WhiteHaven

Grounding Canadians: The Real Aim of the Capital Gains Tax

BY TOMMY BALTZIS, CFA, CPA

Canada's decision to raise the capital gains tax has set off ripples not only through investment markets but has also cast a spotlight on a deeper economic malaise gripping the nation—a creeping surrender to mediocrity. This hike is not merely a tax increase; it's a symptom of a country grappling with its identity, economic vigor, and global stature. But let's unpack this step by step:

Reverse Immigration: Please don't GO! Traditionally, Canada has been viewed as a land brimming with opportunities. Yet, a worrying trend is emerging—a reverse in immigration flows. Skyrocketing living costs are driving residents away, akin to the brain drain seen in economically unstable areas worldwide. Immigrants, once drawn by policies aimed at rapid population growth to counter aging demographics, are now rethinking their options as the affordability of life deteriorates.

Interprovincial Migration: Just as you often hear about the migration trends to Texas and Florida in the U.S., a similar pattern is unfolding in Canada, with Alberta becoming a prime destination for many. Like chess pieces shifting across a board, Canadians are relocating from one province to another—not in a grand strategy for progress but as a tactical move to cope with the spiraling cost of living and the hunt for stable employment. This migration, driven by necessity rather than opportunity, highlights a troubling economic disparity across the regions.

Talent Drain: Come study in Canada…and then leave! The Canadian dream is fading for many skilled workers and innovators who arrive here. After struggling with job markets that don't value their expertise or navigating bureaucratic red tape, many choose to leave. This loss of talent stifles economic innovation and growth, similar to the challenges faced by other Western nations.

Declining Productivity: It is in fact a reality…Mexico is now more productive than Canada! Productivity has been the backbone of economic health, yet Canada now lags behind. Canada is facing challenges with productivity due to several factors including high levels of industry concentration, interprovincial trade barriers, and low private sector R&D. New workers often enter less productive sectors and there's an underutilization of immigrant skills. Moreover, Canadian workers have less capital at their disposal compared to other countries, impacting output per hour worked.

Lack of competition: Canada's competition laws need to be updated to help businesses compete better and give consumers more choices and lower prices. Recent studies have found that competition among businesses has decreased, meaning that a few big companies are controlling more of the market, specifically in airlines, telecom and groceries. This makes it harder for smaller companies to succeed and for prices to go down.

Intergenerational Wealth Transfer: By 2026, Baby Boomers are expected to transfer nearly $1 trillion to millennials, potentially boosting passive income through inheritances. However, this may lead to financial complexities due to the real estate bubble and a preference for passive investments over active business ventures, which could further decrease economic productivity. Without careful management, this wealth transfer might result in capital being tied up in passive assets rather than in productive entrepreneurial activities essential for Canada's economic growth

Public vs. Private Sector Dynamics: Government job growth, while stable, may surpass the private sector's capacity to innovate, leading to an economy reliant on regulation over market-driven creativity. As public sector growth continues, the private sector, the traditional driver of innovation, is losing momentum. This trend risks creating an economy with complacent stability, lacking the competitive spirit that once fueled Canada's growth, sustained more by government hiring than private sector innovation.

Stagnation Similar to Japan's Lost Decade: We can learn from history! In Japan's "Lost Decade," economic stagnation was prolonged partly due to government policies that maintained existing corporate structures instead of allowing market forces to reallocate resources towards more innovative and efficient uses. Drawing a parallel, Canada's labor market, with its strong public sector growth, may risk a similar stagnation. In addition, lets us not forget that Japan's stock market took almost 35 years to hit an all-time highs again, and returns from real estate were flat for close to 20 years.

Fiscal Policies and National Debt: The 2024 Canadian federal budget prioritizes housing and introduces taxes on the highest earners, resulting in a projected deficit of $39.8 billion. It focuses on enhancing housing supply and social supports, with continuous spending showing no signs of slowing down. Additionally, the capital gains tax hike may dampen the entrepreneurial and investment enthusiasm needed for innovation and economic growth.

Competitive Edge in the Global Economy: OECD insights indicate Canada faces a challenging economic forecast with low GDP per capita growth, reflecting diminishing economic vitality. From 2007 to 2020, Canada's real GDP per capita grew only 0.8% annually, placing it in the lower quartile among advanced countries. Projections suggest this trend will continue, putting Canada at the bottom for GDP per capita growth through 2060.The main issue is a lack of focus on labor productivity. Current policies stimulate housing, consumption, and population growth but don't address productivity, crucial for living standards and wage growth. Canada needs to shift towards stimulating innovation, increasing business investment per worker, and fostering a high-productivity economy. Emphasizing innovation and productivity over population growth and credit expansion is essential for long-term prosperity.

“So...what does all this imply?”

In a nutshell, Canada is dealing with a real estate bubble that has increased living costs, especially for younger people. The country faces demographic challenges with an aging population and low birth rate, relying on immigration for population growth. Skilled immigrants often leave for better opportunities abroad. Alberta, with its business-friendly environment and lower living costs, is attracting residents from other provinces. Government job growth is outpacing the private sector, and productivity is declining, with Mexico now surpassing Canada. According to OECD data, Canada may be one of the worst economically performing developed nations in the next two decades.

Rethinking Canada's Global Position

Canada's global influence stems more from its strategic economic contributions than its cultural aspects. Its prominence is due to a robust energy sector, significant potash production, and economic interdependence with the United States. With a population of 40 million, sustained by substantial immigration, Canada faces demographic and economic challenges similar to France's reliance on immigration and aspects of Japan's "lost decade" of economic stagnation.

Reflecting on Four Decades of Economic Strategy

For the past 40 years, Canada has benefited from NAFTA and its energy sector, maintaining economic relevance closely linked with the U.S. Canada complements U.S. activities by focusing on manufacturing while the U.S. designs products. Favorable exchange rates have made Canadian talent affordable for the U.S., leading to more inter-province trade with the U.S. than within Canada. During this time, Canada has adopted a socialist approach, heavily investing in social programs, universal healthcare, affordable education, and minimal military spending, relying on U.S. security. However, the landscape is now rapidly changing.

Assessing the Present: Political Rhetoric and Economic Realities

Political discussions about high living costs, rising interest rates, and unchecked inflation often frustrate me. When asked about alternative strategies, politicians typically respond with uninspired and uniform answers, blaming excessive money printing during COVID-19, rampant overspending, and attributing high grocery prices to greed. These discussions focus more on political theater than substantive economic policy, overshadowing a fundamental lesson from Economics 101: the critical roles of supply and demand. They also reveal a widespread failure to understand global economic dynamics, which are largely beyond Canada's control.

Navigating the Post-COVID Global Environment

In a world largely secured by U.S. military presence, international trade has flourished with minimal disruptions, facilitating rapid urbanization worldwide. This shift has seen a significant migration to urban centers, where many have postponed starting families in favor of careers, leading to increased disposable income. This urban lifestyle contributed to the expansion of middle classes globally, underpinned by the security provided by the U.S. military. This period of global synchronization allowed China to rise as a dominant economic force, while Europe grew increasingly dependent on Russian oil and natural gas.

However, the advent of COVID-19, dubbed 'the great reset,' accelerated changes that were already on the horizon. The pandemic severely disrupted supply chains, causing worldwide economic turmoil and prompting a revaluation of global dependency chains. Although inflation began to stabilize somewhat after the initial shocks, the onset of the Russia/Ukraine conflict introduced new challenges. Russia, a key supplier of fertilizer and energy, saw significant disruptions in its exports, particularly when the Nordstream pipeline went offline, sharply increasing energy costs in Germany and beyond.

Simultaneously, the U.S. has shifted towards a more protectionist stance, gradually distancing itself from China. This move is partly in response to demographic trends that may prevent China from maintaining its status as the world's manufacturing hub. The U.S. is now investing heavily in reindustrialization and reshoring efforts, which, by their very nature, are likely to stoke further inflation. This complex global situation reflects a delicate balance of supply and demand dynamics, reshaping economic relationships and the global order.

Consolidating Global Challenges and Opportunities for Canada

In summary, the world is increasingly competing for resources like energy and food, as well as market share and supply chains that are increasingly localized. This dynamic raises the question: what can Canada do to mitigate inflation and capitalize on these global shifts? Realistically, Canada's options are limited to managing factors within its control, given its relatively modest leverage on the global stage. If Canada lowers interest rates while the U.S. maintains higher rates, the Canadian dollar could weaken significantly, exacerbating inflation due to heavy reliance on imports. Conversely, maintaining high interest rates could further stagnate the real estate market and inflict broader economic damage. Thus, Canada finds itself in a precarious situation, needing to navigate these challenges carefully.

“So why increase the capital gains tax?”

The debate surrounding the increase in capital gains tax often centers on concerns that it might stifle innovation and deter business investment in Canada. Critics warn that higher taxes will make Canada less attractive for business ventures. However, looking at current statistics, it appears Canada is already lagging in fostering an innovative business environment. Apart from Shopify, there are few recent examples of major Canadian innovations or successful new companies—most notable successes like Nortel and BlackBerry belong to a bygone era.

Contrary to popular fears, OECD statistics suggest that Canada already possesses one of the least conducive environments for private business investment due to existing policies. This raises the question: why the strong argument around “discourage innovation” on increasing capital gains taxes if the business community’s investment in Canada is already subdued? This resistance seems more reflexive than based on concrete impacts on innovation or investment.

The primary rationale for increasing capital gains taxes, however, appears to be rooted in social and economic stability objectives rather than just curbing business activities. By making it costlier to sell assets like properties and businesses, the policy seems to aim to discourage mobility as I described earlier around immigrants leaving Canada and interprovincial migration. In other words, the capital gains tax increase seems to be more towards discouraging current investors from selling and leaving Canada, while Canada tries to figure out Canada 2.0.

A FINAL THOUGHT

Canada is at a critical juncture that requires genuine political leadership with a sharp focus on enhancing productivity. *We need to get back to the time where someone handed Canada a piece of paper and we made Bombardier airplanes and not paper airplanes.*

Today, we are getting paper cuts!