6 percentage points, or 20 percent of the existing level, if dividend and non-arm's length interest-withholding taxes were abolished. Canadian investment from the United States would rise by C$10 billion.

These economic gains are substantial – and at relatively small revenue losses to governments. A good place to start is the elimination of the withholding tax on interest, including non-arm's length interest, between Canada and the United States. Again the revenue cost is small, but the economic benefits are large, indeed. As C. D. Howe, a prominent Minister during the Mackenzie King and Louis St. Laurent governments, said almost a half-century ago in referring to a public expenditure of much greater consequence then: "what's a million?"

We must go further down the barrier-removal road. Canada, Mexico and the United States should abolish withholding taxes on income paid to residents of North America.

Dividend Taxation

Just like withholding taxes, dividend taxes discriminate against cross-border flows of income. The Canadian approach – providing a dividend tax credit, but only for dividends issued by Canadian companies – results in higher Canadian taxes imposed on dividends paid by companies listed on stock exchanges in the United States, Mexico and elsewhere. Mexico exempts dividends from tax as long as the dividend is paid out of taxable profits – otherwise both Mexican and foreign shareholders pay tax at a 35-percent rate. The recently adopted U.S. reform – taxing dividends at rates well below the normal personal income rate – will provide relief to U.S. shareholders, not only for dividends paid by U.S. incorporated companies but also qualified foreign companies in treaty countries or companies that are listed on stock exchanges in the United States.

Unlike Canada, the U.S. government clearly establishes a principle that cross-border investments should not be discriminated against under dividend tax-relief systems. This is a profound statement. However, the new law has an important limitation. The dividend relief is only provided if the U.S. Treasury determines that the tax treaty is satisfactory for the purposes of the law. Unlike Mexico, Canada may be put at a disadvantage if it maintains its discriminatory dividend-tax credit regime.

Without U.S. dividend relief provided for shares listed in other North American stock exchanges, businesses and investors will suffer the most. Canadian investors cannot as easily diversify their portfolios because higher taxes are applied to U.S. investments. U.S. investors will face the same consequence.

As well, without U.S. dividend tax relief for Canada, Canadian companies will want to establish a U.S. corporation, or list in the United States, to take advantage of the dividend-tax relief system. Even though most large companies already do this, many smaller ones will find that the Toronto Stock Exchange won't be as competitive if less favourable tax treatment prevails. The Canadian dividend tax rate – which can be as high as 32 percent -- compares unfavourably with the U.S. rate of 15 percent.

In the interest of North American capital market efficiency, I hope Canada and the United States can agree to provide dividend tax relief on a reciprocal basis. Mexico already provides it unilaterally. This is exactly how the current dividend tax credit system operates in Canada at the provincial level. For example, a resident in Alberta receives an

Alberta dividend tax credit whether the dividend originates from an Alberta-based company or from one in another province. In other words, to maintain capital market efficiency in Canada, provinces have not discriminated against non-resident Canadian companies when funding the dividend tax credit. Canada, Mexico and the United States could seek a similar agreement. Dividend tax relief would be provided no matter where the income is earned.

Cross-Border Corporate Tax Issues

Taxes also distort cross-border investment. In some cases, uncoordinated tax policies result in high taxes on cross-border investment, such as capital-gains taxes paid by shareholders on foreign assets when a deferral of tax is provided for gains on domestic acquisitions. In other cases, tax policies result in favouring cross-border investments, the most egregious Canada-U.S. case being Enron's acquisition of a Quebec pulp and paper company.

Corporate tax policies need not be the same for NAFTA partners, but some changes are needed if we are to establish neutrality between domestic and cross-border investments. Two specific situations will illustrate the problem:

- *Capital-gains taxes related to cross-border mergers and acquisitions*: Cross-border mergers and acquisitions increase competition in the market for management. Tax impediments to cross-border mergers undermine better corporate performance by protecting managers from corporate takeovers. Countries could consider providing reciprocal treatment under which shareholders would defer capital-gains taxes not only on share-for-share exchanges for qualifying domestic acquisitions, but also for cross-border transactions within North America. It seems inappropriate to me that businesses construct complicated structures to avoid triggering capital-gains taxes on cross-border mergers such as complex dual holding-company structures in order to achieve deferral of capital taxes for shareholders on both sides of the border. These structures are not necessarily established without some economic cost and distortions in decision-making.

- *Tax-efficient financing of cross-border investments*: At present, Canadian and U.S. law has the potential of encouraging too many cross-border transactions with tax-efficient financing schemes that result in a deduction for interest expense taken on each side of the border for the same investment. Economic efficiency is impaired because the cost of capital for cross-border transactions can sometimes be below that which would result if no taxes were levied in the first place. Governments have tried to limit deductibility of interest expense by imposing complicated so-called thin-capitalization, earnings-stripping and interest-allocation rules that sometimes have unfair consequences for companies that are not engaged in such practices. Far better would be to curtail the use of these corporate structures so that domestic and cross-border investments are treated on the same basis. Canada and the United States could then suspend the use of thin-capitalization and other rules that are directed at foreign-owed companies. A recent European Court of Justice ruling has, in fact, declared German thin-capitalizations to be discriminatory because they only apply to companies owned by non-resident shareholders in other European Union countries. In North America, we should be considering changes that would eliminate discriminatory tax provisions to achieve more neutral treatment of domestic and cross-border transactions.

Corporate tax issues, as illustrated by these two examples, are complicated because attempts to eliminate distortions affecting cross-border investments can affect domestic law. However, in a limited way, Canadian, U.S. and Mexican tax authorities can work to reduce some corporate tax barriers to North American capital efficiency without impairing their own tax systems. It is an objective worth pursuing.

Conclusion

To wrap up, I’ve tried to make a case for pursing an objective that should become more central to tax policy in the coming years – achieving North American capital-market efficiency. Certainly, the abolition of withholding taxes, discriminatory dividend tax relief systems and some limited corporate tax harmonization would go some way to integrating our capital markets in North America.

The potential gains for people in all three countries are substantial. Capital-market efficiency means better returns on diversified asset portfolios held by investors, and lower costs of capital for businesses. With increased capital market efficiency, consumers ultimately gain from having cheaper products and workers from higher incomes. All this sounds like a slam-dunk to me. Governments should get in the game!