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Federal Budget 2024 – Raising the Inclusion Rate on Capital Gains to Finance Housing and Defense Spending and Keep the Moderate Deficit in Check

The newest picture of federal public finances has not fundamentally changed relative to the fiscal update of last November. Finance Minister Chrystia Freeland pledged last November to cap the annual deficit at $40B this year and next, on top of bringing the deficit-to-GDP ratio below 1% starting in 2026. At the margin, the net debt-to-GDP ratio near 42% is a tad higher than before. At least, this key financial metric is poised to edge down as it was proposed last Fall.

Of course, the quasi-unchanged deficit figures derived from revenues and expenses is not the biggest story. Spending and revenue lines are, in fact, materially altered in level terms relative to the November Update, both up by approximately $11B annually over the 5-year plan proposed. The average annual growth rate in revenues (+4.6%) slightly outpaces spending (+4.3%) over time.

This budget sounds significant with spending measures totaling $53B over 5 years, particularly in respect to new financial commitments to housing. The new $6B housing infrastructure fund and the $15B boost to the existing CMHC apartment construction loan program were announced earlier this month. Ottawa pushes forward to build some residential homes on existing public lands too. As announced last week, the federal government increases the capital cost allowance rate from 4% to 10% for new rental units, clearly contributing to improving the economics for promoters. CMHC reported record-high rental construction in six major markets across Canada during 2023, an insufficient pace however as the vacancy rate plunged to multi-decades low. On the demand side, the federal government expects its new immigration policy will reduce the number of temporary residents by 600K over 3 years relative to current levels. Moreover, part of the Canadian Mortgage Charter is the 30-year mortgage amortization for first-time buyers of new homes that will be available starting in August.

In a separate report released recently, the Parliamentary Budget Officer says Canada needs to build 1.3M additional residential units by 2030 to eliminate the supply-demand gap while keeping housing affordability intact. Also, in its *Monetary Policy Report (MPR)* released last week, the BoC estimates the current demographic-driven demand for housing at more than 500K units annualized, more than double the current pace of housing starts. All in all, it remains to be seen to what extent the supply-demand housing gap will narrow over time with the latest federal government efforts. It will notably depend on the speed of funding trickling down to new projects. There are conditions attached for municipalities and provinces for the $6B housing infrastructure fund for instance. As a guide, funding from the Housing Accelerator Fund initiated in 2022 has been distributed to several cities in late 2023 and early 2024, almost two years later. Furthermore, labour shortages remain a major restraint to the federal government's objective to build at least 1.2M net new homes by 2031 (or 2M with the proposed participation of municipalities and provinces), on top of the 1.9M expected to be built already.

In addition to housing policies, the large extent of spending measures proposed in Budget 2024 includes the expansion of defence spending, a national school food program, the first step of the nation-wide pharmacare program, a welcomed new benefit for people with disabilities, and funding for AI development particularly key to promoting productivity.

This time, the federal government did not let higher spending trickle down to larger deficits. Instead, Ottawa made the public policy choice of asking for an additional tax effort from high-income earners and a small portion of companies generating large capital gains other than from a principal residence. Precisely, the inclusion rate for capital gains realized annually over $250K by individuals, corporations, and trusts will increase from the current 50% rate to two-thirds, effective on June 25th. Corporations are expected to pay a little more in additional taxes on capital gains relative to individuals. Such a swift policy change with a short 2-month notice should lead to key behavioural decisions for wealthy Canadians in the upcoming two months: to pay less in taxes now or to face a higher tax burden later. Indeed, some wealthy investors will be tempted to sell their equities and real estate assets to crystalize capital gains during this two-month window of opportunity for tax avoidance. Conversely, higher capital gains taxation can also lead to a lock-in effect, as some people will prefer to hold onto their existing assets for longer to eventually generate the same after-tax gain in dollar terms. With a portion of Canadians among the wealthiest poised to rush and sell soon, the $20B tax gain expected to be generated over five years by the government is front-loaded with a $7B tax windfall in FY 2024-25. If this targeted tax plan does not work, the deficit will be north of $40B, breaking the fiscal guardrails initiated just six months ago. Meanwhile, the inclusion rate on capital gains for entrepreneurs will fall to 33.3% and the lifetime capital gains exemption will rise from $1M to $1.25M.

Raising the capital gain tax burden of the wealthiest Canadians will contribute to financing higher spending and preventing a major surge in bond and T-bills issuance. After issuing $204B in Canadian federal bonds during FY 2023-24, the debt management program indicates a 12% increase to $228B in FY 2024-25, led by 5-year and 10-year bonds. A record high amount of $267B in T-bills were issued during FY 2023-24. FY 2024-25 proposes a tiny increase of 1.9%, to $272B. The federal government moves forward with the consideration highlighted in the November fiscal update of issuing 1-month T-bills on a temporary basis to support the CDOR transition. Combining T-bills and bonds, total gross issuance will hit a record high of $500B, versus $471B last year and $387B two years ago.

In summary, Ottawa shifted from a spend and borrow mindset to a spend and tax approach. The new risk is that additional spending in the future could be financed by additional tax increases. Of course, moderate shortfalls proposed over time imply continuous fiscal easing and thus inflationary pressures. At least, the size of annual deficits has not materially changed relative to the mid-year fiscal update of last November, meaning the 2024 budget does not add new inflationary pressures relative to what was projected last week by the BoC in its *MPR*. From a different perspective, deficits are nonetheless stretched over time as far as the eye can see, without any balanced budget plan as proposed by a few selected Provinces, putting Canada's financial stability at risk if an unexpected adverse economic or financial shock occurs.

As for the short-notice relative to the big jump in the inclusion rate on capital gains, it will generate unexpected tax gains for provinces during FY 2024-25, no matter if they decide to harmonize or not their provincial inclusion rate with Ottawa. Also, it is worth noting that capital tax revenues tend to be more volatile than other taxation sources, posing another risk to the $40B annual deficit projection made for the next two years. Of course, capital gains are disproportionately benefiting the wealthiest people. At the same time, capital gains often arise from riskier investments, something the Canadian economy crucially needs to improve its lagging productivity record and reverse the weakening real GDP per capita trend previously observed during recession periods.

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