# *Intelligence* MEMOS

From: Duncan Munn, John Manley and Dwight Duncan

To: Finance Minister Chrystia Freeland

Date: April 30, 2024

Re: **SHORT-SIGHTED CAPITAL GAINS CHANGES WILL BRING LONG-TERM CONSEQUENCES**

This month's federal budget asks the wealthiest among us to pay for spending initiatives to address intergenerational fairness.

A better way to finance new spending would be to arrest and reverse Canada's growth and productivity challenges. Not only does the budget not do that, but its increase in the capital gains inclusion rate from 50 percent to 66 percent for corporations, trusts, and individuals on gains in excess of $250,000 a year is likely to make these challenges worse.

Some owners of small businesses who are active in their businesses will catch a break – just a 33-percent inclusion rate up to a maximum of $2 million in lifetime capital gains – provided they don't operate in the financial, insurance, real estate, food and accommodation, arts, recreation or entertainment sectors. This very targeted measure costs only $150 million per year at the end of the budget horizon, compared to the $5 billion in revenue forecast from the increase overall.

It's easy enough to dismiss concerns over this tax increase since it's meant to affect only a few individuals. But at the end of the 1990s a Liberal government lowered the inclusion rate, and there were good principle-based reasons then that remain relevant today.

Some policymakers argue that low capital gains taxes represent unfair loopholes. But it's essential to recognize the unique role of capital gains in fostering entrepreneurship, investment and economic growth – the very things Canada needs to focus on now.

There are several reasons why increasing the inclusion rate is a bad idea.

First, the notion that capital gains are enjoyed only by a few older, wealthier people is false. This budget that is supposedly aimed at generational fairness seems to miss the fact that many young people are risk-takers, too, and on a mission to create the next business-busting model. Many young people will feel the pinch of this tax increase before long. Others will arrange their affairs to avoid it altogether.

Second, most of the bigger capital gains that would face the higher inclusion rate are the result of holding assets for a long time – 10, 15 or 20 years – which means much of the return merely compensates for lost purchasing power due to inflation. In theory, we could deal with this unfairness by indexing capital gains but in practice that's hard to do. Instead, a rough-and-ready – but fair – solution is to lower the effective tax rate on gains to account for inflation.

Third, just like capital, people are mobile. Those most affected by this new tax are also those whose mobility is greatest. Canada risks losing part of its entrepreneurial class to other jurisdictions. Those who are thinking about capital formation for future gains – Canada's young business leaders – may well decide to grow their capital in jurisdictions where gains are treated better, in which case we will lose their talent.

Fourth, taxing capital gains upon realization creates a "lock-in" effect: Investors delay asset sales to avoid taxation. This distorts investment decisions, misallocating resources and discouraging efficient diversification. Economic growth suffers as a result.

Finally, taxing capital gains amounts to double taxation: Corporate earnings are taxed once before they reach individual shareholders, only to be taxed a second time. Even in a world stepping back from globalization, capital remains highly mobile. That makes competitiveness a crucial consideration in tax policy. The comparison that matters most for Canada is with the US. Despite high-profile trade irritants, our two economies remain highly integrated. Higher tax rates on capital gains deter job-creating investments and encourage capital flight, ultimately undermining economic growth and our standard of living.

Lower capital gains taxes encourage entrepreneurship by improving the potential payoff from successful ventures. High earners, who often serve as angel investors or venture capitalists, are pivotal in funding startups and growth companies. Increasing capital gains taxes discourages such investment, stifling innovation and economic dynamism.

Economic evidence suggests capital gains tax cuts can increase realizations and investment, which over time generate government revenue and spur economic growth. Because of these effects the revenue losses from capital gains tax cuts may be smaller than anticipated, while the economic benefits can be substantial in terms of innovation, productivity and overall prosperity.

On a practical level, the government's decision to carve out some investments for favourable treatment adds significant complexity and, at a basic level, begs the question: What problems are we trying to solve with this tax? The government is taxing the proceeds of investment, which implies investment is a problem. But of course, with our productivity growth stalled and our competitiveness in decline, our real problem is not too much investment but too little.

Rather than hiking capital gains taxes, the federal government should be prioritizing policies that foster investment, entrepreneurship and economic growth.

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