David Dodge: Income trusts

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the House of Commons Standing Committee on Finance, Ottawa, 1 February 2007.

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Good morning, Mr. Chairman, and members of the Committee. I'm happy to be here and to assist the Committee, insofar as I am able, in your study on income trusts.

I should start by making clear where the Bank of Canada's main interest in the income trust sector lies. Our interest in income trusts relates to the efficient functioning and health of Canada's financial system. A safe and efficient financial system is essential to Canada's economic well-being. The Bank of Canada works with other government agencies, as well as market participants, to promote the safe and efficient functioning of the financial system. Capital markets are a key component of that system. And so we are naturally interested in developments in financial markets – such as the evolution of the income trust market – that have the potential to affect financial system efficiency.

With that introduction, let me quickly summarize the highlights of the Bank's analysis of this topic. I'd refer committee members to the June 2006 edition of our Financial System Review. In that publication, we noted that limited evidence suggests that income trusts can enhance market completeness in a couple of ways. First, income trusts can provide diversification benefits to investors, because trusts can have different risk-return characteristics than either equities or bonds. Second, the income trust structure appears to allow some firms improved access to market financing. So, insofar as income trusts allow investors to achieve risk-return benefits that they could not otherwise achieve, and serve as a source of financing to firms that might not otherwise have had access to markets, it can be said that income trusts enhance market completeness, and therefore support financial system efficiency.

That same article also noted two areas where the standards for trusts are not the same as those for corporations, and where improvement is clearly needed – standards related to accounting, and those related to governance.

These are the aspects of income trusts that we at the Bank have looked at and on which we are best able to comment. Of course, there are very important public policy questions related to income trusts that fall outside the Bank's mandate. The Bank has done no specific research on how the income trust structure affects economic performance, or would affect the future productivity of the Canadian economy.

But, based on general economic principles and my understanding of the structure of the Canadian economy, I can say that while the income trust structure may be very appropriate where firms need only to manage existing assets efficiently, it is definitely not appropriate in cases where innovation and new investment are key. To the extent that the system was favouring the use of the income trust structure in these cases, the incentives for innovation and investment were reduced, and the potential for future productivity growth was reduced.

Finally, members of the Committee should realize that the different risk-return characteristics of income trusts may not enhance market completeness if they arise from differences in tax treatment. Clearly, there has been a very significant tax incentive to use the income trust form of organization in cases where this would not have been the appropriate form of organization from a business efficiency point of view. By giving incentives that led to the inappropriate use of the income trust form of organization, the tax system was actually creating inefficiencies in capital markets, inefficiencies that, over time, would lead to lower levels of investment, output and productivity.

While we at the Bank have not done any research on how the rules of the tax system could be designed so that they do not give inappropriate incentives that would bias the choice of firms to operate either as an income trust or as a corporation, the changes proposed by the government last October would appear to substantially level the playing field. For the income trust sector to deliver efficiency benefits through the enhancement of market completeness, it's important that the tax system provide a level playing field.