taxable. However, the financial institutions on these financings turn over a significant portion of the tax savings to the issuing corporation in the form of lower interest costs. Banks thus receive a pre-tax income on these issues that is well below that of other financings. Typically, for example, if a bank received 12 per cent on traditional debt, its return both before and after tax on term preferred share financing would be in the range of 6 to 7.5 per cent. In other words, they share with the borrower in the tax advantage.

There are two major reasons for the decline in the effective tax rate of banks. The first, as I indicated yesterday, is that the full impact of income debenture and term preferred share financing entered into last year would not appear until this year. Secondly, it is apparent that the spread between borrowing and lending rates on conventional financing has fallen, resulting in less revenue from this part of the banks' operations. As a result, the mix of banks' income has shifted so that a smaller proportion is coming from fully taxable operations. The reduction in the spread can result in a decline of pre-tax balance of income and thus a loss for tax purposes which may be carried forward or backward to reduce taxes in other years.

It would be misleading to conclude from the decline in the banks' effective tax rate that they have been the major beneficiaries of income debenture and term preferred financing. As I have just indicated, banks receive a lower return on this lending.

Over all, for the first nine months of the 1979 year the balance of revenue after tax as a percentage of shareholders' equity has also declined, from 12.4 per cent in the same period a year ago to 11.9 per cent this year.

There was also a question addressed as to when we might expect this carry-over effect to alter. I can say that most of these agreements have a three to five-year term, so there is an automatic expiry which will begin to take effect with some almost immediately, but we will feel the effects for another three years or so at least.

Mr. Rae: Mr. Chairman, I appreciate that explanation which I think makes the situation clear for those of us who are attempting to understand the nature of this device. I do not think the reason that this has been closed was made particularly clear by this government. Some reasons were expressed by the previous minister of finance in his budget speech of November, 1978 to the effect that whereas this was initially put in the Income Tax Act in the 1930s as a method of providing easier means of financing for certain small companies, it was now becoming an increasingly common device used by all corporations in their corporate financing.

Mr. Crosbie: Not all. A few did not have taxable income.

Mr. Rae: Well, by many. One of the things that would be of interest to the Canadian people would be to know what kinds of corporations are in a position to take advantage, or have been in a position to take advantage, of this break. If it is not the banks that are taking advantage of that significant tax break, it will be the corporations. If there had not been some kind of abuse building up in the system over the past three or four years, I suggest to the parliamentary secretary and the minister that they would not have felt obliged to close this particular loophole.

I should like to ask the parliamentary secretary for something of the history of the use of this device, as I did last night, in order that we might understand how it is that what was begun as a technique for allowing smaller corporations to finance themselves has been used by other corporations.

Mr. Crosbie: What happened, of course, is that this was a provision in the act to assist corporations that were in financial difficulty during the 1930s. That is why these provisions were originally put in. What happened, however, was that borrowers started to use them who did not have taxable income, not because they were in financial difficulties, although that could happen, but because of existing tax incentives such as fast write-off, manufacturing assets, general treatment for exploration and development expense, or where a borrower's income was tax exempt, or it might be a public holding corporation receiving dividends from other Canadian companies.

What happened in the last three or four years when this started to get really popular was that most of the companies borrowing under these arrangements were large corporations and they used this provision to refinance existing bebt. It was used for purposes entirely unconnected with its original intention.

I do not know why no steps were taken sooner than last November, but in October, 1976, the holdings of income debentures and term preferred shares by chartered banks totalled $765 million. In October, 1977, they totalled $3,037 million, and in October, 1978, $7,200 million. On November 16, 1978, they totalled $10,100 million, which shows hon. members how rapid the expansion was.

● (1300)

The increase in bank holdings of that kind of instrument grew $6.9 billion between October, 1977, and November, 1978. Why some action was not take sooner to put a stop to this loophole, I do not know.

The Assistant Deputy Chairman: Order. It being one o'clock, it is my duty to rise, report progress, and ask leave to sit again later this day.

Progress reported.