Centre for FutureWork

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House of Commons Standing Committee on Finance

Re: Changes to Capital Gains and Corresponding Measures Announced in Budget 2024

Tuesday June 18, 2024

Introductory Remarks

Thank you for the opportunity to participate in this inquiry. I am Economist and Director of the Centre for Future Work, a labour economics research institute based in Vancouver. I hold a PhD in Economics, honorary appointments at McMaster University and the University of Sydney, and have 30 years of professional experience in economic policy analysis.

The 2024 federal budget allocated modest new resources to several important initiatives: including the school lunch program, affordable housing measures, the roll-out of the dental care program which is proving very popular, and the new disability benefit. These new programs are welcome and important.

At the same time, the budget reaffirmed its commitment to previously stated fiscal targets, expressed in terms of a falling ratio of debt to GDP. How could it announce new programs, but still meet its fiscal targets? New revenue from reforming capital gains taxation allows it to achieve both goals. The change in capital gains taxation is projected to raise close to $20 billion over the next five years.

It is as important, in my view, to consider what new fiscal resources are being used for, as to consider how they are raised. Those new programs will make Canada fairer and healthier. And the fact they will be funded with new revenues collected primarily from high-income Canadians, by narrowing a lucrative and unfair tax loophole, makes this combination of tax reform and new programs a double-barreled boost for fairness.

From my perspective as an economist, let me briefly highlight two important aspects of the capital gains tax reform: first, the very unequal distribution of capital gains (and associated tax savings), and second, the lack of connection between capital gains taxation (and capital taxation more generally) and business capital spending in Canada.

There is no other tax loophole more closely targeted at high-income Canadians than the partial inclusion of capital gains. In 2021 (latest year of Revenue Canada data available), 61% of taxable capital gains were claimed by Canadians with total income over $250,000 that year. That group makes up only 1.5% of taxfilers – yet they claimed 61% of all capital gains, and an even larger share of the tax benefits from partial inclusion (since they receive higher marginal tax savings than other Canadians). 56% of those high-income taxfilers reported capital gains, an average of $180,000 each.

In contrast, seven-eighths of taxfilers reported income below $100,000. Less than 10% of them reported any taxable capital gains at all – most of them very small. Combined, they received just 15% of all capital gains. And an even smaller share of the tax benefits.

So capital gains are concentrated among the highest income households. And so are the favourable tax benefits provided by the current tax system. The vast majority of Canadians will not be affected directly by this change in tax treatment of capital gains for individuals. Most do not receive capital gains at all. And most of those who do, receive well under the threshold for the higher inclusion rate. But those Canadians will benefit from the new programs these revenues will help fund.

By the same token, most of those affected by this reform will be very high-income Canadians, who have been benefiting from a lucrative, targeted, and ultimately inefficient tax loophole that should be narrowed.

Some argue that reducing capital gains exemptions will discourage business capital investment. But the economic evidence shows no connection between capital gains exemptions and rates of business investment in new capital or research, or productivity.

Canada's rate of business investment, especially in machinery and equipment, has been declining since the 1990s. Business and capital taxes have been significantly reduced in that same time: with lower corporate tax rates, lower capital gains and dividend taxation, harmonized sales taxes, and other reforms. All those tax changes were supposed to elicit more business investment. But we've seen less.

In the 1990s, when the capital gains inclusion rate was 75%, and the federal corporate tax rate was 28%, Canadian business invested 5.6% of national GDP in machinery and equipment. In the last ten years, with the inclusion rate at 50%, and a 15% corporate tax rate, machinery and equipment investment averaged 3.5% of GDP – two full percentage points of GDP lower. R&D spending also declined in the same period, as has productivity growth.

Many complex factors determine business investment, and reversing this decline is an urgent economic priority. I have my own theories about the weakness in capital spending: such as Canada's over-reliance on resource extraction and export, the impacts of excessive financialization, the housing bubble, and structural weaknesses of business leadership in Canada. Many policies will be needed to improve Canada's investment and innovation performance – and that will be a bigger discussion.

But it is clearly not credible to blame taxes for this poor performance: taxes have become far more business-friendly over the last quarter-century, but business has responded to by going backward, not forward. Tax policies in general have a second-order influence on investment. Indeed, in some ways, excessively favourable capital gains taxation can undermine corporate investment spending: by distorting the choice between different capital structures, and encouraging cash flow stripping from corporations.

In sum, this reform in capital gains taxation is important in improving the fairness of Canada's tax system, and reducing distortions that encourage tax avoidance and underinvestment. Just as important, it will help fund new programs from the federal government that will make a positive difference in the lives of millions of Canadians. I recommend passage of this legislation. Thank you again for the opportunity to appear before you.