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Estimating the Impact of the Capital Gains Tax Increase on Canada's Economy

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Introduction

One of the most consequential policy changes in this year's federal budget was the increase to the capital gains tax rate.[1] In particular, the government increased the tax rate on realized capital gains from the disposal of assets by including two-thirds instead of one-half of gains as part of income as of June 24, 2024. For individuals, the increase applies to realized capital gains net of losses in excess of $250,000. For corporations, the hike applies to all of their capital gains net of losses.

In a previous article, I analysed the reach of the tax change by estimating the number of taxfilers who would be affected over their lifetime.[2] The key finding was that it would affect far more Canadians than the government seemed to anticipate. On a lifetime basis, I estimated that 1.26 million Canadians (almost 5 percent of taxpayers) will be affected by the increase in the capital gain tax on individuals, half of whom earn less than $117,000 per year. My analysis at the time didn't assess the macroeconomic effects, specifically for investment, employment, and economic output.

Yet a key assumption of the government is that the tax increase will have a limited effect on Canada's economy. In particular, the budget stated: "Increasing the capital gains inclusion rate is not expected to hurt Canada's business competitiveness."[3]

The International Monetary Fund reached a similar conclusion based on its focus on the capital taxes paid by individuals. It observed that "it [the tax change] is likely to have no significant impact on investment or productivity growth."[4]

These claims conflict with a large body of research on the economic costs of capital gains taxes.[5] While studies often focus on capital gains taxes paid by individuals, they typically fail to account for the increase in the corporate capital gains tax rates that would undoubtedly affect many companies that rely on equity financing.

It is important to note that financial traders aren't affected by the budget proposal since their capital gains are fully taxed as a source of business income. Banks and insurance companies also pay capital gains taxes on mark-to-market basis (which is a tax on market value increase in their portfolio net of losses). These latter points were missed by a paper recently published by the Centre for Future Work that claimed financial intermediaries had declining employment despite their supposed capital gains preference.[6] That conclusion was flawed since corporate capital gains earned by financial intermediaries are generally fully taxed and thereby unaffected by the budget proposal.

The purpose of this latest paper therefore is to better understand the economic effects of the capital gains tax increase—with a focus on investment, jobs and GDP. In particular, I estimate Canada's capital stock will fall by $127 billion; employment would decline 414,000; GDP will fall by almost $90 billion; and real per capita GDP will decline by 3 percent.

1 Department of Finance, *Budget 2024*, (Ottawa: Government of Canada, 2024), https://budget.canada.ca/2024/report-rapport/budget-2024.pdf.

2 Jack M. Mintz, "The Capital Gains Tax Hike Will Hurt the Middle-Class Too," *The Centre for Civic Engagement*, June 27, 2024, https://centrecivicengagement.ca/wp-content/uploads/2024/06/CCE_CapitalGainsTaxHikeReport_v1.pdf.

3 Finance, *Budget 2024*.

4 "Canada Staff Concluding Statement of the 2024 Article IV Mission," *IMF*, June 11, 2024, https://www.imf.org/en/News/Articles/2024/06/10/61024-canada-staff-concluding-statement-of-the-2024-article-iv-mission.

5 Jason Clemens, Charles Lammam and Matthew Lo, T*he Economic Costs of Capital Gains Taxes in Canada*, (Vancouver: The Fraser Institute, 2014), https://www.fraserinstitute.org/sites/default/files/economic-costs-of-capital-gains-taxes-in-canada-chpt.pdf.

6 Jim Stanford, "Fact and Fiction on Capital Gains Taxation: A Chartbook," *Centre for Future Work*, August 2024, https://centreforfuturework.ca/wp-content/uploads/2024/08/Capital-Gains-Chartbook.pdf.

Capital Gains Taxes Hurt Business Investment

Neither the Department of Finance nor the IMF produced estimates of the impact of the capital gains tax increase on the economy, specifically investment, employment and GDP. So why did they claim it had no impact on business competitiveness?

There are two possible reasons for this. First, it's typical to assume Canada is a small open economy in capital markets. Under this assumption, businesses borrow freely in international markets at a world interest rate and Canadian saving has no discernible impact on the international interest rate. Even if capital gains taxes discourage Canadian investors to buy corporate equities and bonds, it will have no impact on business investment since companies still borrow at the same international market interest rate.

Second, the typical investment modelling by Finance Canada (the marginal effective tax rate) includes the corporate income tax and provisions, sales tax on capital inputs and asset-related taxes. However, corporate capital gains taxes are not included in the modelling (only the personal capital gains tax is included). So, obviously, an increase in the corporate capital gains tax rate will have no impact on investment in the model.

Neither of these assumptions holds up. While the Canadian capital market is only 2.5 percent of the world stock markets, Canadian companies depend very much on equity capital provided by domestic households, even the largest companies.[7] As many studies have shown, Canadians invest 52 percent of their equity portfolio in Canadian markets even though a properly diversified portfolio would suggest only a small portion of assets would be invested at home.[8]

There are many reasons for "home bias" in equity shares. Smaller companies don't have easy access to international markets. Companies that are Canadian-controlled need a significant share of Canadian ownership beyond 2.5 percent. Also, Canadians have more information about domestic opportunities and risks than they have with respect to international assets. While Canada doesn't have capital controls (except Investment Canada limitations on foreign direct investment), the dividend tax credit and certain other tax preferences apply to only Canadian resident companies, not foreign ones. Thus, under home bias, capital gains taxes have been shown to suppress equity values and raise the cost of equity-financed investment of Canadian companies.[9]

7 "Distribution of countries with largest stock markets worldwide as of January 2023, by share of total world equity market value," *Statista*, March 19, 2024, https://www.statista.com/statistics/710680/global-stock-markets-by-country/.

8 Ruth Saldanha, "Canadians have 15x More Exposure to Canada Than They Need to," *Morningstar*, July 20, 2023, https://www.morningstar.ca/ca/news/237246/canadians-have-15x-more-exposure-to-canada-than-they-need-to.aspx.

9 Kevin Milligan, "Capital Gains Taxation: Recent Empirical Evidence," https://www.academia.edu/52534526/Capital_Gains_Taxation_Recent_Empirical_Evidence.

Based on Statistics Canada data, I estimate that Canadian households own 35.5 percent of large company shares listed in Canada.[10] If there were no home bias, Canadian household ownership of Canadian companies would be obviously much smaller and have little impact on the cost of investment for large companies.

As for corporate capital gains, they are paid when companies operate in Canada regardless of ownership. Corporate capital gains are earned when physical and financial assets are sold. Corporate capital gains taxes are also paid when corporate reorganizations take place such as in the case of mergers and acquisitions. Since the corporate tax applies to nominal capital gains, that capital gains tax increases the cost of investment even if there are no real capital gains.

From 2011 to 2021, taxable corporate capital gains are roughly 7 percent of corporate taxable income of non-financial corporations.[11] Based on merger and acquisition data and the market value of the stock market, I estimate a fairly long holding period for corporate shares (35 years), not dissimilar for structures. Taking into account short holding periods for trading financial assets, I estimate that the annualized non-financial capital gains tax rate (the so-called accrual-equivalent capital gains tax rate) rose from 6.4 percent to 8.5 percent due to the budget's capital gains tax hike.

Thus, the effect of the budget's tax change is twofold. According to financial theory, the supply cost of equity increases as the personal tax on capital gains (and dividends) rises with income.[12] Thus, the marginal investor providing equity finance to companies are higher-taxed investors such as those with gains of more than $250,000. Further, the corporate capital gains tax changes increased taxes on investment for large, medium and small non-financial companies.

10 "National balance sheet and financial flow accounts, first quarter 2024," *Statistics Canada*, June 13, 2024, https://www150.statcan.gc.ca/n1/daily-quotidien/240613/dq240613a-eng.htm.

11 "Balance sheet, income statement and taxation statistics with selected financial ratios, by non-financial industries," *Statistics Canada*, May 13, 2024, https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3310050001.

12 Merton H. Miller, "Debt and Taxes," *The Journal of Finance* 32, no.2 (1977): 261-275.

Impact on the Economy

Overall, the capital gains tax hike has a significant impact on both the incentive to hold capital in Canada and employment. At least half of the impact is due to the increase in the corporate capital gains tax rate.

The budget's capital gains tax hike increased the tax-inclusive cost of capital for large companies by 5 percent (according to estimates by Philip Bazel and me using our marginal effective tax rate model). Based on conventional assumptions that an increase in the tax-inclusive cost of capital by 10 percent causes the capital stock to fall by 7 percent, I estimate that Canada's capital stock would fall by $127 billion. Employment would permanently decline 414,000. To put this in terms of its impact on unemployment, the capital gains tax hike would increase unemployment from 1.5 to 1.9 million of Canadian workers as of August 2024.[13] GDP will fall by almost $90 billion and real per capita GDP by 3 percent.

While the impact of the capital gains tax hike is not catastrophic, it is meaningful. It's another hit on Canada's productivity and economic growth on top of other tax increases and more important, regulatory obstacles to investment.

What about neutrality?

It is not just tax rates that affect economic growth and productivity. Tax distortions that result in the misallocation of resources also undermine productivity when capital resources are misallocated in the economy. With capital gains taxation, however, the impact on distortions is rather complex.

The strongest argument made for increasing the capital gains tax from one-half to two-thirds of the ordinary personal income tax is neutrality in financial structures.[14] As the federal-provincial corporate income tax rates have fallen from 43 percent to 26 percent today, the dividend tax credit was reduced. This resulted in dividend tax rates rising since 2000 while the capital gains tax rate remained unchanged at one-half of the personal income tax rate. When dividends are taxed more heavily than capital gains, it encourages companies to pass out income to investors in the form of capital gains rather than dividends. This is one distortion addressed by the budget, although limited to capital gains in excess of $250,000.

With the corporate capital gains tax, however, a different distortion arises in that corporate capital gains are taxed more heavily than inter-corporate dividends (the latter are exempt from taxation to avoid double taxation on profits distributed from one corporation to another). When corporate capital gains are more heavily taxed than dividends, companies are encouraged to structure inter-corporate payments as dividends rather than capital gains. Thus, increasing the corporate capital gains tax rate widens the distortion between dividend payments and reinvested earnings at the corporate level. As shown in a recent European study, the corporate capital gains tax distorts the market for corporate control by discouraging acquisitions and mergers, resulting in a foregone deal loss of $1.1 billion in 2013 for Canada.[15]

[13] "Labour Force Survey, August 2024," *Statistics Canada*, September 6, 2024, https://www150.statcan.gc.ca/n1/daily-quotidien/240906/dq240906a-eng.htm.

[14] Trevor Tombe, "Why raising capital gains taxes makes sense—yes, really," *The Hub*, April 17, 2024, https://thehub.ca/2024/04/17/trevor-tombe-why-raising-capital-gains-taxes-makes-sense/.

[15] Maximilian Todtenhaupt, et al., "Taxing away M&A: Capital gains taxation and acquisition activity," *European Economic Review* 128 (2020), https://www.sciencedirect.com/science/article/pii/S0014292120301367.

Further, the budget introduces a new distortion in the tax system. In the past, the capital gains tax at the corporate level was the same as that paid by individuals. The reason for this policy was to minimize the incentive to hold assets at the corporate or personal level to avoid capital gains taxes. For example, if there were no corporate capital gains tax, an investor could avoid capital gains taxes by selling real estate assets held by the corporation rather than selling them as an individual.

The 2024 budget introduces a lower tax rate on capital gains at the individual level (due to the $250,000 exemption) compared to the corporate level. This will encourage investors to hold equities directly rather than at the corporate level. While this might seem innocent, it can create distortions in the allocation of capital. For example, corporate assets are subject to limited liability and can be jointly held by many investors. By pushing assets to be held at the individual level, some of the benefits of incorporation can be lost.

Further, the increase in the capital gain tax rate encourages investors to hold on to assets longer rather than replace them with assets that provide superior returns to equity.[16] Capital gains taxes also discourage risk-taking since the government taxes the nominal gains but does not provide a refund for potential losses.

Taking into account all these considerations, the 2024 budget reduces some but increases other tax distortions. Productivity is likely reduced simply by raising taxes on capital investment.

[16] Clemens, Lammam and Lo, *The Economic Costs of Capital Gains Taxes in Canada*.

Key Takeaways

Overall, the increase in the capital gains tax rate at both the corporate and personal level is expected to discourage business investment and employment, unlike that claimed in April's federal budget or by the IMF. I find that the increase in the capital gains tax rate will reduce Canada's GDP by $90 billion, real per capita GDP by 3 percent, its capital stock by $127 billion and employment by 414,000. This is not a trivial loss to the Canadian economy.

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