Drunk on spending, the Liberal government’s too addled to see the idiocy of raising capital gains taxes

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Rumours are swirling that the March 22 federal budget will significantly increase the capital gains tax. This would be very bad policy, especially since the U.S. government intends to move in the opposite direction. Still, the Liberals may be tempted to go down that route because they find themselves in a fiscal pickle, to a significant degree of their own making.

We are told that the budget will not contain big new spending programs. So they want to protect their left flank from the NDP by “soaking the rich,” irrespective of the negative impact on the country. It is easy to imagine the prime minister once again deriding the infamous one per cent and vowing to protect the middle class, many of whom would be hit by the tax increase.

Capital gains taxes are imposed on the sale of assets, like stocks and property other than a principal residence, that have increased in value in non-registered accounts. Currently, 50 per cent of gains are included in taxable income, so that the rate is effectively half the marginal rate. The speculation is that the inclusion might be moved to 75 per cent, resulting in an alarming 50-per-cent increase in the tax rate. If it were increased instead to two-thirds, that would drive up the tax by one-third, still a brutal hike.

You would think that a government that professes to be concerned about the adequacy of retirement savings would avoid discouraging savings. Yet a capital gains tax does precisely that. The Liberals clearly prefer government pensions and income supplements to private savings, the nanny state over the private sector. Furthermore, a capital gains tax unfairly taxes appreciation resulting from inflation. People will see their net worth decline in inflation-adjusted terms because of a government whose profligacy has pushed up prices. Taxing capital gains also imposes double taxation. Alienating investors and job-creators is rarely conducive to economic growth.

The Liberal government is earnestly searching for funds for its ever-escalating social programs and much ballyhooed and elusive infrastructure spending, much of which has not been for infrastructure at all. The deficit has almost tripled from the “modest” $10 billion promised in the election platform. The Finance Department projects deficits continuing past mid-century, with debt ballooning to $1.5 trillion by 2045. Meanwhile, growth remains modest, in spite of the stimulus spending. So the minister of finance is in a squeeze and is looking avariciously at anyone who may want to realize a gain on their investments.

Moving the inclusion rate from 50 per cent to 75 per cent on $25 billion in gains in 2014 would imply more than $3 billion in additional revenue to the federal government. However, estimates based on previous years’ returns are invariably inflated. The reason is that the tax is voluntary and is only triggered when assets are sold. A high rate produces a “lock-in effect” whereby taxpayers avoid selling assets to delay paying the elevated tax. They can also get creative in re-ordering their affairs to avoid
the hit completely. Indeed, tax attorneys are already advertising their ability to create structures to achieve that result.

In the view of most economists, a capital gains tax will slow economic growth, reduce employment and cut take-home pay. Attractive investments may not be pursued because capital will be left in sub-optimal investments simply to avoid taxes. The result is distorted capital allocation and economic inefficiency. Higher taxes also reduce return on capital, discouraging investment. This is particularly true for manufacturers and risk-taking entrepreneurs, leading to diminished research and development, innovation and productivity improvement.

A higher tax will undermine Canada’s ability to attract and retain capital, especially in competition with our neighbours. President Trump has been clear he wants to reduce tax rates and the Republican congressional majority is working on an ambitious tax reform plan. While there is uncertainty about timing and important details, it is quite likely American personal and corporate rates will come down significantly. The U.S. capital gains tax is currently 25 per cent at the federal level, with the intent to reduce it to 20 per cent. Combined with state taxes, the average rate was 28.7 per cent in 2014. Moving the inclusion rate in Canada to 75 per cent, would drive our rate up to over 40 per cent in Ontario. At a two-thirds inclusion rate, it would raise it to 36 per cent. As Jack Mintz pointed out recently in FP Comment, Canada’s performance for investment in manufacturing and service sectors has been particularly disappointing, far lower than the world’s largest economies. A higher capital gains tax would make things worse.

Bad policy but good politics can degenerate into bad policy and bad politics should poor economic performance, stubborn unemployment and mushrooming debt hurt the Liberal base. Then, the government will have the worst of both worlds.

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