ECONOMIC VIEWPOINT

Which Industries Stand to Lose the Most from the Budget 2024 Tax Hikes?

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Highlights

- To pay for sharply higher spending in Budget 2024, the federal government turned to tax hikes on wealthy individuals and corporations. As we outlined in our budget overview, the Finance Minister has committed to increasing the inclusion rate on capital gains realized annually. As much as $19.4B in revenues are expected to be brought in over the next five years as a result.
- About 300,000 corporations declare capital gains in Canada, which is roughly 12.6% of the over 2M businesses operating in the country. According to the Department of Finance Canada's Report on Federal Tax Expenditures (2024) just prior to Budget 2024, the partial inclusion of capital gains is explicitly intended to encourage or attract investment, encourage savings and support competitiveness. Raising the tax burdens of some corporations could rightly be considered equivalent to a corporate income tax hike.
- But not all corporations and industries will be impacted equally. The greater the assets, the greater the risk that some of these industries could be affected by the changed inclusion rate for capital gains. Whether it's holding companies or operating companies, those larger corporations selling subsidiaries, parts of their business or sizeable assets, such as in a business transfer transaction, will likely be impacted by the change.
- Unfortunately, data is not available in Canada to determine the proportion of capital gains in taxable corporate income by industry. But when it comes to corporate taxes paid, one industry stands out, and that's manufacturing. In Canada, the manufacturing sector has accounted for 20% of corporate taxes paid in the past few years. And while not paying nearly as much tax per corporation as mining and oil and gas extraction, manufacturing is second only to it.
- When we look at the literature on the relationship between investment and corporate taxes on assets or income, the direction is clear: higher taxes on business profits reduce business investment. Extensive research by the Department of Finance Canada found that hiking taxes on capital assets and income reduced welfare and real GDP by much more than increasing any other type of tax (Baylor and Beauséjour, 2004; Department of Finance Canada, 2004; Baylor, 2005). This research was instrumental in justifying the axing of the capital tax in 2006 at the federal level. Even though raising the inclusion rate on capital gains is less detrimental and more indirect in the way it weighs on business investment than a capital tax, there are grounds to support a dampening impact nonetheless. This is hardly the time to introduce measures that will weigh on business investment in Canada. As we have written about extensively (most recently here), Canadian labour productivity is in decline, and was essentially stagnant even before the recent population boom.
- Canada has a productivity problem, and it's unclear how reducing Canada's relative tax advantage will reverse this slide, as investment in innovation is urgently needed. In all, while revenues will probably rise as a result of the new tax measures, these could come at an economic cost.

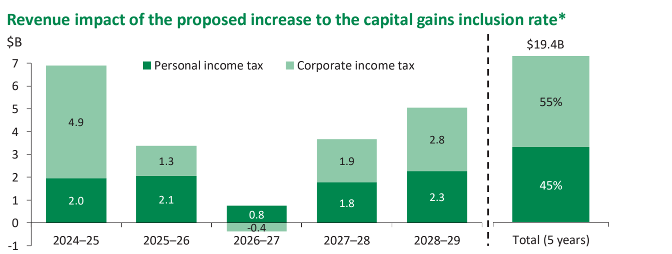
* This note was edited on May 2nd. A previous version had made assumptions that tended to overestimate the impact of the new measure on financial institutions (FIs). In this edited report, we took into account their distinct tax treatment under the *Income Tax Act*: because of the nature of their business, FIs are already being taxed on capital gains in the same way as their other revenue (i.e., there is no "inclusion rate" that applies, because capital gains, like other revenues of FIs, are included at 100%). Other errors and omissions are the responsibility of the authors.

Coming out of the federal government's 2024 budget, the biggest surprise was the increase in taxes for wealthy individuals and corporations. While both will have consequences—intended and unintended—the impact of what essentially amounts to a corporate tax hike by stealth is an open question. The following analysis sheds light on those industries most likely to be impacted.

Lay of the (Tax) Land

To pay for sharply higher spending in Budget 2024, the federal government turned to tax hikes on wealthy individuals and corporations. As we outlined in our budget overview, the Finance Minister has committed to increasing the inclusion rate on capital gains realized annually above $250K by individuals (excluding the sale of primary residences, income from registered retirement and savings accounts, and pension income) and on all capital gains[1] realized by corporations and trusts from one-half to two-thirds. As much as $19.4B in revenues are expected to be brought in over the next five years as a result (graph 1).

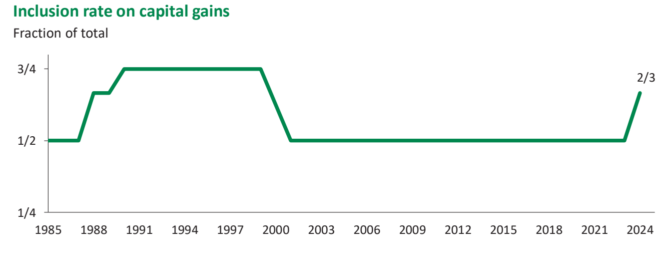
Graph 1
55% of Revenue from the New Measures to Come from Corporations



* Increasing the capital gains inclusion rate from one-half to two-thirds for corporations and trusts, and from one-half to two-thirds on the portion of capital gains realized in the year that exceed $250,000 for individuals. ** A negative number indicates a decrease in revenue.
Federal Budget 2024 Tax Measures Supplementary Information and Desjardins Economic Studies

About 300,000 corporations declare capital gains in Canada, which is roughly 12.6% of the over 2M businesses operating in the country. And they have benefitted from very competitive tax treatment for capital gains for many years.[2] After rising to 75% in 1990 under the government of Brian Mulroney, the inclusion rate was eventually reduced to 50% under Jean Chretien and Paul Martin after federal deficits and debt returned to more sustainable levels (graph 2). This was billed as an approach to spurring business investment in Canada by improving our tax competitiveness. According to the Department of Finance Canada's Report on Federal Tax Expenditures (2024) just prior to Budget 2024, the partial inclusion of capital gains is explicitly intended to encourage or attract investment, encourage savings and support competitiveness. Corporations in the United States and elsewhere already pay corporate income tax on up to 100% of their capital gains. As such, the proposed changes to the treatment of corporate capital gains in Canada mean our tax regime will remain competitive, albeit less so than it was before. There are also some exemptions to the capital gains tax, notably for small business corporation shares[3] and farm and fishing properties. And, as highlighted by Godbout (2024), "reducing the advantage associated with capital gains from 50 per cent to 33.33 per cent will reduce the gap and ensure greater symmetry in the tax treatment of dividends and capital gains."

Graph 2
The Inclusion Rate on Capital Gains Was Higher in the 1990s

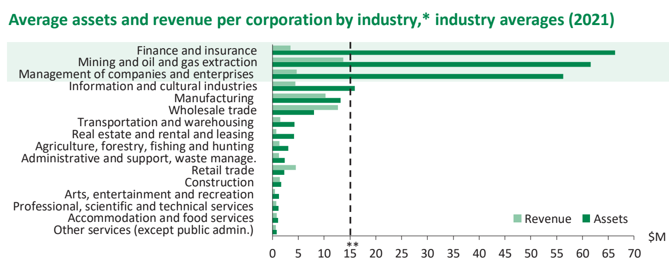


Government of Canada and Desjardins Economic Studies

Potential Sector Impacts of Recent Federal Tax Changes

Raising the tax burdens of some corporations could rightly be considered equivalent to a corporate income tax hike. But not all corporations and industries will be impacted equally. Three sectors stand out, by far, for having the largest average assets per corporation. These are finance and insurance, mining and oil and gas extraction, and management of companies and enterprises (which includes many holding companies) (graph 3). Rounding

Graph 3
Sectors with Higher Assets and Revenues Should Be Most Impacted



* Excluding public administration, utilities, education services, health & social assist., and not assigned (i.e. corporations that did not file a balance sheet).
** Corporations with total assets of more than $15M are classified as "large" by Canada Revenue Agency.
Canada Revenue Agency (2021) and Desjardins Economic Studies

[1] Capital gains: the profit generally made when an asset, such as stocks, is sold (Federal Budget 2024).
[2] Regarding the tax burden of corporations more generally, it's worth mentioning that businesses in Canada no longer pay tax on capital assets. Indeed, the capital tax (which differs from the inclusion rate analyzed in this report) was abolished by the federal government in 2006 due to its dampening effect on investments.
[3] Regarding entrepreneurs selling all or part of a business, the proposed Canadian Entrepreneurs' Incentive reduces the inclusion rate to 33.3% on a lifetime maximum of $2M in eligible capital gains. Combined with the enhanced lifetime capital gains exemption, when this incentive is fully rolled out, entrepreneurs will have a combined exemption of at least $3.25M when selling all or part of a business (Federal Budget 2024).

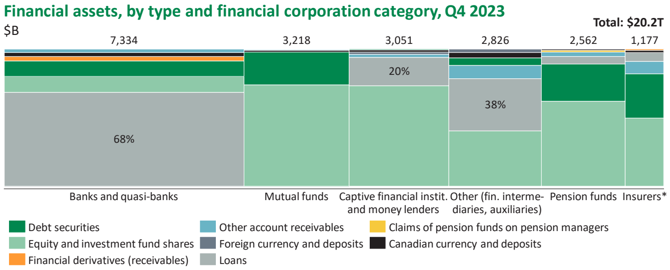
out the top five are information and cultural industries (including the large telecommunication companies) and manufacturing.

In the absence of public data on capital gains by sector, the greater the assets, the greater the risk that some of these industries could be affected by the changed inclusion rate for capital gains.

There is an exception in the case of financial institutions (FIs), which will likely be less affected by the change, even if they derive a not insignificant share of their profit from the appreciation in value of their assets. Indeed, the mark-to-market nature of financial assets held by Fis (including banks and insurers) means these assets are subject to different tax treatment (i.e. they are treated as corporate income). Hence, FIs are not as affected by the change in the inclusion rate on capital gains. Furthermore, pension plans are generally exempt from income tax. Regarding mutual funds, it is rather investors and individual shareholders who will feel the pinch. In all, the impact on individual financial corporations will depend on asset types and certain sector-specific exemptions (graph 4).

Graph 4
Asset Types and Sector-Specific Exemptions Will Influence the Impact of the Measure on Individual Financial Corporations

Financial assets, by type and financial corporation category, Q4 2023



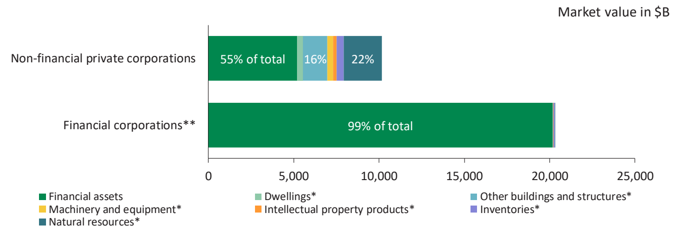
* Life insurance business, segregated funds of life insurers, property and casualty insurers.
Statistics Canada and Desjardins Economic Studies

Turning to non-financial corporations, their asset base is fairly diverse with 55% coming from financial assets and the remainder coming from things like natural resources, non-residential buildings and structures, and inventories, as well as machinery and equipment (graph 5). Whether it's holding companies or operating companies, those larger corporations selling subsidiaries, parts of their business or sizeable assets, such as in a business transfer transaction, will likely be impacted by the change.

Notably, the federal government provided no information in Budget 2024 on the sector impacts of the tax changes. As such, we'll have to wait and see how corporations react during upcoming earnings calls to assess the extent of the impact on corporate balance sheets.

Graph 5
Financial Corporations Have More Liquid Assets

Value of assets, by type and corporation category, Q4 2023



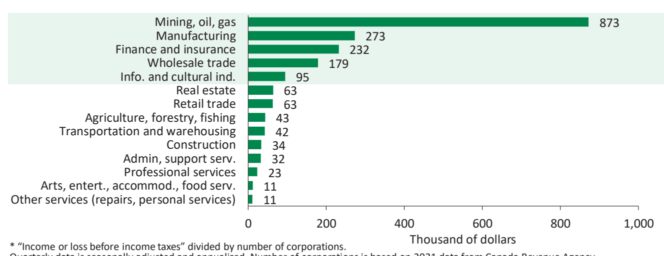
* Non-financial assets. ** Financial corporations include chartered banks and quasi-banks, insurance and pension funds, and other private financial institutions (excludes monetary authority and financial government business enterprises).
Statistics Canada and Desjardins Economic Studies

Which Sectors Pay the Most Corporate Income Tax Currently?

Turning to profitability, mining and oil and gas extraction has had the highest average before-tax annual income per corporation of any sector by a long shot (graph 6). No other industry has come close over the past few years, in large part thanks to elevated commodity prices following Russia's invasion of Ukraine. As such, companies in this sector have paid a substantial amount of corporate income tax on a per-company basis in recent years. Trailing a distant second in average before-tax income per corporation is manufacturing, followed by finance and insurance, wholesale trade, and information and cultural industries.

Graph 6
Average Corporate Income Is Highest in Mining, Oil and Gas

Average before-tax annual income (or loss) per corporation, by industry (average of Q1 2021 to Q3 2023)*



* "Income or loss before income taxes" divided by number of corporations.
Quarterly data is seasonally adjusted and annualized. Number of corporations is based on 2021 data from Canada Revenue Agency.
Statistics Canada (Quarterly Financial Statistics), Canada Revenue Agency and Desjardins Economic Studies

Unfortunately, data is not available in Canada to determine the proportion of capital gains in taxable corporate income by industry. But when it comes to corporate taxes paid, one industry stands out, and that's manufacturing. In Canada, the manufacturing sector has accounted for 20% of corporate taxes paid in the past few years (table 1 on page 4). And while not paying nearly as much tax per corporation as mining and oil and gas extraction, manufacturing is second only to it. Companies in the wholesale trade sector also pay a notable amount of corporate tax—both the sector as a whole and individually, on average. In contrast, while the financial services sector pays

Table 1

Manufacturing Accounts for the Largest Proportion of Corporate Taxes

INDUSTRY	SHARE OF TOTAL		ESTIMATE
	% OF TOTAL TAXES PAID BY CORPORATIONS* (2021–23)	% OF CORPORATIONS (2021)**	INCOME TAX $ / CORPORATION
Non-financial corporations**	85	90	8,689
Manufacturing	20	4	47,901
Wholesale trade	15	4	35,639
Mining, oil, gas	11	1	115,354
Retail trade	10	8	11,868
Transportation and warehousing	6	7	7,683
Arts, entertainment, accommod. & food services	6	6	9,096
Construction	5	13	3,470
Info. and cultural industries	5	2	26,181
Real estate	4	12	3,094
Admin., support serv.	2	4	3,845
Agriculture, forestry, fishing	2	4	3,643
Other services (repairs, personal services)	1	6	1,603
Professional services	1	17	468
Financial corporations	15	10	13,269

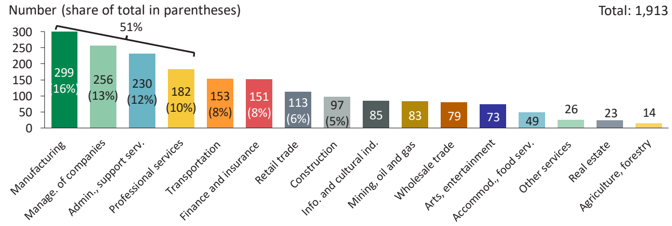
* Calculation: "Income or loss before income taxes" minus "Net income or loss." Average of Q1 2021 to Q4 2023 (seasonally adjusted data).
** Number of corporations based on Canada Revenue Agency (2021 data), excluding public administration, utilities, education services, health and social assistance, as well as management of companies. (The latter is excluded because absent from QFS). Total number of corporations = 2,024,050.

Statistics Canada (Quarterly Financial Statistics (QFS)), Canada Revenue Agency and Desjardins Economic Studies

Graph 7

Half of Large Companies Are in Four Key Sectors, Led by Manufacturing

Large businesses* in Canada, by industry (2022)



* Large employer businesses defined here as those with 500 employees or more. Total excludes public administration, utilities, education services, health and social assistance.

ISED Canada and Desjardins Economic Studies

a notable amount of corporate tax in aggregate (15% of the total), individual corporations pay about half on average what companies in the information and cultural services sector do. Averages can somewhat blur the picture, however, since multiple small companies (such as insurance and financial brokerage firms) can bring down the industry average. Corporate income tax paid in 2019 adds some nuance to the data: in aggregate, finance and insurance contributed nearly 30% that year, followed again by manufacturing (over 12%).[4] But in third place came real estate and rental services, at nearly 10%. This is in contrast to its lesser contribution in 2021–23, especially following the housing market slowdown in early 2022. This last sector could also feel the pinch of the new capital gains measure, given its high volume of transactions in assets. Indeed, real estate investors and developers could prove sensitive to the higher tax burden, with a potential slowdown in transaction activity, shareholder returns and even building incentives for some.

What This Could Mean for Business Investment

According to both the Canadian and Quebec Manufacturers & Exporters, the tax changes will adversely impact manufacturing. This would be a particular blow, as the federal government has worked hard to persuade manufacturers to set up shop in Canada. The hope is that more manufacturing in Canada will create good, high-paying jobs, with spinoffs to research and development, as well as to innovation and productivity. Indeed, many of Canada's largest employers are manufacturers (graph 7). The manufacturing sector is transforming rapidly and increasingly turning to AI. It would benefit from all the help it can get, especially given our southern neighbour's active efforts to boost its own advanced manufacturing sector. Not to mention the critical role that the manufacturing sector is playing in the energy transition. The budget does introduce measures to support clean tech, targeting small- and medium-sized businesses that seek to leverage newly developed intellectual property. It also hopes to crowd in more private investment with the tax credits and incentives in its net-zero economic plan, including a new 10% tax credit for investments in the electric vehicle supply chain.

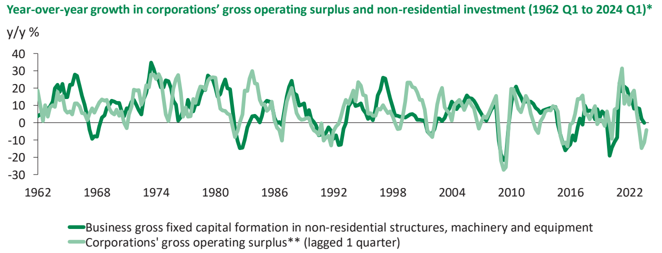
And although these initiatives should provide a helpful boost to the targeted businesses, raising the tax burden for a wide swath of large manufacturing companies appears to run counter to the federal government's broader intended goals. Similar considerations apply for companies in the information and cultural sector, which contains many of the tech start-ups that are so highly desired for innovation, productivity and growth.

Indeed, when we look at the literature on the relationship between investment and corporate taxes on assets or income, the direction is clear: higher taxes on business profits reduce business investment. However, the magnitude of the impact is much debated. Two decades ago, extensive research by the Department of Finance Canada found that hiking taxes on capital assets and income reduced welfare and real GDP by much more than increasing any other type of tax (Baylor and Beauséjour, 2004; Department of Finance Canada, 2004; Baylor, 2005). This research was instrumental in justifying the axing of the capital tax in 2006 at the federal level. Even though raising the inclusion rate on capital gains is less detrimental and more indirect in the way it weighs on business investment than a capital tax, there are grounds to support a dampening impact nonetheless. In effect, the proposed measure increases corporate income tax for some 300K businesses—with government expecting an extra $10.6B from the move by 2029. Recent research has confirmed the benefits of cutting corporate income tax to spur new investment, albeit with the added nuance that the benefits seem to have declined over time (OECD, 2023). Still, Canadian data seems to suggest that profits and business investments often move in tandem, with more or less one quarter's lag between the former and the latter (graph 8 on page 5). Whether this relationship will hold in the future with respect to the capital gains portion of profits remains to be seen.

This is hardly the time to introduce measures that will weigh on business investment in Canada. As we have written about extensively (most recently here), Canadian labour productivity is in decline, and was essentially stagnant even before the recent population boom (graph 9 on page 5). That's in contrast to the

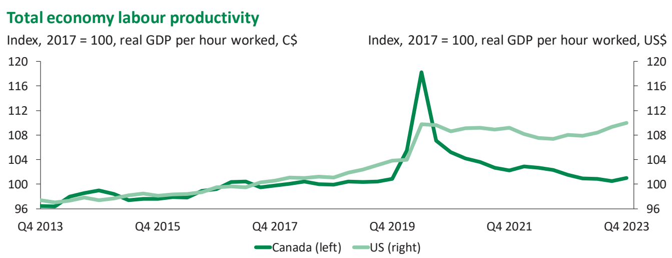
[4] Share of total is based on total excluding education services, health and social assistance, and utilities. Some sectors have only partial data due to confidentiality.

Graph 8
Profits and Business Investments Tend to Move in Tandem



* Quarterly data is seasonally adjusted and annualized. ** Net operating surplus + consumption of fixed capital (corporations)
Statistics Canada and Desjardins Economic Studies

Graph 9
Canada's Labour Productivity Has Been Lagging behind the US's



Bureau of Labor Statistics, Statistics Canada and Desjardins Economic Studies

United States, where productivity looks to be accelerating, driven by significantly higher investments in information processing equipment, software, and research and development over the past decade.

Conclusion

Canada has a productivity problem, and it's unclear how reducing Canada's relative tax advantage will reverse this slide, as investment in innovation is urgently needed. In this context, the effects of these corporate tax changes could even reach manufacturing and information and cultural services, two sectors that have to date been considered darlings of the federal government. Holding companies, real estate, and mining and oil and gas extraction are also likely to be impacted. In all, while revenues will probably rise as a result of the new tax measures, these could come at an economic cost.